RBC Wealth Management

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Does a one-size-fits-all formula exist for how to manage a company, raise a child, or buy a house? Most people would agree that complex processes such as these require thoughtful approaches that depend upon specific circumstances. Yet when it comes to financial planning, many investors think that they should allocate their assets according to an outdated one-size-fits-all formula. In this commentary, we describe the most prevalent one-size-fits-all asset allocation formula, discuss why it’s no longer relevant, and provide our recommendation for the most effective way to determine an asset allocation that will maximize your chances of achieving your financial goals.

For the past several decades, conventional investment wisdom held that an investor should simply subtract their age from one hundred to determine the percentage of their assets that they should invest in stocks, with the remainder invested in bonds. For example, according to the formula, a person 60 years of age should invest 40% of their assets in stocks, with the remainder invested in bonds. While the exact origin of this formula isn’t certain, Forbes pegs its proliferation as taking place around the early 1980’s in the U.S. During that time period, the ten-year Treasury bond yielded more than 10%. The average return on U.S. stocks since 1900 has equaled about 7% (the Dow started the year 1900 at 66 and closed July 2018 at 25,419). Obviously, with bonds guaranteed by the U.S. government paying far more than the average long-term return on stocks, an investor could simply have invested all of their assets in bonds during that time period, and done quite well[(1)(2)(3)].

The world has changed. Over a thirty-five year time period, the yield on the ten-year Treasury bond declined from 13.9% at year-end 1981 to 1.8% at year-end 2016. The Federal Reserve has started increasing its key interest rate over the past few years, and the ten-year Treasury bond currently yields about 3.0%. While 3% represents an increase from two years ago, it’s important to understand what a 3% return means for investors. Since the U.S. government began recording inflation data in 1913, consumer prices in the U.S. have increased about 2,470%, which comes out to a little over 3% a year. So investors who currently place their funds in ten-year U.S. Treasury bonds earn no real return on their assets. Add the hurdle of taxes, and these investors lose money and must live off of what’s leftover[(2)(4)].

Another factor contributes to a false sense of security among bond investors: when interest rates decline, bond prices increase. So, as interest rates in the U.S. steadily declined over thirty-five years from 1981 to 2016, bond prices steadily increased. When bond prices increased, investors who held those bonds saw their investment account values correspondingly increase. The combination of historically high interest rates with increases in bond prices created a distorted view of what investors should expect from bond investing. One cannot simply look at the past thirty-five years and project those bond returns going forward. The next thirty-five years will likely look very different from the past thirty-five years. If interest rates continue to rise, bond investors will experience declines in their account values, rather than the increases of the past. This would lead to a loss of principal on investments intended to add stability to investor portfolios.

Given the dramatic shift in economic circumstances over the past forty years, investors must adapt if they want to provide themselves with financial well-being over a long-term retirement horizon. While previous financial circumstances allowed the convenience of formulaic financial planning, such as subtracting one's age from 100 to determine a stock versus bond allocation, present economic conditions no longer ensure the success of such a simple strategy. Instead, investors must now ask themselves a series of questions, the answers to which determine how they should allocate their assets.

In determining a suitable asset allocation, one of the most important questions to ask is, how much money do I need to live off of every year? If an investor has a million dollars and only needs to live off of $5,000 a year, they can keep their money in Treasury bonds or FDIC insured bank accounts and live happily ever after. But most people need a more sizable income to cover their lifestyle. If an investor with a million dollars needs to generate $40,000 a year from their assets for living expenses and wants to maintain their principal, then they need a 4% annual return to generate that income. Well, not quite. Depending on what age a person retires, their retirement horizon could last twenty to thirty years or longer. With an average inflation rate of 3% per year, an investor's purchasing power will be cut in half in about twenty-four years. So, over a twenty-four year period, your annual income effectively declines from $40,000 to $20,000 in purchasing power. Not the situation you want to find yourself in when you're trying to enjoy a carefree retirement(4).

In reality, an investor who wants to earn $40,000 a year from a million dollars and maintain principal needs a 7% annual return if they want to maintain their lifestyle through retirement. Note that we haven't even included the impact of taxes, which pushes the required return even higher. So in this specific case, the question of how to allocate this investor's assets has been effectively answered by the return they require on their assets. An investor with this amount of assets and this required return cannot invest any meaningful portion of their assets in bonds if they want to achieve their financial goals in retirement. In fact, with a long-term return of about 7% on stocks, this investor really needs to invest the vast majority of their assets in stocks just to achieve the return they need. While most investors would prefer to hold large amounts of cash and bonds in retirement so that they don't have to put up with the temporary swings of stocks, reality dictates that this simply isn't possible if they want to retire the way they hope to(3).

Of course, most investors have other income streams that they need to factor into their retirement equation, such as Social Security, pensions, etc., which complicate the retirement picture even further. And our Group does recommend some level of cash and bond holdings for all investors living off their assets, so that they have a source of funds to withdraw from in the event of a prolonged stock market contraction. These factors and many more point to the need for customized financial planning, and the inadequacy of outdated one-size-fits-all retirement formulas.

Best Regards,

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Sources:

(1) Forbes
(2) Board of Governors of The Federal Reserve System
(3) S&P Dow Jones Indices LLC
(4) Bureau of Labor Statistics