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MARKET SIGHT LINES

The “60/40” Portfolio Breaks Down: What Should Investors Do?

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Any student of investing will learn the concepts behind the “60/40” balanced portfolio. The idea is to invest 60% in stocks and 40% in bonds to create a balanced portfolio experience. But in the first quarter of 2022, the performance experience of 60/40 was anything but balanced, with both stock and bond markets posting negative returns. In this week’s Sight|Lines, we review essential concepts behind the 60/40 portfolio, what happened in the first quarter, and steps an investor can take to go beyond 60/40.

THE 60/40 PORTFOLIO

Finance students learn early that a diversified portfolio is intended to deliver lower volatility than more focused investments. Buy one stock, and the return experience day to day, month to month, and even year to year can be quite volatile. Buy 20 stocks, and the individual returns usually move in different directions day to day, month to month, or year to year, so the blended portfolio theorectially offers a smoother performance experience. The same concept usually holds for 60/40, so when the 60% component invested in stocks moves in one direction, the 40% bond component’s return is often more muted or even goes in a different direction. Importantly, when stocks experience a significantly negative move, bonds often post a positive return, helping soften the sting of negative performance. These asset classes also provide complementary features or objectives. Stocks are known for growth, with modest income from the subset of stocks that pay dividends. Bonds provide income through coupon interest payments to the investor, with the repayment of principal to the investor at maturity.

THE HISTORY OF 60/40 PERFORMANCE

Many U.S.-based investors implement 60/40 with a 60% investment in large cap U.S. stocks, like those that make up the S&P 500, and 40% in investment-grade bonds, as represented by the Bloomberg U.S. Aggregate Index. Figure 1 presents the return of the S&P 500 for each calendar year (vertical axis) plotted against the return of the Bloomberg U.S. Aggregate Index for each year since 1977, including first-quarter 2022 returns. So far, this year is shaping up to be the first calendar year where the 60/40 portfolio “broke down,” meaning both components posted negative returns. Generally speaking, diversification worked over this period. For those more statistically-minded readers, the correlation between these two indexes was 0.22 over this period, based on monthly data. This low correlation parameter, well below 1.0, implies positive diversification benefits from investing in these components together.

IS 60/40 "DEAD?"

While 2022 has been a difficult year, the benefits of a diversified 60/40 portfolio should prove out looking forward, especially for long-term investors. Investors should avoid the temptation to completely rebuild a diversified portfolio because of this short period of negative performance. But there are steps an investor can consider to diversify, or even amplify, the performance experience of the classic 60/40 portfolio.

WHAT SHOULD AN INVESTOR DO? REFINING AND EXTENDING 60/40.

When we write about diversification, we often talk about diversifying within and across asset classes. So, as a first step, we can refine the 60/40 strategy by diversifying within the areas of equity and fixed income. Beyond large cap U.S. stocks, investors can consider an allocation to small cap U.S. stocks, developed markets outside the U.S., and even emerging market equities. On the fixed income side, investors can consider Treasury Inflation-Protection Securities, or TIPS, to hedge against potentially higher inflation in the future. One can also consider a modest investment in high-yield bonds, which are below investment grade. Especially in the current environment, it will be helpful to consider active management for these additional categories – small cap stocks, non-U.S. stocks, TIPS, and high yield.

Looking beyond "traditional" asset classes, the more sophisticated investor, if qualified, can consider what the industry has defined as "alternative investments." Liquid alternatives provide both hedging (diversifying) strategies and higher return objective (amplifying) strategies in the form of mutual funds offering daily liquidity. For sophisticated investors that qualify, hedge funds are similar strategies delivered in a private vehicle format that are less liquid, many offering subscription/redemptions on a quarterly basis, for example. Private asset funds take private equity or debt positions in companies with the goal of delivering enhanced returns. In most cases, these funds are illiquid, with an investment life of up to 7-10 years or beyond. The investor is foregoing liquidity for an enhanced return.

Not to be left out, an investor can also consider an investment in real estate through publicly traded securities, mutual funds, exchange-traded funds, or via a private vehicle.

