INVEST WITH REASON

Should You Take More Risk In Your Portfolio?

Ashvin Viswanathan, CFA
Director of Quantitative Strategy

It's no secret that the yields available today on quality bonds such as Treasuries, Agencies, and Municipals are miserly. Even with the recent rise in Treasuries, investors are asking whether they should continue to hold or to purchase such bonds. We believe quality investment-grade fixed income, even at today's low yields, still plays an important role in a well-diversified portfolio.

However, to grow wealth at rates similar to what they were when bond yields were higher, investors are essentially faced with two rather unpalatable choices: spend less and save more or increase the potential investment return (and risk) of their portfolios.

To understand how an increase in potential return impacts portfolios, a good starting point is to examine the shifting investment landscape in recent decades for pension funds, which resemble an individual's portfolio allocations when investing for retirement. Historically, pension funds have often aimed for a 7.5% annualized return. We conducted research over the past 45 years (i.e., 1976 through 2020) to determine what these retirement funds needed to do in different investment environments to achieve a 7.5% annualized portfolio return.

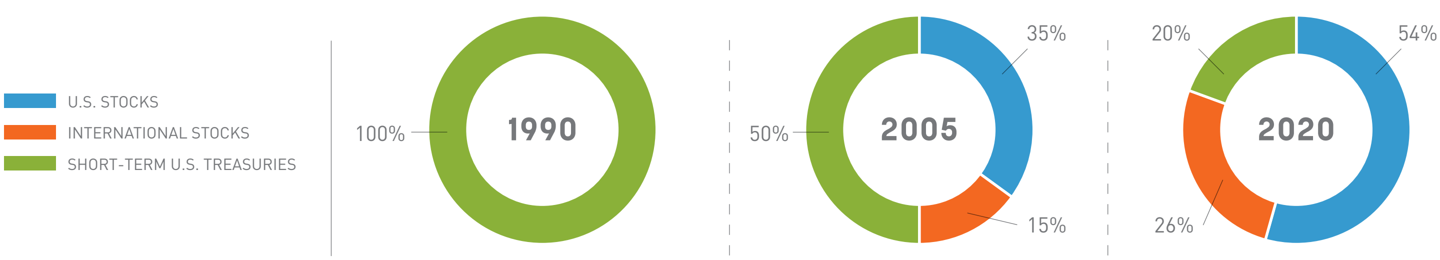
Figure 1, which incorporates asset-class valuations (including interest rates for fixed income), illustrates how dramatically the investment landscape has shifted in recent decades. The chart shows the pension fund allocations (and risk) required to meet the return target during three trailing 15-year periods. Given the current rock-bottom interest rates, it may be difficult for investors today to imagine, but during the 15 years ending in 1990, a portfolio 100% invested in short-term Treasuries would have easily exceeded the total portfolio's 7.5% threshold, with extremely low volatility (measured by the standard deviation of returns). That 15-year time span, of course, was marked by a high interest-rate regime.

During the next 15-year period, ending in 2005, a portfolio of 50% stocks (including international) and 50% Treasuries would have met the return requirement, but with nearly double the risk. Finally, looking back over the 15 years to 2020, our research reveals that a portfolio of 80% stocks was required to reach the target of 7.5% annualized return. Tellingly, this stock-dominated portfolio needed to take more than *three times* the risk of the 1990 counterpart and about twice as much as the 2005 portfolio.

In sum, investors—including those nearing or in retirement—are faced with the difficult decision of whether to take more risk in their portfolio to increase return potential. Everyone's situation is different, but a modest increase in equities may be prudent, given the current low-yield environment and the potential headwinds bonds face from future rate increases.

There is no simple answer or universal advice, but we encourage you to meet with your Advisor to discuss whether it makes sense to add more equity risk to your portfolio.

FIGURE 1: DIFFERENT PERIODS, DIFFERENT ALLOCATIONS TO EARN SIMILAR RETURNS
15-YEAR RISK & RETURN COMPARISON: JAN 1, 1976 – DEC 31, 2020



	1990	2005	2020
15-YEAR TRAILING RETURN	9.8%	8.2%	7.6%
15-YEAR TRAILING STD. DEV.	3.8%	6.7%	12.8%

Sources: Bloomberg, Standard & Poor's, Morgan Stanley Capital International, Russell Investments, Dow Jones & Company, and PUA Research