Products That Mingle Stocks, Bonds Less Risky But Still Profitable

Balanced Funds May Better Weather a Crisis

by Danielle Schultz, CFP, CDFA

When the market leaps upward, many of us, particularly newer investors, are thrilled. Weren't we smart? Early in my investing career, I wondered why anyone would invest in mutual funds (mine were averaging around 8 percent) when the individual stocks did so much better (at the time 12 to 15 percent). But in the 2007-2009 period, I found out — my individual stocks and my mutual funds (which were all stock funds) cratered. Many of us who were investing during that period get a little queasy at market runups, waiting for the next market malaise.

For those whose memory needs jogging, from the peak (Oct. 9, 2007) to the trough (March 9, 2009), the Standard & Poor's 500 index dropped 57 percent to 676.5. If you were able to stay the course, you saw the S&P back up to 1,363.6 by April 29, 2011, at which point it fell 19.4 percent by Oct. 3 of the same year. So what kind of funds can provide some insurance? Let's look at the options for perhaps having at least part of our portfolios devoted to no-drama investments that allow us some peace.

Self-Manage an Asset Allocation

Although *BetterInvesting* readers may have a significant portion of portfolios in individual stocks, we can strategically balance out allocations with mutual funds devoted to other types of assets. For example, according to Janet Brown writing in *Forbes* ("Intelligent Investing," Nov. 16, 2011), a portfolio that was rebalanced annually between 60 percent stocks and 40 percent bonds lost 30 percent from the 2007 peak to the 2009 trough. Such a loss is still painful, particularly if you're already in the withdrawal or retirement phase for your portfolio, but is more survivable than a loss of nearly twice that amount. Over the 25 years from 1985-2010, such a portfolio captured 92 percent of the gains.

A portfolio balanced between stocks and bonds may not make as spectacular a gain in a bull market as an all-stock portfolio, but it plays defense in a bear market. How much protection you need can be determined by your ability to stomach risk. If you look at your investment total and tell yourself you'll never get this again, your tolerance is low and you should focus on preserving what you have. That doesn't mean no-growth, however, as inflation will return and your portfolio needs to keep pace. Or perhaps good returns now will front-load your portfolio for poor market conditions that are certain to appear in the future.

If you have many years until you need portfolio income, or feel confident that your (hopefully long) experience in investing will produce superior results, you're more risk-tolerant and probably skew your portfolio to the overall higher long-term returns of stock investments. Nevertheless, you should still consider incorporating other assets to protect against shorter-term downsides. If you need portfolio income during a huge downturn, you'll be happier if your stock side can sit tight and make withdrawals from assets that have been stable or lost less.

Morningstar's white paper "Fundamentals for Investors 2017" demonstrates returns from a fairly simple selection of asset classes: large-cap stocks, small-cap stocks, international stocks, bonds and cash. As might be expected, small-caps are the most volatile but over the long term provide the most return.

BetterInvesting-style investors probably have the easiest time selecting large-cap stocks. It isn't surprising, because 750 large-cap stocks constitute 89 percent of the U.S. stock market, according to Wilshire Associates. BI growth and diversification principles spur us to consider small-caps and international stocks, so we may also have individual holdings in these categories.

Workplace retirement plans generally offer fewer choices and may be the place to balance your individual stock allocation with bonds. Workplace plans rarely offer individual stocks, unless the stock is that of your employer, and the default target retirement fund may be too heavy on stocks if you have significant individual stock holdings. For protection during a downturn, analyze your portfolio as a whole, not by separate accounts.

Incorporating bonds, particularly in workplace retirement or other tax-sheltered accounts, can be accomplished by selecting a total bond market fund. For example, Vanguard's Total Bond Market Index Fund (ticker: VBMFX) had a 7.3 percent gain from Oct. 9, 2007, to March 9, 2009.

What about individual bonds? If you can purchase an individual investment-quality bond at or above bonds' historical average (just under 5 percent), it might be worth considering locking in that interest rate. But if interest rates drop, just when you want a steady, high-paying bond, the bond might be called. Since individual high-quality bonds are at historic lows, you may want to opt for bond funds for your safety net rather than locking yourself into individual bonds at low rates.

Choose a "Pre-Fab" Balanced Fund

It's quite difficult to perfectly match an index — trading one day later can make a difference in the real world, and owing to management fees, tracking is never perfect. A fund may aim for a 60/40 balance, but such a holding

can be actively or passively managed. If actively managed, a manager's choices definitely affect performance. Finally, a balanced fund may be composed of other index funds or may have individual bond and stock selections.

Three well-known funds that are designed to approximate a 60/40 balance are the **Fidelity Puritan fund (FPURX)**, the **Vanguard Wellington (VWELX)** and the **Vanguard Balanced Index (VBINX)**. The first two funds are actively managed; the last is a fund of other Vanguard index funds. See the table below right to see how they performed in the last crisis and how they're doing over the last 10 years.

FPURX and VWELX can vary in their mix. FPURX is currently about 70 percent in stocks, while VWELX is about 65 percent. VBINX maintains a steady 60/40 balance. As is obvious, all these funds lost far less money than the S&P 500 during the worst period most of us have seen.

Balanced funds can work well for disaster mitigation in accounts with relatively small amounts. If you have a small Roth independent retirement account or inheritance, there may not be enough to fully diversify in individual fund asset classes.

A balanced fund can give both diversification and some limit of downside impact. Two key questions:

- **Can you pay attention to your investment balance regularly?**
- **Can you muster the courage to alter that balance when the market is roiling?**

Jim McMahon, CFP, and financial planner with Forerunner Financial Planning in Sylvania, Ohio, says, "Most of us aren't Warren Buffett, so we'd be better off putting our investment plan on auto pilot by investing in balanced funds that continually rebalance amongst broadly diversified index funds. Those balanced funds can also smooth out the ride because you won't be aware of the higher volatility of some of the underlying funds." As McMahon implies, protecting against disaster means protecting not only your portfolio but also your equanimity.

Keep Cash at the Ready

Many of us relish investing and somewhere in the back of our minds believe "cash is trash." As time has shown us, cash returns little to nothing. Even in markets where money market funds have paid high rates, their real return after inflation has barely kept pace.

Nevertheless, cash as part of your investment portfolio has a role in disaster proofing. Although it doesn't return much, it also doesn't lose money, so when all else fails you have your principal. McMahon points out another important role for cash: "Too many investors panic and lock in those

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Fund	Loss (10/09/07 to 03/09/09)	Yield	Value of $10K for past 10 years (7/16/07 to 7/15/17)
Fidelity Puritan FPURX	(39.5)%	1.49%	$18,082.95
Vanguard Wellington VWELX	(35.7)	2.47	19,225.17
Vanguard Balanced Index VBINX	(35.6)	1.91	18,422.63

Source: Morningstar

How Equity Income Funds React in Times of Financial Crisis

Fund	Loss (10/03/07 to 03/09/09)	Yield	Value of $10,000 (7/17/07 to 7/15/17)
T. Rowe Price Equity Income PRFDX	(58.13)%	2.14%	$16,722.39
Fidelity Equity Income FEIRX	(61.69)	2.15	14,624.10
Vanguard Equity Income VEIRX	(53.61)	2.70	20,205.13
Vanguard High Dividend Yield VHDYX	(56.80)	2.85	19,179.08
Fidelity Equity Dividend Income FEQTX	(60.48)	1.92	19,664.21

Source: Morningstar