SWAN GLOBAL INVESTMENTS

Is the 60/40 Broken?

Challenges to the Traditional Portfolio

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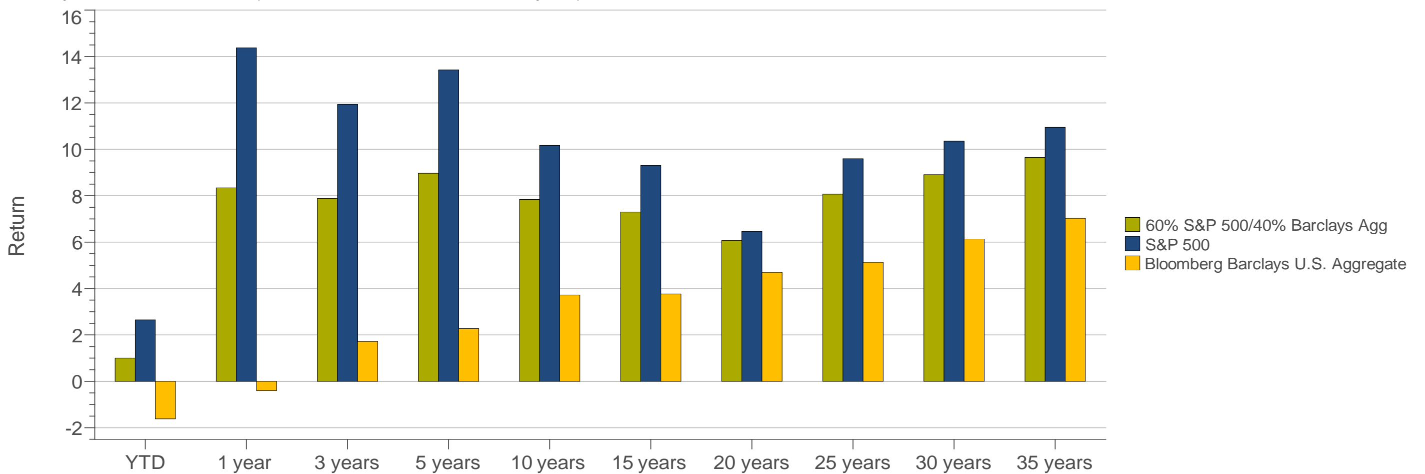
For decades the standard representation for a balanced portfolio has been the 60/40: 60% equities with 40% bonds. Although most investors are diversified beyond this model with small caps, foreign stocks, high yield bonds, and maybe even REITs or commodities, a simple mix of 60% S&P 500 and 40% Barclays U.S. Aggregate Bond is often the shorthand definition of a balanced portfolio. This standard allocation provided just the right amount of risk and conservative investments to reach a targeted return.

The Attraction of the 60/40

For a generation, this simple approach worked well. Stocks provided capital appreciation and dividends, albeit with a dose of volatility. Bonds produced yield and provided capital appreciation, acting as a volatility dampener when stocks went south. One could have met actuarial demands of 6%, 7%, or even 8% via this simple portfolio.

The traditional portfolio has consistently provided decent returns for average investor.

Manager vs Benchmark: Return
January 1979 - June 2018 (not annualized if less than 1 year)



	YTD	1 year	3 years	5 years	10 years	15 years	20 years	25 years	30 years	35 years
60% S&P 500/40% Barclays Agg	1.00%	8.34%	7.88%	8.97%	7.84%	7.30%	6.07%	8.07%	8.91%	9.65%
S&P 500	2.65%	14.37%	11.93%	13.42%	10.17%	9.30%	6.46%	9.60%	10.35%	10.95%
Bloomberg Barclays U.S. Aggregate	-1.62%	-0.40%	1.72%	2.27%	3.72%	3.77%	4.70%	5.13%	6.13%	7.03%

