Is the 60/40 Portfolio Dead? - Transcript

Tom Mullooly: Welcome to the Mullooly Asset Management Podcast. This is episode number 279. Thanks for tuning in. I am one of your cohosts, Tom Mullooly, and with me today...

Brendan M.: I'm chuckling, I'm Brendan Mullooly, because last Saturday night I guess there was a skit on SNL about father son podcasts and it was really funny because we actually do that. And so you just had me chuckling thing because that's basically how they-

Tom Mullooly: That is exactly how it began. Yeah.

Brendan M.: Yeah, the skit, so pretty good.

Tom Mullooly: We just don't get along. We don't see eye to eye. We don't communicate anymore.

Brendan M.: Yeah.

Tom Mullooly: It was pretty good.

Brendan M.: If you haven't seen that, recommend checking it out. It was a pretty funny skit.

Tom Mullooly: Maybe we can link to it in the show notes because I think it's already been on YouTube.

Brendan M.: Yeah, I think they throw most of their stuff on there these days.

Tom Mullooly: Bank of America, what would we do without them? Bank of America declared we've seen the end of the standard 60/40 portfolio. So before we get into our opinions on that, you want to just walk the listeners through what we mean when we say 60/40.

Brendan M.: Yeah, 60% stocks, 40% bonds. Usually whoever is referring to it is probably also referring to a US only portfolio. A lot of different takes, not everybody means the same thing when they're talking about it, but I think most people are referring to a portfolio of 60% US stocks and 40% US bonds.

Tom Mullooly: How did the industry arrive at these kinds of mixes?

Brendan M.: I mean it's a rough mix of an asset class being stocks that you look to get growth from, so you have a little more in there and a little bit less in bonds, which you're hoping are going to provide stability and a little bit of income along the way. Not really sure how it became the default. And I have some thoughts on why there shouldn't ever be a default at all. But I wanted to start off by asking how long have we been saying that 60/40 is dead for? You can attest to it as more than me. I went to a conference in 2015 and listen to a panel discussion about why 60/40 was dead. Four years ago.

Tom Mullooly: I'm guessing they said it was dead because interest rates are going to move up and that's going to crush bonds.

Brendan M.: Right. And the rates are now exactly where they were when we were having this discussion, I wasn't in it, but I was listening to this discussion four years ago and rates were exactly where they are today, more or less.

Tom Mullooly: So I can tell you that I've heard that the end of the 60/40 portfolio was coming for, I'm just kind of like counting in my head, but it's over 20 years and it might be 25.

Brendan M.: Right. I'm just not sure how seriously we should ever take concepts like this. Like, come on, we've been saying that this portfolio is no good now for a really long time. I have an example. You've been hearing it for a long time too. So why is this the default anyway? I mean I gave a brief take on that, but like why?

Tom Mullooly: I think some of this goes back to Markowitz. And I can tell you that there's plenty of pension funds out there and institutional portfolios that religiously stick to a 60/40 asset allocation.

Brendan M.: For no good reason.

Tom Mullooly: Just because everyone else is doing it.

Brendan M.: Yeah, I think that the whole concept of anything being a default portfolio, whatever mix of stocks and bonds or whatever other assets you want to throw into it is ludicrous. Because I think the whole process of determining what an asset allocation should look like should be based on a host of different things. Like, what you need the money for and what you're comfortable with and things like that that matter on an individual basis or an organizational basis. Not necessarily that everybody just does it this way, so `we're going to do it too.

Tom Mullooly: Right. But yet, you're normally, if you're an institutional portfolio manager, asset allocator, pension fund manager, you're measured against your peers. So if everyone else is doing it, you're going to have an opportunity to shine when you're the exception and you're right, and you're probably going to get fired if you take a risk and venture outside what everyone else is doing and you underperform.

Brendan M.: Yeah, so career risk there, which I think is something that should just be discussed rather than blindly followed for no reason. I don't have anything wrong with the idea of a balanced portfolio, but to say that it needs to be 60/40 or any other predetermined number without knowing what this money is supposed to accomplish is kind of foolish.

The primary reason that Bank of America's analysts in this report recently are saying that 60/40 is dead is because they see more risk and volatility and bad returns ahead for the bond side of the portfolio and then they had some suggestions on what people might do as a result of that.

Tom Mullooly: I think you'll agree with me, more and more people are becoming experts in the bond market.

Brendan M.: I didn't get the actual report. I read snippets of it in the MarketWatch article that we'll link to in the show notes, but one of the things that I believe was quoted from their report, which has been thrown around by numerous analysts of late especially, are the words "bond bubble." Which I take great exception with. I think that's fear-mongering in the worst way possible for people saving and investing for retirement, especially people who are coming close to the phase of drawing off of their investments, to tell them that the safe part of their portfolio is the bubble is just a scare tactic that I think is pretty disgusting.

