



Retirement News Highlights

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Rethinking the 60/40 Portfolio

Defined benefit and defined contribution plan sponsors need to adjust the composition of the traditional 60/40 portfolio to meet plan and participant goals, experts say.

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THE TRADITIONAL 60/40 PORTFOLIO ALLOCATION may no longer be effective for meeting retirement plan and plan participants' needs, investment professionals have been suggesting.

In a State Street Global Advisors insights report, "Portfolio Construction In and Out of the Core for the Next Decade," Matthew Bartolini, head of SPDR Americas Research, says scrutiny of the portfolio is warranted, "as recent returns have not been as strong as they were in prior decades."

Bartolini notes that the traditional mix of 60% global stocks and 40% aggregate core bonds has produced double-digit returns in four calendar years in the past decade. "However, that is less than the six years of double-digit returns in both the 2000s and 1990s," he says.

"Given our new reality, the standard 60/40 portfolio needs to be tailored—both in the core and outside of it—if return targets are to be met over the next decade," Bartolini concludes in his report.

The new reality includes expectations of lower returns going forward. Bartolini explains that the S&P 500 is trading at 25.99 times earnings, and, historically, a price-to-earnings ratio above 25 has resulted in returns below 5% more than three-quarters (78%) of the times it's appeared from 1956 to 2010. More than half (54%) of times, returns were negative.

"As a result, if 5% is the best probable return, that equates to just a 3% return from the stock allocation of the 60/40 portfolio—meaning bonds need to return 11.25% over a 10-year period just to reach the long-term median 10-year rolling return (7.7%) of the 60/40 portfolio," Bartolini notes.

His report says core aggregate bonds haven't had a 10-year annualized return greater than 11% since the early 1990s, when interest rates were over 9%. "And given today's 1.18% yield and the historical relationship between yields and future returns ... a 11.25% return from bonds is unlikely."

Bartolini says the asset allocation mix between stocks and bonds isn't what needs to change. "Given that the 60/40 portfolio has generated approximately 91% of equities' return but with 64% less volatility, the mix of traditional asset class exposures is valuable," he says. What should change are the elements within stock and bond allocations.

Jamie Lewin, head of BNY Mellon Investor Solutions, says, “Our position has changed a lot in the last 12 months in reaction to assumptions on a forward-looking basis for returns. In addition, there are economic implications of the pandemic on the outlook for growth and economic policies.”

Lewin says BNY Mellon is questioning whether the traditional 60/40 portfolio is the best way for investors to accumulate wealth.

“We’re questioning the fate of fixed income in particular,” he says. “The magic has been that the 40 piece has served investors well. It has provided a hedge to manage volatility of equities, but going forward how effective of a hedge will it be? It has also contributed through its yield to returns in the past, but now we’re not sure it provides the same benefits.”

Lewin says the percentages of the 60/40 mix aren’t what should change, but investors should reconsider the components within the allocations, especially investors at or approaching retirement.

Building a More Effective 60/40 Portfolio

“On the growth side, there’s a case to be made for more internationally diversified than more U.S.-dominant stocks,” Lewin says. “Forward-looking returns are more attractive for developed international and emerging market stocks.”

On the fixed income side, Lewin says yield is important. BNY Mellon is emphasizing the need to push out on the risk spectrum a little to improve yield. “At the margin, this means using credit more than government-backed bonds, as well as bonds issued by other countries,” he says.

Lewin adds that there’s a growing case to be made for looking at real assets, such as commodities and real estate, that have an inflation link. “Passive returns are more correlated with movement changes in inflation,” he explains. “There is rising uncertainty about the outcome of inflation.”

According to the State Street Global Advisors report, there are four key methods to consider to build a more effective 60/40 portfolio:

- Target active management in areas where there is a strong track record of above-benchmark performance;
- Expand market coverage within the MSCI All Country World Index (ACWI) and Bloomberg Barclays Aggregate Bond Index (Agg) to seek out underrepresented areas or create a different risk/return profile;
- Structure portfolios based on factors that have historically earned a premium, while having patience and trusting the process; and
- Increase exposure to noncorrelated strategies to help navigate market uncertainty and provide a differentiated return path than the one just stocks and bonds would provide.

Bartolini warns that while these four measures might help in terms of return generation, they also will likely impact fees and taxes. “Therefore, a broad representation of traditional beta exposures is needed,” the report says.

Bartolini’s analysis reveals that it would be best not to implement active strategies for U.S. equities. His report suggests: “Use active mandates in overseas equity exposures, while allocating to the U.S. via

indexed-based products. For fixed income, pair active core with a traditional indexed exposure to potentially increase returns while managing fees. If using core-plus, ensure that it is not just surrounded by pure credit instruments, as diversification may become an issue. Meanwhile, consider active senior loan strategies as a potential path to generating income that may be able to maneuver liquidity and trading challenges in an inefficient market in a way that an indexed exposure cannot.”

