1Q 2020 Market Insights
The Future of 60/40
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"If you want to have a better performance than the crowd, you must do things differently from the crowd." - Sir John Templeton

Several years ago, in our 4Q 2017 Market Insights – *Solving The Diversification Problem,* I addressed a number of issues including why investors should not abandon the age old wisdom of not putting all your eggs in one basket. Diversification and its benefits are alive and well. As I made the point that US equities are climbing to unsustainably expensive levels, I also made the following statement:

While I will save opining on the future of investment management and what my beliefs are on how portfolio construction has changed for a later date, suffice it to say, our current unique times are requiring thoughtful and unique solutions. I suspect this may involve investors learning to become more comfortable with unconstrained portfolios, but also arriving at their desired risk levels much differently than they do today. Again, a topic for a later day.

Recently there have been several articles questioning the viability of the traditional diversified portfolio strategy: the good old 60% stock/40% bond portfolio. A quick Google search will reveal that in the month of December alone, there have been at least four articles written on this topic. All four articles identify low bond yields and their recent failure to provide a hedge against falling stock prices as the main reason to question the viability of the strategy. Most cite a poor year in 2018 for both stocks and bonds as evidence to support their claim. While I am obviously in agreement that the traditional diversified portfolio (i.e. a 60/40 portfolio or some other mix of stocks and bonds) will likely need to change, it is not in the manner being proposed. In fact, it is my belief that the proposed solution may make things worse. The topic of this quarter's Market Insights will be to address this issue in greater detail by discussing *The Future of 60/40.*

<u>If it Isn't Broken Why Fix It?</u>

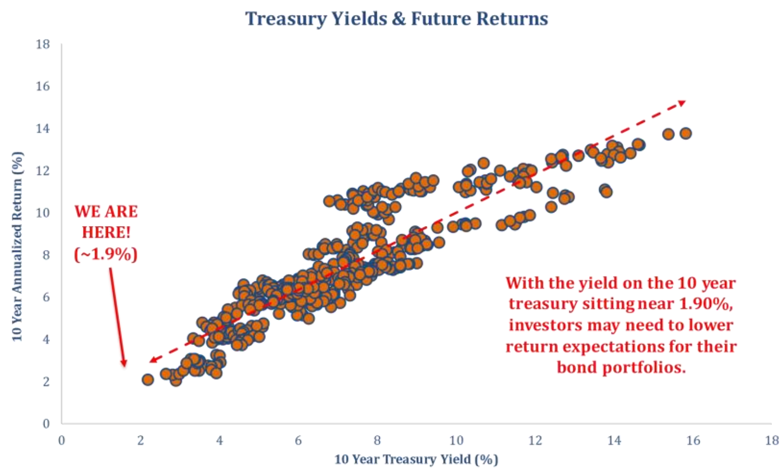
As value managers, we are well aware of the impact that elevated valuations have on long-term future returns. The blessing, as it relates to this awareness, is that you can see both good and bad environments developing way in advance. The curse is that it can take some time for elevated valuations to burst, ultimately impacting returns. This is common during the formation of bubbles. So why are professionals now questioning the validity of 60/40? I would hope that the length of the bull market run at nearly 11 years without a correction, or the 435% gain in the S&P 500 since the market bottom in 2009, have caused investors to stop and wonder how sustainable this might be. Sadly, I think it's for the wrong reasons. Investors are observing strong returns from US stocks and using the low current yields of bonds to justify a larger allocation to the hot asset. My assessment of the reason is pure speculation on my part. However, this behavior is not uncommon to see during the formation of bubbles, as many in the late 1990's used Jeremy Siegel's book *Stocks for the Long Run* to rationalize higher equity allocations near the top of the internet bubble, leading to disastrous outcomes. Regardless of the reason, several are questioning if a 60/40 strategy, to us a proxy for a traditional diversified portfolio regardless of the mix, is still appropriate.

