Seeking Alpha α
Retirement

Financial Planning Just Got A Whole Lot Harder

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by: Alpha Gen Capital

Summary

- Future returns for most assets classes won't be near what they were for the last 10, 20, or 30 years.
- The 60/40 portfolio, for most investors, won't produce the same results that it did for the last half century.
- With bond yields near all-time lows and equity valuations stretched, future returns for both asset classes will be extremely low.
- We detail our solution to the problem in a general sense.
- *This idea was discussed in more depth with members of my private investing community, Yield Hunting: Alt Inc Opps. Get started today »*

Most portfolios today are built on a very simplistic theory and structure. They simply create a 60/40 portfolio (60% stocks, 40% bonds) and in retirement, sell some shares to create a synthetic paycheck. Most do-it-yourselfers and financial advisors do this.

Why?

For one, it has worked. Over the last half century, the 60-40 portfolio has been the best for risk-adjusted returns. Since 1926, the 60-40 portfolio returned 8.7% per year with a max drawdown of 26.6% back in 1931. Over long periods of time, the investor has come out ahead, way ahead. Recessions and bear markets are just bumps in the roads but in the end the client has been ahead in all rolling ten-year periods.

The main draw has been its simplicity.

Nearly three decades ago, a financial planner proposed the "4% Rule" which stated that if a retiree withdrew 4% of their nest egg each year, adjusted for inflation, their money would last at least 30 years. If you earned 8.7% per year in your portfolio, then even in multiple years of bad returns, average years of earning double built a cushion in your plan to avert disaster.

Simplicity tends to rule in the financial industry. Financial advisors love the 60/40 portfolio and the 4% Rule because it allows them to scale. What am I talking about? If everyone has the same or similar portfolios, it becomes very easy to manage dozens, hundreds, or even thousands of clients with minimal staff. Think of the profit margins!

Then add in the 4% Rule for those in distribution mode, and you have two very easy-to-implement strategies (one for portfolio construction and one for de-cumulation) allowing you to focus on getting your next client.

The problem is that times change. Interest rates are rock bottom.Fifteen years ago, we could have simply invested in 10-year Treasuries and achieved a 6% annual return with very little risk. Today, that same instrument earns just 1.8%, a reduction in income of 70%. We are currently between a rock and a hard place in terms of the investing challenge being faced. Financial advisors today basically have no solution to this retirement income problem.

The Death Of The 60/40 Portfolio

Morgan Stanley recently issued a white paper on what they believe will be future returns by asset class. Cutting to the chase, they see US stocks and US treasuries to return just 4.9% and 2.8% per year for the next 10 years, respectively. They see the expected returns for the traditional 60/40 portfolio close to a century low.

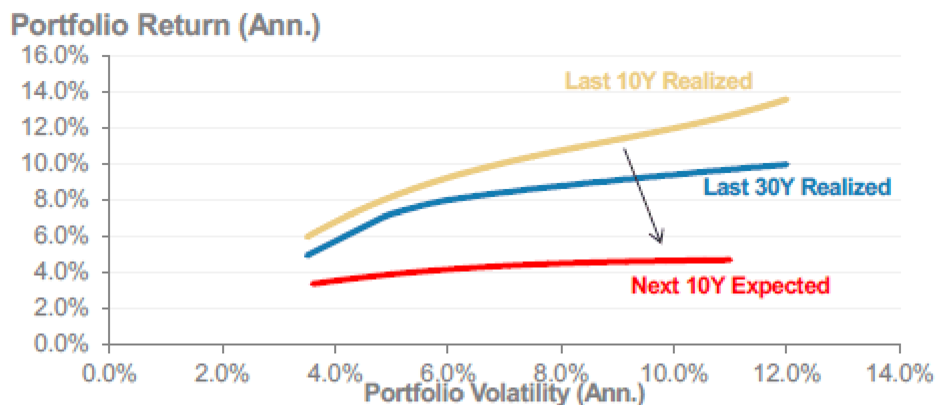
They note:

Many challenges for asset allocators: Low G4 yields pose a problem not only for expected returns, but also for bonds' diversification impact within portfolios. Other assets like credit which are defensive have also become expensive over the last year.

