INVESTMENT BULLETIN

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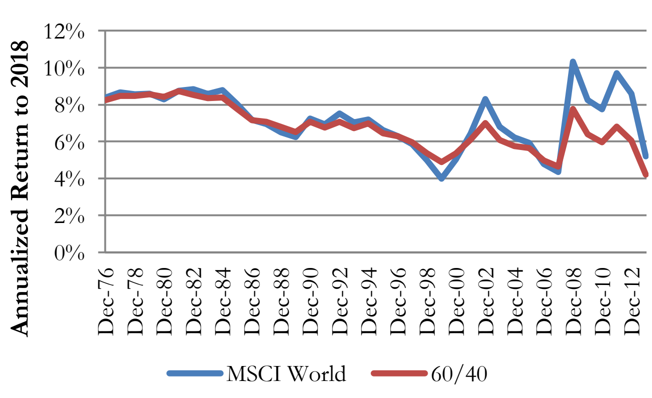
## Then and Now: 60/40 Portfolios

Financial innovation often blows up. That might be said of the high yield bond bonanza led by Drexel Burnham in the '80s, the levered arbitrage strategies of Long Term Capital Management in the '90s, the structured mortgage products of Wall Street at-large in the '00s, etc. On the other end of the spectrum, the 60/40 portfolio innovation has been spectacularly successful. Trading 40% of your stocks for bonds has been a wonderful result for investors who sought less of the wiggles, about-faces, and free-falls for which stock markets are famous. But what worked in the past doesn't always work in the future. In this month's *Investment Bulletin* we analyze the 60/40 portfolio in the context of today's market environment and offer our take on how to improve its prospects.

The 60/40 strategy is so popular because it has worked. Consider Figure 1a. We show the returns you would have earned with a pure stock portfolio (MSCI World) versus a 60/40 portfolio comprised of the MSCI World Index (60%) and Barclays Aggregate Bond Index (40%), rebalanced annually, had you started investing in every year from 1976 to 2013 (we decided to end the starting years here to eliminate the noisiness of short-term returns)[1]. For example, the first point on the graph shows that both a stock-only portfolio and a 60/40 portfolio would have earned a little over 8% a year had you invested it at the end of 1976. Follow the lines to the right to get the same figures for an investment starting in 1977, 1978, and so on.

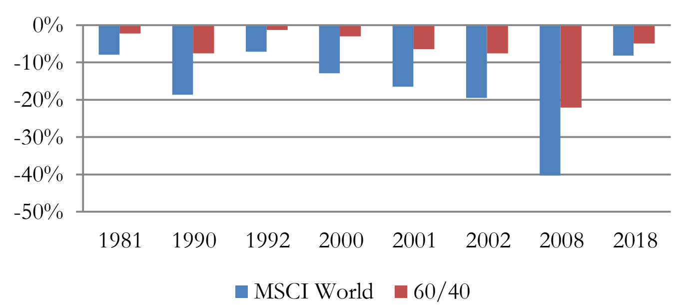
**Figure 1a: 60/40 Didn't Ask for Much Sacrifice...**
*Source: Bloomberg, KP calculations*




The message of the graph is that, except for more recent periods, 60/40 portfolios required almost no return give-up versus 100% stock portfolios. A similar graph using the S&P 500 instead of the MSCI World would show a little give-up, about 1.4% on average, but not meaningfully change the overall conclusion that there hasn't been a large opportunity cost to swapping 40% of your stock portfolio for bonds.

In exchange for minimal return give-up, investors have enjoyed significant risk reduction. Figure 1b presents the evidence. On average, the 60/40 portfolio has only captured about 40% of the market's losses in negative years. The global financial crisis punished stock portfolios (the MSCI World lost 40% in 2008), but 60/40 investors only experienced a 22% decline.

**Figure 1b: ...while Offering Big Boosts in Bad Years**
*Source: Bloomberg, KP calculations*




***So Why Did 60/40 Work?***

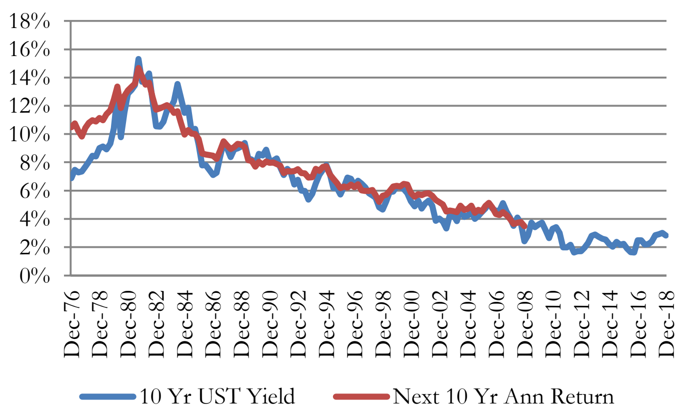
Trading 40% of your stocks for bonds worked so well because bond returns have been stock-like. If you average the experiences of an investor starting in each year from 1976 to 2013 you get just a 2% drop in returns from the MSCI World to the Barclays Aggregate Bond Index (4% if you use the S&P 500). In other words, a 40% swap only costs 0.8% (2% give-up times 40%) a year on average. Plus, you get the benefit of rebalancing – buying stocks after a bad year, selling after a good year – that adds back 0.4% on average. Your net give-up is just 0.4% a year.

