Perspective:
How to Beat 60/40 for the Next 10 Years

Executive Summary

- Financial advisors who have relied on standard 60/40 allocation portfolios now face a generational challenge.

- In an era where consumers increasingly see financial advisors and traditional asset allocation as a commodity, solo and boutique advisory firms must differentiate their practice.

- Low bond rates and a historically overvalued stock market conspire to create a mediocre total return outlook for 60/40 and similar strategies.

- Fortunately, there is a way forward. Advisors must consider disrupting some of their traditional thinking about investment process and portfolio construction.

- By re-assigning the role of bonds in client portfolios, embracing hedging and tactical investing, and making subtle adjustments to the core stock portfolio, advisors can position clients for a much wider range of future outcomes.

- By separating traditional investment myths from new market realities, advisors can be recognized as change-agents, not dinosaurs, as the next decade evolves.

The 60/40 Portfolio Myth

Over the past several decades, financial advisors and investors have been led to believe that investing for retirement is simple. You put 60% of your portfolio in stocks and 40% in bonds. That is all. Now, go and live your best life!

Sure, there are some nuances, like how to fill those 2 magic buckets, the 60% in stocks and the 40% in bonds. An investor can leave that to a financial advisor. They can instead look up any number of suggestions online. In fact, some of those suggestions may actually be from qualified, licensed investment professionals. After all, how hard can it be for an investor to pick a few funds to fill out that 60/40 thing, and check that off your to-do list for the next decade or two?

For today's financial advisor, the 60/40 portfolio has become a double-edged sword. Actually, make that a triple-edged sword. They have succeeded with clients for years using the 60/40 mantra. They have had big, well-known financial firms back them up on the concept, and supply cheap, easy-t0-use solutions to save the advisor time and money.

At the same time, **the advisor's potential client growth is being attacked from all sides.** Robo advisors that offer investing and planning are one source. Consolidation efforts by large brokerages and national RIA firms are another. And, there's the nagging reality that the advisor's current clients have children who are statistically not likely to continue with that advisor.

Those are the first two edges of the sword. Each of those allows the advisor some degree of control over their own fate. They can market differently, collaborate with others in our industry, or try a number of client retention, growth and messaging strategies to fight the organic growth headwind.

However, the third "edge" of that proverbial sword is different. It is an inanimate object, seemingly out of the direct control of the financial advisor and her clients. To paraphrase an old D.C. political line, "it's the market, silly!" And that makes 60/40 portfolios, as successful as they have been in the past, a major point of vulnerability for today's financial advisor.

60/40 and some of the ancient academic research that spawned it are now at risk of being unveiled, in my opinion, for what they are today: an overrated, over-simplified sales tool that has overstayed its usefulness in its current form. The markets are different, the clients are different, and the advisory industry is different from 30 or 40 years ago, when 60/40 grew from academia into a buzzword that investors identify with.

Unfortunately, as with much of investment market history, this comfort level can promote complacency. That complacency is <u>exactly</u> what leads financial advisors to underestimate the major secular market changes that can disrupt client portfolios. That, in turn, leads clients to react emotionally. The knee-jerk reaction is for the advisor to wax poetic about "long-term investing" and "you can't time the market." This has worked well during the past decade, thanks to a generally profitable climate for stocks and bonds.

