The 60/40 Stocks/Bonds Retirement Portfolio Is Dying: Here's How to Revive it

Description

The traditional 60/40 portfolio of stocks/bonds, long considered great blend of risk/return, is now in big trouble. Year to date, a 60/40 portfolio has dropped nearly as much as a 100% stock one, owing to the market pricing in a series of upcoming interest rate hikes.

Case in point, **Vanguard Balanced ETF Portfolio** (TSX:VBAL) is down -11.75% YTD versus -12.75% for **Vanguard All-Equity ETF Portfolio** (TSX:VEQT). Risk-averse investors depending on their bond allocation to limit losses were in for a rude awakening, as yields soared and prices dropped.

A better allocation for a rising-rate environment might be a 40/40/10/10 portfolio of global equities, intermediate duration government bonds, gold, and cash. Today, I'll go over the reasoning for this allocation and suggest some ETFs to implement this portfolio.

Global equities

Even the most risk-averse investors should consider an allocation to stocks in their portfolio. Stocks will drive most of your returns. This is critical if you want your portfolio to reach a sufficient size to ensure a safe perpetual withdrawal rate during retirement (commonly 4%).

You'll want maximum diversification, across large-, mid-, and small-cap stocks and across all countries — including the U.S., Canadian, international developed, and international emerging markets. My pick here is VEQT, which holds over 12,000 global stocks and costs an expense ratio of 0.24%.

Intermediate government bonds

An allocation to bonds usually does two things in a portfolio: it lowers volatility and reduces drawdowns. Your portfolio value will fluctuate less, and the peak-to-trough losses it incurs during a crash will be lower than a 100% stock portfolio.

Most bonds (especially government ones) are also uncorrelated with stocks. When stocks fall, these bonds tend to rise, making them excellent hedges. This is called the “flight to quality,” which is caused by investors panic-selling stocks and buying bonds en masse.

Your best bet is **iShares Core Canadian Government Bond Index ETF** (TSX:XGB). XGB provides exposure to federal, provincial, and municipal bonds with a weighted average maturity of 11.18 years and a current distribution yield of 2.42%. The ETF costs an expense ratio (MER) of 0.27%.

Being comprised of government bonds, XGB is virtually immune to default, a risk where the party issuing the bond can’t pay back the coupon or principal because they’re broke. With Canadian government bonds, default risk is a non-issue, which is why we want it over corporate bonds.

XGB has an intermediate effective duration of 8.46 years, which is a measurement of sensitivity to interest rate changes. Bond prices are inversely related to interest rate movements. A 1% increase in interest rates will cause XGB to drop roughly 8.46% and vice versa. XGB’s duration strikes a sweet spot between interest rate risk and crash protection.

Gold

As a commodity, gold has a low correlation to both stocks and bonds and high volatility, making it an excellent diversifier. Holding gold also protects against tail risks like stagflation and war. As a perceived “safe” and “hard” asset, gold is where investors flee to when their local currency suffers or when their local economy has stagnated.

A small allocation can also help limit losses when rates rise and both stocks and bonds become more correlated. I like **iShares Gold Bullion ETF** (TSX:CGL). This ETF holds physical gold in a vault, and a share of the ETF represents partial ownership of a proportion. CGL gives targeted exposure to the price of gold that is hedged to the Canadian dollar for an expense ratio of 0.55%.

Cash

A truly risk-free asset is cash (albeit not to inflation, which is why we want to keep its allocation small). Cash will hold its value through market crashes and rising rates, allowing us to buy other assets low when we rebalance a portfolio. A good way to hold cash in a portfolio is by using a money market ETF.

My suggestion here is **Purpose High Interest Savings ETF** (TSX:PSA). PSA invests in high-interest savings accounts with Canadian banks and is as safe as it gets, with zero interest rate risk or default risk. PSA does have a very low yield (0.81%), though, and will not outpace inflation. Still, it’s a marginally better solution than holding cash for an expense ratio of 0.15%.

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1. TSX:CGL (iShares Gold Bullion ETF)
2. TSX:PSA (Purpose Fund - Purpose High Interest Savings ETF)
3. TSX:VBAL (Vanguard Balanced ETF Portfolio)

4. TSX:VEQT (Vanguard All-Equity ETF Portfolio)
5. TSX:XGB (iShares Canadian Government Bond Index ETF)

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