

## Building an all-weather portfolio with ETFs

- 60/40 portfolios are under pressure with rising rates and inflation
- An Equal Risk “all-weather” portfolio provides true diversification
- An Equal Weight “permanent” portfolio provides resilience

For investors with long time horizons who want an all-equity portfolio, there is no shortage of low- cost global equity ETFs. In cricketing terms, when sunshine’s guaranteed, a grass pitch works just fine.

But when time horizons are shorter and risk control matters more – as in these uncertain times - a multi-asset approach might make better sense. Put differently, when the weather is changeable or extreme, an all-weather pitch makes more sense.

It’s the same for investments. In these times of market volatility, rising interest rates and inflation pressure, we explore three different types of multi-asset strategy: the 60/40 portfolio, the “Equal Risk” or all-weather portfolio, and the “Equal Weight” or Permanent Portfolio.

### The problem with 60/40

The traditional multi-asset portfolio is the so-called “60/40” portfolio – where 60% is invested in equities, and 40% is invested in bonds. This is the “classic” multi-asset strategy. The idea being that you can combine higher risk and return from equities with lower risk income from bonds. A 60/40 portfolio can be constructed with just two ETFs. 60% in a global equity ETF like **SSAC** (iShares MSCI ACWI UCITS ETF) or **VWRP** (Vanguard FTSE All-World UCITS ETF); and 40% in a bond ETF – for example **AGBP** (iShares Core Global Aggregate Bond UCITS ETF GBP hedged) for those wanting global bond (hedged to GBP) exposure, or **IGLT** (iShares Core UK Gilts UCITS ETF) for those wanting UK government bond exposure. Or you can make it more and more granular.

But this traditional 60/40 model is under pressure, and the suggestion currently is that the 60/40 portfolio is now “dead”. Why is this? Well because for the last 30 years or so, we’ve lived in a world where inflation and interest rates have been trending down – which is doubly good for bonds. But now we are now in an economic regime where both interest rates and inflation are starting to trend up – which is doubly bad for bonds.

The other problem with 60/40, is that in times of market stress, the correlation between equities and bonds increases, meaning that bonds lack the diversifying power they may have had in the historical long-run, at a time when it is needed most.

In summary: the advantage of this approach a 60/40 portfolio is easy to construct, and is a classic “balanced” portfolio. The disadvantage of this approach is that bonds are facing an uphill struggle for the next few years, so may not be as “balanced” as you would want.

### The all-weather portfolio

The [all-weather portfolio](#) concept is that of a multi-asset portfolio that is designed to deliver resilient, consistent performance in different market regimes, or “whatever the weather”. The term and idea was pioneered by Ray Dalio of Bridgewater Associates (which was established in 1974, shortly after Nixon took the US Dollar off the gold standard) and is designed to answer the question: *“What kind of investment portfolio would you hold that would perform well across all environments, be it a devaluation or something completely different?”*<sup>1</sup>. Dalio and Bridgewater’s all-weather portfolio assumes equal odds of any of four market regimes (rising/falling growth/inflation) prevailing at any time. This approach created and pioneered what is also referred to as a “Risk Parity” approach to investing.

The concept of risk parity requires some additional explanation. A classic 60/40 equity/bond allocation results in a portfolio where over 95% of overall portfolio risk comes from the equity position, and the balance comes from the bond position. In short, the asset allocation drives portfolio risk, and while a portfolio may be balanced in terms of asset allocation, it is imbalanced in terms of risk allocation. Risk parity reverses the maths: it means that each asset class contributes equally to the overall risk of a portfolio. This is why it is also known as an “Equal Risk” approach. But as risk is dynamic, not stable, the asset weights must adapt to keep the risk allocation stable.

UK investors can build their own all-weather portfolio using four to six ETFs representing broad asset classes: global equities, UK equities, gilts, property, gold and cash equivalent, depending on complexity. In order to keep the risk allocation stable, the asset weights might need to change each month to reflect the changing risk and correlation relationships of and between those asset classes.

In summary: the advantage of this Equal Risk approach is that a portfolio is truly diversified from a risk contribution perspective. The disadvantage of this approach is it requires a regular change of weights to reflect changing short-term volatilities and correlations.

### The Permanent Portfolio

The [permanent portfolio](#) is a concept pioneered by the late Harry Browne, a US financial adviser, in his 1999 book *“Fail-Safe Investing”*. It has many adherents in both the US and the UK, but to date it is only really in the US that one can find ‘Permanent Portfolios’ on offer, something UK investors seem keen to change.

The concept is similar to the all-weather portfolio, but in a more straightforward format. Rather than trying to target an “Equal Risk” contribution with changing asset-class weights, the

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<sup>1</sup> <https://www.bridgewater.com/research-and-insights/the-all-weather-story>

Permanent Portfolio is a simple Equal Weight approach to four main asset classes to reflect different market regimes, so that whatever the regime, the portfolio has got it covered.

Browne outlines four market regimes<sup>2</sup>, and related asset exposure for that regime:

1. **Prosperity**: growing economy, falling rates: equities (and also bonds) are best assets to hold
2. **Inflation**: inflation is rising moderately, rapidly or at a runaway rate: gold is best asset to hold
3. **Tight money or recession**: slowing money supply and recession: cash (or equivalent) is best asset to hold
4. **Deflation**: prices decline and purchasing power of money grows: bonds are best asset to hold

An equal-weight portfolio therefore consists of 25% equities, 25% bonds, 25% gold and 25% cash (or cash equivalents to earn some interest). Browne advocates reviewing this portfolio once per annum, and if necessary rebalancing the allocations to their strategic equal weights.

US versions of this strategy use US equities for the equity exposure and US treasuries for the bond exposure. So what would a UK version look like?

We constructed a Permanent Portfolio for UK investors using 4 London listed ETFs: **SSAC** for global equities, **IGLT** for UK bonds, **SGLN** (iShares Physical Gold ETC) for gold and **ERNS** (iShares GBP Ultrashort Bond UCITS ETF) for cash equivalents for some additional yield over cash that will capture rising interest rates.

**In summary: the advantage of this Equal Weight approach is its simplicity and low-level of maintenance required. The disadvantage of this approach is that it disregards short-run changes in volatility and correlation that are captured in the Equal Risk approach.**

**How do they all compare?**

Obviously the strategies vary from each other. To evaluate performance, we have created [research portfolios](#) for both these strategies. What becomes apparent is that the outperformance of these low-cost, equal-risk and equal-weight all-weather and permanent portfolios looks relatively attractive when set against many more complex (and expensive) "all-weather" absolute return funds.

Find out more about our [All-Weather Portfolio](#) of ETFs for UK investors.

Find out more about our [Permanent Portfolio](#) of ETFs for UK investors.

See all our [Research Portfolios](#)

Research Team, Elston Consulting

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<sup>2</sup> Harry Browne, *Fail-Safe Investing*, (1999) *Rule #11 Build a bullet-proof portfolio for protection* (pp.38-49)



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