60/40 Portfolios Are In A Slump, and likely to remain that way

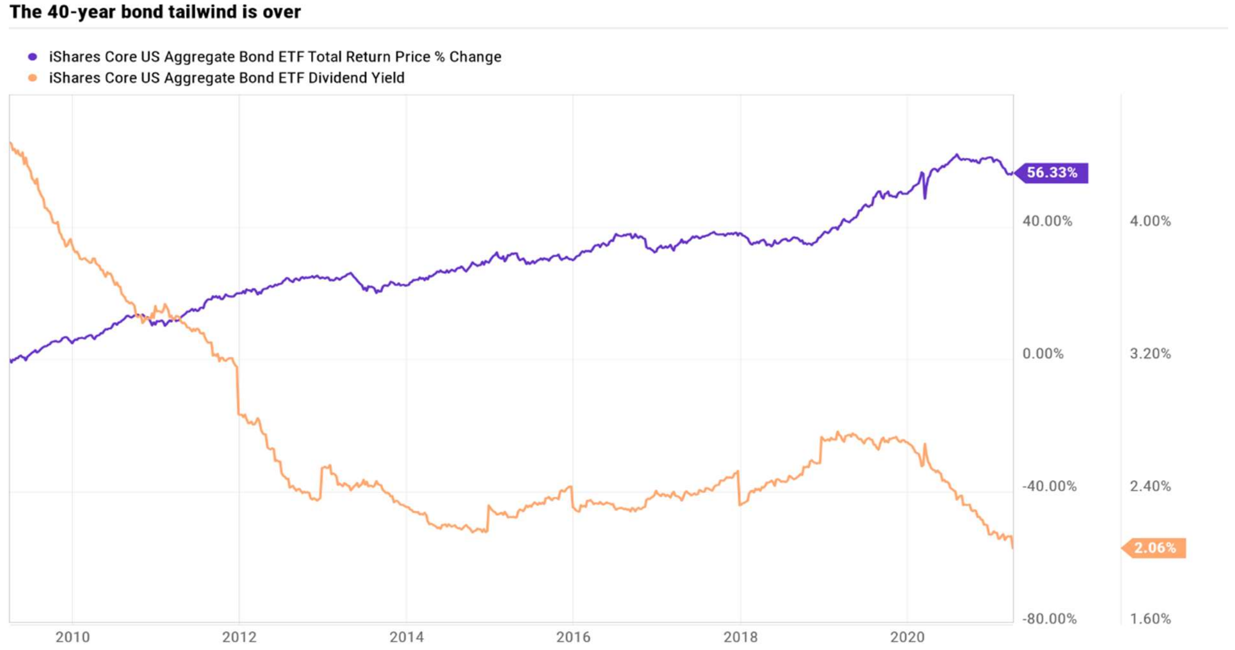
Today’s global markets: a toxic combination

- Low bond rates
- Stocks near all-time highs.
- Low spreads on “credit” bonds despite weak corporate credit conditions in many segments of the economy
- Massive Central Bank intervention

The first two of those four items have not been seen since the 1970s. That was way before the investment industry turned 60/40 into a vehicle for big firms to build scale in their businesses, by herding people into a unified asset allocation.

However, **as Bob Dylan famously wrote, the times they are a-changing.** U.S. Treasury Bond rates are near generational lows, and recently show hints of rising. That combination of “low and trending upward” rates is toxic for fixed income portfolios.

As the chart below shows, at the end of the Global Financial Crisis in 2009, interest rates were much higher. In the dozen years since, falling rates added significant return to bond portfolios. Now, that tailwind is reversing. Low but rising rates are a formula for low, or even negative bond returns over the next decade.



Advisor fees have been "juiced" by consistently falling rates. Today's low yields and troublesome credit conditions prevent a repeat. This calls for a change in strategy.

The third item, low credit spreads, describe a condition where investors are very willing to accept a yield only modestly above comparable U.S. Treasuries in exchange for owning BBB bonds. BBB used to be just another rating, below AAA, AA and A, and above the “junk bond” category.

Today, however, BBB bonds make up about half of the U.S. corporate bond market. That implies many of those bonds are merely “junk bonds in investment grade clothing” to avoid a major re-shuffling of that market.

However, Federal Reserve has supported this predicament by buying corporate bonds. And, they have been buying outright junk-rated bonds too.

Combine this with the trillions of bonds elsewhere around the world that carry negative yields, and you have a ticking time bomb. Given all of that, do you still want to allocate 40% of client portfolios exactly the way you have been?

As for the stock market, it is historically overvalued by many measures. And, even if the bull market that began in 2009 is not over, it is hard to argue that stocks are a low-risk asset at this stage of the market cycle.

TINA and the equity index bubble

One reason for this is that **stock indexes have benefitted from two significant tailwinds. One is the "TINA" phenomenon. Investors have argued that with bond rates so low, "there is no alternative (TINA)" to owning stocks. That, and a big marketing push toward passive investing, opened the floodgates for investors of all types to pile into the "common denominator" of mega-cap, technology-dominated equity indexes, particularly the S&P 500 and large cap growth indexes.**

This had the effect of pulling forward returns on those indexes. That is, the returns they probably should have earned over the next 10 years have been mostly or entirely gathered during the last 5 years.

