

# INVESTMENTS & WEALTH MONITOR

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## Investing in a 'Post-60/40' Market Regime

*By Scott Welch, CIMA®, and Joseph Tenaglia, CFA®*



**INVESTMENTS & WEALTH INSTITUTE®**

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**M**ost advisors and investors recognize that “this time it’s different” is one of the most dangerous expressions in all of wealth management. Investment trends and market regimes tend to cycle and mean-revert, and extrapolating from now to forever is a fool’s game.

That said, advisors need to pay attention to market environments, changing demographics, and evolving investor needs, and they need to build and manage investment portfolios accordingly.

We have identified three current trends within asset and wealth management that are demanding your attention: a “lower for longer” interest-rate environment, increased longevity among clients, and the growing need for buying stocks for the long term. Taken together, we think these trends signal that we’re now investing in a “post-60/40” market regime.

## CURRENT TRENDS IN ASSET AND WEALTH MANAGEMENT LOWER FOR LONGER

A significant school of thought<sup>1</sup> holds that we are in for a “lower for longer” interest-rate environment, due to many contributing factors. The most obvious (but probably not the most important) reason is the zero interest-rate policy regimes of most global central banks. As we write this, more than \$10 trillion is tied up in negative-yielding sovereign and corporate debt, with little to no significant upward pressure on rates. Given sluggish global growth, low to moderate inflation, and exploding national deficits, the underlying pressure on rates is downward, not up.

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Combine this with an aging demographic in the developed markets, which is accompanied by an insatiable demand for income and hedge assets, and there simply is no identifiable catalyst for increasing rates. Rates may grind higher if the global economy improves, but, for example, a normalized 10-year U.S. Treasury rate of 4–5 percent is hard to imagine at any point in the next several years. Rates of 2–3 percent are more likely, with rates even lower in Europe and Japan.

Bonds, of course, are supposed to be the safe part of a portfolio, acting as a source of income and as a hedge to equity risk. But that may not be true going forward: (1) we expect coupon rates to remain fairly muted, and if rates do begin to grind higher, the value of the bonds will fall; and (2) if inflation picks up, investors may end up actually generating a negative real return on their bond portfolios. In other words, it may not be safe to assume that bonds will, in fact, remain the safe part of the portfolio.

The investment implications, if this assessment is correct, are fairly profound. Specifically, it means that moderate-risk investors—the typical 60/40 investors—will have difficulty

generating sufficient yield from their income portfolios to maintain a desired lifestyle. Although investors could seek to increase the income out of bond portfolios by taking on increased duration or credit risk, this may not be appropriate if one of the purposes of the bond allocation is to mitigate the risk of equity exposure.

To put it bluntly, for many investors a 60/40 portfolio may not get the job done, now or in the long term. We may now be in a post-60/40 world.

## LONGEVITY IS THE NEW BLACK

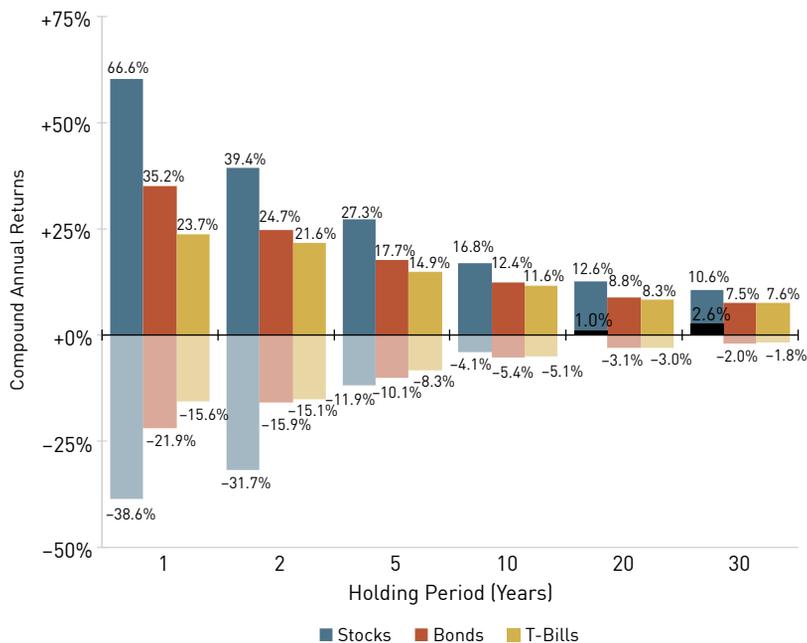
Research from organizations such as the MIT AgeLab<sup>2</sup> indicates that (1) we are living longer and longevity will continue to grow with advances in health science and technology, and therefore (2) our wealth and financial plans need to evolve. Specifically, the income-focused retirement portfolios many investors traditionally have relied upon may not be appropriate for the new retiree demographics in the post-60/40 world.

