The end of the 60/40 portfolio

The financial world has been turned upside down since the Great Financial Crisis (GFC). In an effort to prop up the global economy, central banks implemented unorthodox monetary policy measures, such as negative or zero interest rates (ZIRP) and quantitative easing (QE). Although the global economy slowly recovered, creating one of the longest expansions in the post-war era, there were also many unintended negative consequences. At the start of this year, the Covid-19 pandemic forced central banks, including the Federal Reserve (Fed), to reinstate most of the same unorthodox measures used after the GFC, producing most of the same unintended results. In this issue of the Thinking Man, we discuss the consequences of these policies for portfolio construction, focusing on the current scarcity of hedge assets, and providing specific recommendations to implement in clients' portfolios.

Traditional hedge assets are not providing any meaningful protection

The 60/40 portfolio has historically provided significant value to investors over more than 40 years. This portfolio refers to a typical allocation that has approximately 60% in stocks and 40% in bonds. The main goal is to provide an attractive long-term return through the growth of the equity exposure, while using the bond exposure, typically through Treasuries and high-grade bonds, as a protection against short-term market swings. Yields on U.S. Treasuries have usually fallen when stocks markets tumble. Since yields move inversely to bond prices, this alleviated portfolio losses. However, this relationship has been broken because of the Fed and other central banks' unprecedented interventions in the market, making many analysts predict the inevitable demise of the 60/40 portfolio; mainly explained by two reasons.

First, successive rounds of QE have caused a collapse in nominal and real yields of bonds, particularly in sovereign debt. In the U.S., Treasury nominal yields have fallen once again to historical lows, while in most of Europe and parts of Asia sovereign bond yields are negative. Even worse, global real yields are deep into negative territory, as can be seen in the graph below. With yields this low, they are unlikely to continue falling in order to provide the necessary ballast to protect investors' portfolios in times of turmoil.

The Thinking Man's Approach

November 2020 | Series #81
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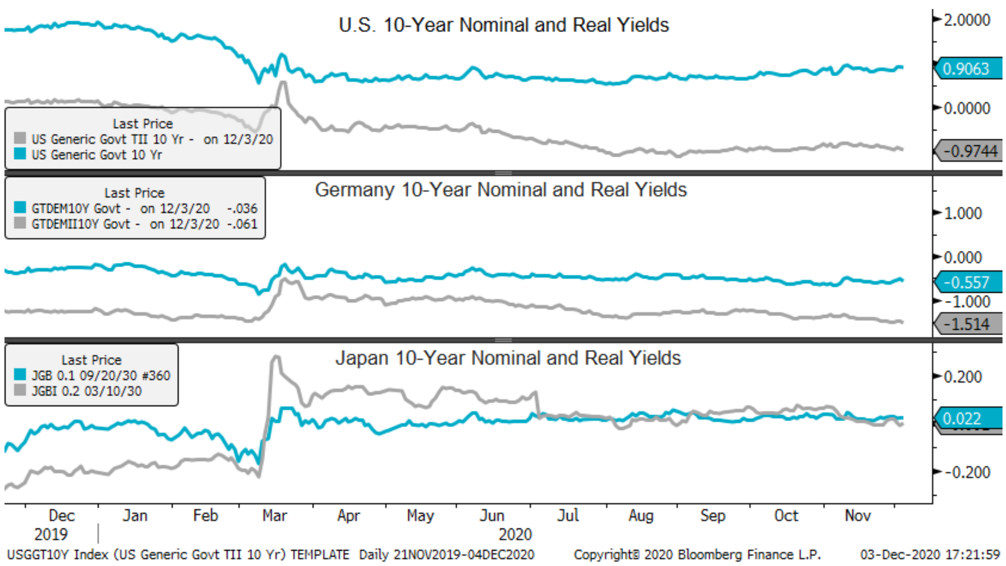
- The demise of the 60/40 portfolio has been caused by two main reasons:
- Successive rounds of QE have resulted in fixed income failing to provide the necessary ballast to protect investors' portfolios.
- The Fed and other central banks through QE have flooded the market with liquidity, disrupting traditional uncorrelated or negatively correlated assets, such as equities and bonds, which have been moving in tandem.
- Advisors and investors need to adapt by incorporating non-traditional or alternative hedge assets.
- On the fixed income side, we recommend investors to use a "barbell" strategy that combines risky high yielding bonds with cash and complement the portfolio by using hybrid and perpetual bonds.
- On the equity side, we continue to believe that the best approach is to maintain a "barbell" positioning, while implementing covered writing strategies.
- Finally, on the alternatives side, portfolios should include precious metals such as gold and silver and start building positions in cryptocurrencies. Finally, we continue to advocate for a significant increase in the allocation of illiquid private investments.

