

GEMS: The “Safest” Portfolio

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Often clients will come to us and ask us about investing in the “safest” portfolio. While it’s important to note that no investment can guarantee safety or eliminate risk entirely, this may seem like a straightforward question with an easy answer, but it isn’t. Everyone views risk differently, and their perspective on what is “safe” will naturally vary. In this GEMS, we discuss what “safety” could mean and then look at historical evidence to help guide how the answer would vary depending on what definition of “safety” is used by each client.

There are many ways to think about the “safety” of a portfolio. The most common way people think of “safety” is how likely or how often they will lose money. People view bank accounts as “safe” because they slowly accrue interest (and the balance doesn’t go down) and defaults of banks are rare. If you keep less than the FDIC insurance limit (\$250,000 per depositor) in an account, then this can represent a very safe nominal alternative. We say a safe alternative because although bank accounts will protect the nominal value of your dollars, they won’t necessarily protect the purchasing power of those dollars. Another dimension outside of frequency of loss is the magnitude of loss. If there was an investment that made money every day for 10 years but then lost 100% of its value permanently once every 10 years, that would not be considered “safe” by most. In fact, we have seen that many would prefer investments that regularly lose 10-20% temporarily if they feel confident the losses won’t exceed certain thresholds. This discussion leads us to the realization that we must consider both the frequency and size of losses in both nominal and real terms when considering the safety of various portfolios.

Clients ask us about investing in the “safest” portfolio, but “safety” depends on how the investor views risk. We must consider both frequency and size of losses in both nominal and real terms when considering the safety of various portfolios.

There are two remaining points: over what time period should we do this analysis and what investments should we consider? For most analysis, and this one, we feel having the longest possible set of data is important as it allows these numbers to stand in the face of the widest possible set of adversities: two world wars, gold standard, a great depression, and many large recessions. We are using data of annual loss levels and standard going back to 1872 from a combination of Robert Shiller’s dataset¹ and Bloomberg. We consider annual changes in the value of investments over that 150+ years of data on various assets including short term US treasuries (1 year), long-term US treasuries (10 year), US equities, and gold.

First let’s consider the nominal returns (before inflation) of each asset individually. Not surprisingly, 1 year US Treasuries we view the “safest” assets on every metric in the chart below – experiencing no less than a 0.1% gain in any one year. Based on the analysis, the 10-year US Treasuries are the next safest although over the 150+ years of returns they had negative returns in 11.8% of the years. They also had a maximum annual loss of 20.4% and the 5th percentile worst loss of 4.6%. Equities and gold had 26.3% and 28.3% of the years with negative returns and had maximum annual losses of 42.9% and 32.6% respectively.

¹ <http://www.econ.yale.edu/~shiller/data.htm>

Comparison of Losses with 100% Allocations to Various Assets

% Allocation to 1y UST	100%	0.0%	0.0%	0.0%
% Allocation to 10y UST	0.0%	100.0%	0.0%	0.0%
% Allocation to US Equities	0.0%	0.0%	100.0%	0.0%
% Allocation to Gold	0.0%	0.0%	0.0%	100.0%
Largest Annual Loss	0.10%	-20.36%	-42.93%	-32.60%
5th Percentile Loss	0.41%	-4.62%	-18.30%	-12.22%
% Yrs Negative	0.00%	11.84%	26.32%	28.29%
Standard Deviation	2.95%	6.52%	17.94%	16.58%

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As a next step, let's look at various combinations of 10y US Treasuries and US Equities to see if there are any correlation benefits from holding both assets. The portfolio based on the chart below that minimizes the largest annual loss is 60% bonds and 40% equities but the portfolio that minimizes the 5th percentile loss is 80% bonds and 20% equities. Further, the 80%/20% portfolio only losses money in 13.8% of years whereas the 60%/40% portfolio losses money in 17.7% of the years. From this we can infer that an 80% bond / 20% equity portfolio is "safer" than a 100% bond portfolio on every metric except the frequency of loss which is counterintuitive to most investors.