To address this question, let's start with why it was ever appropriate, just for some perspective. Using historical inputs for risk, return, and correlation, along with a very basic split of 48% US equity, 12% Non-US equity, 38% US bonds and 2% cash will produce a portfolio that historically provided a return of 9.51% per year with a risk level, or standard deviation, of 9.33%. This combination of return and risk over several decades has served as a remarkable combination to both grow wealth and manage risk. The problem today is that it isn't likely to be achievable going forward. To understand why let's examine the inputs.

The historical rates of return used to generate this were 11.56% for US stocks and 9.05% for international stocks, hardly controversial to most. Here is where the problem becomes obvious, and why bonds are taking fire. The historical rate of return for bonds and cash was 7.32% and 4.47% respectively. With interest rates at near rock bottom levels, it is pretty obvious to even the untrained eye that 7% may not be achievable.

Bond Yields & Future Returns

Chart 1



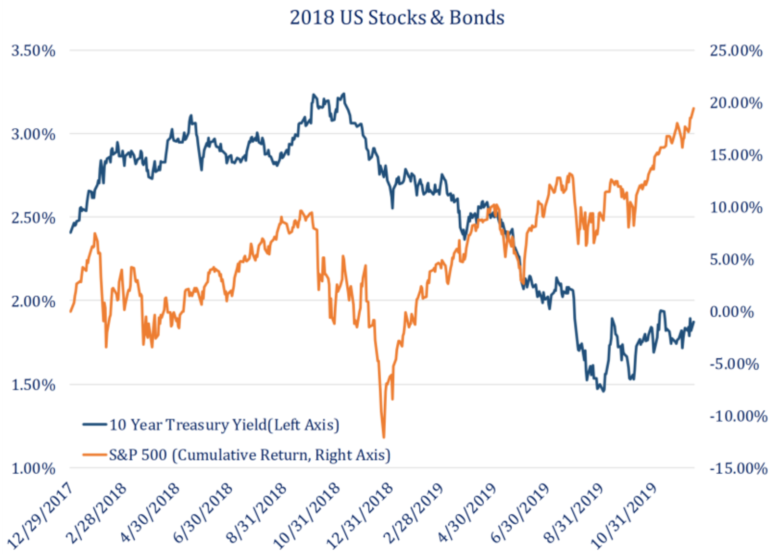
Data Source: FRB, iCM Capital Markets Research

To a be a bit more scientific. I give you Chart 1. Bonds, more than any other asset, over a sufficiently long time-horizon, are a "what you see is what you get" asset. That is, the next 10-year return on the 10-year treasury bond is directly related to its beginning period yield. It matters very little if interest rates rise or fall next week, next month, or even next year. For the treasury, beginning yield, which currently sits at 1.92%, drives the majority of the return an investor will receive over the long-term. This is clearly a far cry from the 7.32% used in our example, not to mention the overzealous expectation for cash, making these assets easy targets for those questioning 60/40. But therein lies the issue. While I will agree that the low return on fixed income assets presents a challenge, it does not even come close to being the primary problem with 60/40.

The second issue identified in the anti-bond argument relates to correlation. Correlation is the manner in which one asset moves in relation to another. Assets that move in perfect unison will have a +1 correlation, while those that move in the exact opposite direction will have a -1 correlation. For the purpose of diversifying a portfolio, having a low or negative correlation is desirable since you want some assets to appreciate while others decline. In most environments, especially times of stress, sellers of stocks find bonds to be a safe haven, driving up the prices of bonds as stocks fall. Historically, the average correlation between US stocks and bonds is .09, essentially no correlation. The recent criticism, as it relates to the stock/bond relationship pertains to 2018, when stocks declined by -4.38% (-13.52% for the 4th quarter) and bonds were essentially flat. While bonds didn't hurt, they also did little to help when it mattered most, in the minds of the critics. Their conclusion is that bonds are likely to be a low returning asset and one's fortunes would be better served eschewing bonds in favor of an all equity portfolio.

