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CAN YOUR INVESTMENTS BE TOO CONSERVATIVE?
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Is there a danger of being too conservative with your investments? Many investors have an aversion to risk. They are marked by events in their lives such as the Great Depression or declining markets. These investors seek “safe and secure” investments with returns that they can count on when ever they need to liquidate an investment. However, as an investor you should be aware that being too conservative with your investments may result in your investment being significantly less than what you had hoped for or required.

Let’s examine a favorite of many conservative investors, the bank Certificate of Deposit. Many people are attracted to a CD’s guaranteed rate of return and the FDIC insurance of $100,000.00 dollars for each account. It seems like a good option until you look at the rates that are being paid currently on CD’s. For example, if you purchase a $10,000.00 dollar CD with a rate of 4.5% and a 10 year term, your will receive total interest income of $5,529.00.

If you are in the 20% tax bracket, you will pay $1,105.00 in taxes, leaving you with $4,423.00 in your pocket.

You also need to consider how inflation will erode your returns over time. You can be sure that the cost of living will likely be going up during the 10 years that your CD rate will be fixed (bear in mind, there is usually a penalty for an early withdraw). Historically, the annual rate of inflation has averaged 3.1%. Inflation has not approached that level for quite some time and is currently under 2%. Over a long time horizon, such as the 10 year term that we are considering here, it is reasonable to expect rates of return and inflation to approach their long term averages. Therefore, subtracting the historical inflation rate from your 4.5% CD rate provides you with a real return of only 1.4%.

Let’s compare your safe, secure, 1.4% real return on a CD to the return that you could receive on a portfolio that included stock. You will find that two features stand out in comparison to a Certificate of Deposit. The first is that a small allocation of stock will allow your portfolio to enjoy much higher returns on average. The second feature is the reduction of risk that you will see in a stock portfolio held over a long period of time.

From 1950 to 2003, the one year returns on a portfolio consisting of 10% stocks and 90% bonds averaged 7%. The largest loss for such a portfolio was 3.9% while the largest gain for such a portfolio was 28.9%. If you reverse that ratio to 90% stocks and 10% cash, the portfolios return 12.2% on average while the largest loss was 34.3% and the largest gain 55.9%.

Extending the holding period to 10 years, a 90% bond 10% stock portfolio experienced an average return of 7.1% and the lowest return was 3.1% and the highest return 13.1%. A portfolio of 90% stocks returned 11.3% on average with the lowest return being a positive 1% and the largest return for any 10 year period being 18%.

The major difference between a CD portfolio and one with a mix of stocks and bonds is that after netting out the effect of taxes and inflation you enjoy a significantly larger return on your money. A thousand dollars invested in a portfolio consisting of 90% stocks and 10% bonds would grow to $29,171.00 after 10 years. Compare this with the $15,529.00 ($10,000.00 plus $5,529.00 interest) that you would accrue for 10 years on a bank CD.

Bear in mind that there are no guarantees with the riskier portfolio of 90% stocks/10% bonds. The numbers quoted in this article are historical numbers and you could experience a loss in a stock portfolio during a given period of time. What the data suggests is that the longer you hold a stock portfolio, the less likely a loss will be and the more likely you will have a gain.

The question that you must ask yourself is which portfolio is more likely to meet your financial goals? A surefire CD investment that offers a guaranteed return that will be eroded by inflation and taxes over time or a somewhat riskier investment that can earn you a much higher return? Choose wisely.