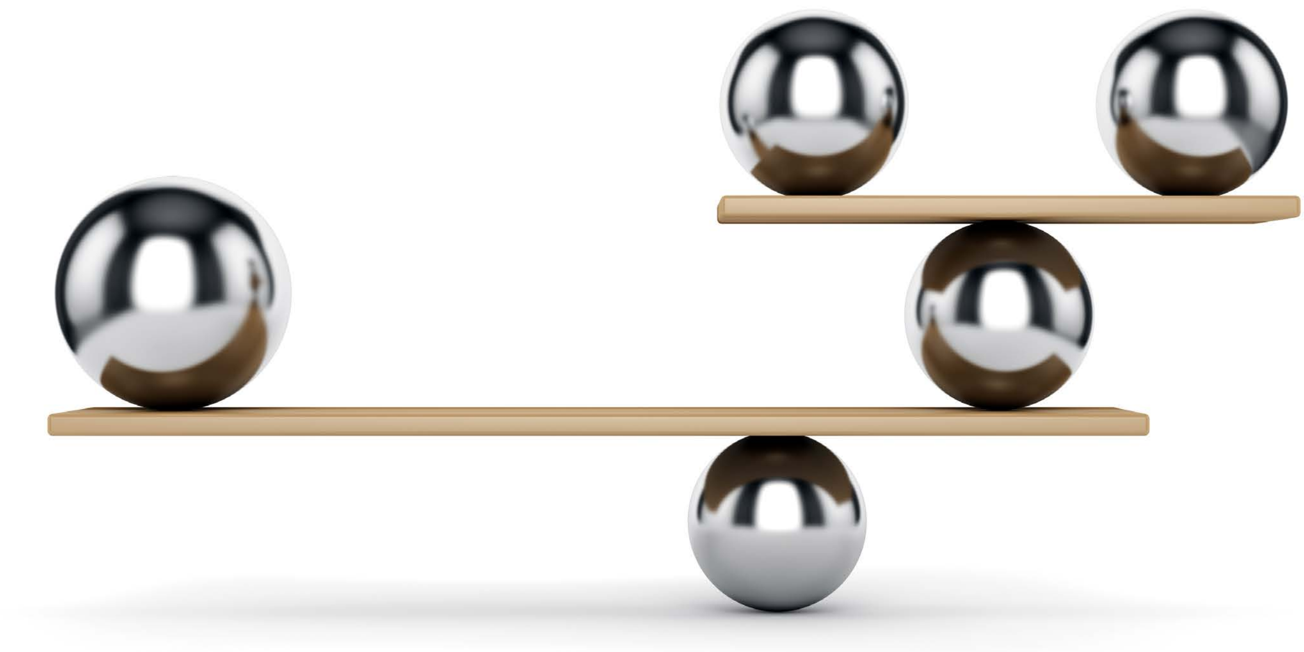
INVESTOR

The Balancing Act of Stocks and Bonds in Your Investment Portfolio

Helping you make informed investing decisions.

