How a Balanced Portfolio Can Help You Manage the Next Recession

Description

Ask any professional, and they'll tell you that over time the stock market tends to outperform the other major asset classes, like fixed income and real estate.

But why is it then that those same professionals almost always build for their clients a balanced portfolio that is sure to include not just the stocks of publicly traded companies, but also shares in fixed-income mutual funds, exchange-traded funds, and preferred shares?

This article will help to explain some of the reasons why a balanced portfolio holding both stocks and bonds can help to reduce some of the risk and volatility when the economy goes into a recession.

Understanding the role that inflation plays in the economy

Understanding economic cycles is far from being a science, but based on the available evidence, there is good reason to believe that inflation has played a major role in causing the recessions of the past few decades.

In large part, the factor driving inflation — and the ensuing market meltdowns — has been the price of energy — namely, crude oil and gasoline prices.

Gasoline prices are obviously a large component of any family household budget, particularly in the summer months, when families plan for vacations, camping trips, and excursions to local sporting events.

But beyond filling up the family SUV, energy is also a vital component of so many other parts of society — and the economy.

Manufacturing companies like **Caterpillar Inc.** (NYSE:CAT), **Bombardier, Inc.** (TSX:BBD.B), and **Magna International Inc.** (TSX:MG)(NYSE:MGA) employ massive factories full of machinery that generally runs on fossil fuels.

When these companies are faced with higher energy costs, they are forced to pass these higher costs through to consumers.

The result of that is higher prices for everyday household items like the ones you'd find at your local **Canadian Tire Corporation Limited** (TSX:CTC.A), **Loblaw Companies Ltd.** (TSX:L), or **Dollarama Inc.** (TSX:DOL).

Why inflation is generally good for stocks

For all of these companies, inflation is generally a good thing, as long as they are successful in passing those higher costs along to customers by charging more for their products.

That's because charging a higher price tag for a company's products and services inevitability leads to higher sales and profits for the company, which drives demand for the company's stock, pushing its share price higher and creating wealth for the company's shareholders.

But there can be too much of a good thing

The problem arises if the government and central bankers believe that inflation is rising too much or too quickly.

If inflation begins to accelerate and risks getting out of control, the cost of everyday items can become so expensive that it hurts tax payers, and that's something the government certainly doesn't want on its hands.

So, to combat inflation, governments and central banks will typically raise interest rates, making the cost of borrowing money more expensive, which tends to have the desired effect of curbing inflation and keeping things in check.

How does this affect your portfolio strategy?

Stocks, generally speaking, are the beneficiaries of healthy inflation, as it tends to drive higher prices, profits, and share prices.

But as inflation continues to rise, at some point it will almost inevitably be followed by higher interest rates.

When this happens, companies in your stock portfolio will be faced with higher borrowing costs, making it prohibitively more expensive for them to pursue plans to expand operations.

That's bad for stocks, but it will be good for your fixed-income holdings, which will benefit from higher interest rates and coupon payments.

Conclusion

Particularly if you are risk adverse, you are going to want to avoid any undesirable — and unexpected — swings in the value of your investment portfolio.

A balanced approach that holds at least some mix of bonds along with your stock holdings can go a long way to seeing that you manage the next recession without losing too much sleep.

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Date
2025/06/29
Date Created
2018/06/12
Author
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