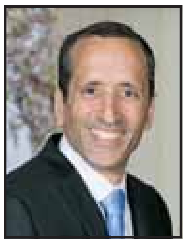
60/40 Hindsight: Is It Time to Reconsider One of the Key Tenets of Portfolio Management?



By Jonathan Caplan

For many decades, investment professionals have embraced the 60/40 investment strategy for clients, hoping to achieve strong and steady long-term returns. While returns on stocks have generally bested returns on bonds, the higher volatility of the stock market has caused advisors to search for asset classes that can help buffer the negative effects of equity market volatility. An asset class whose returns are negatively correlated with stock returns can theoretically produce improved risk-adjusted overall returns.

If one looks at historical returns of stocks versus bonds over the past half century, bond returns have been quite competitive vis-a-vis stock returns. Moreover, the correlation between stock returns and bond returns was generally negative for the last three decades of the 20th century, according to a report from asset management firm PGIM ("U.S. Stock-Bond Correlation—What are the Macroeconomic Drivers?").

Another favorable characteristic of bonds in the late 20th century was that real yields (interest rates adjusted for inflation) were generally positive. Finally, yields on bonds were significantly higher than dividend yields on stocks, helping to generate prodigious streams of cash flow for income-oriented investors.

A New Investment Paradigm

The fundamental characteristics of both stocks and bonds have changed markedly in recent years. One of the most notable changes for bonds is that nominal yields have been hovering near historic lows. For example, the yield on the 30-year Treasury bond peaked at about 15% in 1981 before a steady decline over the next few decades. Currently, the 30-year Treasury Bond is yielding slightly north of 2%. Shorter dated Treasury maturities yield even less. Bond investors are challenged to generate income without investing in long dated and less creditworthy bonds.

Another notable change has been that dividend yields on equities are increasingly more competitive with yields on bonds. The dividend yield on the S&P 500 index is currently about 1.33%, just slightly below the yield on a 10-year Treasury note. This narrowing comes even after the sharp rise in equity prices since the March 2020 low. At the market nadir last year, the dividend yield on the S&P 500 index reached 2.76% according to Datastream, an unusually large premium to the 10-year Treasury note yield of 0.76% at that time.

A more perplexing issue for fixed-income investors today is that yields on many bonds are below the rate of inflation. For example, assume one purchased a 10-year Treasury note today with a yield of 1.5% with the intention of holding it until maturity. With the inflation rate on an upward trajectory this year, it is not unreasonable to expect the inflation rate to exceed the Federal Reserve's target of 2% over the next decade. In this scenario, an investor will effectively be losing purchasing power on their investment as the rate of inflation exceeds the bond interest payments. (Moreover, after taking into account the effects of taxes, the loss of purchasing power would be even greater.)

Returning to the 60/40 portfolio strategy, a final point on the evolving question on its effectiveness going forward: The same study published by PGIM notes that bond returns and stock returns have been increasingly more correlated over the past 20 years. When the Federal Reserve begins to tighten monetary policy, we may see an even higher correlation. Rising interest rates could translate into lower bond prices as well as lower stock prices. Stocks have benefitted in recent years from the "TINA" syndrome, namely that "there is no alternative" in terms of an asset class that can produce attractive returns. In a rising-interest-rate environment, asset allocators will be incentivized to re-allocate more dollars into a higher yielding bond market and reduce their allocation to equities.

Rethinking the Role of Bonds

Perhaps we need to rethink how to optimally position one's bond portfolio given the current state of the financial markets. Interest rate "repression" due to the unprecedented easy monetary policies of the Federal Reserve should give investors pause. More specifically, if one believes that the Federal Reserve will taper its easy monetary policy as inflationary pressures continue to simmer, one should consider alternatives that could outperform traditional bonds. Moreover, during periods of rising inflation like the 1970s, most fixed-income securities perform rather poorly. Even so, some sectors of the bond market will perform better than others.

There are a number of fixed-income securities that can perform well in a rising-interest-rate environment. One segment of the fixed-income market that has been outperforming the rest of the bond market so far this year has been the "TIPS" market. "TIPS" stands for "Treasury Inflation-Protected Securities." These bonds have lower interest rates than conventional bonds, but they have the advantage of the principal being protected from the rising rate of inflation.

Final Thoughts

We are living in unprecedented times from a number of perspectives. We have just recovered from one of the most disastrous external events in recent memory, namely the COVID-19 pandemic. Moreover, from a risk perspective, we are experiencing a period of strong monetary and fiscal stimulus, leaving investors with uncertainty as to how well the markets will perform as policies normalize. Both monetary and fiscal stimulus will undoubtedly need to be unwound, perhaps sooner than many expect. The magnitude and rapidity of that normalization process could lead to a variety of outcomes that need to be contemplated by investors as they weigh the risks in a post-pandemic world. While the 60/40 investment model may still prove to be effective in reducing portfolio volatility, the likelihood of unanticipated outcomes should give investors pause. The need to factor in the many risks ahead should motivate investors to consider asset allocation solutions that can provide the ballast to minimize portfolio risk while generating healthy returns.

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