A lower and flatter frontier: We run portfolio optimization exercises using our long-term return forecasts as inputs and construct an efficient frontier for insight into the asset allocation decision. The US frontier is much lower and flatter than history, offering little incentive to go out the risk spectrum.

The chart below shows the change in the annual return of the 60/40 portfolio over the last 10 years, 30 years, and next 10 years expected. The flattening and lowering of those lines means it doesn't pay to add risk. In other words, investors would need to accept a lot more volatility/risk in order to eek out small incremental returns.

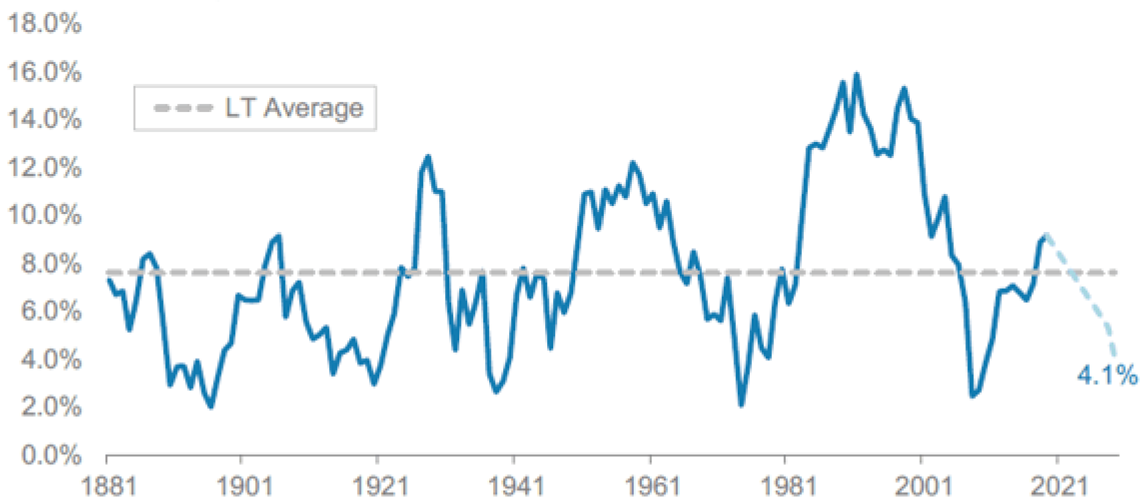
Exhibit 1: USD investors' efficient frontier is low and flat



Source: Morgan Stanley Research forecasts; Note: Based on realized and expected nominal returns, realized correlation and vol of S&P 500, UST 10Y, USD IG, USD HY and cash, with min 0%, max 60% asset weight constraint for fixed income, min 0% max 80% for equities and min 0% max 10% for cash.

The last 10 years has been very strong which may lull some investors to think they are in the clear. But 10 years ago was 2009 and we were in the first inning of a recovery following the worst recession since the 1930s. The 10-year return for most asset classes looks exceptional. The problem is the next 10 years.

Exhibit 4: Traditional 60/40 equity/bond portfolio returns over the next 10Y are expected to be close to a *century* low



Source: NBER, Jordà-Schularick-Taylor Macrohistory Database, Bloomberg, Morgan Stanley Research; Note: Dotted line based on our long-term expected return estimates.

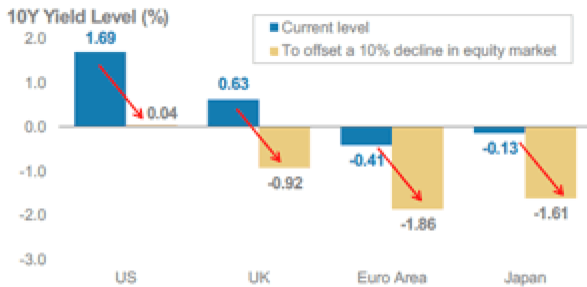
Asset Allocation: The Point of No Returns

So what's the solution?

