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Prospect of lean returns for stocks, bonds suggests getting creative

Most investors have a mix of stocks and bonds in their portfolios. Stocks are there for long-term growth, whereas bonds are generally purchased for stability and income generation. This has worked out pretty well historically, as stock returns averaged over 10 percent annually since the 1920s, and bonds have yielded over 5 percent, according to Ibbotson data. A balanced portfolio of 60 percent in stocks and 40 percent in bonds has become the de facto standard for many investment portfolios, as the returns have been substantial enough to meet most investors' returns, while keeping risk in check.

While we tend to look back at history through the lens of today's standards, the reality is that not many investors over the past 100 years actually invested this way. Our 60 percent stock/40 percent bond paradigm would have been considered out of place, and even reckless over much of the period for which we have data.

Industry practice on how to build portfolios has often followed trust law, which we inherited from our British forebears. Trial and error played a role, as did the need to mitigate risk and a desire for stronger returns.

In 1719, Britain's parliament allowed trustees to purchase shares of the South Sea Co., which was set up to reduce the cost of national debt in the U.K., and was granted a monopoly to conduct trade with South America. Shares in the South Sea Co. rose strongly, as this was the only "stock" allowed in trust portfolios. A year later, after it became clear that trade with South America was not developing, shares fell by roughly 90 percent.

The crash caused massive damage to investors, including many trusts. In reaction, the English courts developed lists of acceptable investments that could

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be used in trusts. These lists were highly restrictive, allowing government bonds and sometimes first mortgages on properties, but even those were controversial. Early portfolios were therefore invested almost exclusively in ultra-safe bonds.

In 1830, a court case in Massachusetts established the Prudent Man Rule. This held that trustees should "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

While the Prudent Man Rule seemed reasonable, over time it was strictly interpreted to mean that every asset within a portfolio had to be prudent. The courts took a narrow view of "prudence," and held trustees liable if a single security declined in value, even if it was part of a well-diversified portfolio. Practically, this meant that "speculative" investments such as stocks were not permitted within trust portfolios.

Then, in 1952, Professor Harry Markowitz introduced the concept of Modern Portfolio Theory. Markowitz asserted that risk should be viewed in a portfolio context, and that adding uncorrelated risky securities to a portfolio can actually reduce the risk of an overall portfolio. By 1959, after Markowitz's research, higher quality stocks were more widely used in trusts.

Legal standards finally changed in the mid-1980s as a handful of states repealed the Prudent Man Rule and implemented a new Prudent Investor standard. By the early 1990s, most states had codified the Prudent Investor Rule, which allowed for a holistic assessment of portfolio risk. Thus, trustees are currently allowed to invest in a diversified portfolio of stocks, bonds, and potentially other asset classes as well.

The key point here is that legal standards, investment practice, and even markets themselves evolve. This is frequently out of necessity, and we may be at an inflection point today that causes investors to rethink traditional portfolio construction limited to just stocks and bonds.

Looking forward, markets are not likely to provide the same strong returns as in the past. Economists and strategists are generally warning of the likelihood of contracted returns, and there is some basic math that supports their beliefs. Bond yields currently are just north of 2 percent, and current yields are a strong predictor of future long-term returns. Stock valuations are at a level that historically has been associated with mid-single-digit future returns.

Accordingly, traditional approaches may not be sufficient to meet investors' needs in the future, but tools to build better portfolios currently exist. The advent, and acceptance, of "alternative" investments gives investors the ability to add return streams that differ from those of stocks and bonds. They can also help reduce portfolio risk.

This has resulted in the institutional portfolios that we hear about today, like Yale's endowment, which invested less

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than 25 percent of its assets in traditional stocks and bonds as of 2018. The remaining assets include investments such as hedge funds, private equity, real estate, and natural resources.

Not all of us are able to invest like Yale University, with its roughly $30 billion endowment. That said, the investment world is democratizing. Just as stocks were considered overly risky in the past, but are well established today, many alternative investments have come into their own, and are now available to main street investors.

Direct investment in institutional-quality real estate historically required large sums of money, but today there are funds through which investors can get these exposures with minimum investments of $25,000 or less. While all investments, except perhaps T-bills, are risky, private real estate returns have often been attractive, and offer relatively low correlations to stock and bond returns. Just beware of high-cost, high-commission real estate investments sold through brokerage firms.

Other "liquid alternatives," which are unique strategies in mutual fund wrappers, have offered fairly anemic returns the past few years. However, that is not necessarily a reason to avoid them. Every asset class goes through up and down cycles. Buying low, particularly when stocks and bonds appear expensive, could prove lucrative over time.

Alternative investments often come with higher costs, tax inefficiencies, and may have restricted liquidity. Proper due diligence is required. However, for those able to work around these issues, such as non-taxable investors or those investing in retirement plans, the net returns can be attractive, particularly when you compare them with the returns of the bond market.

Investments like private real estate, managed futures, catastrophe bonds, private lending, and others offer expected return streams that differ materially from stocks and bonds. As Markowitz showed in the 1950s, adding uncorrelated investments to a portfolio can increase returns, reduce risk, or sometimes both.

Given the potential for lean returns for stocks and bonds in the future, a more creative approach is warranted. Incorporating unfamiliar investments can be uncomfortable, but there is historical precedent for evolution with respect to asset allocation.

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