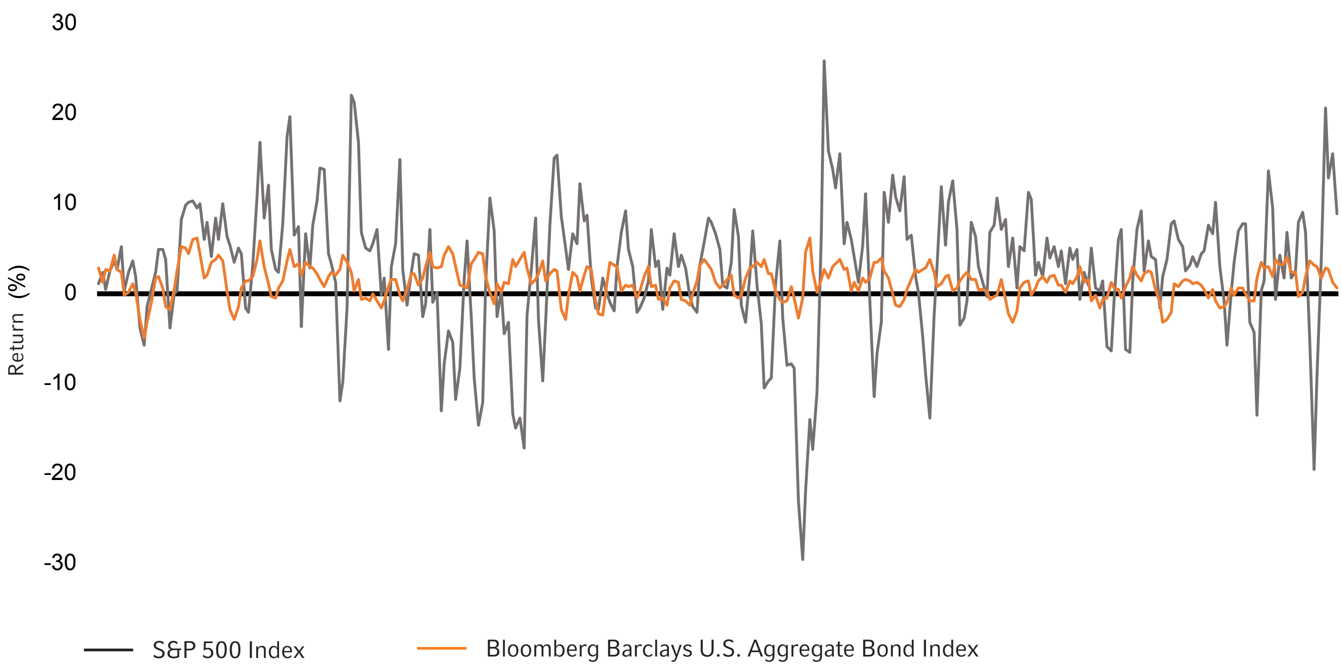


A typical balanced portfolio holds a mix of 60% stocks and 40% bonds.

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, 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 and diversification.

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

Rolling 3-Month Cumulative Return / U.S. Fixed Income v. U.S. Equities



Source: Morningstar. Based on monthly data through 09/30/2020. S&P 500 Index represents U.S. equities. Bloomberg Barclays U.S. Aggregate Bond Index represents fixed income. 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 role bonds can play:

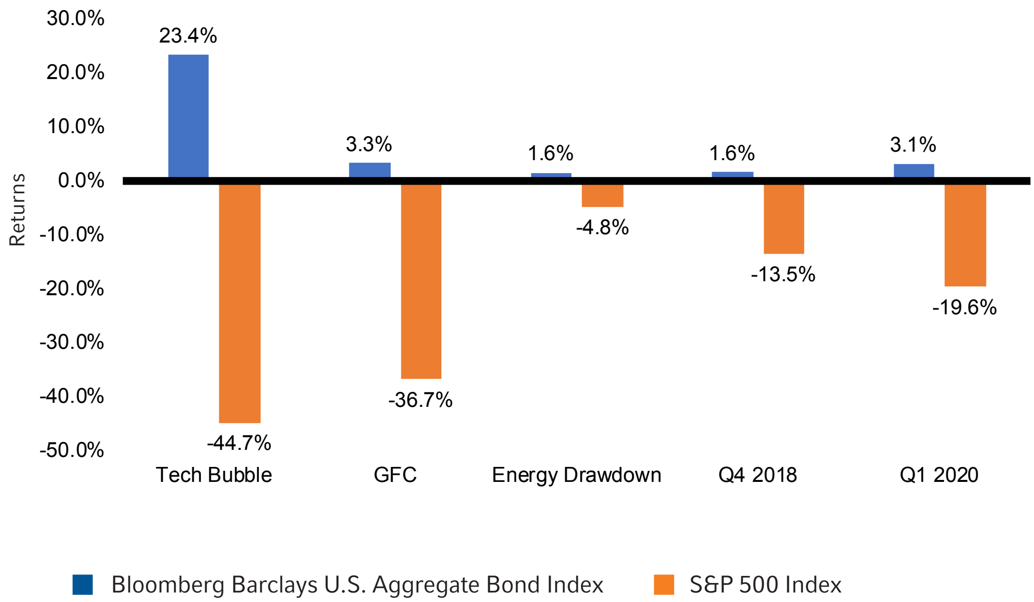
- They generally act as a counterpoint to the volatility of equities
- They can help provide regular income

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

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 below clearly shows, bonds can be a valuable diversifier during extreme market events.

Bonds v. Equities during periods of market volatility



Source: Morningstar. Indexes are unmanaged and cannot be invested in directly. Past performance is not indicative of future results.

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 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 any potential adjustments to an allocation would have on a total portfolio. Even at low yields, bonds are one of the few assets that can effectively hedge deflation risk. Bonds become more valuable as equity risk rises and therefore it is likely bonds will continue to maintain a negative correlation with equities and directionally buffer large declines in stock markets.

Investors with a multi-year horizon may consider the value of maintaining some exposure to core government bonds.

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.

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S&P 500 Index: an index, with dividends reinvested, of 500 issues representative of leading companies in the U.S. large cap securities market.

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