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The Death of the 60/40 Portfolio Approach

After almost 70 years of success, the 60/40 portfolio investment approach has become too risky and structurally incapable of meeting its intended objectives. It needs revisiting.

First a bit of background. A 60/40 portfolio, which divides assets between equities and bonds, has been the standard for most personal investment portfolios. It is the starting point for many wealth advisors who might recommend a percent adjustment based on age; whereas, for instance, a higher equity allocation is recommended for younger people.

Foundations of the 60/40 portfolio emerged from Harry Markowitz's Modern Portfolio Theory (MPT) work in the 1950's which won him the Nobel Prize. It is also the basis on which today's robo-advising algorithms are written. Yet, MPT never envisioned a world in which someone has to pay to lend money. Today, we have $15 trillion worth of bonds with a negative nominal yield and trillions more whose yield is less than the rate of inflation. It is extraordinary to think that an investor can receive no compensation for assuming interest rate risk, and in some cases, for taking credit risk either.

Many passive institutional investors use products, funds or ETFs that track the now flawed Barclays U.S. Aggregate Index (Agg) as their core fixed-income allocation. With well over 9,000 bonds in the index, it is certainly well diversified, but the top two components - Treasuries and Mortgage Backed Securities - now have an 84% correlation. In addition, the Agg is weighted toward the companies and agencies that have the greatest debt. Having a large amount of debt might indicate a bigger company, but it doesn't necessarily make for a better bond investment.

Today the Agg yields 2.20% with duration of 5.6 years. There is also an index for global bonds, the Barclays Global Aggregate Index, which yields 1.22% with a duration of 7 years. These results should be considered 'return free risk' rather than a 'risk free return'. Objectives of a complete portfolio break down even further when investors sell low or negative-yielding fixed income securities and indexes, and replace them with dividend paying stocks.

For over a half-century, the two-asset 60/40 stock and bond portfolio did an excellent job providing the four main goals of a sound portfolio: growth, inflation-protection, income and down-side protection. Stocks would typically benefit over time from the first two objectives and bonds from the latter two.

There is no doubt that realized returns from 60/40-type portfolios have been extraordinary; and, even more so in recent years due to the "Everything Bubble"- which is the result of excessive accommodation from global central banks. The strategy has provided a wonderful, convenient and easy way to structure a simple portfolio and still achieve the intended objectives of the portfolio. However, bonds have been in a bull market since 1982 and may have reached their practical limits, and US stock market capitalization has risen to an astounding 164% of GDP.

Unfortunately, the Everything Bubble has also elevated correlations, disfigured the proper functioning of capital markets, destroyed price discovery, and pushed securities to valuations levels which no longer justify many of the risks being assumed. The 60/40 strategy is now ineffectual and too risky. Stated differently, a diversified, but long-only, mix of stocks and bonds, is no longer a safe, balanced or prudent portfolio structure.

Since the great financial crisis of 2008, the Fed has changed investor psychology. During this period, investors developed a “fear of missing out” and were encouraged to engage in risk-seeking behavior. The Everything Bubble led by stocks and bonds prices soaring to record levels was an intended goal for central bankers. Simultaneously, the Fed eased many fears of downside risk by providing a “put,” or instilling the belief that the Fed was ready to provide ever-more market stimulus at the first signs of any market, or economic, wobble.

Markets have come to rely on central bank actions too heavily. Central banks have limited tools and do not have the ability to fix underlying problems. Today’s investment environment with negative rates and the Everything Bubble is unsustainable. After 11 years of financial repression and wild market speculation, the setting is ripe for a “Minsky Moment” whereby stocks and bonds snap violently lower without central banks having the power to stop or prevent the crash. Unfolding global currency wars, with their corresponding geo-political tensions, could easily be the catalyst for a “Minsky Moment” and could mark the beginning and return of a 1970s-type of stagflation.

It is imperative for investors to keep the pervasive ‘psychology of bullishness’ in-check, particularly now that asset prices no longer reflect the underlying economic fundamentals which they are supposed to track. It is also imperative that investors understand that correlations between stocks and bonds have risen well-above the historical average, and thus no longer effectively provide the proper balance and attributes needed to achieve the four investment objectives outlined earlier.

Long-only stock and bond investors should immediately develop an action plan for making adjustments to their portfolio. Institutional investors and their trustees should re-evaluate which benchmarks, if any, are prudent to track. Individual investors should stop asking themselves “How can I beat the market?”, and, in an Everything Bubble world, should not even be asking “How can I match the market?” All bubbles eventually pop. Fear of missing the upside of a bigger stock and bond bubble fueled by central bank actions is a poor strategy, as well as being reckless and unwise.

When building or adjusting a portfolio, the question an investor should be asking is: “How can I can I achieve my life’s goals and my portfolio objectives with some degree of certainty?” Stocks and bonds represent only a small sliver of the investible landscape. There are hundreds of alternative investment exposures that investors can choose from today, many of which were not available in the past. Some examples include long/short strategies, peer-to-peer lending, TIPS, royalties, venture capital or real investment strategies, to name a few.

In short, investors should seek a diversified portfolio whose components and exposures are non- or less-correlated and more idiosyncratic. Some of the goals of making these adjustments to the portfolio should be as follow: 1)Decrease correlations; 2)Increase current income; 3)Reduce risk and avoid losses in a down turn; 4)Maximize returns for the risks that one takes; 5)Align with the objectives of what is trying to be achieved; and/or, 6)Protect accumulated wealth against inflation and currency devaluation.

An active plan for adjusting portfolios will improve the balance between upside-capture and downside-risks. Of equal importance is that refocusing will increase the probability of meeting the portfolios intended objective with increased certainty, while steering it away from its reliance on central bank experimentation – a strategy whose success relies on inflating ever-bigger asset bubbles.