The Return of the Three Asset Class Portfolio

Cash, Bonds, and Stocks

For the first time in 20 years, many investors are asking about cash as an asset class and investment tool. It usually goes something like "if the expected return on a Moderate portfolio is 5% and I can earn 5% in cash, why don't I just own that and not take the risk associated with the stock and the bond market?" This is a fair question. We will start to address it by examining the goal of all three asset classes and then dive into a few scenarios that point out the pros and cons of each of the asset classes in those scenarios.

Cash

Cash is the most basic asset class. No matter how rich, poor, young, old, or of what nationality we all use cash in some form. It is how we pay bills and transact the daily activities of our lives. For the better part of two decades, cash has had a near 0% return associated with it, but that is no longer the case. In fact, the rate on money market accounts and other cash-like accounts is now over 5%, even better than the average return on cash dating back to 1928 which is 3.3% as measured by the 3-month T-Bill. Relative to what investors are accustomed to from both cash and bonds, this seems like a great return. However, as we will examine in the scenarios below, we believe that keeping cash in its place to manage short-term needs is exactly where it should stay - not as a mechanism for investment returns. From a financial planning perspective, cash should be held to meet short-term spending needs, conduct daily life, and maintain a liquid emergency fund usually ranging between 3-6 months of expenses. If you haven't gone through our financial planning process, your Relationship Manager would be happy to go through it with you and determine an emergency fund specific to your situation. If you have cash in an account earning less than 4%, talk to your Relationship Manager and see if it should be invested or put into a money market account at Schwab or Fidelity currently paying around 5%.

Bonds

Bonds are held to generate some form of investment return over and above cash. They carry some risk, usually tied to interest rates as we saw in 2022. They normally return more than cash over time, but less than stocks. Since 1928, they have averaged about a 5% return. More importantly, they often perform well when stocks perform poorly. That wasn't the case in the rising rate environment of 2022, but in both 2008 and the tech bubble from 2000-2002, bonds performed incredibly well. This allows for rebalancing towards your risk tolerance as bonds go up and stocks go down. Then when stocks recover, you will own more shares for the recovery. Commonly, as clients age, they own more bonds in their portfolio as they are less willing to take the risks associated with stocks and often have less need to do so. We view bonds as a ballast to a portfolio that creates some protection on the portfolio and allows us to be opportunistic when stocks drop and more conservative when stocks rally.

Stocks

Stocks have been the best returning asset class over the last 100 years; they have also been the riskiest. As the chart below highlights, twenty times since 1928 stocks (measured by the S&P 500) have fallen at least 25% within a calendar year. Despite that, the average return on the S&P 500 over that period is 11.5% per year.

S&P 500 Index: Max Intra-Year Drawdowns vs. End of Year Total Returns (1928 - 2023)

Year	DD	TR	Year	DD	TR	Year	DD	TR	Year	DD	TR	Year	DD	TR
1928	-10.3%	43.8%	1948	-13.5%	5.7%	1968	-9.3%	10.8%	1988	-7.6%	16.6%	2008	-48.8%	-37.0%
1929	-44.6%	-8.3%	1949	-13.2%	18.3%	1969	-16.0%	-8.2%	1989	-7.6%	31.7%	2009	-27.6%	26.5%
1930	-44.3%	-25.1%	1950	-14.0%	30.8%	1970	-25.9%	3.6%	1990	-19.9%	-3.1%	2010	-16.0%	15.1%
1931	-57.5%	-43.8%	1951	-8.1%	23.7%	1971	-13.9%	14.2%	1991	-5.7%	30.5%	2011	-19.4%	2.1%
1932	-51.0%	-8.6%	1952	-6.8%	18.2%	1972	-5.1%	18.8%	1992	-6.2%	7.6%	2012	-9.9%	16.0%
1933	-29.4%	50.0%	1953	-14.8%	-1.2%	1973	-23.4%	-14.3%	1993	-5.0%	10.1%	2013	-5.8%	32.4%
1934	-29.3%	-1.2%	1954	-4.4%	52.6%	1974	-37.6%	-25.9%	1994	-8.9%	1.3%	2014	-7.4%	13.7%
1935	-15.9%	46.7%	1955	-10.6%	32.6%	1975	-14.1%	37.0%	1995	-2.5%	37.6%	2015	-12.4%	1.4%
1936	-12.8%	31.9%	1956	-10.8%	7.4%	1976	-8.4%	23.8%	1996	-7.6%	23.0%	2016	-10.5%	12.0%
1937	-45.5%	-35.3%	1957	-20.7%	-10.5%	1977	-15.6%	-7.0%	1997	-10.8%	33.4%	2017	-2.8%	21.8%
1938	-28.9%	29.3%	1958	-4.4%	43.7%	1978	-13.6%	6.5%	1998	-19.3%	28.6%	2018	-19.8%	-4.4%
1939	-21.2%	-1.1%	1959	-9.2%	12.1%	1979	-10.2%	18.5%	1999	-12.1%	21.0%	2019	-6.8%	31.5%
1940	-29.6%	-10.7%	1960	-13.4%	0.3%	1980	-17.1%	31.7%	2000	-17.2%	-9.1%	2020	-33.9%	18.4%
1941	-22.9%	-12.8%	1961	-4.4%	26.6%	1981	-18.4%	-4.7%	2001	-29.7%	-11.9%	2021	-5.2%	28.7%
1942	-17.8%	19.2%	1962	-26.9%	-8.8%	1982	-16.6%	20.4%	2002	-33.8%	-22.1%	2022	-25.4%	-18.1%
1943	-13.1%	25.1%	1963	-6.5%	22.6%	1983	-6.9%	22.3%	2003	-14.1%	28.7%	2023 YTD	-7.8%	14.0%
1944	-6.9%	19.0%	1964	-3.5%	16.4%	1984	-12.7%	6.1%	2004	-8.2%	10.9%			
1945	-6.9%	35.8%	1965	-9.6%	12.4%	1985	-7.7%	31.2%	2005	-7.2%	4.9%			
1946	-26.6%	-8.4%	1966	-22.2%	-10.0%	1986	-9.4%	18.5%	2006	-7.7%	15.8%			
1947	-14.7%	5.2%	1967	-6.6%	23.8%	1987	-33.5%	5.8%	2007	-10.1%	5.5%			

