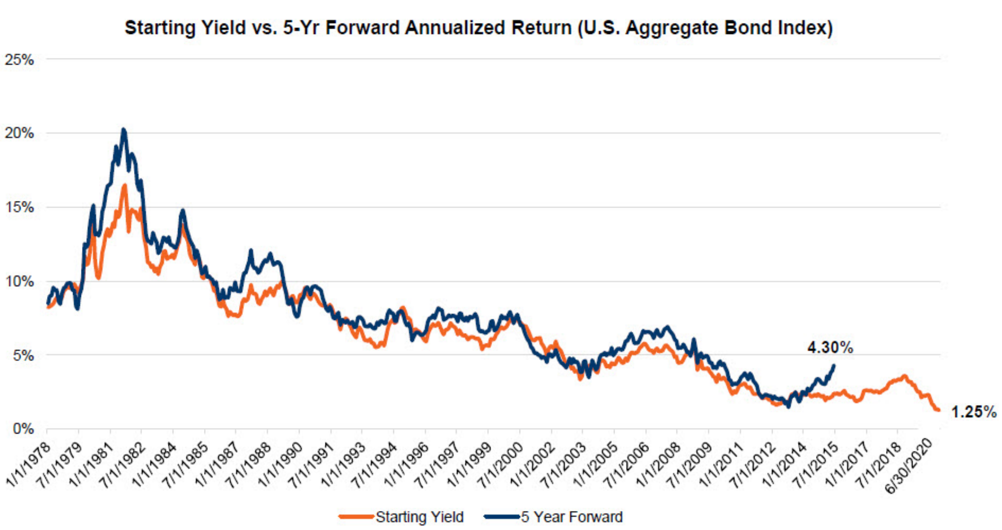
60/40 Revisited: Risk/Return Assumptions Require Imagination in Today's Environment

Traditional expectations of the 60/40 stock and bond portfolio may be due for a rethink. From today's yield levels, bonds simply can't contribute to a portfolio the way they historically have. For advisors and other allocators, this could mean shifting assets away from fixed income and into alternatives if they want to preserve the same risk and return profile that the 60/40 portfolio has historically delivered.

The following considers the challenges of a 60/40 portfolio, and the simple math behind how advisors can achieve a more optimal solution for clients.

Paltry Yields Diminish Return Potential of Fixed Income

While fixed income's primary role is as a diversifier and the asset class has never been counted on to provide returns as much as equities, bonds still must provide some level of return if they are going to comprise a sizeable allocation within a portfolio. Today's yield levels make that increasingly difficult. Future fixed income returns are highly correlated to current yields. The chart below puts this relationship in perspective, tracking the starting yield and five-year annualized returns for bonds from that point. If history is any guide, this doesn't bode well for bonds' future return potential.



Past performance is not indicative of future results. U.S. Aggregate Bond Index is represented by the Bloomberg Barclays US Aggregate Bond Index. Source: Bloomberg Calculations/361 Capital. Data from 01/01/78-06/30/20.

KEY TAKEAWAYS

- With today's yield levels, bonds simply can't contribute to a portfolio the way they historically have.
- If advisors want to achieve the same level of return a 60/40 portfolio historically provided— without taking on more equity risk—they must add new asset classes to the mix.
- Against this backdrop, any incremental return improvement one can make to a client's portfolio is a bigger value add than it would be in a roaring bull market.

The problem is magnified by the fact that yields aren't likely to improve any time soon. The Federal Reserve's recent policy shift adopting a looser inflation target for interest rates means it will likely wait even longer to raise rates from current low levels. This means low return expectations for fixed income are likely to endure.

Low return expectations for fixed income are likely to endure.

The only option to improve the return profile within a fixed income portfolio would be to take on increased credit risk, but this in turn makes the fixed income allocation more correlated to equities. A lagging economy due to the pandemic also raises default risk among high-yield bonds.

Advisors Must Tweak the 60/40 Allocation

If advisors want to achieve the same level of return a 60/40 portfolio historically provided —without taking on more equity risk—they must add new asset classes to the mix. The tables below show how adding alternatives can help achieve this objective. In our chart, we use returns for Morningstar's long/short equity category as a proxy for how alternatives can contribute.

	Stocks	Bonds
Equity Beta	1	0
Allocation	60%	40%
Return	5%	0.25%
Return Contribution	3%	0.10%
Risk Contribution	0.60	-
Portfolio Return	3.1%	
Portfolio Beta	0.60	

Stocks	Alts	Bonds
1	0.2	0
55%	20%	25%
5%	5%	0.25%
2.75%	1%	0.06%
0.55	0.04	-
3.8%		
0.59		

The table on the left demonstrates the risk and return of a standard 60/40 portfolio. While bonds will likely eke out some gains even in a low-yield environment, we used the current five year yield of 0.25% return. As the left table shows, an investor could expect a total return of just 3.10%.

The table on the right assumes the investor takes 5% away from equity and 15% from the fixed income allocation and directs that toward a portfolio made up of four different alternative strategies*. In this scenario, the broader portfolio preserves the same risk level as the original 60/40 split, but by allocating toward an asset class that exceeds bonds' likely return potential in a low-yield environment, the investor raises their return level.

Every Incremental Return Improvement Helps

The extra 70 basis points assumed in the previous example may not sound like much, but in the context of the current investment landscape, any improvement is meaningful. As we've mentioned in past articles, we believe investors likely face a low-return environment going forward. Lofty stock valuations do not reflect the current economic reality of the pandemic-induced slowdown. As such, it is reasonable to believe that equities could be volatile, or fail to achieve much higher returns after the run-up since March. As discussed earlier, the return prospects for fixed income are even more dim.

Against this backdrop, any incremental return improvement an advisor or allocator can make to a client's portfolio is a bigger value add than it would be in a roaring bull market. Alternatives can provide that improvement, without adding on more risk.

For additional viewpoints: Call 866.361.1720 or visit 361capital.com.

About 361 Capital

361 Capital is a leading boutique asset manager focused on alternative solutions that seek to deliver meaningful alpha, manage risk and offer diversification potential to investor portfolios. Founded in 2001, we offer a suite of investment products including Long/Short Equity and Managed Futures.

---

* Alternatives are represented by the HFRI Equity Market Neutral Index, HFRI Merger Arbitrage Index, HFRI Macro: Systematic Diversified Index, and HFRI Equity Hedge Index. While this portfolio actually has a return of 8%, we chose to discount this to 5% given lower overall return expectations for all investments.

HRFI Equity Market Neutral Index is defined as Equity Market Neutral Strategies that typically maintain characteristic net equity market exposure no greater than 10% long or short. **HFRI Merger Arbitrage Index** is defined as Merger Arbitrage strategies which employ an investment process primarily focused on opportunities in equity and equity related instruments of companies which are currently engaged in a corporate transaction. **HFRI Macro Systematic Diversified Index** is defined as systematic: diversified strategies have investment processes typically as function of mathematical, algorithmic and technical models, with little or no influence of individuals over the portfolio positioning. **HFRI Equity Hedge Index** is a global, equal-weighted index of the largest hedge funds that report to the HFR Database which are open to new investments and offer quarterly liquidity or better.

December 2020

361 Capital | 4600 South Syracuse Street, Suite 500, Denver, CO 80237 | 866.361.1720 | 361capital.com | Follow us: