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Rethinking the 60/40 portfolio

- What is the 60/40 portfolio, and why does it matter?
- The problem with Bonds in a 60/40 framework
- Rethinking the 40%: What are the alternatives?

We agree it's time to rethink the 60/40 portfolio. It's a useful benchmark, but a problematic strategy.

What is the 60/40 portfolio, and why does it matter?

What it represents?

Trying to find the very first mention of a 60/40 portfolio is proving 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 depends on the investor. US investor 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 in a 60/40 framework

In October 2019, Bank of America Merrill Lynch published a research paper "The End of 60/40" which argues that "the relationship between asset classes has changed so much that many investors now buy equities not for future growth but for current income, and buy bonds to participate in price rallies".

This has prompted a flurry of opinions on whether or not 60/40 is still a valid strategy

The key challenges with a 60/40 portfolio approach is more on the bond side:

- Government bond provide negligible or negative yield, so investors who want income need riskier asset, like equities, not bonds
- With interest rates at an all-time low, following a sustained bull-market in bonds, there is downside risk to bonds as/when the rate cycle turns
- Returns may not always be negatively correlated so there is reduced diversification effect
- Inflation risk puts growing pressure on nominal bonds

So is 60/40 really dead?

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 this time – face the significant challenges identified in the 2019 report, that have been vindicated in 2020 and 2021.

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 to hide". The growing inflation risk has put additional pressure on nominal bonds. Real yields are negative. Interest rates won't go lower.

But outside of some low-cost retail products, very few portfolio managers, would offer a vanilla equity/bond portfolio as a client strategy. The inclusion of alternatives have always had an important role to play as diversifiers.

Rethinking the 40%: What are the alternatives?

When it comes to rethinking the 60/40 portfolio, investors will have a certain level of risk budget. So if that risk budget is to be maintained, there is little change to the "60% equity" part of a 60/40 portfolio.

What about the 40%?

We see opportunity for rethinking the 40% bond allocation by:

We nonetheless think it is important to:

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 approach between yield & duration.

We would concur that long-dated nominal bonds look problematic, so would suggest a more "barbell" approach between shorter-dated bonds (as volatility dampener), 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 also 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.

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.

Summary

So 60/40 is not dead. It will remain a useful benchmark for mult-asset investors.

As an investment strategy, vanilla 60/40 equity/bond products will continue to attract assets for their inherent simplicity. But we do believe a careful rethink of the "40" is required.

Find out more

For more insights and information on research, portfolios and indices, visit:

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