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Don't give up on fixed income

An important aspect of long-term portfolio success

The year got off to a great start as enthusiastic investors drove equities prices upward, but much of the first quarter rally momentum has been tempered by news from Europe and China. It has made investors jittery and resulted in significant volatility.

Although not many investors appreciate market volatility, it does come with some positives. Bumpy markets are a wake-up call for exuberant investors to reflect on asset allocation and ensure that equity exposure hasn't strayed too far from long-term positioning.

When the markets are hot, investors tend to shift away from cash and fixed income holdings in favor of the opportunities offered by equities. While over-weighting equities during market upswings can be good from a tactical standpoint, many investors tend to go overboard by repositioning huge amounts of their portfolios and significantly increasing their risk profile. It is a dangerous strategy in unpredictable markets.

Look at what happened in 2007. Investors had grown so accustomed to good returns that they viewed 20% performance as average. They scoffed at fixed income and money market, shifting away from more conservative holdings and into progressively overweight equity positions. With very little buffer for volatility, they paid dearly when the financial crisis hit.

History offers a chance to learn. Investors should re-assess their portfolios to ensure they have a healthy amount of fixed income. It has many benefits, outside of simply buffering volatility. Fixed income generally has a low correlation to the equity markets, helping to manage risk and improve portfolio diversification; the regular interest income helps reduce dependency on pure price appreciation for portfolio returns; and fixed income returns have historically been more stable than the broad equity markets.

One general rule of thumb for fixed income is to hold the same amount as one's age in years. That is, the portfolio of a 70 year old should have approximately 70% in fixed income. The premise is that younger investors can assume more risk because they have a longer time horizon and are better positioned to handle market volatility.

However even a general rule needs to be tailored to an individual investor's specific goals and expectations. Whatever guideline might be chosen, there is one constant: older investors are more sensitive to market movements and preservation of capital is paramount. If you are approaching or are in retirement, fixed income must be a portfolio priority.

Some pundits believe investors should avoid fixed income because of its sensitivity to interest rates, rationalizing that when interest rates rise fixed income prices generally fall. Economists do not

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foresee this being an issue over the near-term though. Central banks around the world have created an unprecedented amount of liquidity. As a result, the Federal Reserve has indicated that the low-rate environment is unlikely to change until 2014. In either case, wise investors will assess the interest rate environment when choosing fixed income products to fit their individual situations.

These are extraordinary times, with the last three years being the most volatile since the 1930s, and investors are understandably nervous. Although market volatility can be a little unnerving, it is not a time to panic. It is a time to think. Make certain asset allocations are appropriate and remain defensively positioned.

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