Tom Mullooly: We may have talked about this in the last podcast, but just give an old guy some slack, an example of a bubble is, the most recent one I can think of 20 years ago NASDAQ bubble, in the fourth quarter of 1999 in one quarter, 90 days, went from 2,000 to 5,000. That's a bubble. And it burst almost immediately, just as quickly. Oh Bitcoin, right?

Brendan M.: Yeah. I would also say though, obviously without having a been there in the capacity you were, that during that phase to say... Like, we know that it's a bubble now in hindsight and it probably was like, "Wow, this is crazy." in the moment. But also if you weren't participating in it in some capacity, you were getting fired if you were managing money for people.

Tom Mullooly: That's correct.

Brendan M.: So to suggest in real time that things are bubbles is a phenomenon that I think has become more and more popular because of the decade of the 2000s where you had an internet stock, NASDAQ bubble, that we then saw out of the rear view mirror. And then another one where we found out that housing and all of the investment creations that were packaged up and surrounding the housing market, we could tell that that was a bubble out of the rear view mirror too.

Tom Mullooly: Yeah, I agree with you that you can only see a bubble from the rear view mirror. But it just seems like anything that goes up is now tagged as a bubble.

Brendan M.: That's what I mean, it's so-

Tom Mullooly: The stock market was pretty good in 2017 and people were like, "Oh, the stock market's a bubble."

Brendan M.: Right, yeah. Yeah. So I think that's what I was getting at is that since we had some bubbles that we saw on hindsight, now everybody wants to predict them in real time because it will catapult you to fame, like the people they made a movie about The Big Short.

Tom Mullooly: Right.

Brendan M.: You know that bubble. Like there were people who saw these things ahead of time, but a combination of their hard work and getting lucky with the timing is what allowed them to do that. But now everybody wants to be the person who called the bubble beforehand. And so we say, "Bonds are a bubble, stocks are a bubble. This is a bubble, that is a bubble." There's no way all of these things can be a bubble. But what does it mean for people out there when they see these headlines? Because it sounds scary. It's like, "Oh, well, you know, like the last time things were a bubble that didn't turn out pretty good. So should I be selling all of my bonds? Should I be listening to this?"

Tom Mullooly: Right.

Brendan M.: I don't know.

Tom Mullooly: Yeah. "Should we act on it?"

So the headlines are doing their job because they want people to click on the articles and they want people to maybe act on it. And unfortunately now we are a population of scanners, not readers. So we read the headline. A lot of people just make snap decisions off of the headlines. There's a tweet that's going around, New York Post talked about how Jamie Dimon said there's a recession coming. That's what the New York post captured. But the actual quote was, "There's a recession coming. When it comes, I don't know."

Brendan M.: Right.

Tom Mullooly: You know, same kind of thing.

Brendan M.: A very honest take.

Tom Mullooly: Yeah.

Brendan M.: The suggestion from this Bank of America research piece was that 60/40 might be dead because the bond side isn't going to do what people signed up for when they first got involved. Meaning that-

Tom Mullooly: This is really important.

Brendan M.: Meaning that think there's going to be more risk of sharp and sudden sell offs in your bonds, and they think that forward expected returns are going to be really low on that piece of the portfolio. So their suggestion is to put more money into stocks.

Tom Mullooly: Namely into like...

Brendan M.: Dividend stocks.

Tom Mullooly: Dividend stocks. High yields stocks.

Brendan M.: Saying that you could get a higher dividend yield from buying stock X, Y, Z today than you could by putting it into five or 10 year treasury. So you should move from 60/40 to 80/20 but that extra 20% can be dividend stocks, so it's cool.

Tom Mullooly: And really that makes it 100% stocks.

Brendan M.: Right.

Tom Mullooly: Which is...

Brendan M.: I mean, look, it's one thing to make a shift in your asset allocation because something has changed in your life and you understand what that's going to mean in terms of the volatility for your portfolio moving forward if you're moving in the direction we're talking about, but to do it not because anything has changed in your life and because you think, or somebody else thinks who works at a bank, that things aren't going... Like you're predicting the future. That's what you're doing. You're not making changes based upon anything that's relevant to your life or when you're going to need money or anything like that, that I think is a little bit more rational. You're saying, "Eh, we don't like how things look right now. And so we're going to decide to own more stocks because of this."

Tom Mullooly: So this goes to a much deeper issue and it's something that we talk about here at the conference table with folks that come in to meet with us. Changes to the portfolio really depend on things happening in their life, not necessarily because we're trying to time specific events in the market.

