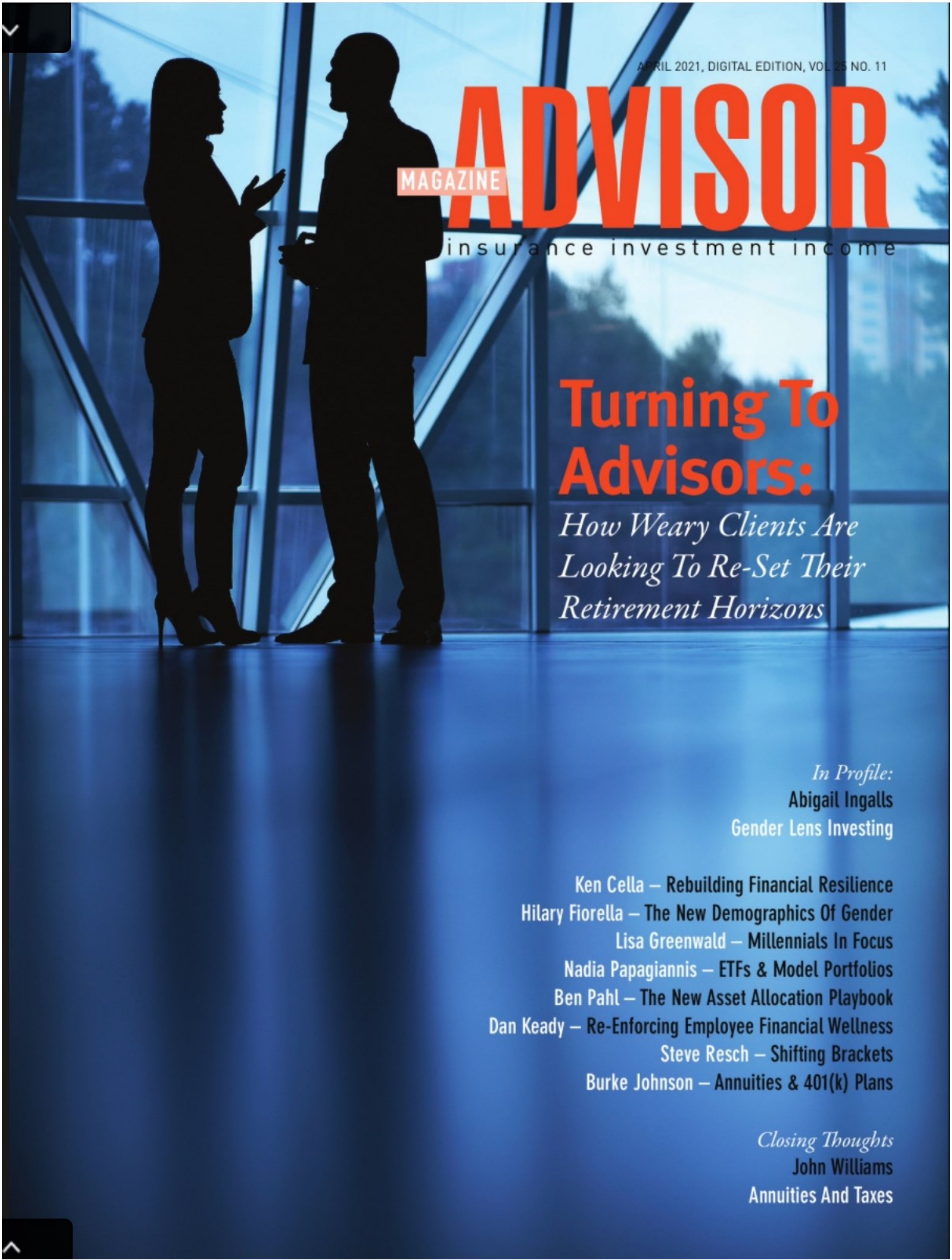
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MAGAZINE
ADVISOR
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Turning To Advisors:
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Asset Allocation - The New Playbook

The classic 60/40 allocation may be a thing of the past... So now what?

BY BEN PAHL

Interest rates reached their highest point in modern history in 1981 when the annual average mortgage interest rate was 16.63%. Savings and CD rates were equally high and the average yield of a 10-year treasury was 13.92%. In 1990, the average mortgage interest rate was 10.13%, falling to 6.94% by 1998. The 2000s saw mortgage rates fall to 5.04% by 2009. The following decade saw mortgage rates hit 3.85% in 2015. In 2020, the federal funds rate fell to the 0 – 0.25% range, and on June 23 Freddie Mac reported a 30-year fixed rate mortgage figure of 3.6%.

