The Great Asset Allocation Debate

For decades, the “right” asset allocation for a portfolio designed for long-term returns was 60-30-10 or 60% in stocks, 30% in bonds and 10% in cash or for a fully invested portfolio, a 60/40 stock/bond ratio. This mix provided what is called a balanced approach to building wealth. Over the past 40 years, bonds provided an attractive complement to stocks as long-term interest rates started out at a peak rate of about 15% in 1980 as measured by the 30-year Treasury bond with the yield falling to a low of 1.4% in September. The problem is that historical returns of bonds are boosted by the rise in bond prices as yields declined. However, bonds are usually issued at par ($100) and mature at par. Any capital gains implied by price appreciation in the short-term is given up as the bond approaches or reaches maturity. Professional investors see the loss of the interest return component as a major impediment to the 40% of the fixed income allocation of a balanced portfolio. In other words, if the average yield was 6% then, the 1.4% yield today will undermine the expected portfolio return.

The challenge for investment advisors designing asset allocation portfolios that have a long-term, total return objective is to estimate how much additional stock risk is reasonable to offset the substantially lower yields of the bond allocation. The shift to a 70/30 stock/bond mix is a step in the right direction. However, using historical returns on bonds in any asset allocation model is not an accurate way to forecast the future returns of that bond portfolio; the better way is to use the current rates that are substantially lower than historical rates.

On the other hand, estimates of stock returns can follow historical returns because the determinants of stock prices are some mix of earnings growth, dividends, interest rates and inflation. In most cases, these variables are more favorable than they have been in many years. For investors who see that a conservative approach may be too conservative given the outlook for lower portfolio returns from bonds, alternative allocation strategies embodied in various portfolios with higher stock weightings could be the solution to increasing the value of a retirement portfolio.

“Market Commentary

September lived up to historical expectations as the market rally came to an abrupt halt and promptly fell 3.8% as measured by the S&P 500. The record setting performance this year of the NASDAQ was also deflated with a sharper decline of 5.2%. Not until the last few days of September did we see the beginning of a rebound even in the face of rising Coronavirus cases and the intensifying complexity surrounding the national elections. The Coronavirus is still contributing to the strength of large capitalization growth stocks as many of them are included in our “Survival of the Fittest” theme. Interest rates remained at or near record lows in September and the outlook remains for rates to remain stable.

U.S. ports received ships carrying 2.06 million containers loaded with cargo in August. That is the largest number since 2002, 18 years ago. (source: National Retail Federation Global Port Tracker)

“In investing, what is comfortable is rarely profitable.”
Robert Arnott