Brendan M.: Right? Especially-

Tom Mullooly: "This guy got elected or this happened, and then we had a recession so we made all these changes." Talk a little more about that in the sense that we want to know what's going on with clients and that helps us drive what they should be owning in a portfolio.

Brendan M.: Yeah. And just to add, especially at the super high level that this is being discussed in, there's no context or nuance given to the 60/40 here. So we don't know of the 60% in stocks, how is that made up?

Tom Mullooly: Sure.

Brendan M.: What does that mean? Is it US? Large cap? Small cap? International? What are we talking here?

Tom Mullooly: Right.

Brendan M.: And the bonds, what are we talking there? Are we talking quality bonds, like government treasury bonds? Short term? Long term? Are we talking corporates? Are they high yield? Are the international bonds? There's a lot to...

Tom Mullooly: A lot, a lot to-

Brendan M.: Unpack there. But at the super high level of how much should somebody have in stocks or bonds, a lot of that's going to be driven by when they're expecting to use money from this account in what capacity. So like how much are they going to need? How frequently? What are they comfortable with? Which is impossible to pin down to a tee.

But you can, as we do here, we have discussions with our clients and try to nail that part as closely as we can. Letting that determine your allocation versus what you project will occur with any given asset class or something, I mean, I just think you're doing it in a more logical and personalized way as opposed to just taking blanket advice. Like blanket advice said 60/40 is even, right, to begin with.

Tom Mullooly: Right.

Brendan M.: May not be. But to suggest that, I take that to mean less so the exact percentages and more so just the idea of a plain vanilla balanced portfolio with stocks and bonds. They're saying that that's no longer going to be a valid approach for people because there are risks on the bond side of the portfolio that maybe don't make them as good a diversifier as they have been in the past.

Tom Mullooly: So let's drill down there, not trying to get into the specific reasons why, but do you think it's a concern because overseas there's a lot of negative interest rates and we're lowering rates, we're getting back down to some really, really low numbers. Is the thought behind this that bonds will be a negative place to live because of where we're at?

Brendan M.: The best way, if you're looking at a bond mutual fund or a bond ETF, to determine what returns will be into the future is to look at today's starting yield and to just assume that that will be the annual rate of return moving forward. And there's going to be some oscillation around that because there's going to be years where the price itself rises or falls depending on what's going on. But yeah, you're looking at an asset class that is going to have low expected returns moving forward. I'm not debating that, but to suggest that there's a better alternative out there that's going to give you some kind of higher rate of return, and also the characteristics of what bonds do in the portfolio, which I think is more important here in terms of lowering the volatility of what you have, and giving you at least a chance to stay ahead of inflation over time. I don't really think anything else fits the bill there. What are you replacing bonds with if you do believe that they don't belong in your portfolio, because of all these different reasons?

Tom Mullooly: So the problem is that a lot of folks will say, "Well I have money in the money market now and that's kind of sort of my bond proxy."

Brendan M.: We talked about this a couple episodes ago.

Tom Mullooly: Right.

Brendan M.: There was an article from Christine Benz, I believe, so we had our once an episode mentioned for Christine.

Tom Mullooly: There we go.

Brendan M.: I bring her up every time because I love her work. But she basically shared something that she's wrestled with over the years saying that there were certain points over the last decade or so where she didn't really think bonds looked great moving forward and maybe thought, "Okay I'm going to use a money market or cash as my bonds because I'm worried about what might go on with interest rates and I don't think I'm being paid enough to take on duration risk of intermediate or long term bonds." And then she admitted that she has been wrong every one of those times. And so to say you're going to use the money market as your bond piece means that at some point in the future you're going to know when bonds are good again because what you're being paid to do is own stuff that... When you're in a money market that's all 12 months and in in terms of the debt that makes up that, the bonds that you're investing in.

If you're buying an intermediate term bond portfolio, it's something in the realm of five to seven years in terms of the average maturity of the bonds in the portfolio. And if it's a longterm, it might be 10 to 20 or even longer sometimes, but you're being paid to bear the risk that comes along with loaning your money out for longer periods of time, and that may not be reflected in today's starting interest rates. Like they may all look pretty similar because of what's going on with with yields right now, but over time that kind of plays itself out and you might get more price appreciation from a longterm bond portfolio than you do from a money market where you're not going to get any.

Tom Mullooly: You won't get any appreciation.

Brendan M.: It will continue to go down.

Tom Mullooly: Right.