This requires us to redefine risk as it pertains to long-term investment portfolios. We have trained ourselves (and our clients) to define risk as the standard deviation of portfolio returns—a fancy way of saying “short-term volatility.”

Figure 1

## STOCKS FOR THE LONG RUN

Maximum and Minimum Real Holding Period Returns, 1802–2019



However, if investors are living longer (and they are), then we need to introduce another definition of risk: the risk of outliving your money. In other words, we need to sensitize investors to the risk of not having enough money to live an increasingly long life or to fulfill legacy objectives. This is also known as longevity risk or long-term terminal value shortfall risk.

### STOCKS FOR THE LONG RUN

The risk of outliving your money is, of course, not a new idea. Jeremy Siegel, of The Wharton School at the University of Pennsylvania, has been preaching this gospel for decades.<sup>3</sup> The basic premise is easy to understand: Stocks may be volatile in the short term, but over full market cycles and through time, equities dramatically outperform all other major asset classes, and with lower long-term volatility (see figure 1).

Now let us examine the typical investor. Almost all investors are concerned with three primary investment objectives (in differing levels of importance, depending on individual priorities):

1. Generating sufficient income to maintain or improve current lifestyle
2. Not outliving their money or not having enough money at death to fulfill legacy objectives (inheritance, philanthropy, or some combination)
3. Minimizing fees and taxes paid along the way

So, in this post-60/40 investment landscape, how should we be rethinking long-term portfolio construction in order to meet these universal investor objectives? We think there is a way:

**Build portfolios that are allocated more heavily to equities to mitigate longevity shortfall risk.** Let's consider, for example, a "75/25" allocation, where 75 percent of the portfolio is allocated to global equities and 25 percent is allocated to bond and income strategies.

**Within the equity allocation, allocate more heavily to dividend-, income-, and yield-oriented equities.** This accomplishes two goals: (1) Equities currently deliver higher yield than most

bonds (a relative historical anomaly, but we believe it will continue), so a yield-focused equity portfolio may have better potential to deliver the income required. (2) These equities tend to be defensive or lower beta in nature, so despite the higher allocation to equities, the equity-heavy model has only modestly higher short-term volatility risk and comparable risk-adjusted returns.<sup>4</sup>

**Within the income allocation, allocate to high-quality, income-focused strategies.** Because the income allocation is lower than in the traditional 60/40 model, this is not the place to take excessive risk. The 25-percent allocation should generate additional income while acting as an appropriate hedge to the equity exposures.

**Use an all exchange-traded fund portfolio structure.** This is not required, but it optimizes both the cost and the tax-efficiency of the portfolio.

### AN EXAMPLE

How do sample 60/40 and 75/25 portfolios compare? Let's begin with the following assumptions:

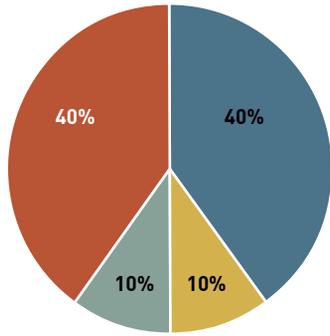
- Initial investment amount: \$1 million
- Fixed annual withdrawal amount: \$50,000
- Simulation period: 30 years
- Assumed annual inflation: 2.00%
- Assumed risk-free rate: 1.90% (the current 10-year U.S. Treasury rate as we write this)

We constructed three portfolios: (1) a basic 60/40 portfolio, (2) a basic 75/25 portfolio, and (3) a 75/25 portfolio with size and value tilts, which is more reflective of how we actually would construct this portfolio. These are summarized in figures 2, 3, and 4.