CONCLUSION

In the first quarter, both components of the 60/40 portfolio posted negative returns. If both post negative returns for the full year of 2022, this will be the first time this has happened since 1977. Is 60/40 "dead?" We don't think so, but investors may yet benefit from considering investing in additional asset classes to diversify, and potentially amplify, the performance experience of their portfolio.

Want to learn more? Check out Stifel's approach to asset allocation here.

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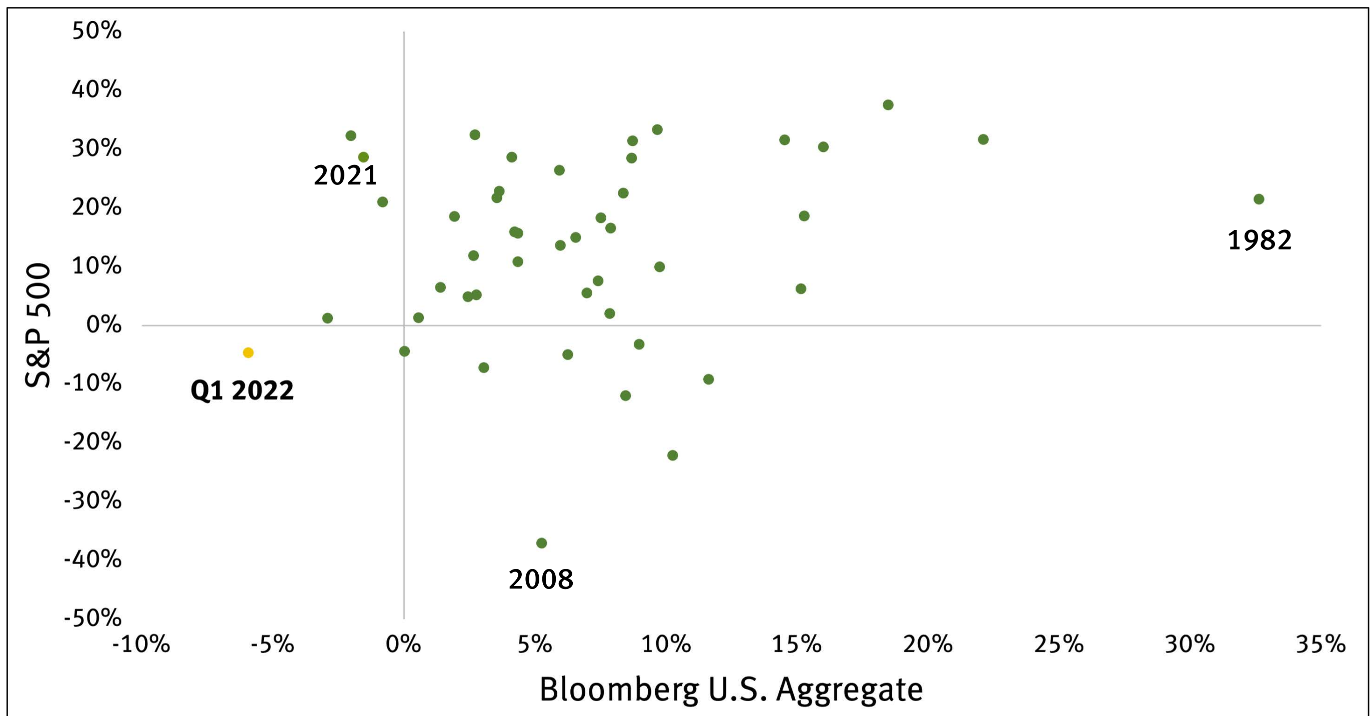
Figure 1. S&P 500 vs. Bloomberg U.S. Aggregate Annual Returns (1977-2022)



Source: Stifel Investment Strategy via Bloomberg, as of April 6, 2022

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Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. The Standard & Poor's 500 index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The DJIA was invented by Charles Dow back in 1896. The MSCI EAFE index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

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