Losses on Portfolios of 10y US Treasuries and US Equities

% Allocation to 1y UST	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
% Allocation to 10y UST	100.0%	90.0%	80.0%	70.0%	60.0%	50.0%
% Allocation to US Equities	0.0%	10.0%	20.0%	30.0%	40.0%	50.0%
% Allocation to Gold	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Largest Annual Loss	-20.36%	-20.14%	-19.91%	-19.69%	-19.46%	-21.25%
5th Percentile Loss	-4.62%	-3.60%	-3.37%	-4.36%	-5.66%	-7.73%
% Yrs Negative	11.84%	11.84%	13.82%	15.13%	17.76%	21.71%
Standard Deviation	6.52%	6.24%	6.51%	7.27%	8.39%	9.74%

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The environment in which both stocks and bonds do poorly is one of high inflation such as during the 1970s and 2022. In that environment, having an allocation to gold would help increase the "safety" of the portfolio. Moving from 80% bonds / 20% equities to 70% bonds / 20% equities / 10% gold would reduce the largest annual loss from 19.9% to 17.9%, reduce the 5th percentile worst loss from 3.4% to 2.9% and reduce the % of years with negative returns from 13.8% to 12.5%.

Losses for Portfolios of 10y US Treasuries, US Equities, and Gold

% Allocation to 1y UST	0.0%	0.0%	0.0%	0.0%	0.0%
% Allocation to 10y UST	80.0%	75.0%	70.0%	60.0%	60.0%
% Allocation to US Equities	20.0%	20.0%	20.0%	30.0%	40.0%
% Allocation to Gold	0.0%	5.0%	10.0%	10.0%	0.0%
Largest Annual Loss	-19.91%	-18.91%	-17.91%	-17.68%	-19.46%
5th Percentile Loss	-3.37%	-2.92%	-2.92%	-4.30%	-5.66%
% Yrs Negative	13.82%	13.16%	12.50%	13.82%	17.76%
Standard Deviation	6.51%	6.29%	6.18%	7.00%	8.39%

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Finally, let's compare our "safe" portfolio of 70% bonds, 20% equities and 10% gold to 1 year US Treasuries by looking at real returns (nominal returns minus inflation) by year. As you can see, once you switch from nominal to real, the 1-year US Treasury looks a lot "riskier." Although the largest real annual loss is still less 17.3% vs 24.4%, the 5th Percentile real losses and % of years with negative real returns are surprisingly similar. Plus, the median annual real return for the 70/20/10 portfolio is 3.76% compared to just 2.04% for the 1-year US Treasury.

100% 1y US Treasuries vs. The "Safe" Portfolio

% Allocation to 1y UST	100%	0.0%
% Allocation to 10y UST	0.0%	70.0%
% Allocation to US Equities	0.0%	20.0%
% Allocation to Gold	0.0%	10.0%
Largest Real Annual Loss	-17.34%	-24.41%
5th Percentile Real Loss	-8.63%	-10.26%
% Yrs Negative Real Return	28.95%	28.29%
Median Annual Real Return	2.04%	3.76%

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"Safety" and risk are in the eye of the beholder. While short-term US Treasuries provide the "safest" portfolio in nominal terms, a portfolio that holds long-term US Treasuries, US equities, and an inflation hedge like gold looks comparably "safe" in real terms and has the potential to produce a higher long-term return.

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Gold represents the afternoon gold price as reported by the London Bullion Market Association (LBMA). The gold price is set twice daily by the London Gold Fixing Company at 10:30 and 15:00 and is expressed in U.S. dollars per fine troy ounce.

In applying the \$250,000 insurance limit, the FDIC must add together all deposits owned by the same depositor in the same ownership capacity. In the case of deposits owned by a principal but held by an agent, custodian or nominee, the deposits are insured to the same extent as if deposited in the name of the principal.