For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com

Making things worse, given the economic recovery currently underway following the easing of global lockdowns and restrictions, and encouraging news coming from potential vaccines, yields are actually more likely to increase than to fall over the next few months. As a result, bond investors face a dramatic dilemma; they can lose money either slowly to inflation, or more quickly if there is a repricing of expectations and yields rise significantly.



Second, the Fed and other central banks have flooded the market with liquidity through the implementation of the asset purchase programs. Although these programs have been successful in restoring investors' confidence in financial markets and promoting economic growth, they have also disrupted its functioning. Central banks' interventions have resulted in binary markets, where financial assets have started to move in tandem in either direction. Traditional uncorrelated or negatively correlated assets, such as equities and bonds have started moving in tandem together. In times of stress, all assets are selling-off, while rallying together in times of enthusiasm. For example, in the week before the U.S. Presidential election, the S&P 500 fell almost 6%, marking one of the worst weeks since the March sell-off. In the same week, government bonds and gold, which are textbook safe havens, did not provide any protection. Treasuries barely budged, and even had a small yield increase, while gold lost approximately over 1% during the week.

Investors are now confronting a market where traditional hedge assets or safe havens are not providing any meaningful protection. Rather, they are moving in unison with other risky assets, while in moments of stress markets are crashing at a much sharper and faster rate than before, as was the case during the Covid-19 crash earlier in the year. To make things worse, expected returns of balanced portfolios have dropped to mid-single digits. As the 60/40 portfolio is quickly becoming irrelevant, advisors and investors need to adapt to the new investment landscape by turning to non-traditional or alternative hedge assets. Below, we provide some options from a fixed income, equity and alternative asset class perspective.

Fixed income

The first alternative that we suggest does not entail a complete break-up from the 60/40 model, but rather a reconfiguration. Instead of using Treasuries and high-grade bonds for the fixed income portion of the portfolio, investors could use a "barbell" strategy that combines risky high yielding bonds with cash. This combination has the advantage of providing greater upside for the same average yield, while giving investors the optionality of adding additional risk at more attractive prices in case of a market sell-off. With the Fed indicating its intention to leave rates on hold for the near future, and the economy continuing to recover from the Covid-19 meltdown, defaults should remain low, and spreads should continue to compress to near historical lows.

The fixed income portion can also be complemented using hybrid and perpetual bonds that not only offer significant income in a yield deprived world, but also provide a much higher expected return than sovereign debt. A fixed income portfolio that has a significant portion in high yield, and hybrids and perpetuals does not necessarily provide an adequate downside protection for a portfolio. In fact, as happened in this year's sell-off in March, they fell almost as much as equities. However, retaining a significant portion in cash and cash-like securities limits the downside, while giving the flexibility to increase exposure in risk assets in times of stress, most likely increasing the long-term return of the portfolio.

Equity

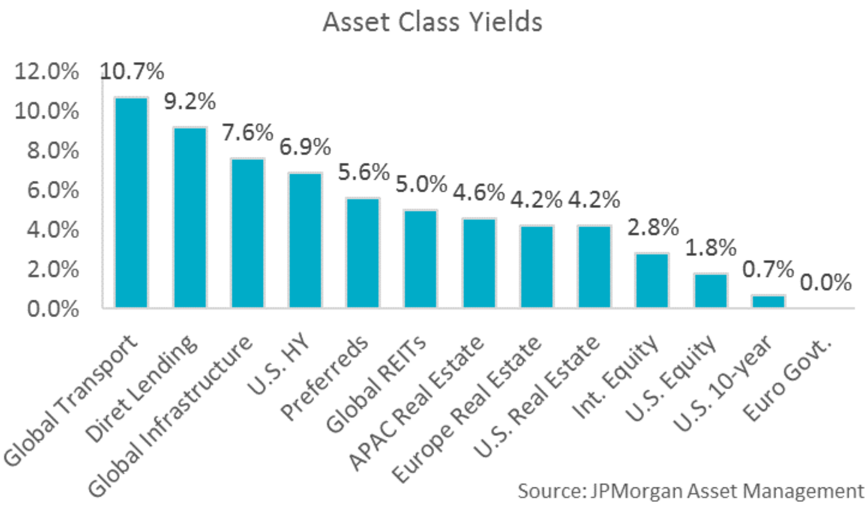
The equity portion of the portfolio can also be hedged using single stock and index options, although they have soared in popularity in recent months due to the rise of work from home day traders, making them quite expensive. There is also a wide availability of inverse ETFs that aim to give the holder the opposite performance of many of stock and bond indices in the U.S. and abroad. Nevertheless, inverse ETFs are not good medium or long-term hedges, as their performance will differ from the one of the underlying index because of fees, trading costs, and the effect of compounding. Finally, structured products such as structured notes are designed to provide investors with upside exposure, while limiting or eliminating the downside risk. Even as structured products are good long-term hedges, the main limitation is that investors are usually tied to them for long periods, since they are not liquid securities.

