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Stocks and Bonds: When to Jump, and Where?

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Christian from Oakland asks what he should be doing today with his investments. He's mostly in fixed income/bond holdings. And he is considering moving everything to more aggressive stock holdings. After all, Warren Buffett says to buy when others are fearful and sell when others are greedy. So Christian wants to know if he should bail out of his fixed income/bond holdings and buy stocks now.

Every person's situation is individual and specific, but let's paint with a broad brushstroke. Warren Buffett's advice is accurate (after all, he is Warren Buffett), but it's not meant to be all-encompassing and doesn't cover every aspect of investing.

Buffett also said, "Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years." So let's look at not just what's going on today, but what's going to happen over the next five, 10, even 20 years. By focusing on the big picture, we'll see how short term swings—like the dramatic market we've seen over the last year or so—can have less impact on our investment accounts as well as our psyche.

Successful investors (e.g. large institutional investors) build portfolios. They typically don't bet on one or two holdings, but create a model that includes investments from different categories, called asset classes, and their Investment Policy Statement dictates that they must stick with those asset classes. Statistically, these institutional investors fare better over time (source: Dalbar).

Most of the time, these models include fixed income/bond holdings which historically return less than equity/stock holdings. If history indicates that stocks perform better than bonds over time, why hold them at all?

One of the many reasons we use bond holdings is that math does some surprising things. Let me explain.

Let's take two hypothetical investments, portfolio A and portfolio B, both of which begin on a given day with identical amounts. At the end of 10 years, both portfolios have experienced the identical average annual rate of return. Which portfolio has more money?

Simple, right? If they both experienced the same average annual rate of return, then they'll both have the same balance, no problem. A child could figure that out.

Except that in this case, the child would be wrong. The correct answer is that the portfolio that experienced less volatility will have the larger balance. Why? Because the internal rate of return is different than the average annual rate of return. The internal rate of return is what determines the ending balance, and the portfolio with the lower volatility will enjoy a higher internal rate of return. Holding fixed income holdings is one way to dampen volatility.

Over time, an investor will be better served maintaining a portfolio spread over different asset classes than trying to jump in or out of what seems like the right asset class at the moment. The problem with jumping from investment to investment is that you may be right once, twice, even three times, but eventually you will be wrong. That one ill-timed decision may erase all of the previous good decisions, and then some.

Witness the billionaire in Germany who made a poorly timed decision against Volkswagen in 2008. In this extreme case, he took his own life. The man was clearly a brilliant investor, having amassed billions of dollars in his lifetime, but one bad decision made all the difference. If you are the type to place bets, then have at it. But if you are the type who wants to accumulate assets that will fund retirement or a college education, then you will likely be better served using the portfolio approach.

Again, consider the math. A 50 percent decline in an investment requires a 100 percent increase just to break even. So if you can manage to temper the downside (via diversifying across different asset classes), your success ratio over time should see a marked increase.

So I would recommend that Christian, rather than jumping from one asset class to another, create a portfolio he can live with in good times and bad and that will serve him over the years, rather than making major short-term swaps in and out of asset classes.

If you work with a financial advisor, ask that advisor for help. If you do it yourself, do your homework. Study institutional investors' methods. Most importantly, resist the urge to make large, sweeping changes. Rather, build a portfolio that can be modified if necessary, and rebalance regularly.

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