Is 80/20 the *New* 60/40?

The 60% stock and 40% bond portfolio that is often thought of as the starting point for basic asset allocation decisions may no longer be sufficient to generate the returns required by many institutions and individuals to meet their long-term financial goals and objectives. In this issue of Investment Strategy Quarterly, we explore the details behind our own long-term return assumptions and risk management process while also focusing on ways in which investors can think about the relationships among risk, return, and portfolio construction in this lower-return environment.

A Challenging Time for Investors

Our view is that the current prices being paid for both stocks and bonds will be a forceful headwind for returns over the coming decade. We believe investors may find it difficult to escape the reality that paying a high price for a stream of future cash flows mathematically necessitates a lower expected return on investment.

As interest rates have decreased, investors have been forced to assume greater portfolio risk and asset class diversification just to keep pace with their return objectives. In 1995, an investor could earn a 7.5% return with a simple 100% fixed income portfolio. By 2015, investors needed a drastically more diversified portfolio, with fixed income shrinking to 12% of the total portfolio. We think the most striking issue is the volatility measure, which has increased nearly three-fold relative to 1995.

The Mechanics of Developing Capital Market Assumptions

Our capital market assumptions are derived from a rigorous process of correlation estimation, risk/return forecasting, and a mixed estimation process using the Black-Litterman methodology. The output becomes our capital market assumptions, detailing our mean annual return and mean annual volatility expectations for each asset and subasset class. They are key input variables for our asset allocation work, including mean-variance optimization, Monte Carlo simulations, and risk budgeting.

Falling Return Expectations

As a reflection of the current environment, our own capital market return assumptions have been in a declining trend, with much of this decrease concentrated in the past five years. Our expected returns for equities and fixed income are approximately 150 and 100 basis points (bps) lower, respectively, over that period. We think there has been a cyclical shift lower in returns, largely a function of the current phase of the business cycle, peaking corporate profits, monetary policy tightening, and stretched valuations.

To Meet or Not to Meet? That Is the Question

Assuming a 7.5% annual return objective (common for many pension funds and foundations), a 60/40 asset allocation would have struggled to meet this goal during the last 10 years. Is 80/20 the answer? We do not believe so because it is nowhere near sufficient based on our analysis and capital market assumptions for risk and return over the next 10 years (achieving only a 5.82% growth rate). Our analysis underscores the importance of considering a more nuanced approach to portfolio construction, particularly in today's market. For this reason, we generally have smaller allocations to traditional, plain-vanilla fixed income while using allocations to international markets and alternatives, when practical, to help generate incremental return while still being conscious of portfolio risk.

Pick Your Poison: Shortfall/Spending Risk versus Volatility Risk

Asset allocation decisions may differ depending on the way one chooses to define risk. Is risk purely volatility? Is risk a permanent loss of capital or return target shortfall? We think risk can be defined in different ways depending on each investor's circumstances, and a clear understanding of this can have a meaningful impact on one's investment strategy. Stocks may be considered risky in the short term, but over the typical investment period (often 25+ years) an all-equity portfolio nearly always maximizes wealth. In fact, there are only 10 months in the past 140 years in which if you invested in bonds instead of stocks, you would have come out ahead over the following 25-year period. We are not suggesting that a 100% equity portfolio is appropriate for most investors, as the associated volatility could create liquidity issues and, perhaps more importantly, many sleepless nights. The data do highlight, however, the historical relationship among increased equity exposure, risk, and ultimate wealth maximization (return) over longer time horizons. Shortfall risk may be a bigger consideration for a pension or endowment than an ultra-high-net-worth individual, so it is important to focus on the risks that are most critical to each investor. Which risks are more palatable?

Call to Action

- Re-evaluate your investment policy statement and asset allocation regularly.
- Consider the mix of active and passive strategies employed in portfolios.
- Reduce/adjust the spending rate and methodology used to calculate it, if possible.
- Reinvest excess returns.
- Explore the use of alternative investments, when practical.

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