Interest Rates Impact Stocks & Bonds in 2018

Chart 2



Data Source: FRB, S&P

Is it reasonable to assume that last year provides sufficient evidence to draw a long-term conclusion that bonds don't provide sufficient diversification to make them worth your while? To answer, it is common for correlations to rise temporarily, but it is nowhere near enough data to draw even a reasonable, much less statistical, conclusion. In fact, in 2018, while 12-month correlations between stocks and bonds did hit a high of .23, they also sank to a low of -.55 during the same year.

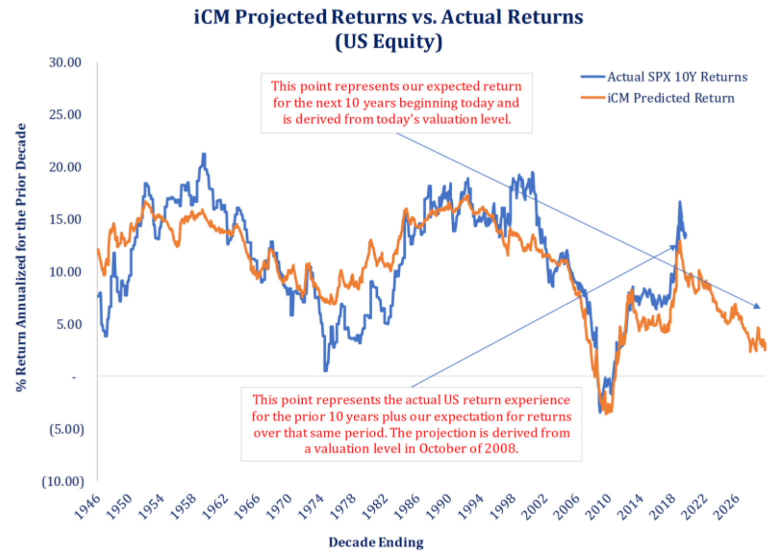
Spikes in correlation generally occur when the driver of performance is a common factor. In the case of stocks and bonds, the typical common link is inflation and/or interest rates. In fact, in our 2Q 2018 Market Insights, *The Elephant in the Room,* we identified that as a single variable, inflation has a large influence over the equity valuation multiple explaining roughly 60% of the change in valuation. By contrast, the level of interest rates across the entirety of the yield curve explains approximately 80% of the change in the valuation multiple. In 2018, we were faced with both concerns over rising inflation and, correspondingly, a series of interest rate hikes, an environment that is not conducive to generating strong returns for stocks or bonds. While I agree that portfolio management and structure as we know it are likely to change substantially over the next decade, the reason has less to do with bonds than it has to do with stocks, particularly US equities, and very little to do with changing correlations.

To borrow the title of one of my prior quarterly letters, the rather large elephant in the room is not US bonds, but US stocks. On virtually every valuation metric, P/E, P/B, CAPE, P/S (the list goes on), the US market is meaningfully overvalued. While short periods can be quite random in terms of return, as we extend our view to periods of a decade or more stock returns become quite predictable and highly correlated to their beginning valuation, much in the same way future bond returns are predictable by their beginning period yield. Chart 3 demonstrates this via our US equity valuation model and its prediction for the forthcoming 10-year return plotted against the corresponding actual 10-year return.

There are two takeaways here. First, the model is highly accurate at predicting long-term returns, as the blue and orange lines lie in close proximity to one another. The second take away is the low level of return that correspond with our current valuation, 2.51% per year for the next 10 years. So, which presents the bigger problem; bonds, where treasuries are priced to provide 1.9%, but where a diversified US portfolio of treasuries corporates and mortgages may give you 2.5%, or US large cap stocks that are likely to provide the same return with at least three times the risk? Recalculating the return for the traditional diversified 60/40 portfolio using these new inputs and I arrive at an expected return of 3.25% per year for the next decade (before management fees or expenses, yikes!). I would venture to guess that this would put a dent in most financial plans, mine included.