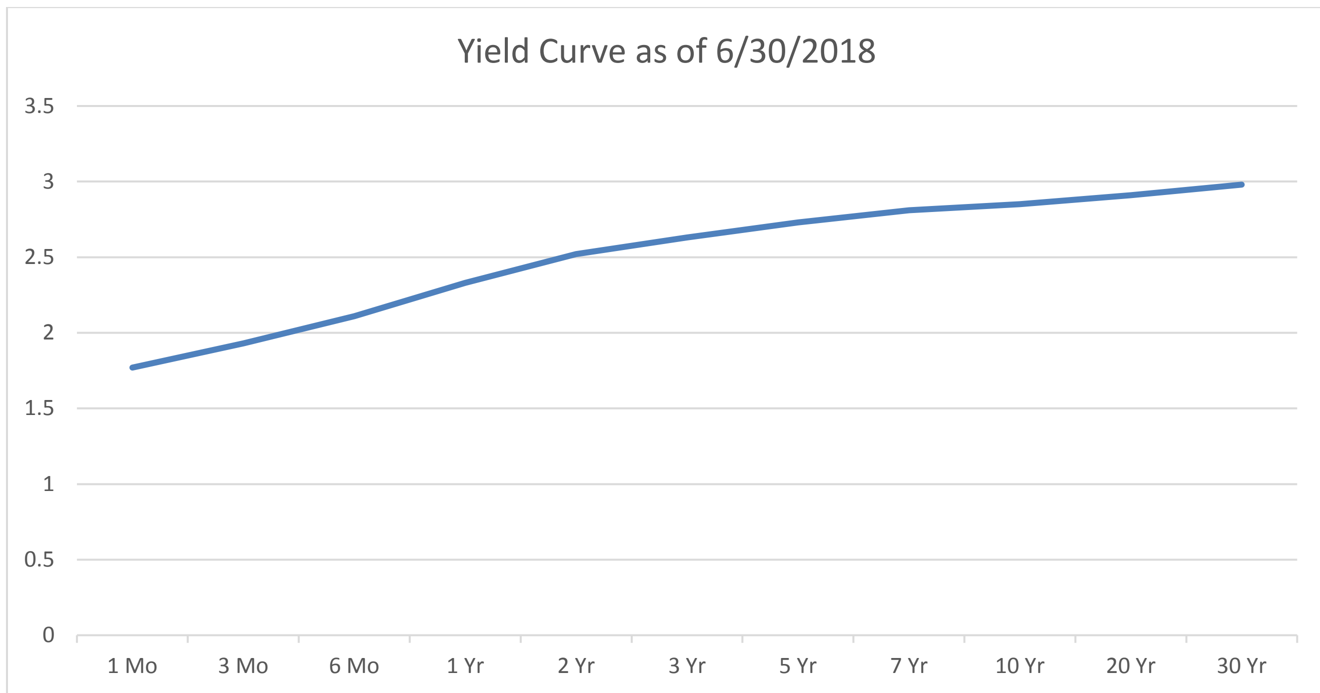
Source: Zephyr StyleADVISOR

Looking at the above numbers, one might be tempted to say, “If it ain’t broke, then don’t fix it.” But such an approach is dangerously naïve.

This simple approach may not meet these expectations going forward and the main culprit is the 40 in the portfolio: bonds.

Yield Curve

With rates at historic lows, the likelihood of bonds posting returns anywhere near their historic levels is close to zero. Since yields and bond prices are inversely related, the upside potential of bonds is essentially capped.



Source: U.S. Treasury Department

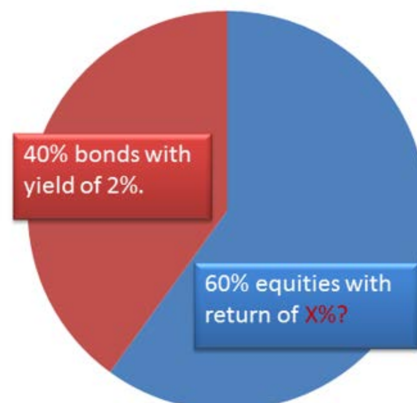
With the current yield curve, an investor purchasing 10, 20, or 30-year bonds will be hard-pressed to outperform inflation.

So what does this mean for the traditional 60/40 components?

Impact of Low Yields on Portfolio Return

Low bonds yields will ask more of the equities portion of the portfolio, which may require riskier positions.

Assume we have a standard 60/40 portfolio mix and the target return for the overall portfolio is 8%. If we assume that the 40% position in fixed income will return 2%, what would the remaining 60% in equities have to return to lift the portfolio up to 8%?



The answer may come as a nasty surprise: 12%.

Fixed Income			Equity			Total Portfolio
Weight	Yield	Return	Weight	Equity Return	Return	
40%	2.0%	0.8%	60%	8.67%	5.2%	**6.0%**
40%	2.0%	0.8%	60%	10.33%	6.2%	**7.0%**
40%	**2.0%**	**0.8%**	**60%**	**12.00%**	**7.2%**	**8.0%**
40%	2.0%	0.8%	60%	13.67%	8.2%	**9.0%**
40%	2.0%	0.8%	60%	15.33%	9.2%	**10.0%**

Source: Swan Global Investments

A forecasted return of 2% on bonds might be too generous. Should rates rise, bonds could suffer losses damaging the return of the portfolio.

Rising Rate means Losing Value

The average duration of several Morningstar fixed income categories is listed below. Should rates rise the average fund in these categories would be expected to lose the following amounts.

Morningstar Category Averages	Average Eff Duration 6/30/2018	Rate Increase 0.5%	1.0%	1.5%	2.0%	2.5%	3.0%
Short-Term Bond	2.19	-1.10%	-2.19%	-3.29%	-4.39%	-5.48%	-6.58%
Intermediate-Term Bond	5.29	-2.64%	-5.29%	-7.93%	-10.57%	-13.22%	-15.86%
Long-Term Bond	9.13	-4.56%	-9.13%	-13.69%	-18.25%	-22.81%	-27.38%
Corporate Bond	6.24	-3.12%	-6.24%	-9.35%	-12.47%	-15.59%	-18.71%
High Yield Bond	3.50	-1.75%	-3.50%	-5.25%	-6.99%	-8.74%	-10.49%
World Bond	5.62	-2.81%	-5.62%	-8.43%	-11.23%	-14.04%	-16.85%
Emerging Markets Bond	5.45	-2.73%	-5.45%	-8.18%	-10.91%	-13.63%	-16.36%

(Numbers are based off of duration information and only take into account changes in interest rates. Convexity is not taken into consideration, nor are other factors such as a widening or tightening of credit spreads.)

In one of Bill Gross's newsletters from a few years ago, Gross mentions that in order to generate a level of return equal to the 7.5% return bonds have delivered over the past 40 years, yields would need to drop to negative 17%.

In other words, bonds will NOT be delivering return similar to its long-term average over the past four decades.

Unappealing Set of Options

Given these circumstances, investors and advisors are left with an unappealing set of options:

1. Lowering the return expectation for the overall portfolio.
2. Increase the equity portion and take on more risk.
3. Simply hoping that the capital markets will do better than expected and deliver high returns.

Lowering expectations or taking on more risk may not be an option for many investors and hoping that capital markets will do better than expected is a dangerous choice.

If bonds won't provide the return stream necessary to investors, it may be time to rethink how that 40% of the portfolio is allocated.

About the Author:

Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Client Portfolio Manager, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly, Marc was the Director of Research at Zephyr Associates for 11 years.

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