With bond values rising as interest rates fall, fixed income investors have been swimming with the current for forty years. Benefiting from interest payments and upward pressure to bond values, fixed income investors have reaped the rewards that come with four decades of declining interest rates.

Past Performance Does Not Guarantee Future Results...

We have all read and heard the phrase repeatedly – Past performance does not guarantee future results. As advisors construct strategies among the backdrop of the forecasted rising interest rate environment, perhaps fixed income – more than any other asset class – is setup to not have historical performance repeat itself.

Fixed income aside, equity markets provide advisors with their fair share of challenges as well. Current valuation multiples are in the 90th percentile. Valuations are stretched nearly as high as they have ever been.

These variables coming together simultaneously put advisors into a unique position. In today's current climate, advisors are facing a challenge they have never encountered before –constructing client portfolios while interest rates are at all-time lows and equity market valuations are near all-time highs.

Sure, advisors could construct a wide range of portfolios, run back tested illustrations, stress tests, and Monte Carlo simulations – but what good is any of that when we all know the fixed income portion involved in the analysis will likely not come close to behaving the same way in the future as it has done in the past. As appealing as a historical 70/30 or 60/40

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analysis may look on paper, we cannot expect similar results moving forward.

Different Playbook – Same Goals

As unique as the current investment climate is, the fundamental goals and objectives advisors must solve for their clients remain the same. Clients, especially retirees, still seek reduced volatility, reasonable upside capture, a strong and consistent income stream, liquidity, and tax-efficiency. Advisors need to accommodate these goals and objectives while navigating through the unique challenges brought forth by today's low interest rates and high equity valuations.

Perhaps it is time for advisors to pull pages from a different playbook.

The old playbook favored asset allocation over security selection. It favored broad diversification that could be broadly tied to a client's risk tolerance. For a long time, the classic 60/40 portfolio was a one-size fits all strategy – a staple allocation for many retirees. Advisors could allocate various pieces of the pie to their favorite mutual funds and ETFs. Equity funds were divided between small, mid, and large cap funds while balancing between growth and value. The fixed income portion would diversify duration, credit quality, and issuer. When it was all said and done, a classic 60/40 strategy owning nine to 15 different funds would often hold hundreds of underlying holdings. A classic broad-based asset allocation approach.

SURE, ADVISORS COULD CONSTRUCT A WIDE RANGE OF PORTFOLIOS, RUN BACK TESTED ILLUSTRATIONS, STRESS TESTS, AND MONTE CARLO SIMULATIONS – BUT WHAT GOOD IS ANY OF THAT WHEN WE ALL KNOW THE FIXED INCOME PORTION INVOLVED IN THE ANALYSIS WILL LIKELY NOT COME CLOSE TO BEHAVING THE SAME WAY IN THE FUTURE AS IT HAS DONE IN THE PAST

With valuation multiples near all-time highs, the new playbook will likely require a more precise approach – something narrower in focus. The new playbook will favor individual security selection over fund selection. Even sector specific ETFs may be too broad in scope to navigate through today's challenging investment climate.

Take technology for example. Even with technology valuations stretched, there is still good value to be found in the sector. We could all name a dozen technology companies we would rather not own right now – companies with stock prices and multiples we may want to avoid at current levels. That is even more reason for advisors to add a greater element of precision to their portfolio construction process. Don't own the market, don't even own the sector – drill down to the exact underlying positions you want your clients to own. Be precise. There is value to be found.

Income Planning

Retirement planning is all about income planning. It is all about cash flow. When it comes to income planning, the old playbook often starts with that classic 60/40 or 70/30 allocation and a projected 3.5% to 5% client withdrawal rate. Many advisors would then stress test their allocation against a Monte Carlo simulation to calculate a probability of success. Perhaps the biggest risk to a classic 3.5% to 5% drawdown approach is sequence of return risk. Clients who begin their drawdown phase during a strong bull market compared to clients beginning their drawdown during a weak market will often have drastically different retirement income journeys.

The old playbook manages sequence of return risk by reducing volatility. How does one reduce volatility? – by introducing bonds to the strategy. We have already discussed the inherent risks involved in today's fixed income climate. In the years to come, bonds may actually end up increasing risk. Try to explain that to your compliance department.