The old theory was that the bonds were the ballast to your portfolio while the equity the growth driver. However, lower yields and rising volatility in bonds means that the diversifying effect has been reduced. Morgan Stanley noted this in their paper:

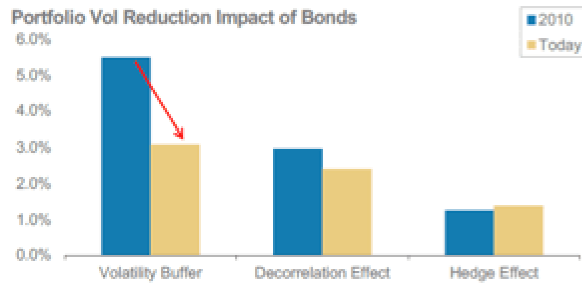
> To offset a 10% decline in stocks in a 60/40 stock/bond portfolio, bond yields have to go (deeper) into negative territory across most G4 regions. 10Y UST yields will need to fall to ~0.04% while 10Y Bund yields will need to fall to almost -2% (Exhibit 10). And that's before accounting for the yield (or the cost) of buying the bond. While a part of this decline can be offset by the carry one gets from still positive-yielding USTs, negative yields in Bunds and JGBs mean that yields have to fall more (to fundamentally damaging levels for their domestic financial system) to offset the negative carry of owning the bond.

Exhibit 10: To offset a 10% decline in stocks in a 60/40 portfolio, bond yields have to go deeper into negative territory across most G4 regions



Source: Bloomberg, Morgan Stanley Research; Note: Using a portfolio of 60% stocks and 40% government bonds in that particular region.

Exhibit 11: Higher bond vol relative to stocks vol today means that bonds provide a lower volatility buffer



Source: Morgan Stanley Research; Note: We use realized vol and correlation of S&P 500 and UST 10Y over the last 10 years in a 60/40 stocks/bond portfolio here.

Financial advisors and do-it-yourselfers have a conundrum on their hands. Do you just accept lower returns or do you change your strategy and possibly accept more risk?

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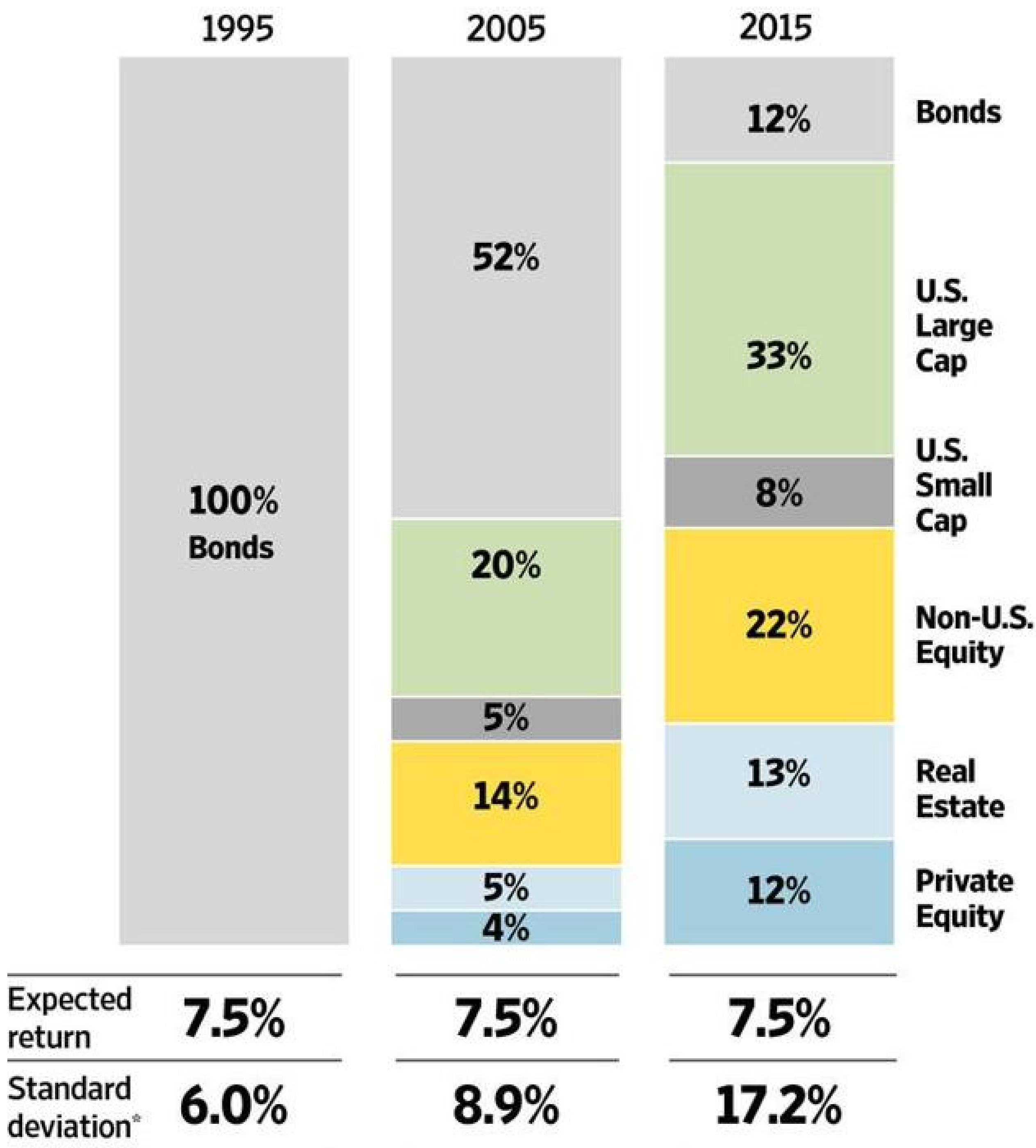
Many investors have done the latter. Used to very strong returns since the early eighties, investors are unwilling to budge and reduce their total returns. So they've just continued to nudge out bonds in favor of higher return (and higher risk) assets to keep the expected return the same. The chart below details that nicely. Though it's in relation to pension funds, it makes a good point about the change in the markets since 1995 and what an investor had to do to achieve the same rate of return.

