INVESTOR

The Balancing Act of Stocks and Bonds in Your Investment Portfolio

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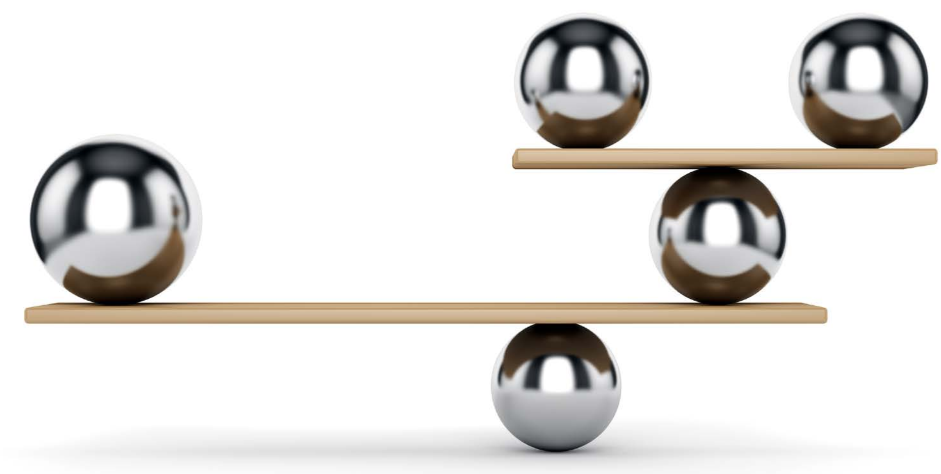
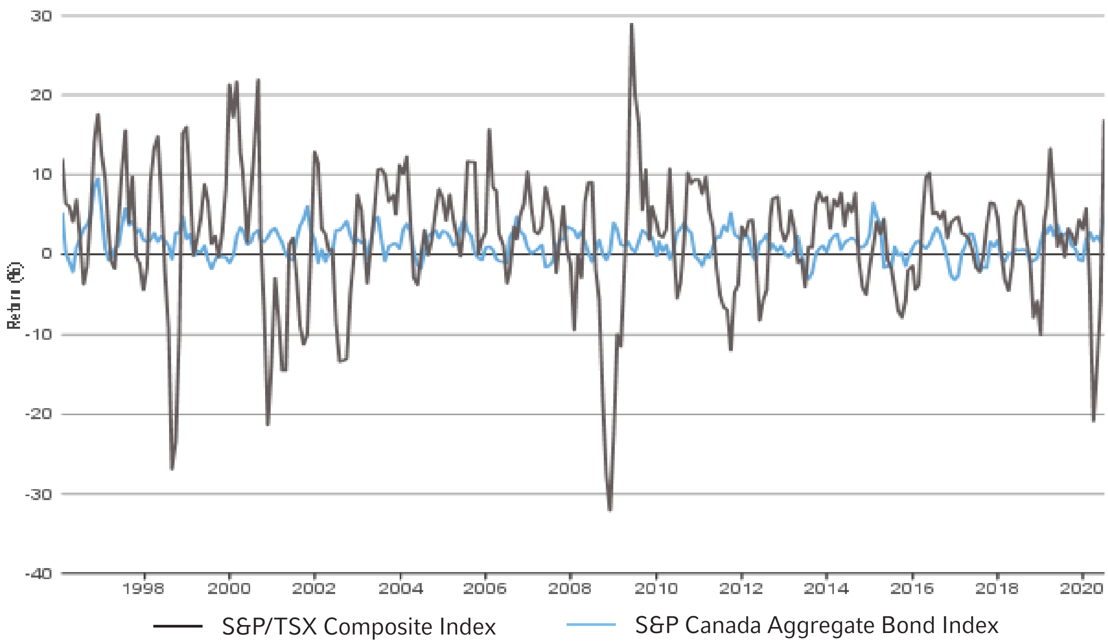


A typical balanced portfolio holds a mix of stocks and bonds.

The ratio of bonds to stocks in a portfolio can be a key factor to reaching the investor's goals and should be based on the investor's age, circumstances, time horizon, their risk tolerance and other factors. In general, the role of stocks is to provide long-term growth potential and the role of bonds is to provide a steady stream of income as well as diversification.

Stocks and bonds generally have quite different return patterns, which is why combining them can provide a smoother ride for an investor. Just take a look at the chart below.

Rolling 3-Month Cumulative Return / Canadian Fixed Income Vs. Canadian Equity



Source: Refinitiv Datastream, Russell Investments. Based on monthly data 1/31/1996–9/30/2020. S&P Canada Aggregate Bond Index represents fixed income; S&P/TSX Composite Index represents equities. Indexes are unmanaged and cannot be invested in directly. Past performance is not indicative of future results.

For most of the latter half of the previous century, investors were advised to dedicate a substantial portion of their portfolios to fixed income—mainly to reliable government bonds, which returned an average of 5.5% annually between 1926 and 2018[1]. Indeed, many analysts refer to core government bonds as "safe haven" assets because the chance of losing principal has been negligible.

But recently the return from bonds has been much lower—and in some cases, such as in Europe during the 2008 financial crisis—even negative. And with interest rates likely to continue at historically low levels due to the COVID-19 crisis, the return from bonds is likely to remain mediocre for some time. Bonds have also gotten a little riskier since interest rates are unlikely to get much lower and could eventually go up if inflation begins to rise. Bond prices fall when rates rise and vice versa.