This is like when your child asks for $5 to play games in the arcade, and you advise them to spend it slowly, because that is all you are going to give to them that day. Then, they come back 5 minutes later, with empty pockets, asking for more cash. They had their fun, they pulled their "fun" return forward. So, unless you decide to "leverage up" on your arcade money to them, they have already earned all of the enjoyment they are capable of with your money, perhaps until tomorrow.

Similarly, most of the stock market, particularly the growth-oriented, low/no yield segments of the equity universe, have been masking the weakness in bonds for several years. This is not likely to be the case going forward.

And, as Warren Buffet famously said, "when the tide goes out, you can see who was swimming naked." **A big reason for alarms bells to go off for advisors now is simple: the reality is hitting the radar. That means you had better get in front of this secular shift, before your clients do.**

The classic 60/40 mindset will ultimately transform from a "fan favorite" to a client concern, and potentially become the latest in a long line of Wall Street phrases that had their era, before wearing out their welcome. Think about how popular hedge funds were not long ago. Every big investment firm was doing all they could to find a backdoor way to get a slice of the hedge fund pie for their clients.

Before that, it was mortgage-related securities such as CMOs, and so-called "dot-com" stocks with no earnings. And for those old enough to remember, there was "portfolio insurance." The clamor over those strategies abruptly ended, when they were blamed in part for the 1987 stock market crash.

Hearing that brief history of "hot-to-not" investment concepts, financial advisors might be tempted to separate 60/40 portfolios from that dubious group. After all, 60/40 is just an asset mix, right?

Unfortunately, what started as a reasonable concept of putting $3 of every $5 you have in stocks, and the other $2 in bonds, is no longer that simple. Billions of dollars of marketing muscle later, 60/40 has become Wall Street's equivalent of a band-aid. I mean that in two different ways.

First, 60/40 has been a way to prevent advisors from bleeding the asset allocation discussion with clients into something more personal. It has become akin to a verb. "Just 60/40 that portfolio" and focus the rest of your time on financial planning, client service, and pursuing referrals to grow your practice.

The other way in which 60/40 is a proverbial band-aid is that a Band-Aid adhesive bandage is not a unique product. It is simply the dominant brand name in adhesive bandages. Similarly, 60/40 has been so over-marketed by advisors to investors for so long, one could be excused for thinking there is nothing else that works!

Don't Worry, Get Scrappy! Evolve Your Process

Financial advisors should NOT be discouraged or concerned about any of this. That is, unless they are part of the complacency camp mentioned above. I do believe that the next decade brings significant opportunities for wealth creation and protection. For financial advisors, that not only means the potential for revenue growth, but also a massive competitive opportunity.

Since markets are likely to behave differently in the future than they have throughout most of our careers, **financial advisors are now at a precise turning point. They have a big choice to make, one that could have a serious impact on their clients' retirement lifestyle**. As a result, it is a critical choice for the advisor's practice, and thus for their own livelihood.

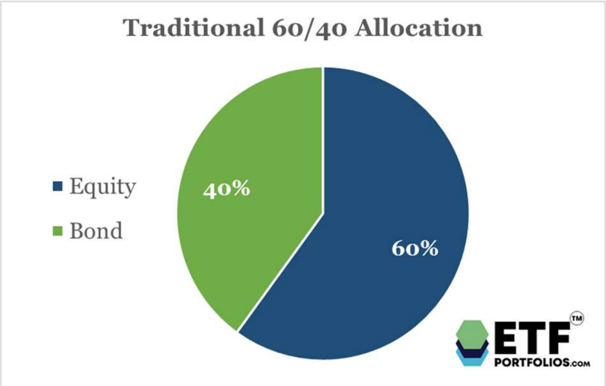
The choice:

