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Rethinking Stocks' Starring Role

Some financial professionals are challenging the traditional view that long-term investors should load up on equities

By SAM MAMUDI

For at least a generation, financial professionals have urged mutual-fund investors to put more money in stocks than in bonds. The logic: Stocks power a portfolio, while bonds provide some protection.

Now some pros are questioning that conventional wisdom. After last year's stock crash, and ahead of a potentially weak economic recovery, they're arguing that bonds and alternative asset classes such as commodities deserve more weight.

Sure, the Standard & Poor's 500-stock index ended August up 51% from its March low, for a 13% return for the year to date (before sliding 2.2% yesterday). But that spurt has left stocks far less cheap than they were a few months ago. And at least for the next several years, these pros say, stocks are unlikely to return to their previous highs—especially if a slow recovery restrains growth in corporate profits. Even if stocks deliver higher returns over time than bonds, the difference may not be large enough to justify the often higher volatility of stocks.

What's more, the classic 60-40 split between stocks and bonds—the formula that many balanced funds use to allocate investments—ignores alternative asset classes that can deliver returns with different levels of risk.

"The whole 60-40 idea is almost like Betamax videotapes—it's now passé," says Andrew Silverberg, co-manager of Alger Balanced Fund. "It gained popularity while we were still in a bull market."

Asset allocation should be "more dynamic," Mr. Silverberg says. "There are a lot of opportunities on the other side of the balance sheet," he adds, referring to corporate bonds. Earlier this year, Alger Balanced's stock allocation was 48%, though it has since increased to about 56%.

Gibson Smith, co-chief investment officer at Janus Capital Group and co-manager of Janus Balanced Fund, doesn't stick with the 60-40 formula either. "We're not just about driving returns, but also preserving capital," he says.

Late last year, Janus Balanced held 60% bonds and 40% stocks. While a 60-40 split between stocks and bonds is the nominal default of the fund, "we like having the flexibility" of ignoring that standard based on risk-reward profiles, says Mr. Smith. As of July 31, the fund was 55% in stocks and 45% in bonds.

Even with the recent climb, stocks definitely haven't been pulling their weight over the past year or two. The S&P 500 is still down 30% since Dec. 31, 2007. Bonds have fared much better: The Barclays Capital U.S. Aggregate Bond Index is up 10.1% over the same period.

Bond investors are also ahead of stock investors over the past five and 10 years—challenging the view that stocks beat bonds over longer periods. Over the past five years, the S&P 500 returned an average 0.1% a year, while the Barclays bond index returned an average 5%. Over the decade, the stock measure fell an average 3.7% a year, while the bond gauge returned an average 6.3%.

Historically, meanwhile, stocks have had higher highs but much lower lows than bonds. In their best year in the past half-century, 1975, stocks delivered a 37% total return—but they fell 37% in their worst year, 2008. By contrast, the best year for bonds was 1982, when they produced a 36% total return, while their worst year was 1999, when they fell 6%.

As for alternative investments, the Reuters/Jefferies CRB Index, the oldest global commodities index, has annualized total returns of 1.5% over the past five years and 8.6% over the past 10 years. The MSCI Emerging Markets Index is up just over 50% this year, and has five- and 10-year annualized total returns of 17% and 10.4%, respectively.

How closely do investors really watch their investment portfolios? Sam Mamudi asks New Yorkers about their stock and bond allocations and their views.

One of the loudest critics of the idea of investing heavily in stocks for the long run is Rob Arnott, chairman of money manager Research Affiliates in Newport Beach, Calif. Mr. Arnott, a veteran financial analyst and market pundit, recently wrote an article for the Journal of Indexes that highlighted that bonds have outperformed stocks over long stretches. Mr. Arnott found that from February 1969 through February this year, investors in 20-year Treasurys, rolling to the nearest 20-year bond and reinvesting the income, would have beaten investors in the S&P 500—a 40-year record of bonds beating stocks.

Mr. Arnott says the 60-40 balanced-portfolio theory took hold following the stock market's rocketing growth from 1949 to 1965, which gave investors the "incorrect idea of placing stocks at the center of our investing universe." During that 17-year period, annualized returns for the S&P 500 were 16.3%, while bonds rose 1.9% a year.

Over the past 200 years, Mr. Arnott says, stocks have beaten bonds by 2.5 percentage points a year—but half of that advantage comes from the 1949-1965 period. He believes last year's losses should be a wake-up call for investors to reduce stock allocations and more broadly diversify.