Using publicly available market indexes<sup>5</sup> and publicly available capital market assumptions for projected risk and return characteristics,<sup>6</sup> we ran optimization and Monte Carlo simulation analysis<sup>7</sup> comparing the portfolios.

Figure 2

60/40 BASIC PORTFOLIO

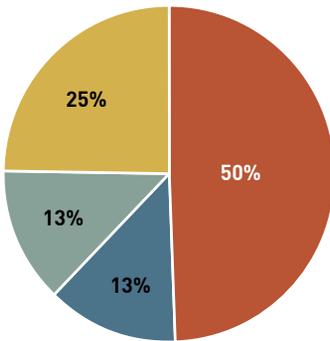


■ U.S. Large Cap ■ International Developed ex-U.S. Market  
■ Emerging Markets ■ Total U.S. Bond Market

Portfolio				
Asset Class	Allocation	CAGR	Expected Annual Return	Annualized Volatility
U.S. Large Cap	40.00%	5.65%	6.60%	14.30%
Intl Developed ex-U.S. Market	10.00%	7.22%	8.50%	16.80%
Emerging Markets	10.00%	9.25%	11.20%	21.10%
Total U.S. Bond Market	40.00%	3.14%	3.20%	3.40%

Figure 3

75/25 BASIC PORTFOLIO

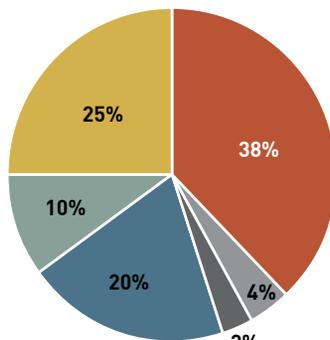


■ U.S. Large Cap ■ International Developed Ex-U.S. Market  
■ Emerging Markets ■ Total U.S. Bond Market

Portfolio				
Asset Class	Allocation	CAGR	Expected Annual Return	Annualized Volatility
U.S. Large Cap	50.00%	5.65%	6.60%	14.30%
Intl Developed ex-U.S. Market	12.50%	7.22%	8.50%	16.80%
Emerging Markets	12.50%	9.25%	11.20%	21.10%
Total U.S. Bond Market	25.00%	3.14%	3.20%	3.40%

Figure 4

75/25 FACTOR TILTED PORTFOLIO



■ U.S. Large Cap Value ■ U.S. Mid Cap  
■ U.S. Small Cap ■ International Developed Ex-U.S. Market  
■ Emerging Markets ■ Total U.S. Bond Market

Portfolio				
Asset Class	Allocation	CAGR	Expected Annual Return	Annualized Volatility
U.S. Large Cap Value	37.50%	7.19%	8.30%	15.60%
U.S. Mid Cap	4.50%	5.88%	7.10%	16.30%
U.S. Small Cap	3.00%	6.47%	8.10%	19.00%
Intl Developed ex-U.S. Market	20.25%	7.22%	8.50%	16.80%
Emerging Markets	9.75%	9.25%	11.20%	21.10%
Total U.S. Bond Market	25.00%	3.14%	3.20%	3.40%

The analysis, summarized in table 1, suggests that the 75/25 portfolios have the following characteristics relative to a traditional 60/40 portfolio:

- Higher expected returns and modestly higher short-term volatility,

resulting in comparable risk-adjusted returns

- Higher current income or yield for lifestyle maintenance; that is, an improved ability to meet the \$50,000 annual withdrawal rate and avoid dipping into principal

- Superior long-term probability of not outliving your money or being able to fund legacy objectives

The Monte Carlo simulation analysis also suggests that the 75/25 portfolios exhibit a much better longevity risk

profile, which is not surprising given the heavier allocation to equities. Figure 5 illustrates the probability of still having money in the portfolio at the end of the 30-year period, and figure 6 shows the expected dollar value of the portfolio at the 50-percent or average expected outcome of the simulation analysis.