Valuations Impact Future Returns

Chart 3

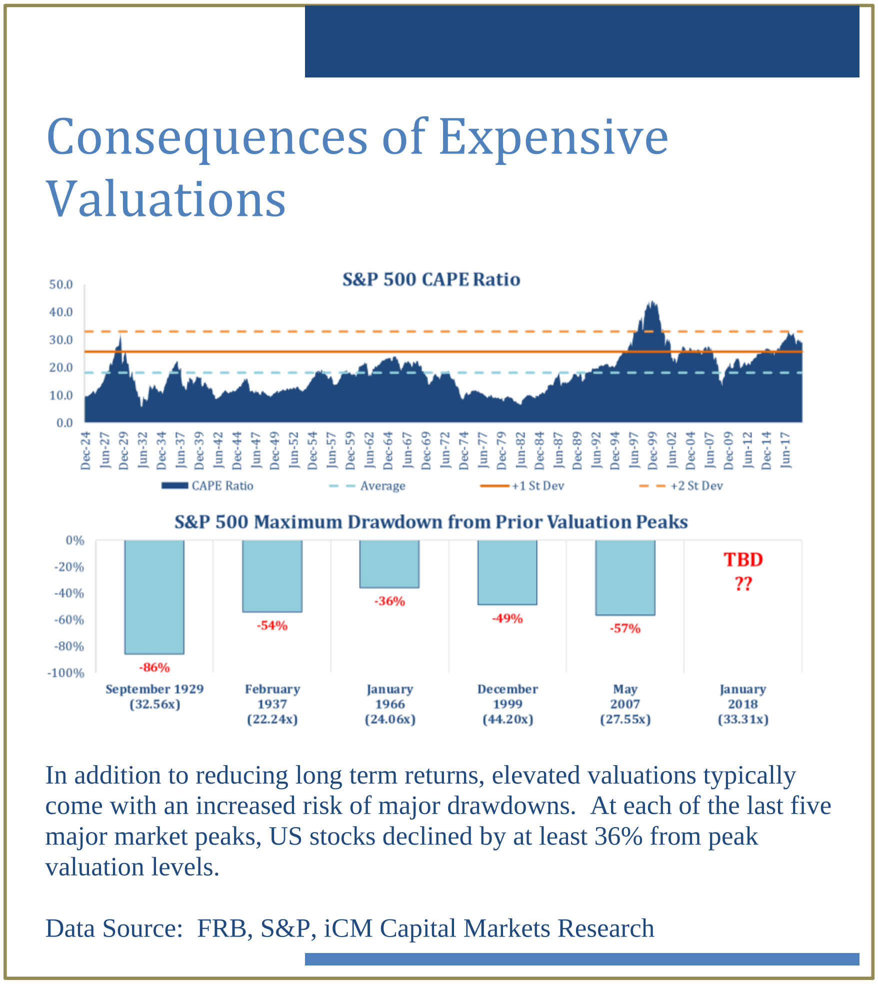


Data Source: FRB, S&P, iCM Capital Markets Research

<u>Fixing 60/40</u>

In the preceding paragraphs we discussed several issues facing the traditional diversified portfolio, in our example a 60% stock/40% bond split. While many others point to bonds being the problem, with the corresponding solution being buy more US stocks, we believe that comes with disastrous consequences, in terms of risk, and does little to offer a return solution even over the long-term. From a risk perspective, high valuations of this nature often correspond with market declines. In fact, with each of the prior five valuation peaks, all produced declines of more than 36%. When comparing US stocks vs. US bonds, we can derive the following: both US stocks and bonds are likely to provide returns for the next decade that are somewhere around 2.5%, with stocks carrying far greater risk. Needless to say, shifting to stocks to solve the low return of bonds is probably not a sound solution.

