The role of bonds in a balanced portfolio today

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The purpose of a balanced portfolio has been to combine the income and safety of fixed income securities with the potential for capital appreciation from stocks. A typical blend would start with 40% bonds and 60% equity. This formula has long been a structure for pension funds, foundations and portfolios built for families and individuals, though there are many variations depending on an investor's need for current income, safety of capital or ambitions for growth.

The challenge for many investors today is that bonds, the fixed income instruments that have traditionally provided secure income and capital safety, offer less of both today. For example, interest rates for many sovereign European debt instruments are currently negative. Yields on German 10-year Bunds are –0.6%! This means that at maturity 10 years from now, the holder will have lost 6 euros per 100 euros invested today. Assuming inflation averages 1% per year over the next decade, an investor gives up an additional 10 euros in purchasing power. Furthermore, should the yield rise to 3%, the level prevailing a decade ago, the value of that 10-year instrument would immediately fall by 25%. This government bond strikes out in both providing reasonable current income and safety of capital.

While the German Bund may be at an extreme from a valuation perspective, bonds around the world today offer historically low yields. A 10-year U.S. Treasury yields 0.8%, and the Canadian government equivalent trades at 0.7%. High-quality corporate bonds of the same maturity issued by Google and Coca Cola are priced at 1.2% and 1.3% respectively.

Most investors will find this level of income too low, particularly after tax, and would only purchase these securities if there was concern for a deeper recession, a regulatory imperative, a liquidity requirement, or other necessity for holding these instruments.

Indeed, we believe that more and more investors are questioning the wisdom of bond investments as they are no longer no-risk or low-risk. Some are seeking other options with similar risk but greater return prospects, such as high dividend yield stocks, infrastructure projects, real estate, or even gold. We find private equity investments in infrastructure and real estate to be opaque with limited liquidity and expensive valuations, particularly relative to what is available in the public markets. We believe owning gold amounts to speculating on its price as it offers no current income. We find high dividend yielding stocks are the most appealing investment substitute for fixed income securities.

Equity portfolios managed by Letko Brosseau currently offer yields of approximately 3%, with dividends paid by a diversified group of businesses operating in many different industries and geographies. These companies have been chosen not just for their attractive yield characteristics, but also for their ability to grow earnings and similarly grow their dividends. They include companies in utility industries generating power, treating water and providing telecommunications infrastructure, relatively stable consumer product businesses such as food production and retail, as well as healthcare firms. The portfolios' average 3% dividend yield is considerably higher than what is available in the bond markets today. In addition, the portfolio companies are able to grow, providing the prospect of capital appreciation. This seems a more favourable alternative for yield-conscious investors with long investment horizons. Indeed, we see some institutions beginning to convert part of their bond portfolios to specialized portfolios focused on high yields.

Two questions must be considered, however.

First, given that bond yields are at historic lows, is this also true for dividend yields? A review of various stable dividend-payers shows that this does not appear to be the case. For example, Canadian companies such as Canadian Utilities, BCE and the Royal Bank of Canada offer yields at about the mid-point between their lowest and highest levels over the last 20-30 years. The same is true for non-Canadian companies. This stands in stark contrast to today's low bond yields.

Second, what portion of a balanced portfolio ought to be reallocated from medium and long-term bonds to high yielding stocks? While switching from one risky asset to another similarly risky asset that generates a substantially higher yield may make sense, some thought should still be given to the appropriate amount to put aside in short-term high-quality bonds as a reserve against unplanned spending requirements or turbulent financial market conditions. The final answer will depend on the investor's particular circumstances. Consideration should be given to the size of the portfolio relative to the investor's requirement for income. All else equal, the larger the portfolio, the greater the tolerance for dealing with risk.

Letko Brosseau balanced portfolios are already well insulated from the bond risks cited above. Bond holdings are at minimum levels under investment policy guidelines and are both high quality and short in duration, which protects from business risks as well as an upward move in interest rates. We also have a meaningful weight in dependable dividend payers across several industries, including utility and infrastructure companies which contribute to the overall yields in our portfolios today.