Note that the tilted 75/25 portfolio delivers even better performance than the basic 75/25 portfolio.

Note also that projections are just that—projections. Actual results could turn out dramatically different. In addition, we used index-level assumptions and

inputs, and the use of active management could change the outcomes dramatically, for better or worse.

### CONCLUSION

As we enter a market regime with lower expected interest rates and longer expected lifetimes for years to come, we believe advisors and clients need to rethink what a moderate portfolio needs to look like in order to accomplish client goals.

We never subscribe to the phrase, “It’s different this time.” But we do believe in paying attention and responding to investor objectives and current market conditions.

The prototypical 60/40 portfolio will not go the way of the dinosaurs. It will remain appropriate for many investors, especially those who can’t tolerate the higher expected short-term volatility of the 75/25 portfolio.

But for investors who can accept higher short-term volatility in exchange for a better longevity profile and who need more income than a low-rate environment can deliver, the yield-focused equity-oriented longevity portfolio deserves a hard look. ●

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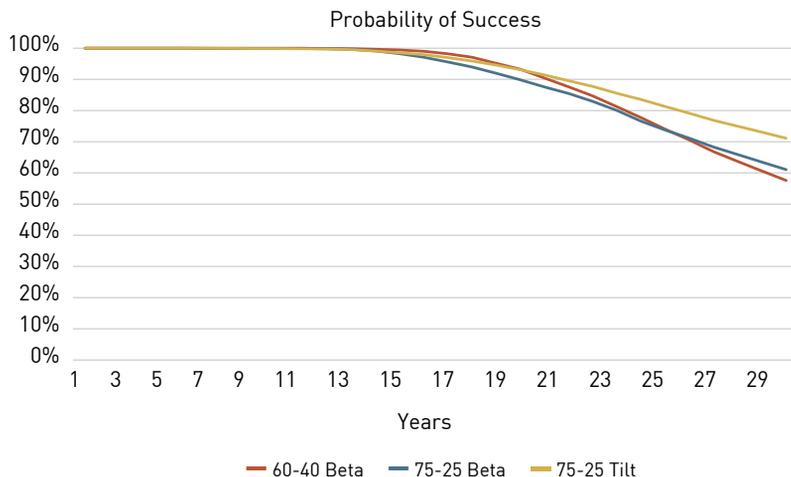
### ENDNOTES

- See, for example:
  - The Advisor Perspectives interview with Jeremy Siegel (November 25, 2019), <https://www.advisorperspectives.com/articles/2019/11/25/jeremy-siegel-the-market-is-fairly-valued-but-there-are-two-big-risks>.

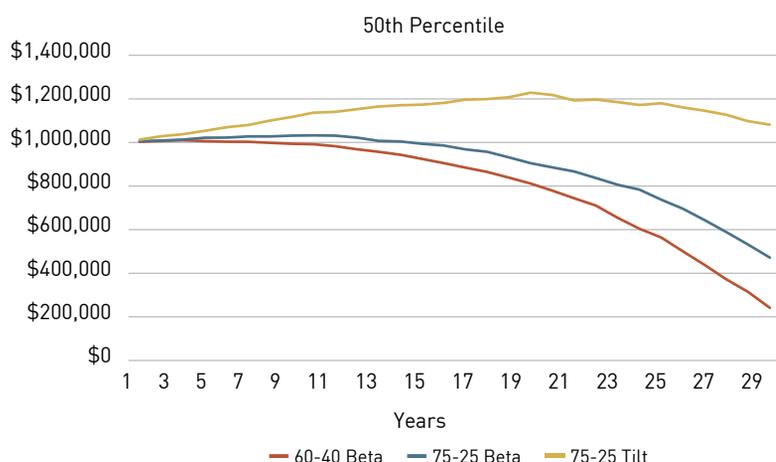
**Table 1**  
**COMPARING THE MODEL PORTFOLIO PERFORMANCES**

	60/40 Beta	75/25 Beta	75/25 Tilt
Expected Return	5.86%	6.54%	7.26%
Standard Deviation	8.83%	11.02%	11.53%
Sharpe Ratio	0.45	0.42	0.46

