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PARADIGM

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***The review of the merits of index funds led us to believe that a review of two other concepts would make sense. The "60% stock / 40% bond portfolio" plus "the 4% rule" are concepts we believe are still relevant because they have been adapted to a changing world.***

## 60% Stock / 40% Bond Portfolio

Modern portfolio theory can be traced to the 1950s when Harry Markowitz showed that diversification can, up to a point, increase returns for a given level of risk.

The early research didn't specifically limit itself to stocks and bonds; however, the data on these two asset classes was easily available. One could construct portfolios that varied between 0% stocks/100% bonds and 100% stocks/0% bonds. It turned out that one of the best risk/reward portfolios was roughly 60% stocks and 40% bonds.

Over the past 60 years, the definition of stocks, bonds, and asset classes has changed materially, as has the application of asset allocation.

Initially, the definition of stocks was U.S. large cap stocks, which, as a group, resembled the S&P 500. The idea of using U.S. small cap stocks started to gain traction around 1980. The use of foreign equities followed later.

The definition of bonds began as U.S. Government bonds and high-grade corporate bonds. The use of high-yield and foreign bonds started in the 1980s.

The result is that the number of asset classes has increased dramatically. For example, stocks can now mean large, small, foreign, and emerging markets. The same expanded choices exist for bonds. Private Asset includes real estate as a mainstream asset class. Finally, some believe that commodities, private equity, and hedge funds can be considered for inclusion.

Asset allocation has evolved to include the new asset classes. Also, the likelihood of longer retirements and lower future returns requires individuals to rethink what an appropriate asset allocation might be. Put another way, should some people think about a higher risk, higher return portfolio, given their current age and/or life expectancy?

All told, the initial 60/40 portfolio has evolved as investment choices and investment needs have changed.

## The 4% Rule

William Bengen wrote an article in 1994 that came to be known as The Four Percent Drawdown rule, commonly referred to as "the 4 percent rule." The essence of the rule is:

1. During the first year of retirement, you withdraw 4 percent of the beginning balance of your portfolio.
2. You increase this amount annually by the rate of inflation.
3. By following this formula, the chances are low that you will run out of money during a 30-year retirement.

Three points about the rule. First, the rule was always meant more as a guideline than a rule. Second, Mr. Bengen has encouraged investors to adapt the rule for potentially lower future returns and longer retirements.  Third, we believe two new concepts are now implicit in the rule: the need for most to save more for retirement and the need for most to better understand their spending habits.

## Key Takeaways

There are three key points we want to make. First, the original authors of these concepts believed that the concepts were dynamic and would be improved on over time. Having more choices of asset classes is an improvement.

Second, your unique situation (risk tolerance, spending and savings habits, and life expectancy) requires additional adjustments to these concepts. For example, someone who expects to have 35 years in retirement may need to start with an initial withdrawal rate of less than 4%.

Third, since its inception in 1996, Private Asset has embraced an approach that applies these two concepts to a changing world. Our portfolios utilize seven asset classes. Also, we work with clients to adjust spending rates to an era of lower expected returns and longer retirements.

***The "60% stock / 40% bond portfolio" plus "the 4% rule" are concepts that are still useful because they can be adapted to a changing world. Private Asset believes its approach has proven to be adaptive, too.***

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