Note: Closing Prices for Drawdowns as of 9/21/23 (does not include intra-day or dividends)

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Unfortunately, the typical investor does not experience that average return because they tend to overreact in down periods and then miss the associated recoveries. This is where a disciplined and process-oriented investment philosophy, like the one utilized by Legacy Wealth Management, adds value. Historically, stocks have been the best way to grow assets over time after adjusting for inflation and the associated loss of purchasing power.

Now that we have examined the history and use of each of these asset classes, it is time to examine how they could react going forward based on different economic outcomes.

"Soft-landing" - No Recession but a longer period of higher interest rates

This has been the Federal Reserve's (Fed) goal for the better part of two years since they started talking about inflation and raising interest rates in 2021. Their goal has been to slow economic growth to tame inflation in a way that does not cause significant problems across the entire economy. Specific sectors will get hit very hard with rising rates (housing in particular as many home purchases are based on mortgage rates). In this scenario, bonds may continue to suffer price declines. The higher yields that bonds pay now will make those price declines more manageable, potentially leading to positive returns in spite of smaller price declines. As of this writing, the Barclays Agg (Bond index) is down 1.04% on the year but is also yielding over 4.5%, so if the price declines cease, bonds could finish 2023 in positive territory even with the continued rate increases we've seen in 2023. Stocks in this situation should continue to recover from their 2022 lows. So far in 2023, the S&P 500 is up 13% and the MSCI All-Country World is up 10%. In this scenario a 70/30 portfolio consisting of 70% MSCI All-Country World and 30% Barclay's Agg is up 6.7%, well ahead of the YTD money market return of 3.06% (based on a representative fund available through Charles Schwab).

"Hard-landing" - Recession leading to lower inflation and a shorter period of higher rates.

If the United States does fall into a recession, bonds should add significant value to the portfolio. The Fed has raised rates back up toward historical averages. That means that if we enter a recession, for the first time in over 15 years, the Fed has the ability to cut interest rates significantly to help offset economic slowdowns. If the Fed begins to cut rates due to a recession, the large negative bond decline of 2022 could be reversed, creating significant capital appreciation in addition to the interest paid. This scenario, while bad for stocks, could see bonds return 10%+ and help offset stock market declines. Further, in this scenario, the nice cash yield of around 5% would decline, likely significantly. If holding cash, you wouldn't see any of the capital appreciation that bonds may experience and the rate you earn on cash would decline at the same time making it less attractive to own.

In either scenario, the goal of the Fed is not to keep cash rates where they are now. While the return may be nice in the short term, it is important to recognize that it is not presently a long-term investment strategy to hold cash. The return of stocks has historically outpaced both inflation and cash and has been the best way to accumulate long-term returns. Bonds have historically been a great counterpart to stocks and a good portfolio hedge. That wasn't the case in 2022, but going forward the Fed has raised rates enough that we think they should again provide a hedge to stock volatility going forward. The fact that cash rates are now around 5% is great and should be utilized for short-term spending needs, emergency funds, and checking/savings balances where appropriate. Stocks and bonds should continue to be the place to seek investment returns going forward. Bonds consistently outpace cash returns over time and offer better diversification from stocks. Stocks are still the best way to grow long-term wealth through compounding returns over time and have been proven to beat both the return on cash and outpace inflation over the course of a long-term planning horizon.