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60/40: The Arguments For and Against

- 60/40 portfolios are under review
- We look at the arguments both for and against
- With inflation on the rise. It's time to rethink the "40"

Since an article published in 2019 pointed the historic lows in bond yields, many investment firms are starting to rethink the 60/40 portfolio. This came under even more scrutiny following the market turmoil of 2020.

While some affirm that the 60/40 will outlive us all, others argue against this notion.

We take a look at the main arguments for and against and key insights

What is a 60/40 portfolio?

A 60/40 equity/bond portfolio is a heuristic "rule of thumb" approach considered to be a proxy for the optimal allocation between equities and bonds. Conventionally equities were for growth and bonds were for ballast.

The composition of a 60/40 portfolio might vary depending on the base currency and opportunity set of the investor/manager. Defining terms is therefore key.

We summarise a range of potential definitions of terms:

Fig 1. Types of 60/40 equity/bond strategies

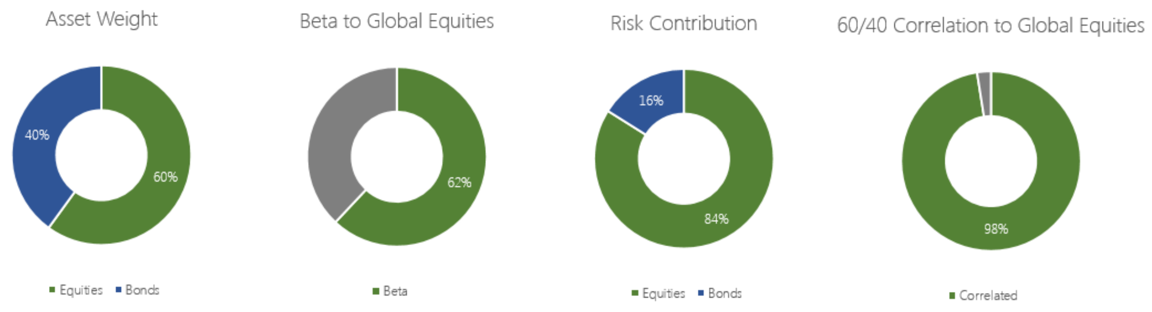
"60/40"	Global	US Domestic	US Global	UK Domestic	UK Global
60% Equities	60% Global Equities	60% US Equities	60% Global Equities	60% UK Equities	60% Global Equities
40% Bonds	40% Global Bonds	40% US Bonds	40% US Bonds	40% UK Bonds	40% UK Bonds

Source: Elston research

Furthermore, whilst 60/40 seems simple in terms of asset weighting scheme, it is important to understand the inherent risk characteristics that this simple allocation creates.

For example, a UK Global 60/40 portfolio has 62% beta to Global Equities; equities contribute approximately 84% of total risk, and a 60/40 portfolio is approximately 98% correlated to Global Equities[1].

Fig.2. Asset allocation and risk characteristics



Source: Elston research, Bloomberg data

Why some think 60/40 will outlive us all.

The relevance of 60/40 portfolio lies in its established historic, mathematical and academic backup. Whilst past performances do not guarantee future returns, it nonetheless provides us with experience and guidance. (Martin,2019)

