Looking Beyond the 60/40 Portfolio

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A 60% stock / 40% bond portfolio has been generally accepted as the standard allocation for many decades. For the most part, it has served the investment community well as solid gains from its widely used benchmarks, the S&P 500 and the Bloomberg Barclays US Aggregate Bond Index ("Aggregate Bond Index"), resulted in the 60/40 model outperforming most mutual funds and hedge funds. However, as we look forward, there are several challenges facing the traditional 60/40 model. In fact, its risk-return profile is likely to be less attractive than several other portfolio structures.

One of the problems with the traditional 60/40 allocation is that the fixed income side of the portfolio cannot recreate the gains it has enjoyed over the last 35 years. As you can see from the graph below, the yield on the 10-Yr US Treasury peaked in 1981 at 15.8% and essentially moved in one direction until July 2016, when it bottomed at 1.36%. This decline in rates created significant and consistent gains for treasury bonds, the largest component of the Aggregate Bond Index.

Source: Bloomberg

As illustrated above, rates began to move higher in the second half of 2016. After a relatively flat 2017, they are again moving higher in 2018. Higher rates can lead to significant losses for fixed income investors. For example, in the second half of 2016 the

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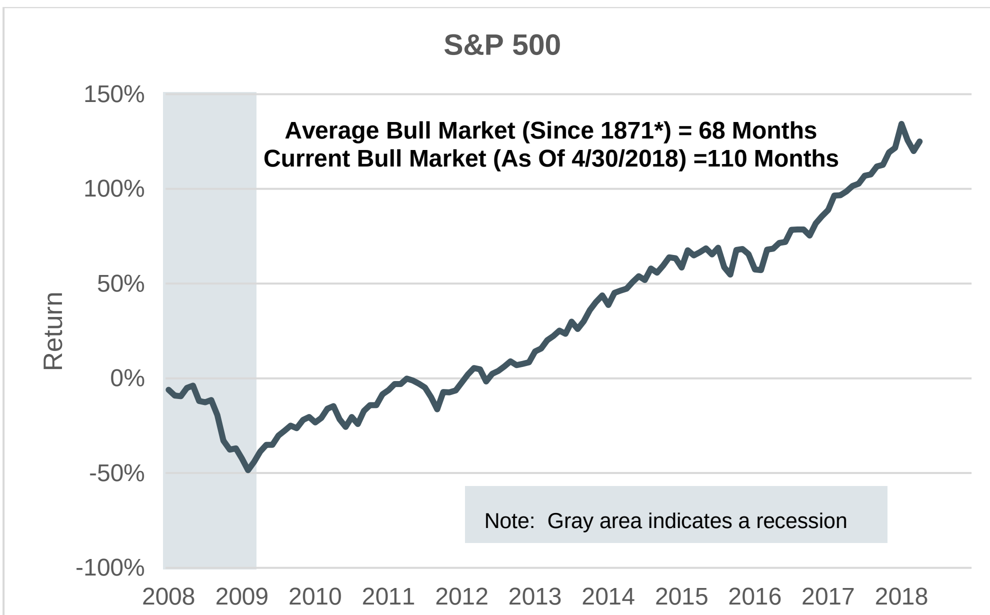
Aggregate Bond Index suffered a decline of -2.5%, including interest payments. After generating positive returns in the flat rate environment of 2017, the Aggregate Bond Index is again generating losses in 2018, with a decline of -2.2% through April 30, 2018.

Going forward, the risk-reward from owning traditional bonds continues to be challenging. With yields still relatively low by historical standards, gains from treasury bonds are expected to be constrained even if rates stay at current levels. Conversely, if interest rates do continue to move up and reverse even a small portion of the move from the last 35 years, investors are likely to suffer continued losses which could be substantial.

Another concern regarding future returns of a 60/40 portfolio is the expected return for equity markets. As the graph below shows, the current Bull Market is entering its 9th year, whereas the average Bull Market has historically lasted less than six years.



Source: Bloomberg, as of 4/30/2018

In addition, equity valuations are relatively high by historical standards. As of the end of April, the S&P 500 is trading at a Price-to-Earnings ratio ("P/E ratio") of nearly 17x this year's earnings. Of course, the Bull Market could continue and valuations can become even richer if investors focus on the positives like; a favorable economic backdrop, strong corporate earnings and relatively low interest rates. Whether that's the case or not, it is clear that the setup for the S&P 500 is less attractive than it was in 1981 when the P/E ratio was approximately 9.0x[1].

[1]*Source: Thomson Reuters and Bloomberg*

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Now that we've reviewed the challenges that the 60/40 portfolio faces, we will list some alternative portfolio structures that we believe will lead to better risk adjusted returns going forward. The most important element of this is downside protection on both the equity and fixed income sides of the portfolio. This can be achieved with a more dynamic portfolio that maintains higher than a 60% equity allocation in normal times but has the flexibility to significantly lower the equity allocations during times of market stress. Stress can be measured by various factors such as credit spreads, risk of recession, geopolitical events, and central bank liquidity. The point here is that outside of recessions, adverse geopolitical events (such as war), and overly restrictive central banks, it usually is beneficial to have a healthy equity allocation.

Another way to enhance the 60/40 model is to incorporate equity investments that have a risk-return profile preferable to the S&P 500. This can include domestic market segments, as well as, international exposure. SSI uses our proprietary quantitative model to identify attractive regions, sectors and style factors (such as value, quality, and small-cap.) We then apply extensive fundamental analysis in these areas and build an equity portfolio with higher return expectations and similar risk characteristics to the S&P 500.

Over the last decade it has been beneficial to be strictly in the U.S. stock market because it has outperformed almost all other geographies, most by a very large margin. Since 2010 through April of 2018, the S&P 500 returned 182% on a total return basis. The rest of the global stock market, both developed and emerging, returned only 25% (as measured by the returns on the MSCI All Country World Ex US Index in USD – ACWI ex US). While there are many fundamental reasons for the U.S. outperforming, relative performance going forward is likely to be very different and opportunities overseas should not be ignored.

In the fixed income portion of the portfolio, there appears to be attractive alternatives to the Aggregate Bond Index. This index has a high allocation to treasuries and government agency bonds. They offer very low coupon rates and there is a high probability that capital appreciation will be low or even negative if rates move higher. Floating rate securities and credit oriented investments can provide a higher yield and hold up relatively well in a rising interest rate environment. Although credit exposure must be monitored, in the current non-recession, solid growth environment these investments can perform quite well, while acting to diversify the portfolio, increase yields, and lower duration risk. In the bond portion of the SSI Flexible Allocation Strategy, we currently hold 5 bond ETFs. Combined, these ETFs provide a higher yield than the Aggregate Bond Index, have a significantly lower duration, and have a lower standard deviation (trailing 12 months as of 4/30/2018). We believe this fixed income portfolio should outperform the Aggregate Bond Index in most scenarios.

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About SSI

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