

Insights

The Narrowing Stock-Bond Risk Gap

Numerous studies have shown that both bonds and stocks should form part of an “efficient portfolio” — a portfolio that provides the greatest expected return for a given level of risk or, alternatively, the lowest risk for an expected return.

In determining the ideal asset allocation mix to form an efficient portfolio, it is important to know that volatility levels exhibited by both bonds and stocks have changed over the years. A recent study determined that, since 1965, stock risk relative to bond risk has declined dramatically. In light of these findings, it might make sense for long-term investors to take a closer look at the percentage of bonds vs. stocks in their portfolios.

A Study of the Risk-Reward Tradeoff

Charles Jones and Jack Wilson, finance professors at North Carolina State University, studied the risk-reward tradeoff of stocks and bonds in light of inflation, with the goal of gaining a better understanding of the relative merits of investing in either asset class. They looked at the years 1871 through 2000, with the data divided into 26 separate five-year periods. The result was that the geometric mean of stock returns exceeded that of bond returns in 18 of 26 periods. For example, for the five five-year periods beginning in 1976, the average nominal return on stocks exceeded 13%. Stock returns during the 1990s were particularly strong. Meanwhile, US Treasury bonds registered large total returns for the four consecutive periods beginning in 1981. From 1940 through 1980, however, bonds had extraordinarily low average returns, ranging between 1.12% and 2.28% in all but one of the eight periods during this time frame.

Inflation-adjusted stock returns were negative in just three of the 26 five-year periods, whilst inflation-adjusted bond returns were negative in 10 of the 26 periods. In the eight periods from 1941 through 1980, bonds registered a positive average inflation-adjusted return in only one period, with a 1.01% annual average return.

Volatility Levels for Bonds Increasing

The standard deviation of stock returns exceeded that of bond returns in all of the 26 five-year periods. The standard deviation of stock returns was highest during the years associated with the Great Depression. However, since then, the five-year standard deviations have varied in a relatively narrow range. The one exception was for the 1986-1990 period — during the time of the market crash of 1987.

Bond volatility is a very different scenario. Rather than staying within a narrow range, volatility levels have been increasing, particularly since 1965. The standard deviation for bonds has been greater for each of the seven periods from December 1965 through December 2000 than for any previous five-year period. The three highest standard deviations for bond returns came during the consecutive five-year periods from January 1976 through December 1990. Therefore, it appears that bond risk has increased since 1965. It also means that the risk gap between stocks and bonds had narrowed dramatically in the last half of the 20th century.

Meanwhile, the correlation between stocks and bonds was generally positive except for four periods. For the full period studied, the correlation is slightly positive, at 0.2. However, while they both tend to move up during the same time periods, they still move in less than perfect lockstep (less than 1), which means there are still diversification benefits to buying both asset classes.

Conclusion

According to the results of the study, long-term investors could have increased their overall portfolio returns while lowering risk, if they had increased the amount of stock held in their portfolios. In light of this study, conservative investors with primarily bond holdings may want to consider taking a closer look at their asset allocation.

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