The Stan Clark Financial Team's

# PERSPECTIVES

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Asset allocation

## Asset allocation: Risks and returns of equities vs. fixed income

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**Previously, we introduced the concept of *asset allocation* – how you divide your money between the different types of assets. We also introduced the two main types of assets: *equities* and *fixed income*.**

In this article, we'll discuss the risks and returns of equities versus fixed income.

Equities represent ownership in businesses. Their main source of returns is the profits or earnings that those businesses make. But, for any company, future profits are always uncertain. That's because every company faces competition. It's a dog-eat-dog world – and usually it's hard to know who will be the diner and who will be the dinner! However, if you look at all the companies *together*, the total profits are much more stable. One company's decline tends to be another company's gain. So, in total, the earnings of the entire economy are much more stable and reliable than those of any individual company.

Still, aggregate earnings do fluctuate. One of the main causes of this is the business cycle: the ebb and flow of the economy as it expands and contracts. The normal course of the economy is expansion. Contractions usually last six to nine months, and occur two to three times in a decade. That means that, 80 percent of the time, the economy is expanding.

Company profits tend to fall when the economy contracts. But they typically recover quickly. This is because companies adjust to contractions, and restore profits by cutting costs. Over longer periods, profits can rise at a different pace than the economy, depending on how the economic pie is split between wages, profits and taxes. Improvements in productivity are a key to increasing profits faster than the economy.

Stocks trade at prices that are a multiple of expected earnings, commonly known as the *price-to-earnings ratio*. Over the past 100 years, this multiple has averaged around 15 times earnings. But the multiple varies over time. During optimistic times, stocks trade at a higher multiple. During pessimistic times, stocks trade at a lower multiple. Add human psychology to the mix, and you will get huge swings in stock prices from one year to the next. But, over the long term – five to 10 years or longer – the swings mostly cancel each other out. This levelling leaves equity investors with returns that are linked to the overall profits the companies have made.

With fixed income investments, the returns you get are usually set when you invest. For government bonds, the returns tend to be just slightly above the expected inflation. The risk is that the actual inflation may be higher than expected, maybe even higher than the entire return of the bond. In this case, you would lose purchasing power. For fixed income investments that are *not* government-guaranteed, the return is usually higher – allowing for the risk that the principal and interest might not be paid.

In our next issue, we'll discuss the actual historical returns for both equities and fixed income over the past 100 years.

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