

Dividing Your Assets Between Stocks, Bonds and Cash

At first glance, many investors assume that the basic asset allocation decision is easy. After all, at this level you are focusing on only three choices—stocks, bonds and cash (money market funds and short-term certificates of deposit).

While the choices are few, the way you allocate your portfolio among these three categories will have by far the greatest impact on your performance of any investment decision you make, assuming that you don't violate the basic investment principles.

Why? If you follow basic investment principles—and in particular are well-diversified within each category—you will eliminate many of the specific risk characteristics that are unique to a single investment. Most of what will remain, however, are the broad risk and return characteristics of the overall category. For instance, assuming you have a well-diversified stock portfolio of, say, 20 stocks, your decision several years ago to invest in IBM instead of Intel may have caused you to kick yourself once or twice, but it will have cost you far less than a decision several years ago to invest only 10% of your total portfolio in the stock market and the remainder in cash investments.

How does an investor make this important decision?

You should start with one of the basic investment principles: "In building an investment portfolio, you are simply seeking answers to these questions: What are the risks? What risks can be eliminated or reduced through diversification and which risks will remain? What are the returns associated with the risks I will be undertaking?"

This step will try to provide you with an answer to those questions by looking at the historical returns associated with the three major categories. Then, it will show you ways to balance those risks and potential returns based on your personal investment profile.

What Are the Differences Between Stocks, Bonds and Cash?

Most investors don't possess reliable crystal balls, which makes the future unknown and therefore uncertain.

The past, however, is known, and can serve as a useful guide which we will use here. But there are limitations.

First and foremost, the past may not be repeated.

Second, it is important to look over enough of the past to cover various economic and market conditions, yet to avoid extending so far back that you are viewing conditions that may no longer be applicable due to structural changes in the economy. It is a judgment call, and the data presented here, in [Table 1](#), covers 1946 through 1996—the post-World War II period.

TABLE 1.
Stock, Bonds and Cash: 1946 through 1996

Returns, Growth and Income for Entire Period

	Stocks	Bonds	Cash
Average Annual Return (%)	12.1	5.8	4.8
Average Annual Return After Inflation (%)	7.8	1.5	0.5
Average Annual Growth (%)	7.6	0.0	0.0
Average Annual Income (%)	4.5	5.8	4.8

Returns (Annualized) and Losses Based on Holding Period

One-Year Holding Periods	Stocks	Bonds	Cash
Best Return (%)	52.6	29.1	14.7
Worst Return (%)	-26.5	-5.1	0.4
Percentage of Losses (%)	26.8	11.0	0.0
Percentage of Returns Below Inflation (%)	36.6	56.1	36.6
Five-Year Holding Periods	Stocks	Bonds	Cash
Best Return (%)	23.9	17.0	11.1
Worst Return (%)	-2.4	1.0	0.8
Percentage of Losses (%)	4.2	0.0	0.0
Percentage of Returns Below Inflation (%)	17.0	29.8	27.7
Ten-Year Holding Periods	Stocks	Bonds	Cash
Best Return (%)	20.1	13.1	9.2
Worst Return (%)	1.2	1.3	1.1
Percentage of Losses (%)	0.0	0.0	0.0
Percentage of Returns Below Inflation (%)	14.9	23.4	27.7
Twenty-Year Holding Periods	Stocks	Bonds	Cash
Best Return (%)	14.9	9.8	7.7
Worst Return (%)	6.5	2.2	2.0
Percentage of Losses (%)	0.0	0.0	0.0
Percentage of Returns Below Inflation (%)	0.0	11.0	4.0

Stocks: Standard & Poor's 500

Bonds: Intermediate-Term (5-Year) Government Bonds

Cash: Treasury Bills

Source: "Stocks, Bonds, Bills and Inflation—1997 Yearbook," Ibbotson Associates, Chicago.

Lastly, it is important to understand the data itself. The stock data presented here covers the Standard & Poor's 500, which are larger, established companies. The bond data is for intermediate-term government bonds, with a maturity of about five years. Cash is represented by Treasury bills, the most conservative segment of the cash investment market. This data represents the core areas in which most investors will concentrate, but there are more volatile segments of each category—small stocks and longer-term bonds, for instance.

The data includes annual returns for the overall period, as well as annual returns based on one-, five-, 10-, 15- and 20-year holding periods, to indicate how the risk-return equation can change with time. (These holding period returns encompass all the years using rolling holding periods. For instance, five-year periods include 1946 through 1950; 1947 through 1951; etc.). The data also indicates the percentage of holding period returns that were losses, and the percentage of holding period returns that were below the rate of inflation.