Bonds used to not only help advisors reduce volatility, they also provided an attractive income stream to offset the projected drawdown. As backwards as it may sound, bonds are positioned to pay historically low income and could increase the downward pricing pressure of the overall strategy. In our present environment, bonds could very well do more harm than good.

If not interest from bonds, where else can advisors go to find income for their clients? Dividends. The new playbook will surely place heavy emphasis on dividends. Dividends can be very attractive to advisors and clients. Afterall, dividends are paid on a per-share basis. Price fluctuation does not affect the number of shares a client owns and therefore does not affect the dividend income power of the holdings. Dividend income also provides an attractive offset against a drawdown approach.

Depending on the size of the portfolio and the needed income stream, some clients can accommodate their entire income need simply by taking the dividend "off the top," negating the need to sell any shares at all. Doing so keeps underlying holdings intact – essentially eliminating sequence of return risk. If a client does not need to sell anything to generate the income, sequence of return risk is a non-factor.

Can dividends go down? – of course. This is even more reason to stay narrow – to manage with precision. Certain companies in certain sectors provide more dividend security than others. That is where the precision component shines. Beyond that, advisors need to be careful not to chase yield. Some dividend yields are high simply because the stock price is depressed. In many cases, the price is depressed for a reason. Chasing yields that are too high may be subjecting clients to unnecessary risks. Precisely balancing the risk associated with the holdings as well as the risk associated with dividend security are critical components of navigating clients through the current environment.

What About Inflation?

Today's inflation concerns place further emphasis on an advisor's need to manage with precision. Not all dividends are created equal. When it comes to bonds, income is fixed. Dividend income on the other hand has the potential to rise over time, creating an attractive hedge against inflation. However, not all dividends have the same potential to increase over time. That is where the new playbook comes into play once again – the necessity to be selective – to manage with precision.

In 2020 the S&P 500 posted a modest overall dividend increase of 0.72%. In fact, 17% of companies who started 2020 paying a dividend either reduced or suspended their dividend in 2020. On the other hand, 56% of those companies increased their dividend by at least 4% last year. Many of those companies have enjoyed over 25 consecutive years of healthy dividend increases. Here again, a case for precision-based management. The broad market experienced less than 1% increase to income power while a narrow selection generated more than four times the increased income power. Going too broad will often dilute the long-term income generating power of a portfolio.

PERHAPS THE BIGGEST RISK TO A CLASSIC 3.5% TO 5% DRAWDOWN APPROACH IS SEQUENCE OF RETURN RISK. CLIENTS WHO BEGIN THEIR DRAWDOWN PHASE DURING A STRONG BULL MARKET COMPARED TO CLIENTS BEGINNING THEIR DRAWDOWN DURING A WEAK MARKET WILL OFTEN HAVE DRASTICALLY DIFFERENT RETIREMENT INCOME JOURNEYS

Just like there is value to be found among today's high valuations, there is also healthy income to be had. Advisors just need to find it and bring it to the forefront.

A Word About Taxes

High market valuations lead to high levels of pent-up potential capital gain exposure embedded in many broad-based mutual funds. Fund participants are walking into what could be steep tax consequences on capital gains they did not even participate in. Here again, we make a case for managing with precision. When clients own the underlying positions directly, they own their own shares, in their own name, most importantly with their own cost basis. Going straight to the individual equity position allows clients to avoid the unnecessary tax burden associated with turnover and potential capital gain exposure found in many mutual funds.

Conclusion

With interest rates near all-time lows and valuations near all-time highs, advisors will need to closely examine how they construct client portfolios moving forward. A classic 60/40 or 70/30 drawdown approach may very well be a thing of the past. Not only is this classic balanced approach outdated, but the instruments used to color in the slivers of the pie chart will likely require a more precise approach – forcing many advisors to go straight to the underlying holdings to find the right mix of value and income for their clients. Some advisors will develop their own security selection process within their firm while others will rely on third-party managers to construct portfolios best suited for their practice. No matter the direction advisors take, the goals and objectives of the client will remain the same.

No doubt the next decade will provide its fair share of challenges. Then again, has there ever been a decade that has not? As advisors, we need to embrace these challenges and navigate our clients through them. Challenges like these are why our industry exists. Overcoming challenges and obstacles for clients is how we create value in the marketplace. The only question is – which playbook will you use? ■

Mr. Pahl is President of Liberty One Investment Management, a solution based third-party asset manager. Please visit www.LibertyOneIM.com