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Inflation on the rise: time to rethink the 60/40 portfolio

- How the 60/40 portfolio came to be
- In an inflationary environment, bond allocation will not preserve value in real terms
- Rethinking the “40” with a focus on risk budget

What is the 60/40 portfolio?

Trying to find the very first mention of a 60/40 portfolio is a challenge, but it links back to Markowitz Modern Portfolio Theory and was for many years seen as close to the optimal allocation between [US] equities and [US] bonds. Harry Markowitz himself when considering a “heuristic” rule of thumb talked of a 50/50 portfolio. But the notional 60/40 equity/bond portfolio has been a long-standing proxy for a balanced mandate, combining higher-risk-return growth assets with lower-risk-return income-generating assets.

What’s in a 60/40?

Obviously the nature of the equity and the nature of the bonds depend on the investor. US investors look at 60% US equities/40% US treasuries. Global investors might look at 60% Global Equities/40% Global Bonds. For UK investors – and our Elston 60/40 GBP Index – we look at 60% predominantly Global Equities and 40% predominantly UK bonds

Why does it matter?

In the same way as a Global Equities index is a useful benchmark for a “do-nothing” stock picker, the 60/40 portfolio is a useful benchmark for a “do-nothing” multi-asset investor.

Multi-asset investors, with all their detailed decision making around asset allocation, risk management, hedging overlays and implementation options either do better than, or worse than this straightforward “do-nothing” approach of a regularly rebalanced 60/40 portfolio.

Indeed – its simplicity is part of its appeal that enables investors to access a simple multi-asset strategy at low cost.

The problem with bonds (the ‘40’) in an inflationary environment

Over the years, the relationship between asset classes has changed so much that the validity of 60/40 as a strategy can legitimately be questioned.

The key challenges with a 60/40 portfolio approach lie generally on the bond side:

- Inflation risk is ramping up pressure on nominal bonds in such a way that they can no longer be considered capable of preserving value
- Government bonds provide negligible or negative yield, so investors who want income need a riskier asset like equities, not bonds
- With interest rates at all-time lows following a sustained bull-market in bonds, there is downside risk to bonds as/when the rate cycle turns
- Returns between equities and bonds may not always be negatively correlated so there is reduced diversification effect

So is 60/40 an outdated concept?

In short, as a benchmark no. As a strategy – we would argue that for serious investors, it never was one.

We therefore think it’s important to distinguish between 60/40 as an investment strategy and 60/40 as a benchmark.

We think that a vanilla 60/40 equity/bond portfolio remains useful as a benchmark to represent the “do nothing” multi-asset approach.

However, we would concur that a vanilla 60/40 equity/bond portfolio, as a strategy offered by some low cost providers does – at present – face significant challenges.

For example, during the peak of the COVID market crisis in March 2020, correlations between equities and bonds spiked upwards meaning there was no place for investors to hide. Current inflation risk, proving to be less transitory as each day passes, has put additional pressure on nominal bonds. Real yields are negative. Interest rates won’t go lower.

In this day and age, beyond certain low-cost retail products, very few portfolio managers would offer a vanilla equity/bond portfolio as a client strategy. It is the inclusion of alternatives that now has an important role to play as a diversifier.

Rethinking the 40% with a focus on risk budget

When it comes to rethinking the 60/40 portfolio, one starts with an investor’s level of risk budget. For that risk budget is to be maintained, there can be little change to the “60% equity” part of a 60/40 portfolio. But for the 40%, we see opportunity for a shake-up as follows:

1. Rethink the bond portfolio
2. Incorporate sensible alternatives
3. Consider risk-based diversification

1. Rethinking the bond portfolio

Whilst more extreme advocates of the death of 60/40 would push for removing bonds entirely, we would not concur.

Bonds have a role to play for portfolio resilience in terms of their portfolio function (liquidity, volatility dampener), so would instead focus on a more nuanced balancing of yield and duration.

We agree that long-dated nominal bonds look problematic, so would suggest a more "barbell" approach between shorter-dated bonds (as a dampener of volatility), and targeted, diversified bond exposures: emerging markets, high yield, inflation-linked (for diversification and real yield pick-up).

2. Incorporating sensible alternative assets

Allocating a portfolio of the bond portfolio to alternatives makes sense, but we need to consider what kind of alternatives.

Whilst some managers are making the case for hedge funds or private markets as an alternative to bonds, we think there are sensible cost-efficient and liquid alternatives that can be considered for inclusion that either have bond-like characteristics (regular stable income streams), or provide inflation protection (real assets).

For regular diversified income and inflation protection, we would consider: asset-backed securities, infrastructure, utilities and property. The challenge, however, is how to incorporate these asset classes without materially up-risking the overall portfolio.

For inflation protection, we would consider real assets: property, diversified, commodities, gold and inflation-protected bonds.

Properly incorporated these can fulfil a portfolio function that bonds traditionally provided (liquidity, income, ballast and diversification).

3. Consider risk-based diversification as an alternative strategy

One of the key reasons for including bonds in a multi-asset portfolio is for diversification purposes from equities on the basis that one zigs when the other zags.

In the short-term, and particularly at times of market stress, correlations between asset classes can increase, this reduces the diversification effect if bonds zag when equities zag.

We would argue risk-based diversification strategies have a role to play to here, on the basis that rather than relying on long-run theoretical correlation, they systematically focus on short-run actual correlation between asset classes and adapt their asset allocation accordingly.

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Structuring traditional portfolios means choosing asset weights which then drive portfolio risk and correlation metrics. Risk-based diversification strategies do this in reverse: they use short-run portfolio risk and correlation metrics to drive asset weights. If the ambition is to diversify and decorrelate, using a strategy that has this as its objective makes more sense.

60/40 will remain a useful benchmark for multi-asset investors but we do believe a careful rethink of the "40" is required.

Henry Cobbe

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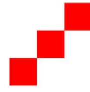

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