**Figure 5**  
**THE PROBABILITY OF SUCCESS—NOT OUTLIVING YOUR MONEY**



**Figure 6**  
**THE 50% OUTCOME FOR AMOUNT OF MONEY REMAINING AFTER 30 YEARS**



- Federal Reserve Vice Chairman Richard Clarida's speech to The Bank of International Settlements in November 2019, "Monetary Policy, Price Stability, and Equilibrium Bond Yields: Success and Consequences," <https://www.federalreserve.gov/newsevents/speech/clarida20191112a.htm>.
  - "Lower for Longer Interest Rates: Causes, Consequences, and Credit Implications," Moody's, <https://www.moodys.com/newsandevents/topics/Lower-for-longer-Interest-Rates-007053> (registration required).
  - "'Lower For Longer': Interest Rates Remain Low," Munich Re, <https://www.munichre.com/topics-online/en/economy/insurance-markets/lower-for-longer-interest-rates-remain-low.html>.
  - "The Hoisington Quarterly Review & Outlook," 4th Quarter 2019, <https://hoisingtonmgt.com/pdf/HIM2019Q4NP.pdf>.
2. See, for example, Coughlin (2017).
  3. See, for example, Siegel (2014).
  4. Analysis was conducted using index-level risk and return inputs, and is based on historical index performances. Actual investor experience going forward may be different. Past performance is not indicative of future performance, and projected performance is not indicative of actual performance.
  5. The market indexes are:
    - For U.S. Stock Market: AQR US MKT Factor Returns 1972–1992 (AQR Data Sets); Vanguard Total Stock Market Index Fund (VTSMX) 1993+

- For International ex-U.S. Developed Markets (EAFE): AQR Global ex US MKT Factor (AQR Data Sets) 1986–1999; Vanguard Developed Markets Index Fund (VTMGX) 2000+, <https://www.aqr.com/Insights/Datasets>
  - For Emerging Markets: Vanguard Emerging Markets Stock Index Fund (VEIEX) 1995+
  - For Total Bond Market: Vanguard Total Bond Market Index Fund (VBMFX) 1987+
6. We used the 2020 capital market assumptions from JP Morgan Asset Management, available at <https://am.jpmorgan.com/us/en/asset-management/gim/adv/ltcma>.
  7. We used the publicly available analytical tools available at PortfolioVisualizer.com. Please see the disclaimers at the end of the article for important information about the use of Monte Carlo simulation.

## REFERENCES

- Coughlin, Joseph F. 2017. *The Longevity Economy: Unlocking the World's Fastest-Growing, Most Misunderstood Market*. New York: PublicAffairs,
- Siegel, Jeremy J. 2014. *Stocks for the Long Run: The Definitive Guide to Financial Market Returns & Long-Term Investment Strategies* (5th edition). New York: McGraw-Hill Education Publishing.

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- Investing involves risk, including possible loss of principal. The value of the investments and the income derived from them may fluctuate over time.
- The projections and other information generated by the Monte Carlo simulation tool regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Results may vary with each use and over time, and hypothetical returns do not reflect trading costs, transaction fees, or taxes.
- A Monte Carlo simulation is a mathematical technique designed to provide a range of possible outcomes to determine the probability of a particular result or set of results. The simulation provides a distribution of possible results, which are used to derive the probability of different outcomes.
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- The results do not constitute investment advice or recommendation, are provided solely for informational purposes, and are not an offer to buy or sell any securities.
- The results are based on the total return of assets and assume that all received dividends and distributions are reinvested.
- The probability of success is based on the number of simulations the portfolio survives with a positive end balance.
- Maximum drawdown statistics are calculated from simulated monthly balances.
- Safe withdrawal rate is the percentage of the original portfolio balance that can be withdrawn at the end of each year with inflation adjustment without the portfolio running out of money.
- Perpetual withdrawal rate is the percentage of portfolio balance that can be withdrawn at the end of each year while retaining the inflation adjusted portfolio balance.
- The results assume annual rebalancing of portfolio assets at the end of each year.
- Contributions and withdrawals are done at the end of each specified time period.



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