"There's no single answer" to the question of how a typical investor should allocate assets, Mr. Arnott says. But he adds that most investors should put at least 20% into alternatives.

Since 2006, Mr. Arnott has been generally reducing the stock exposure in the Pimco All Asset fund he subadvises for Pacific Investment Management Co. While he increased his stockholdings earlier this year, the rally saw him sell once more. As of June 30, the fund was about 9% in stocks and convertibles, 37% in corporate bonds and 54% in alternative assets, including 25% in Treasury inflation-protected securities, or TIPS. According to Morningstar Inc., the fund is up 16.3% so far this year and has annualized returns of 4.4% over the past five years.

"We have a very cautious, i.e., negative, view on growth stocks," Mr. Arnott says, and he notes that those shares dominate standard market benchmarks such as the S&P 500, which weight stocks based on their total stock-market value. On the bond side, Mr. Arnott has concerns about a resurgence in inflation; he suggests TIPS, as well as shorter-duration and lower-grade bonds.

For investors with a heavy stock exposure, "this is the perfect time to move elsewhere," including alternative assets such as commodities, Mr. Arnott says. "But a lot of folks will follow that conventional path of 60-40—and I think that's a mistake."

Other managers agree. "Any kind of strict percentage allocation doesn't make sense," says Steven Romick, manager of FPA Crescent Fund. "It's just ridiculous." FPA Crescent, which has a go-anywhere mandate, is about 38% in stocks, 28% in corporate bonds and 7% in shorts; the rest is in cash, waiting to be deployed.

Mr. Romick sees corporate bonds as more attractive than stocks in the current market. With stock prices at historically average valuations following the rally, "you're not getting paid enough to play," says Mr. Romick, adding, "growth's not going to be great for a number of years." The fund is up 18.2% so far this year.

James Shelton, chief investment officer at Houston-based wealth manager Kanaly Trust, says his firm reduced its stock exposure in favor of both bonds and alternative investments such as energy and commodities in the past year. His firm sees stocks returning 5% a year over the next seven years but is not more heavily into bonds because of inflation fears.

Mr. Shelton, whose firm manages about $2 billion, says that clients have not questioned the pullback in stock exposure. Some aggressive portfolios had as much as 80% in stocks, Mr. Shelton says, and those levels have been reduced to 50%. For balanced accounts, he says he's splitting assets evenly among stocks, bonds and alternatives.

"A lot of people who said they wanted to be aggressive [in investment approach] realized last year that they weren't comfortable with that," he says, adding that he increased some investors' stock allocations in the first half of August.

Still, many financial pros continue to believe that stocks should be the biggest element of a long-term portfolio. Ned Notzon, chairman of the asset-allocation committee at T. Rowe Price Group Inc., believes stocks will generally beat bonds over long time periods. And he says it's hazardous to try to sidestep periods of weak stock performance and then heavily invest in shares in the good times.

For investors with long-term time horizons, such as a far-off retirement, he says, "It's a bad idea to underweight stocks because you think you're in an economic crisis and you'll get back before there's a recovery."

Mr. Notzon is also cautious about bonds "because of the inflation question."

T. Rowe Price's asset-allocation group sets portfolio allocations for the firm's three target-risk funds and 12 retirement funds, typically based on the outlook for the next six to 18 months. The current allocation is overweighting stocks by five percentage points, meaning that in a traditional balanced portfolio the weighting would be 65% in stocks and 35% in bonds, Mr. Notzon says. The stock figure has varied by a few percentage points in recent years, though typically it has stayed overweight.

But the fund industry does seem to be moving in the direction of offerings that focus less on stocks. Rather than the old balanced-fund format, some fund firms are launching tactical allocation funds similar to Mr. Arnott's Pimco All Asset, says Russ Kinnel, director of mutual-fund research at Morningstar.

"There is a growing class of tactical allocation funds that have little to do with balanced strategies because they really have every asset class at their disposal and are making active shifts into those classes," says Mr. Kinnel. For instance, Legg Mason Permal Tactical Allocation, which launched in April, held about 30% in stocks as of July 31. Mr. Kinnel also points to Goldman Sachs Income Strategies, which reverses the traditional balanced-fund approach by aiming for 60% bond holdings and 40% in stocks.

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