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The 60/40 Stock/Bond Portfolio's Time May Be Over. Here's What to Do Instead.

By Randall W. Forsyth Updated Dec. 6, 2019 8:36 pm ET / Original Dec. 6, 2019 10:35 am ET

It doesn't take much of a rise in yields to produce bond-price declines that translate to negative total returns.

The year 2019 is likely to be remembered for many things, but for investors, what stands out is that it was the rare one in which nearly everything worked. Stocks and bonds, domestic and international—all have posted nicely positive returns, along with real estate investment trusts and precious metals. Real assets, such as commodities and energy-related master limited partnerships, have been among the few downers.

That's made the traditional balanced portfolio of 60% stocks and 40% bonds a standout performer. A 60/40 mix of the SPDR S&P 500 ETF Trust (ticker: SPY) and iShares Core U.S. Aggregate Bond (AGG)—exchange-traded funds that track the most widely used benchmarks for the U.S. equity and fixed-income markets—have returned 19.20% for the year, through Wednesday, according to Morningstar. That's the sort of showing that would please most equity-only investors in a typical year, although putting all your chips in the SPDR ETF would have generated a 26.36% return.

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But these sparkling results actually were the flip side of the annus horibilis of 2018, when nothing worked. A 60/40 portfolio fell 2.70% last year, as the meager 0.1% gain from the iShares ETF only partially offset the SPDR ETF's 4.56% negative return.

That means, for the past two years, the traditional 60/40 stock/bond portfolio hasn't worked as assumed. The two asset classes haven't been negatively correlated, as textbooks teach; when stocks zigged, bonds didn't zag. This phenomenon was noted in this space when it began to emerge in early 2018.

Pramod Atluri, a fixed-income portfolio manager at Capital Group, which runs the American Funds, suggests that monetary policy mainly has been driving markets.

In 2018, the Federal Reserve raised its federal-funds target range four times, for a total of 100 basis points (one percentage point), while it was also shrinking its balance sheet, further tightening policy. This year, the Fed has reversed course, cutting its fed-funds target three times, totaling 75 basis points. At the same time, the central bank halted its balance-sheet contraction and then resumed its expansion with repurchase-agreement operations and outright Treasury bill purchases.

Over the past decade, however, 2018 was the exception. Morgan Stanley found that various combinations of stock and bond portfolios produced strong returns during that stretch. Weighting riskier assets more heavily also paid off in higher returns.

But Morgan Stanley expects the opposite for the next 10 years, as it sees valuations and returns reverting to their means. Translated, today's high stock prices point to low future equity returns. Low bond yields necessarily mean lesser fixed-income returns. Moreover, taking on bigger risks also isn't likely to pay off in bigger returns, the investment firm adds. "We estimate the average 60%/40% stock/bond portfolio will return only 4% to 5%, roughly half that of the past decade," writes Lisa Shalett, chief investment officer at Morgan Stanley Wealth Management, in a client note.

Given that limited upside for a diversified portfolio, limiting losses would be paramount. Unfortunately, the 2018 experience shows that bonds don't always offset equity declines. That's because it doesn't take much of a rise in yields to produce bond-price declines that translate to negative total returns.

The iShares bond ETF's duration is 5.73 years. That means a 100-basis-point rise in yields would result in a 5.73% price decline (all else being equal along the yield curve and bond sectors). That's possible, but unlikely. But consider a 25-basis-point rise in yields, which is more within the realm of possibility. The resulting 1.4% price decline would wipe out more than half of the ETF's annual SEC yield, currently 2.23%.

Indeed, Goldman Sachs Chief Economist Jan Hatzius told CNBC Friday that the Treasury 10-year note yield could rise to 2.25% next year, a roughly 40-basis-point increase, which would result in a bigger price decline than this hypothetical example.

A shorter-duration fixed-income portfolio would carry less risk from an uptick in yields. And that's what BCA Research is advising clients to hold, based on what it dubs "the Golden Rule of Bond Investment." First, determine the change in the federal-funds rate that the market is pricing for 12 months hence. Then, decide if you think the central bank will peg the funds rate higher than the market is expecting. On that basis, shorten duration or vice versa.

As of Thursday, fed-funds futures were pricing in a 67.5% probability that the target range will be below the current 1.50%-1.75% by December 2020, according to the CME Group's FedWatch site. In contrast, BCA thinks the Fed won't cut rates over that time horizon, so it argues a shorter duration portfolio would do better.

Going shorter also was the advice offered by John Coumarianos last month in *Barron's*. He listed three ETFs— Vanguard Short-Term Bond (BSV), iShares Core 1-5 Year USD Bond (ISTB), and Vanguard Short-Term Corporate Bond (VCSH)—with roughly half the duration of the iShares bond ETF with little sacrifice in yield. For even less interest-rate risk, consider an ultrashort ETF, such as Pimco Enhanced Short Maturity Active (MINT), which has a duration of only 0.4 years and nearly as high a yield as the short-term bond ETFs.

Diversification is necessary for any investor lacking omniscience. Unfortunately, high asset prices and low bond yields may require a revision of the traditional 60/40 mix.

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