Brendan M.: Or if rates go up, yeah, you're going to feel more short term pain when you own a longer duration portfolio when that happens, but you're also going to be simultaneously reinvesting that portfolio. As bonds come off the books, they're going to be putting them into new longer term bonds that had a higher yield then and so the yield on the portfolio arises and you make up for the short term losses in time by getting more and higher interest rates.

Tom Mullooly: I think that's a really good rule of thumb. Just something to kind of file away in your back pocket that if you look at the original yield when you enter into some kind of fixed income investment, that should be your expected return from the investment. Now-

Brendan M.: Important caveat with that, that works when we're talking about things like treasury bonds and investment grade corporates. It's not the case if you're talking about high yield bonds, but from what I've understood by reading and researching this a little bit. So it's a good proxy for quality fixed income.

Tom Mullooly: Right. And for high yield bonds, I mean a lot of times we discuss with folks that you may not even be aware of the level of risk that you're taking by investing in some of these high yield bonds or bond funds.

Brendan M.: Can we turn that though? Because so while we're talking about high yield bonds as being sometimes, you know, maybe that's, let's use the 60/40, if you've got high yield in you're 40% you may not necessarily have that 40% in as safe a stuff as you think.

Tom Mullooly: Right.

Brendan M.: What Bank of America Merrill Lynch is saying here is for your 60% or whatever percent is in stocks that you can hide some of that in dividend names, blue-chippers, utilities, REITs, things like that, and pretend that they're bonds. Which is worse or at least equal to what you just said about high yield.

Tom Mullooly: Right.

Brendan M.: Those are not bonds. So yeah, you might get an interest payment from stuff like that, but when the market's down 20% your utility stocks are going to be down 20% too or pretty close to it. They're not going to hold up like bonds.

Tom Mullooly: And we've seen episodes in just the last few years where periods of time have gone by and rates are down and people flock into these yield alternatives, dividend stocks, utilities like you just mentioned, and they wind up getting their face ripped off, losing money, and they say, "I thought these things were safe. They paid a good dividend."

Brendan M.: Oh yeah, "I don't like bonds now, so I'm going to put my money into utility stocks instead."

Tom Mullooly: Yeah, bad move.

Brendan M.: I don't know. You're fundamentally changing the high level amount of risk that you're taking. When you talk about stocks and bonds and you shouldn't misconstrue these things that people use as bond proxies as bonds. Because if you're buying bonds to have something stable in the portfolio when the stock side is getting crushed, you're not going to find help with stocks even if they're lower volatility stocks or in a sector that's a little more stable than the rest of the sock market, like utilities.

Tom Mullooly: Before we go, just address why sometimes we talk about having 30%, 40% in someone's portfolio to offset the volatility?

Brendan M.: Well, I mean depending on what a person's doing with their money and when, it could be, like you said, 30%, 40%, 50% I mean there's no predetermined numbers here. So we determine that by taking a look at when they're going to need their money, how much risk they need to take in order for the money to be there for them when they want it and then into the future so that they hopefully do not run out one day. And so when somebody doesn't need to take a ton of risk, they don't need super high growth and they're going to be taking withdrawals, they might have a more balanced portfolio where they do have bonds. Because, the idea being, that if it's a 60/40, let's say, and we have a year, like last year where at the end of the year the stock side of that portfolio, the 60%, may have been down somewhere in the realm of 15% to 25% depending on the mix of what kind of stocks you held. That 60% might have been down, let's just call it 20%, the other 40% was either flat or maybe even up a couple percent because of what was going on in the stock market.

And so if somebody needed to take a distribution from anywhere between September through December or January, they had a side of their portfolio that was not down, so they didn't have to sell their stocks when they were down. They continued to give them the lease that they needed to then recover over the course of this year and they had somewhere to get their money in the interim so that they weren't forced into making a poor portfolio decision. Which I think is huge because if you're doing what these people say from Bank of America, and you're taking your 60/40 and saying, "I don't like bonds. I'm just going to be 100% stocks, but I'm going to have 40% in dividend payers or utility stocks." But they were still down last year and so you had to sell something at 80 cents on the dollar to take your money out and pay the bills.

And that's not something that most retirees are looking to do, because if you do that enough then you eventually run out of money because you've been eating into the principle of your portfolio. And that's not good.

Tom Mullooly: It's a bad outcome.

Brendan M.: Right. So it's less about what we think bonds are going to do in the future and more about just realizing that people are going to need money from their accounts or they're just straight up not comfortable with the amount of volatility that a more stock heavy portfolio might give them. And building a portfolio based on that rather than some forecast on interest rates.

Tom Mullooly: That's good. That's a wrap on episode 279. Thanks again for tuning in and we will catch up with you on the next episode.