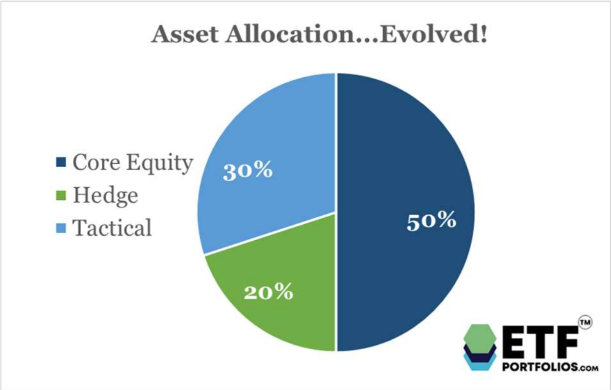
- Pivot gracefully and proactively from the 60/40 concept that used to work, and move toward an approach to asset allocation and diversification that puts them in the driver's seat. In turn, it will position them as an advisor who is evolving with changing markets.

  OR

  They can continue to defend the traditional 60/40 portfolio, when the market cycle, market history and frankly, basic investment math is starting to turn against them. This is analogous to a buggy whip salesman once automobiles became readily available for the first time.

Portfolio construction and allocation in the next 10 years will be about mixing three different but collaborative components. Two of these may be new or somewhat unfamiliar to many financial advisors.





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- A **core equity** portfolio that acknowledges the historic over-valuation of some parts of the global stock market, and how that has influenced the capitalization-weighted indexes that dominate financial advisor-driven portfolios today.
- A **hedge** component that acts as a stabilizer during inevitable market declines, including potential multi-year bear markets. This does not have to be fancy. It merely has to do its job when the time comes, and not drag the portfolio's long-term returns in a way that distances clients from their return objectives.
- The addition of a **tactical** discipline for part of the portfolio. This does not require the advisor to learn how to invest in certain positions to seek results over weeks or months instead of years. But it does mean they should identify the process and people who can. This is perhaps the most critical aspect of navigating markets the next 10 years, without having bonds as the easy fallback strategy in your allocation. After all, bond returns have an excellent chance of producing future returns net of your advisory fee that are either negative or slightly positive.

Clients are somewhat accustomed to seeing their stock portfolio values gyrate up and down. But **when clients start to reckon with longer periods of low or negative bond returns, there is a risk of "capital flight." In other words, you, the advisor, gets that call you don't ever want to get: "I am moving my bond portfolio into bank CDs. If I am going to get low returns, I don't want to have to pay you for the privilege."**

With these realities facing hard-working, well-meaning advisors today, how do they make sure they are doing what clients will expect from the investment part of their advisory service. In a word, "BEYOND."

Going Beyond

Of course, I am not talking about that new plant-based meat, though disrupting tradition is part of it. The advisor needs to go beyond what their peers are doing. Their peers are "the herd," the commodity in our industry. Part of the evolution of any industry is that there reaches a phase of the industry cycle where those who chose not to be part of the scale-driven, corporate, mass-market financial firms have a "fight-or-flight" scenario on their hands.

The investment process you use is quickly becoming one of those areas. **You can differentiate, and make the investment process an asset to your practice (thereby increasing its ultimate sale value). Or, you can just cross your fingers.** Maybe clients will continue to pay somewhere close to what they used to for the same basic investment approach that has now been part of the "war on fees" against our industry.

You may see your greatest value in planning, yet your clients pay you in large part based on assets under management. In an environment where prospective returns on stocks and bonds are likely to be underwhelming versus what they experienced the past decade, defending the past gets old quickly. You don't want to reach the point where clients question whether they have been shoehorned into something that is not really in their best interests, just to make it easier on the people they are paying for professional advice.

Alternatively, **using the next few years to educate them about a philosophy and process that they will see as more relevant to the new realities of their age, stage of life and how markets now work? That seems like a better route.**

For those motivated to go way beyond the cookie-cutter, mass-appeal, buzzword-laden approach that still dominates the portfolios of unsuspecting investors, re-visiting the purpose of 60/40 is a good starting point. It won't take you long to show them clearly that the good times are likely over for that classic mix.

However, **you do not have to totally reinvent what you already have. The adjustments can actually be in a very subtle fashion, over time.** You simply need to re-examine the underlying parts, and run your current methodology through a fresh, contemporary filter, if you will. In the end, you control what changes and what remains the same, and why.