What can you do? How about diversification? Well, it helps some in this case. As poor as the valuation landscape looks for the US, emerging markets stocks and bonds, international developed markets stocks, and commodities futures all look correspondingly good. Using the same valuation process, we arrive at expected returns of 9.5% for emerging markets, 7.5% for international developed markets, 8% for commodities futures and 6% for emerging markets bonds. For the sake of space, I will spare you the analytics. However, we encourage anyone who is interested to reach out to us, as we are glad to share that information (we've published it previously). If we add a modest layer of diversification by including these assets, the expected return of the 60/40 portfolio would improve marginally to 3.5%, while risk would actually decline to 8.86%. If we overdiversified beyond conventional norms, taking our international weight from 12% to 18%, add emerging markets equity at a 6% weight, emerging markets bonds at a 4% weight, and commodities at 6%, correspondingly reducing US stocks and bonds to 30% and 34% respectively (cash remains 2%), the expected return now improves to 4.25%, with less risk



than the original portfolio (9.2% vs 9.33%). While that's a full 1% per year better than where we started, I doubt this fully addresses the problem, with most requiring a rate of return higher than this to meet their objectives. The root cause, we still own rather large weights in low returning assets. Why? Because, conventional portfolio management tells us to lean heavily on US stocks and sprinkle in some diversifiers. Folks, I will state this directly. I don't believe that investors have that luxury anymore. In order to solve this problem, we need to be willing to approach this differently. We need to be willing to allow those assets with better return prospects to consume larger amounts of our portfolio than is customary. Allow me to illustrate with a simple example.

I'll hold the mix of stocks vs. bonds at 60/40, but equal weight the assets within each instead of leaning toward US stocks and bonds. The new bond portfolio will have 19% each in emerging markets bonds and US bonds (2% cash). The equity side of the portfolio will be divided equally among 4 assets with 15% to each, US stocks, emerging markets stocks, international stocks, and commodities futures. The portfolio's expected return now becomes 5.75%, with a marginal uptick in risk to 11% from 9.33%. To move from a portfolio with a 3.25% return to one that potentially approaches 6%, is a marginal uptick in volatility worth it? On the original portfolio, the range of returns in 2/3 of all environments would be -6.08% per year to +12.58% with an average of 3.25%. On the new portfolio, the range would be -5.25% to +16.25% with an average of 5.75%. Which would you prefer? I think most would select the second. In the case above, I used a simple equal weighting scheme to objectively illustrate a point. While the real-world implementation would likely be different than equal weighting, the point is that the weighting methodology and home country bias are leading investors toward a very poor outcome, simply because the investment community has always done it that way.

Is there a catch?

Well, yes there is a catch. If you are benchmark sensitive, the proposed approach will produce greater variations around a benchmark than the original. Said differently, the proposed portfolio will likely out- and under-perform a benchmark by wider margins than a conventional portfolio. If you are uncomfortable seeing the US equity market gain 30%, while your diversified portfolio that is half stocks and half bonds gains less than half that number, this solution could prove difficult to stick with for the long run. Alternatively, is it better to hug a benchmark that is expected to produce a return that is insufficient to meet your goals at 3.25% per year for the next decade or dare to be different? People fund retirement goals, pay for weddings and college educations from the total return on their investment portfolio. Meeting these obligations with a thoughtful approach to risk management are always our priorities.

As we began this article, many investors have recently questioned the continued viability of the traditional 60/40 portfolio. Several years ago, I also questioned its usefulness, as traditionally structured. As is often the case during bubble periods, critics will present seemingly logical reasons to hold larger allocations to hot asset classes, in this case US stocks, while eschewing the safety of bonds. By the same sense, bonds are clearly no panacea, but serve a second, yet crucially important role in a diversified portfolio. That is, they serve as the conservative anchor that many of us require, and are likely to provide returns that are similar to US stocks with less volatility over the next decade. To us, the problem is obvious. Investors have allowed themselves to be boxed into a historical solution that leans heavily on US stocks, simply because the industry has always done it that way. If investors are to meet their objectives, we believe that we all must dare to be different, embrace over-diversification, and do what is painfully obvious, at least to us. That is, to own assets that are likely to generate better returns in greater quantity in place of those that are unlikely to meet client needs. I thank you for your trust and confidence and wish you all a healthy and prosperous new year.

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