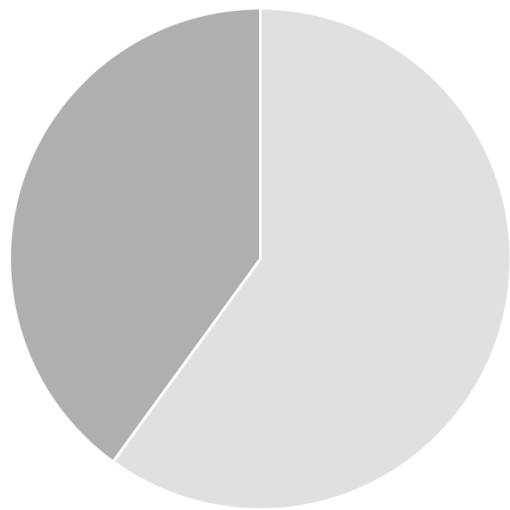
First Ascent Asset Management

IS NEWS OF THE 60/40 PORTFOLIO'S DEATH GREATLY EXAGGERATED?



First Ascent Asset Management
firstascentam.com

IS NEWS OF THE 60/40 PORTFOLIO'S DEATH GREATLY EXAGGERATED?

"The news of my death is greatly exaggerated."
- Mark Twain

For over a decade now commentators have been pronouncing the death of the traditional 60/40 portfolio, or at least predicting its imminent demise. Yet the humble 60/40 portfolio, apparently oblivious to these prognostications, has continued to produce solid results.

The target for these commentators is a portfolio consisting of 60% US stocks and 40% US bonds. The portfolio is rebalanced periodically to roughly maintain this asset allocation.

Just the Facts

From January 2007 through March 2021, a period that includes two Bear markets, the 60/40 portfolio produced an annualized return of 7.97% vs. 9.88% for the US stock market.

The maximum drawdown for the 60/40 portfolio during that period was 30.7% vs. 50.9% for the US stock market.

So, the 60/40 portfolio achieved 80% of the return of the US stock market with a maximum drawdown that was 40% less. Clearly the 60/40 portfolio is alive and well.

What about the future? Will it continue to show strong vital signs, or will it finally succumb, thus redeeming the pundits who have been in error for so long?

Stating the Case

The case against the 60/40 portfolio is the same now as it has been for the better part of the last decade. Bond yields are close to historic lows. They are likely to rise, causing capital losses for investors. Even if they remain at current levels, they will not produce a sufficient return. The stock market is highly valued and will likely produce lower returns going forward.

This case rests, largely, on predictions about what is "likely" to happen in the future. These predictions have been wrong for the last ten years. Why would they be any better now? Financial theorist and author William Bernstein once said, "Trying to predict stock market returns is merely foolish; trying to predict interest rates is outright idiotic."

But what if these predictions do finally come to pass? After all, bond yields have been at historic lows for a long time and there have been recent flickers of upward movement. Stock prices have also long been high by historic valuation measures. How much higher can they go?

Why the 60/40 Portfolio Still Has Life

If bond yields rise, investors will suffer capital losses. But research shows that these losses are often temporary. As investors reinvest in bonds with higher nominal yields, they can make back those losses within a relatively short period. They may even be far better off taking the capital loss in the short-term and owning the higher yielding bonds over the long-term.

If bond yields remain low, the bonds in the 60/40 portfolio can still perform another important role. Minimizing volatility. During the January 2007-March 2021 period referred to earlier, the standard deviation of the 60/40 portfolio was 9.49% vs. 16.04% for the US stock market. And, as we saw, the maximum drawdown of the 60/40 portfolio was far less, thanks to its bonds.

The correlation of US stocks to US bonds during this period was roughly zero, providing a decent diversification benefit. Of course, you could hold only US Treasuries and get the benefit of their negative correlation to US stocks, but then the diversification of your bond holdings would be less and the long-term return of the bond portion of your portfolio would likely be lower.

You must also remember to assess the returns you receive on your bond holdings in real, rather than nominal terms. In 1980 you could buy a 10-year Treasury yielding 12.3%. But individual tax rates could be as high as 70% and inflation was about 11.9%. So, after taxes and inflation that fat nominal Treasury yield could be significantly negative in real terms. In today's lower tax, lower inflation environment, bonds yielding far less could produce a higher real return.

It is certainly true that stocks are highly valued by traditional measures and could produce lower returns in the future. But if stocks produce only 5% to 6% percent returns, is that so bad?

Compared to What?

It depends entirely on the alternatives, and this is an important point that is often overlooked in the debate about the vitality of the 60/40 portfolio. Stocks and bonds may well produce somewhat lower returns in the next 10 years than they did in the last 10 years. There is no way to know for sure. But if you believe that to be true, what should you do about it?

Many of the 60/40 portfolio doomsayers have a not so hidden motive for predicting its demise. They have something to sell. It might be a tactical or an alternative strategy. It might be commodities, managed futures, or real estate. Of course, these products always come with a convincing story. But on closer examination these stories are often flawed.

Certainly, adding asset classes with the right performance characteristics can, theoretically, improve the traditional 60% US stock/40% US bonds portfolio. International stocks and bonds are examples of investments that can further diversify the portfolio without adding unwarranted risk or costs. But additions should only be made if there is a compelling case after considering the potential performance benefits, risks, and costs.

It is certainly possible that the returns of the traditional 60/40 portfolio could be lower in the next 10 years than they were in the past 10 years. But we should be cautious before we declare the death of a portfolio that has been such a stalwart and produced such strong results for decades. Tinkering with the portfolio to boost returns could easily have the opposite impact, while introducing unintended risks and increasing costs.