Starting in 1995, they would have had 100% in bonds to achieve 7.5% annual returns with your risk at 6%. By 2005, half of your bond portfolio was gone in favor of riskier assets to boost the return, with risk up to 8.9%. By 2015, nearly all of the bonds were gone and your risk was nearly triple- all for the same return.

Rolling the Dice

Investors grappling with lower interest rates have to take bigger risks if they want to equal returns of two decades ago.

Estimates of what investors needed to earn 7.5%



*Likely amount by which returns could vary

Source: Callan Associates

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Our Solution

The Yield Hunting paycheck replacement system is meant to solve a lot of that problem. Our goal is to achieve higher rates of return on our bond sleeves to not be forced into those riskier asset classes. Many investors cannot handle another 50% peak-to-trough decline in the equity markets and the devastating effects that has on the longevity of their portfolios.

We think the closed-end fund (NYSEARCA:CEF) wrapper is the best tool to achieve this without taking on more risk. We use bond CEFs that use institutional leverage rates and take advantage of a slope in the yield curve to boost returns. And by buying them opportunistically at anomalous discounts, we can produce a strong total return in excess of just the distribution yield.

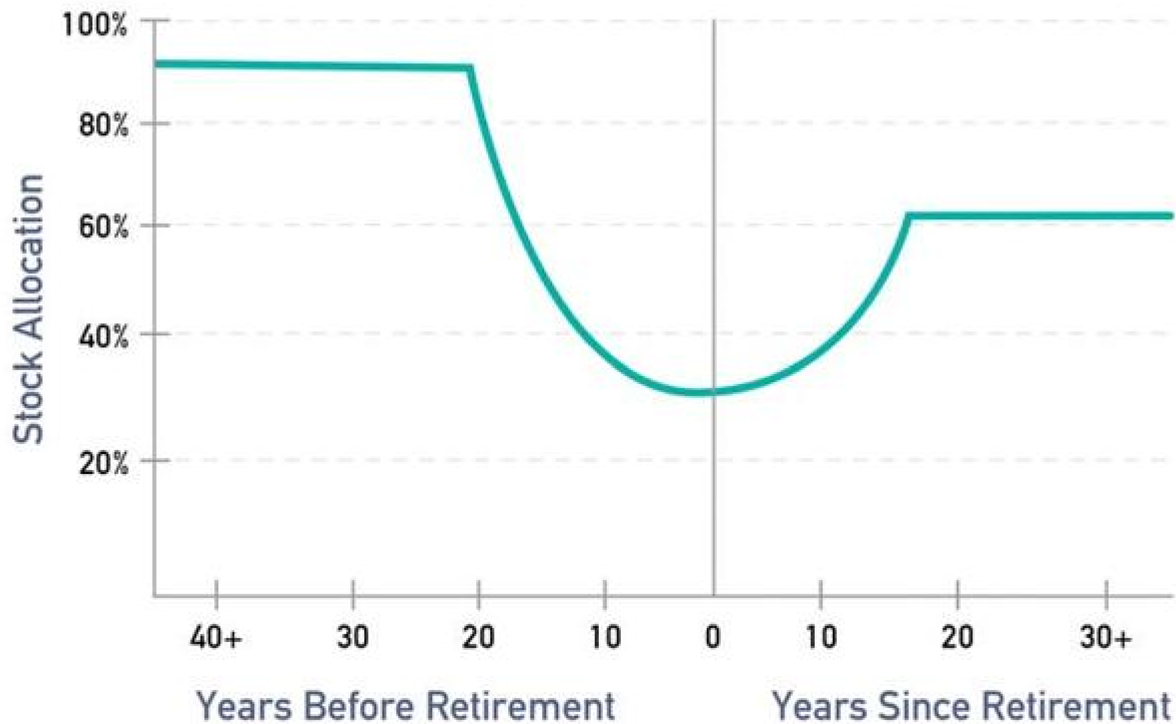
The CEF is probably the most underutilized and unknown "good" tool available to investors. A large part of that is because of the size of the space- with just ~520 funds and $400B in assets. Big fund sponsors and organizations are not going to be going around promoting them because of their small size and because new cash cannot be added to them.

We detailed why investors largely shouldn't be using mutual funds and ETFs for their bond allocation in a recent blog post titled "What is the Cash Flow Problem For Open End Mutual Funds?" We implore readers to take a moment to read it.

What we've detailed to our members is what investors in, at, or near retirement *should* be doing. Effectively, it boils down to liability-driven investing to offset sequence of returns risk and deploying a rising equity glide-path. Huh? What did he just say?