But the averages belie a trend working against 60/40 investors. While stock returns have generally remained in the high single-digit to low double-digit range (unless you started in the dot-com mania) bond returns have steadily trended down. That means that the gap between stocks and bonds has widened considerably. You can see that in the divergence of the lines in Figure 1a – the return give-up starts to be meaningful for 2008 vintage investors to present. This begs the question of 60/40's sustainability.

***Will It Keep Working?***

One statement we can make with high confidence is that bond returns will be low going forward. We know our clients and friends have heard this many times, but it is worth demonstrating, especially in a year like this one with bond returns pushing towards double-digits. Figure 2 shows that the starting yield of the ten-year treasury bond predicts the next ten years of bond returns with high accuracy. The series are in fact 94% correlated (100% indicates perfect prediction accuracy). The blue line gives the yield at each date and the red line shows the ten-year annualized Barclays Aggregate return from that date forward. For example, the yield at the end of 1976 was about 7% while the return from 1976 to 1986 was a little more than 10% a year. While that prediction wasn't spot on, the blue and red lines have been on top of each other from the '80s forward. If history holds, the graph says that today's yields – above 2% at the beginning of the year, below 2% now – predict about a 2% return over ten years.

**Figure 2: Yields Predict Returns**
*Source: Bloomberg, KP calculations*




This doesn't necessarily mean that 60/40 portfolios won't operate the way they have in the past. It could be that forward stock returns are also lower meaning the 60/40 strategy still asks for minimal return give-up and provides downside protection in line with history. But it could be that stock returns are closer to average which would mean that the return give-up is meaningful. We don't think we need to make a call on the path here to recognize that either way will likely leave 60/40 clients less than satisfied – lower absolute returns in the former case or higher opportunity cost in the latter.

***What to Do About It?***

We think there are two natural responses to this conundrum. First, look to be dynamic in your portfolio. We dedicate a segment of many client portfolios to tactical strategies that use quantitatively verified processes to dial risk up or down based on a synthesis of economic and market data inputs. (See the August 2017 *Investment Bulletin* for a write-up on our internal strategy). We believe these strategies could be an effective antidote to lower expected returns, especially if there are periods of prolonged sell-offs in the next ten years – market volatility creates an opportunity for outperformance if a tactical strategy is successful at reducing risk ahead of or at the beginning of a slump. Of course, no one strategy will always get it right so we advocate using multiple and only for a segment of the portfolio.

Second, look for alternative sources of return. This has been an area that has struggled recently but has the potential to deliver in a low yield environment. We have a liquid alternative sleeve in our Advisor level portfolios that invests in a number of a different strategies that have low correlation to both stocks and bonds. Some examples include gold, managed futures, market neutral equity, merger arbitrage, and insurance-linked securities. If bonds deliver 2% a year over the next ten, we think these types of strategies as a group have a good chance of delivering a better result. Also, for clients that meet regulatory requirements, we think the alternative universe is even richer in quantitative equity, absolute return, and global macro partnerships.

We wrote on this topic not to alert you to the problem (we don't think it's a secret) but rather to offer solutions. This means both access to ideas that address the 60/40 conundrum, and the analytical ability to synthesize how the ideas work together to build a portfolio that still delivers on the downside protection illustrated in Figure 1b. We often see suggestions to mitigate the low yield problem by buying high yield bonds. While this may be a solution, if you swap investment grade bonds for high yield bonds, one for one, you probably lose out on some Figure 1b protection. Likewise, if all your bonds are short duration, you probably are weakening the effectiveness of your rebalancing discipline (short duration bonds will likely appreciate less in a flight from stocks to bonds, thus generating less profits for purchasing depressed stocks). If we can help you think about new ideas for your 60/40 portfolio and/or demonstrate how the decisions you've already made impact the risk of your portfolio please reach out to any of us at Keel Point. □

[1] The analysis starts in 1976 because that is the first year of common data history. We have chosen to use the MSCI World, which excludes emerging markets, instead of the MSCI All Country World Index (our typical benchmark) because the latter only has data history to 1988.