What to do about it

Here is my suggestion on how to replace the 60-40 portfolio. Actually, its more than a suggestion. I have been running portfolios with this philosophy for about 10 years. The key tenets are these, following on the basic descriptions and pie chart shown earlier:

Incorporate Tactical Investing (a.k.a. less owning, more renting): your clients want you to do what works, not what sounds good

The 60% you used to have in stocks can still be in stocks. However, the stock bull market threatening to give way to a bear market. The last 2 bear markets would have cut that 60% allocation of many index-based portfolio in half! So, the way you approach the stock portion has to change. Namely, you need to think less about “owning” your positions, and more about “renting” them.

I do this by designating a “Core” segment of stocks and/or ETFs, depending on the requirements of the advisor we are working with. In most cases, some of their clients will “do Core” with all individual stocks, some with all ETFs, and others with a mix. As noted earlier, **the structure and strategy of building a contemporary portfolio is what you learn. The application of it to your practice is a collaborative effort between you and us.**

That is the “owning,” or Core part. The other main source of growth is a series positions that are moderate in size, held over shorter holding periods, and are approached with a more tactical mindset. Think about a sector, industry, theme or specialty investment you like. Then, instead of forcing yourself to buy and hold it for years, think weeks or months.

After all, more than any time in our careers, the stock market offers pockets of opportunities, more than “buy and hold” situations. Blame the algorithmic traders, the hedge funds, and the index funds that sweep in and out of stocks and sectors based on “asset flow,” technical patterns and a completely unemotional, quantitative factors. That, in turn, has taken what was one a business of “price discovery” and turned it into something else.

You do not have to learn to do what these new market forces do in detail. However, you do need to understand that they exist, acknowledge that, and be your clients’ navigator in a world they heavily influence. Because there are no signs that we’ll go back to the old way any time soon.

Hedging: learn it properly, and it becomes an asset-gathering juggernaut for your practice

Why? Because the stock market is liquid. That means you can hedge it in a variety of ways. Inverse ETFs, low-correlation asset classes, short-term bonds, and options-based strategies are just some of the alternatives.

That word, “alternatives” is used with increasing frequency in our field. There is a clamor to find alternatives to equity and fixed income. Advisors, in an effort to do so, get pitched all varieties of “fancy.” More often, straightforward approaches will do. After all, if you need to sit through a 1-hour presentation from a company to understand how their “alternative thing” works, that means it will be difficult to explain and rationalize for some of your clients.

Remember this about hedging: it is just a one-word description of a key investment tenet: risk management. For all the waxing poetic about risk management in 60/40 portfolios, here is a warning to advisors who still think that exists. If 60% of your portfolio drops by 30-50% (again), but the 40% no longer offers you the cushion of 5-6% interest rates plus additional return from the “flight to quality” trade, the next bear market might just bust the 60/40 bubble in the eyes of the investor. As I have said throughout this paper, your goal should be to get out in front of that train, well before you can see it down the tracks.

Hedging is not mysterious. Furthermore, it is not the exclusive domain of hedge funds. At least, not anymore. The goal of hedging is not simply about having something in the portfolio that “goes up when the market goes down.” If you are willing to learn the range of possibilities that can be injected into your client portfolios, efficiently and systematically, hedging can go further for you and your clients. And, it even has some additional value-add when it comes to portfolio tax-efficiency.

Sure, hedging can reduce loss of portfolio value in market drawdowns. But it also may give you a fighting chance to profit in bear markets. And, while we all hope that we do not have a decade or half-decade of near-zero returns for stocks, bonds, or both, you can imagine what it can do for your practice if you can show clients a potential path to making positive return when their friends and neighbors are re-thinking if they can retire. Is there any more powerful business-builder for an advisor than that?

With hedging, as with tactical and core investing in the market climate of today, the key is to learn the tools of the trade, and how to use them properly. To do so, you need to release from your brain the standard, worn-out 60% stock/ 40% bond mix, and think instead about positioning clients for an ever-changing tradeoff between return potential and risk of major loss. This will vary during different points in the market cycle.

So, instead of sitting there trying to make up clever ways to defend the un-defensible methods of the past, consider disrupting your thinking, separating investment myth from the contemporary realities of our industry and client demands, evolving your investment process and capitalizing on this major opportunity. Your current and future clients will thank you.

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