The liability-driven investing strategy means you generate cash flow from the portfolio that pays your bills. It's your paycheck replacement. To do that we use our Core Income Portfolio which yields about 8% today. The rising equity glide path throws traditional investing norms upside down. Most think that you should reduce your equity as you age. However, academic research suggests that you should be highly exposed to equities until about age 50 (assuming a normal retirement age). Then, gradually reduce your equity allocation to a 30/70 portfolio as you approach retirement (age 65 in this example). This helps avoid sequence of returns risk. After age 72, you then start gradually increasing the equity exposure.

The increasing equity exposure at the end is because the time horizon is actually extending as the retirees age. The capital is then being invested for their beneficiaries time lines as they approach death. Obviously those time horizons can be quite long and could tolerate more equity exposure.



The disadvantage of such a system is that it could limit your upside performance potential. By reducing your equity exposure from ~70% to ~30%, you are significantly reducing your capital gain potential. The opportunity cost in doing so can be fairly significant in that equity return volatility is about 15%. In any given year the stock market can be up or down double digits. If you are risk averse, than reducing the roller coaster exposure is likely an advantage.

Conclusion

Forward returns are looking ugly, especially after another good year in the stock and bond market. If you are banking on those returns to continue for the next ten years, you should have a backup plan, just in case that doesn't materialize.

We are offering a **25% off flash sale** for membership in our Yield Hunting marketplace premium service. The service provides the most comprehensive research on closed-end funds. Our Core Portfolio currently yields 8% and is a great compliment to dividend portfolios. We now have four portfolios that members use to construct income spigots that produce monthly cash flows. These portfolios are far less risky than the stock market and can help diversify stock-heavy portfolios.

-**YH Core Income Portfolio**: yield 8.08%

-**YH Flexible Income Portfolio**: yield 7.53%

-**YH Taxable Core Portfolio**: yield 5.24%

-YH Financial Advisor Model

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.