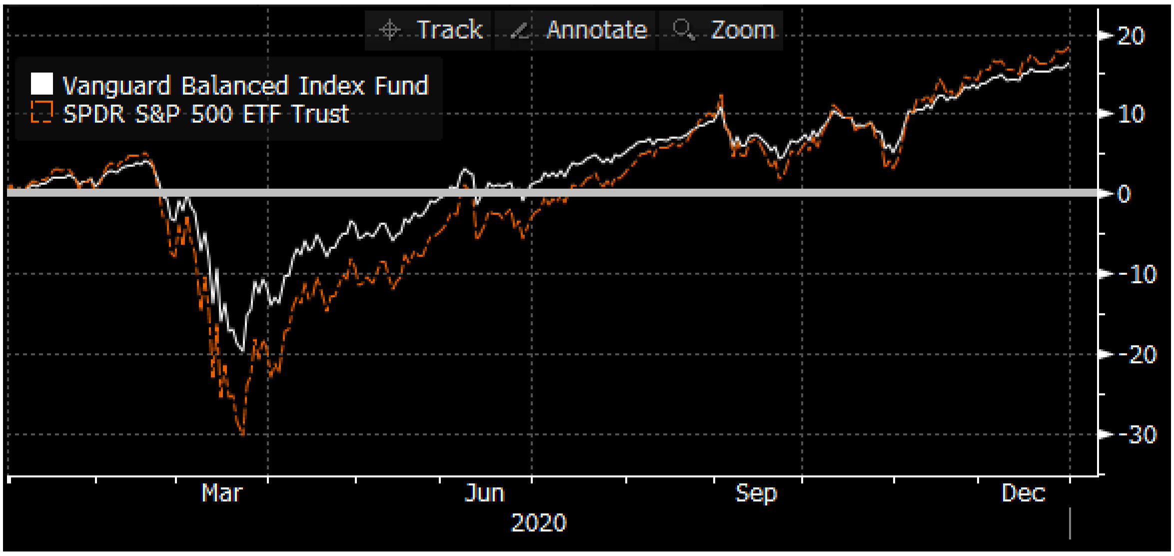
Research also suggests that straightforward heuristic or "rule-of-thumb" strategies work well because they aren't likely to inspire greed or fear in investors. They become timeless. Thus, creating a 'Mind-Gap'. (Martin,2019)

In the US, the Vanguard Balanced Index Fund (Ticker: VBINX US) which combines US Total Market Index and 40% into US Aggregate bonds, plays a major role in showcasing the success of the 60/40 portfolio that has proved popular with US retail investors (Jaffe,2019). Similarly, in the UK the popularity of Vanguard LifeStrategy 60% (Ticker VGLS60A) showcases the merits of a straightforward 60/40 equity/bond approach.

In 2020, for US investors VBINX provided greater (peak-to-trough) downside protection owing to lower beta (-19.5% vs -30.3% for US equity) and delivered total return of +16.26% volatility of 20.79%, compared to +18.37% for an ETF tracking the S&P 500 with volatility of 33.91%, both funds are net of fees. In this respect, the strategy captured 89% of market returns, with 61% of market risk.

[1] Elston research, Bloomberg data. Risk Contribution based on Elston 60/40 GBP Index weighted average contribution to summed 1 Year Value At Risk 95% Confidence as at Dec-20. Beta Correlation to Global Equities based on 5 year correlation of Elston 60/40 GBP Index to global equity index as at Dec-20.

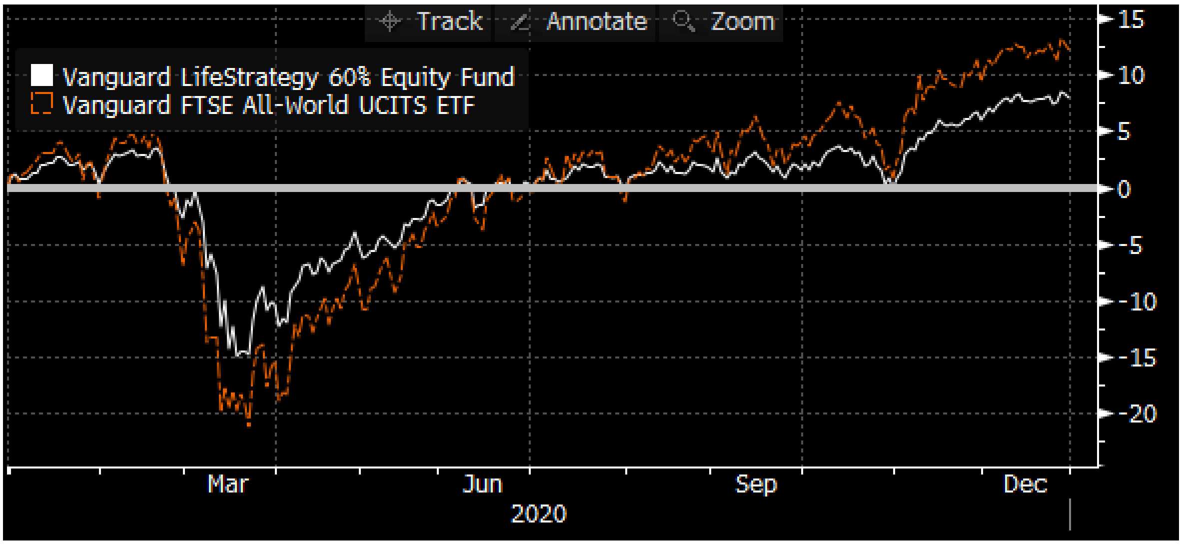
Fig.3. US 60/40 (USD) performance in 2020



