Perhaps an Equity/Bonds 60/40 Strategy is not the Best for Retirement Income?

The 60/40 Cornerstone of Investing

The universal theory of an investment strategy comprised of approximately 60% allocation to 'risk' assets, such as equities, and 40% to 'safe' assets, typically government bonds, is one of these 'standard' ways of doing things, and here's the logic. The equities will drive returns most of the time, but exposure to government bonds will reduce overall portfolio volatility and cushion losses in times of turbulence.

It relies on the fact that, historically, equity returns and government bonds have been negatively correlated. In times of stock market stresses like recessions, investors can rely on the safe consistent income offered by government bonds and, a more general move to bonds drives up prices (and hence drives down yields), generating a positive return which offsets losses in equity investments.

Bonds = Crumple Zones for Stock Market Crashes

During the bursting of the dotcom bubble, starting in 2000, the FTSE 100 index fell by 50.3% between 30th December 1999 (at 6930.4) and 1st March 2003 (3,491.6).

At the same time, the FTSE Actuaries UK Gilts All Stocks index returned +24.6%.

This meant that an investor only in UK equities would have lost half of their money, but an investor with a 60/40 portfolio would have lost less than 20%. Subsequently, the 100% equity-investor would then need 100% return, just to get back to where they started, but the investor with the 60/40 portfolio would only need to make 25%.

The same thing happened in 2008, during the global financial crisis. The FTSE 100 index fell by 44% peak-to-trough between 15th June 2007 and 3rd March 2009. Over the same period, the FTSE Actuaries UK Gilts All Stocks index gained +19.5% as 10-year gilt yields fell from 5.5% to 3.6%. An investor with a 60/40 portfolio therefore had substantially smaller losses at -18.6%.

The amounts by which gilt yields declined, 1.4% in the dotcom bust and 1.9% in the global financial crisis, are important, along with the fact that they fell from a starting point of 5.5% on both occasions.

Something Changed

The frailty of the global economic recovery ever since 2009 has been used to justify almost continuous quantitative easing and near zero interest rates.

Bond yields have therefore never returned to their previous levels, and in fact, have continued to decline almost relentlessly, with the FTSE Actuaries UK Gilts All Stocks index currently showing year-to-date return of minus 6.09% as I write (4th November 2021).

As Covid 19 became a pandemic in early 2020, UK equities suffered their biggest slump since the financial crisis. Between 21st. February 2020 and 20th March 2020, the FTSE 100 index plunged by 32%, and dividends essentially dried up too.

Over the same period, the FTSE Actuaries UK Gilts All Stocks index was up by only 5%.

A 40% allocation to government bonds did little to offset losses from a 60% equity allocation, unlike in previous bear markets (and hampered the subsequent stock market rally's effect on portfolios). This is because 10-year gilt yields declined from 0.7% to 0.4% during the period, a fall of only 0.3%.

To offer the same protection as they did in 2000, and 2008, gilt yields would have to have fallen much further and be well into the negative.

While negative bond yields have become commonplace in Germany, France and the Netherlands, the UK and US are so far, hanging on to positive yields.

Using bonds to act as a cushion against losses in equity markets therefore depends on the absolute level of yields and how much they can fall. Although 10-year gilt yields have risen from the lows of less than 0.2% seen a year or so ago and are now at about 1.07%, they really do not seem to offer much as a defensive tool at these low yields.

If this is the case, why do we insist on a significant proportion of 'balanced portfolios' in bonds. Recent bond returns seem incapable of offsetting the impact short-term equity market falls, and impose drag on equity performance over the longer term too.

Income in Retirement

What about investors relying on consistent performance for income, in retirement, for example?

Well, Chancery Lane Income Planners, based in London, recently found that equity-based investments are often the safest income solution in the longer term.

Based on Morningstar data, their study shows that high equity allocations reduce the risk of running out of funds. This means that equity is the least risky asset for long-term income. Chancery Lane wrote in their white paper: ‘When investing in drawdown income, there are certainly risks posed by the equity portion of the portfolio, but there is the risk that the equity of the portfolio is too low and not too high.’

In the study, they compared a 100% equity portfolio, a 100% fixed income portfolio, and a traditional 60-40 fund mix.

Next, they compared how the capital position of each portfolio changed over 10 and 20 years. 100% equity investment outperformed the other two almost every year. As a result, Chancery Lane is calling on the industry to reassess its views on equity-related risks.

The White Paper States:

“Risk is usually defined as volatility, which is the amount by which an asset moves in relation to its own historical value or other assets. We believe it is wrong, misunderstood and misleading."

"Volatility is a valid measure of risk, but risk is not one of fluctuations, but the risk of adverse behavior. Investors are worried when they see the value of their savings fluctuate, but even those who hate risk prefer some confusion over the possibility that they may not have enough money to live in retirement. maybe."

"Bonds, on the other hand, no longer provide low-risk, safe income, according to research."

The Chancery Lane White Paper added the following:

"Both bond income and inflation have fluctuated, but the latter has generally remained stubbornly high in recent years, and as a result, bond income has not been maintained for all three periods investigated."

Therefore, Chancery Lane rejects modern portfolio theory (MPT), which seeks to offset investment risk by diversifying assets.

In a standard MPT portfolio, profits (and therefore risks) come from equities, but containment (and traditionally the main source of income) is provided by bonds.

Chancery Lane believes that the purpose of MPT is not the growth of capital, but the credibility of income. Therefore, generating retirement income using bonds is an inappropriate strategy.

As a result, Chancery Lane CEO Doug Brody wrote to the UK's Financial Conduct Authority to encourage regulators to distinguish between the definitions of income risk and capital risk and to revise the rulebook.

'There is no correlation between stock market risk on capital and dividend stability. We need to not only communicate total return payments, but also show Joe Public what our income will be'.

'Telling an 80-year-old who isn't working that he needs to sit in a bond and suffer the consequences of low-yielding assets is illogical and useless, if there are other solutions'.

I am not suggesting the 60/40 balanced investment strategy is obsolete. It has been the mainstay of balanced portfolio building for and extremely long time, but it seems to no longer be the reliable cornerstone it was once thought to be.

Maybe in these more modern times, we need to consider dividend stocks, absolute return funds, perhaps even precious metals in lieu of bonds?