From an equity perspective, what is more interesting, and has become apparent recently, is that some sectors have started to behave like safe havens. Utilities, consumer staples and high-dividend paying stocks used to be the go to sectors where investors would seek protection when the equity market was correcting. Nonetheless, most recently, we have seen the ascent of other sectors to take this spot. Earlier in the year mega cap tech work from home stocks, supported the market and led the recovery in the spring and summer months. Most recently, we have seen how other industries such as gun manufacturers and metal mining companies have outperformed the market, boosted by political fears and expectations of continued economic recovery.

We continue to believe that the best approach for the equity portion of the portfolio is also to maintain a "barbell" approach. On one side, investors should include stocks in their portfolios that are expected to outperform in case of a sell-off caused by a prolonged third Covid-19 spike or unexpected political turmoil, as we believe is the case with mega-cap tech, and other work from home stocks and gun manufacturers. On the other side, investors should have exposure to cyclical sectors that can benefit from the economic recovery, such as industrials, financials, transportation and value companies in general. On a final note, we continue to recommend income generation strategies such as selling calls on existing portfolio positions with expected limited upside, as a way of increasing return in clients' portfolios.

Alternatives

A final option is increasing the allocation to alternative assets. In commodities, portfolios should continue to incorporate precious metals such as gold and silver. These commodities are not only hedges against market downturns, but also provide protection against unexpected increases in inflation expectations. Another interesting alternative is for investors to slowly start to build a position in cryptocurrencies such as Bitcoin and Ethereum. These securities are likely to have a wider appeal going forward now that PayPal has put its support behind it, as it has started to accept it as payment of method for its transactions. As digital currencies, they can protect investors from the unintended consequences of the monetization of sovereign debt that will continue, we believe, at least over the next few years.



Source: JPMorgan Asset Management

Finally, we continue to advocate for the inclusion of illiquid private investments in portfolios. This is a rising trend, in which sovereign wealth funds and endowments have relied on heavily since the last decade. At BigSur, we have also taken big strides to increase our clients' allocation to this particular sub-asset class as we expect that going forward it will likely continue to become a vital portion of investors' portfolios. From a short-term perspective, this option makes sense as a way to reduce mark to market volatility, avoiding daily price swings and selling pressures. Over the long-term, replacing the fixed income portion with private debt and real estate investments can also increase substantially the effective return of a portfolio. Private credit in particular continues to command a significant yield differential over public markets, mainly driven by the illiquidity premium, as can be seen in the graph above.

Key Takeaways

The financial world has changed significantly since the GFC and will continue to evolve in the current decade. Investors need to adapt their portfolios to the changing investment landscape, otherwise, they risk earning a return that barely covers the rate of inflation or even worse, sustaining bigger losses in times of financial turmoil. Even conservative investors need to get out of their comfort zone of safe, low volatility securities, and start creating dynamic portfolios that have greater expected returns by maintaining a tactical mindset and increasing the exposure to riskier or illiquid sub-asset classes. We believe that ultimately, investors will have to move away from the traditional private client 60/40 model and move closer to the highly diversified and dynamic long-term endowment model. The following is a summary of the problem we have identified, and the possible solutions described through the document.

- With both bonds and equities being currently expensive, we expect lower future returns, and larger and more frequent drawdowns for the traditional 60/40 portfolio.
- From current yield levels, bonds are unlikely to protect equity losses, in what could potentially become a future "nowhere to hide" bear market. Tail risks for equities and bonds have significantly increased making balanced portfolios much more risky going forward.
- Furthermore, in periods of high volatility, the negative correlation between bonds and equities have actually turned positive, even across regions. Other traditional "safe haven" assets such as gold, Yen and Swiss Franc, have also been more positively correlated to the equity market, pointing to a declining benefit in diversification.
- With this in mind, it is important to adapt the traditional 60/40 portfolio, not only so there is a portion that provides ballast in times of crises, but also to enhance the expected long-term return.
- Combining high yielding, hybrid and perpetual securities with cash creates a portfolio with a similar average yield, but with potential greater expected return, while retaining the option of buying risky securities at a significant discount in case of a market correction. Investors should not be afraid of holding more cash than before.
- On the equity side, inverse ETFs, options and structured products remain the primary ways to hedge portfolios in our view. Companies in some sectors, such as information technology, gun manufacturing and metal mining have started behaving as "safe havens" recently. We also continue to recommend engaging in income generating strategies to enhance expected returns, such as covered calls.
- Finally, endowment style investing, which increases a portfolio allocation to alternatives, has been experiencing strong growth and it is now the time to continue implementing in private client portfolios.

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