Source: Elston research, Bloomberg data

For GBP-based investors in 2020 the 60/40 approach had lower (peak-to-trough) drawdown levels (-15%, vs -21% for global equities) owing to lower beta. The 60% equity fund delivered total return of +7.84% with volatility of 15.12%, compared to +12.15% for an ETF tracking the FTSE All World Index with volatility of 24.29%. In this respect, the strategy captured 65% of market returns, with 62% of market risk.

Fig.4. Global UK (GBP) 60/40 performance in 2020



Source: Elston research, Bloomberg data

Why some think 60/40 has neared its end

Since its inception the 60/40 portfolio, derived 90% of the risk from stocks. In simple terms, 60% of the asset allocation of the portfolio was therefore the main driver of the portfolio. Returns (Robertson,2021). This hardly a surprise given that equities have a 84% contribution to portfolio ris, on our analysis, but the challenge made by some researchers is that if a 60/40 portfolio mainly reflects equity risk, what role does the 40% bond allocation provide, other than beta reduction?

The bond allocation is under increasing scrutiny now is because global economic growth has slowed and traditionally safer asset classes like bonds have grown in popularity making bonds susceptible to sharp and sudden selloffs. (Matthews,2019)

Strategists such as for Woodard and Harris, for Bank of America and Bob Rice for Tangent Capital have stated in their analysis that the core premise of the 60/40 portfolio has declined as equity has provided income, and bonds total return, rather than the other way round.. (Browne,2020)

Another study shows that over the past 65 years bonds can no longer effectively hedge against inflation and risk reduction through diversification can be done more adequately by exploring alternatives such as private equity, venture capital etc. (Toschi, 2021). Left unconstrained, however, this can necessarily up-risk portfolios.

With bond yields at an all-time low, nearing zero and the fact that they can no longer provide the protection in the up-and-coming markets many investors query the value provided by a bond allocation within a portfolio. (Robertson,2021)

Key insights

While point of views might differ about 60/40 as an investment strategy, one aspect that is accepted is that the future of asset allocation looks very different when compared to the recent past. Rising correlations, low yields have led strategists and investors to incorporate smarter ways of risk management, explore new bond markets like China, create modified opportunities for bonds to hedge volatility through risk parity strategies, as well as using real asset exposure such as real estate and infrastructure. (Toschi, 2021)

Research conducted by The MAN Institute summarises that modifying from traditional to a more trend-following approach introduces the initial layer of active risk management. By adding an element of market timing investors further reduce the risk, when a market's price declines.

While bonds have declined in yield, they still hold importance in asset allocation for beta reduction.

Further diversifying the portfolio with an allocation to real assets has potential to provide more yield and increased return than government bonds.

Summary

The 60/40 portfolio strategy has established itself over many decades, it has seen investors through four major wars, 14 recessions, 11 bear markets, and 113 rolling interest rate spikes.

It has proved resilience as a strategy and utility as a benchmark.

Our conclusion is that 60/40 is not dead: it is a useful multi-asset benchmark and remains a starting point for strategic asset allocation strategies. But the detail of the bond allocation needs a rethink. Incorporating alternative assets or strategies so long as any increased risk can be constrained to ensure comparable portfolio risk characteristics.

Henry Cobbe & Aayushi Srivastava

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