So…do you still need bonds in your portfolio? We believe the answer is yes.

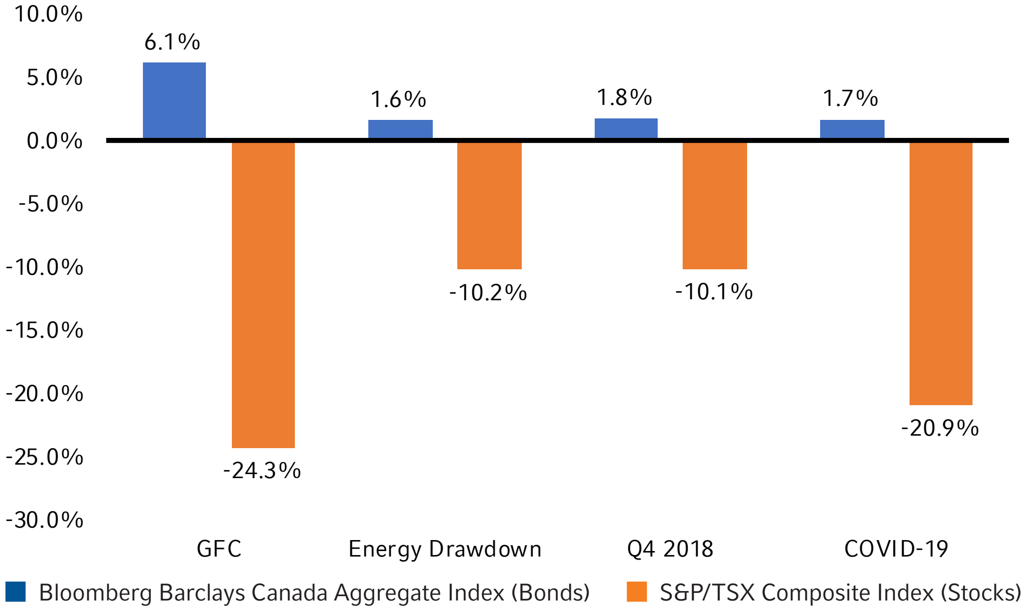
First, let's look at the roles bonds can play:

- They generally act as a counterpoint to the volatility of equities
- They can help provide regular income

These roles can aid in pursuing retirement goals or simply help a portfolio be more resilient when markets react to economic shocks.

The latter may be the most important benefit to holding bonds in a portfolio at this time. As the chart on the next page clearly shows, bonds can be a valuable diversifier during extreme market events.

Bonds v. Equities during periods of market volatility



Source: Russell Investments, Morningstar. Indexes are unmanaged and cannot be invested in directly. Past performance is not indicative of future results. GFC refers to the Great Financial Crisis of 2008/09, the Energy Drawdown was the period in 2015/16 when oil prices declined sharply due to oversupply and U.S. energy independence. Stocks fell in Q4 2018 on expectations of sustained interest-rate increases. The COVID-19 pandemic in March 2020 caused governments around the world to shutter their economies to help slow its spread.

The diversification benefits of bonds can vary depending on economic conditions. A drop in economic growth is bad for stocks, which are more closely tied to the business cycle, but may be good for bonds if central banks cut interest rates to stimulate the economy. As well, if equity indexes decline due to the poor economy, investors may prefer the more stable return potential of bonds.

Bonds usually perform well when needed most. Indeed, during recent episodes of equity market distress—such as that seen earlier in 2020—bond prices soared and yields sank as central banks cut policy rates to mitigate the economic damage from the restrictions imposed by governments to control the spread of the COVID-19 coronavirus.

However, investors also need to be aware that while they are much less risky than equities, bonds do hold some risks.

Credit risk: The issuer might not pay interest or return principal. This is highly unlikely with government bonds but can happen with corporate bonds.

Interest-rate risk: Interest rates might change, reducing the value of a bond's coupon and principal cash flows.

With yields on government bonds so low, it may seem like their role within a portfolio is being minimized. However, we suggest it's important to weigh the impact changing the ratio of bonds and equities would have on a total portfolio. Even with low yields, bonds are one of the few assets that can effectively hedge against the risk of deflation, or falling prices for goods and services. Bonds become more valuable as equity risk rises and that means bonds will still help diversify the returns in your portfolio and play a role in buffering any potential large declines in stock markets.

Investors with a multi-year horizon may consider the value of maintaining some exposure to core government bonds, either through a balanced portfolio or a multi-asset solution.

A **stock** (or equity) represents part ownership in a corporation. As such, the value of that corporation's stock will tend to reflect the earnings experience of the firm—up during profitable periods and down during periods of loss. Generally speaking, the higher the potential return, the higher the risk. A stock's value can fall quite sharply—in fact it can even become worthless in certain circumstances, such as when a corporation declares bankruptcy.

A **bond** is simply a loan you make to a corporation, municipality, or government agency. The borrower gets the cash it needs, while you, the lender, earn interest for the term of the loan. For the use of your money, the borrower promises to pay you a specific interest rate on a regular basis for a set period of time.

[1] Ibbotson. https://static.twentyoverten.com/59384d067cdd6a62d6fcc61f/pDJb2Hh_ux0/DSWM-Long-Term-Market-Returns.pdf

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IMPORTANT INFORMATION

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