Once some of the 60/40 portfolio is reallocated to active strategies, indexed exposures can be further refined, Bartolini says. “Ensure proper market-cap coverage by expanding into small-cap overseas as well as into thematic strategies that contain innovative firms not well represented in the core while restructuring core bonds in a low-cost manner, with more precise control over yield and duration.”

The report also suggests considering multifactor-based portfolios to replace certain core equity assets, as well as using sector rotation portfolios within a U.S. allocation. “Seeking out noncorrelated strategies may be one way to bolster a portfolio’s defense,” the report says, suggesting investors consider gold, commodities and other real assets, or options-based or managed futures mandates. “Think about paring back some of both the stock and bond allocations in the 60/40 portfolio and replacing them with an alternative strategy as a potential source of diversification—with the weight depending on investment-specific constraints and criteria,” the report says.

The 60/40 Mix for DC Plans

Susan Czochara, head of retirement solutions, Northern Trust Asset Management (NTAM), notes that market volatility has increased in the past decade, a trend that is expected to continue. In addition, there have been lower equity returns overall, and return expectations are lower.

The 60/40, or balanced, portfolio is achieved differently by participants in defined contribution (DC) retirement plans than by institutional investors, such as defined benefit (DB) plans, she notes. The balanced portfolio is intended to provide returns to help participants accumulate savings for retirement, while at the same time mitigating equity risk and preserving wealth.

With lower expected returns and increased volatility, participants have two options for achieving their retirement goals: saving more or taking on more risk in equities to try to get higher returns, Czochara says. “It’s been a challenge to get them to save more, so we believe they’ll take on more risk,” she says.

A NTAM white paper, “Equity Designed With Retirement in Mind,” written by Paul Kubasiak, retirement strategist, NTAM Retirement Solutions, says NTAM expects U.S. stock returns to average 4.7% annually over the next five years. This is significantly lower than the 10.8% average growth of the past five years.

The report notes that taking on more risk in equities is unattractive to retirement savers, especially those nearing retirement. It suggests one way to mitigate risk and market volatility is through the use of a quality low volatility (QLV) portfolio. Low volatility stocks are shares of companies that tend to experience a narrower range of returns versus the market as a whole, such as the Russell 1000 Index, a large-cap stock index, the report explains.

Czochara says it is important for investors to be compensated for the risk they take, and low volatility stocks do this. “[Low volatility stocks] as an equity strategy narrow the range of outcomes, offer consistency in returns and help increase participants’ confidence,” she says.

The NTAM report shows that when comparing two 60/40 portfolios, one using the Northern Trust Quality Low Volatility Index and the other using the Russell 1000 Index for the equity portion of the

portfolio, accumulations are greater for young and mid-career investors. For retirees in the decumulation phase, the portfolio with the Quality Low Volatility Index allocation increased in value through age 85, even though the participant is withdrawing retirement income each year. The portfolio with the Russell 1000 Index equity allocation decreased in value.

Czochara says DC plan sponsors can revisit their target-date funds (TDFs) and white-labeled funds to incorporate more low volatility stocks. “Thinking as a plan sponsor about helping participants accumulate savings and helping retirees spend down their savings, this strategy helps with both,” she says. “It helps retirees have peace of mind and achieve their goals.”

During times of increased market volatility, it is especially important for participants close to retirement to stay committed to their investment strategies, Czochara says. She adds that Northern Trust found that as volatility increased last year, participants close to retirement were more likely to sell out of the equity in their portfolios than younger or mid-career participants.

For DC plans, investment choices available to participants who want to build their own portfolios should be expanded to include private credit and real assets to benefit from more yield and inflation protection, as well as to more globally diversified equity choices, Lewin says.

For plan sponsors that are using a balanced fund as their DC plan’s qualified default investment alternative (QDIA), Lewin says it is important to preserve the cost effectiveness of balanced funds, so passive strategies are still important; however, “a bit more dynamism” can be considered. “In the next decade, those managing balanced portfolios will take an active view of selection for both equity and fixed income,” he says. “Active selection and choice, not necessarily active investing, will separate the winners from the losers and will help savers continue to accumulate.”

For TDFs, Lewin says he doesn’t think the emphasis on equity for young investor glide paths needs to change. However, as participants move along in age, particularly when there is an increasing role of fixed income to hedge against risk and protect wealth, there needs to be a consideration in addition to age, he says. “We think there needs to be one more input: How has the investor done? That is, has the participant accumulated above or below what is expected to adequately meet his needs in retirement? If the participant has under accumulated and is just adding fixed income because he is getting closer to retirement age, that may compound the problem,” Lewin says. “We’re projecting 0% to 2% returns for fixed income at best, so now may not be the best time to increase the fixed income allocation.

“The underlying market conditions that have prevailed in the past 30 years have made the traditional 60/40 portfolio an effective strategy, but we don’t think it will continue in the next decade,” Lewin says.

[Back to top](#)