A Brief History and Outlook for Traditional 60/40 Investment Portfolios

One of the most common investor portfolios we see utilizes an allocation that funds 60% of investible assets into stocks and 40% into bonds. These so-called "60/40" portfolios are typically rebalanced at the end of each year to reestablish their target ratios. Although they are used by individual and institutional investors alike, the advent of exchange traded funds has made it especially easy for individuals to further diversify both sides of the equation to also include global stocks and bonds, real estate, and commodities.

These portfolios are often presented as suitable for clients with moderate investing objectives, reducing the risk of investing in stocks alone. This has generally held true during the last forty years. Why is it then, that countless market professionals have recently heralded the "death" of these ubiquitous 60/40 stock and bond portfolios?

In this paper, we will discuss a brief history of 60/40 portfolios and their short-comings, the current "state of the market" for stocks and bonds from a valuation and behavioral standpoint, then more deeply consider the recent calls for these common portfolios' demise. Finally, we will present alternative approaches for readers who share concerns that these traditional portfolios may face more serious headwinds ahead.

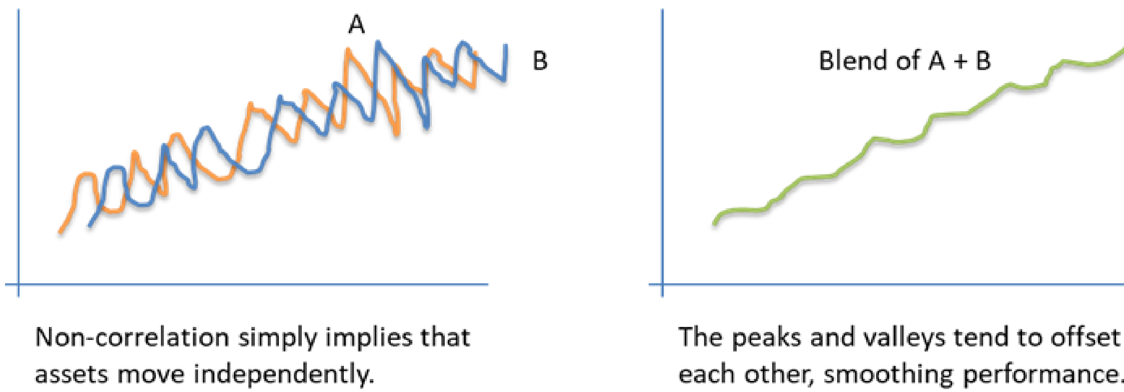
A Brief History of 60/40 Portfolios

To understand the prevalence of 60/40 portfolios is to understand the history of "Modern Portfolio Theory" ('MPT'). Nearly seventy-years ago in the early-1950s, Harry Markowitz proposed that the optimal portfolio from a risk-reward standpoint should incorporate not only return expectations, but also how each component is cross-correlated to all the other assets within a proposed portfolio.

Correlation is the degree to which any two assets change in relation to one another. High correlation is expressed by coefficients approaching +1, while negative correlations are represented by coefficients approaching -1. A second precept of MPT theory is that financial risk should be measured by how noisy, choppy, or dispersed the day-to-day returns of the portfolio are.

Ideally, any two assets would have positive return expectations, but be relatively non-correlated to one another. In this ideal scenario, both assets would rise over time, while on a day-to-day basis their respective gains or losses would offset one another to smooth portfolio performances, reducing financial risk and enhancing an ability to compound. The optimal MPT portfolio applies allocations among available assets such that expected returns for each unit of risk (e.g., ‘standard deviation’) are maximized at the portfolio level. Markowitz was awarded a Nobel Prize for this work and the mathematics behind it. In a traditional two-asset class portfolio comprised of stocks and bonds, it should come as no surprise at this point that the optimal MPT blend over extended periods centers towards, you guessed it, 60% stock and 40% bond portfolios.

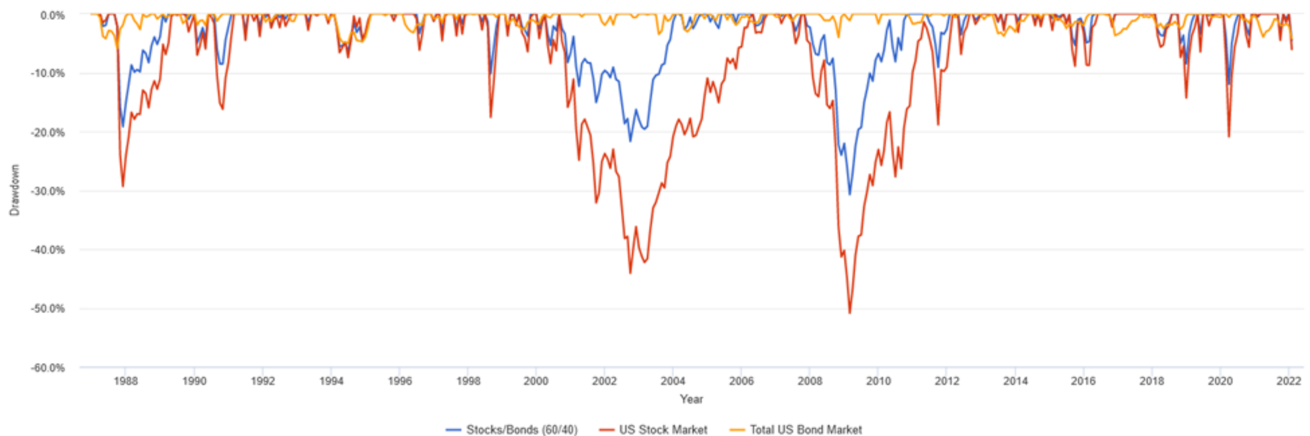
Illus. 1. Conceptual Portfolio Non-Correlation



The illustration above reveals the intuition behind MPT, while the charts below delineate the long-term performance of the allocation for US assets as rebalanced each year-end to reestablish the 60/40 target:

Illus. 2. Historical US 60/40 Portfolio Growth of $10,000
(Logarithmic Scale Jan. 1987 to Jan. 2022)

Illus. 3. Historical US 60/40 Portfolio Drawdowns
(Jan. 1987 to Jan. 2022)



Source: portfoliovisualizer.com

As indicated, compared to stocks or bonds alone, the 60/40 portfolio supported higher returns than bonds alone, while reducing volatility and drawdowns significantly as compared to stocks alone. While reducing peak-to-trough drawdowns, they have still reached meaningful levels of -10% to -30% dominated by the riskier stock component.

Beyond the mathematics of MPT, an added benefit of applying an annual rebalancing assumption to the portfolio is enforcing a discipline of selling each year's category winner and buying each year's loser. This strategy captures the reversionary effect we tend to see between asset classes and sub-asset classes, where returns tend to catch up with one another over time, intrinsically enforcing the common wisdom of "buying low and selling high."

Short-Comings of MPT Assumptions

Nobel prize status aside, numerous short-comings of MPT and the resultant 60/40 portfolio have subsequently been pointed out, particularly after the major stock market retreats observed in this new millennia, as follows:

1. Volatility as a Measure of Risk. MPT assumes daily volatility is the sole measure of financial risk That works fine in a mathematical construct; however, in the real world of personal investing we know that absolute draw-downs and an ability to reach long-term goals are paramount. That is why we say the long-term "buy-and-hold" view espoused by MPT is only fully applicable to institutions and younger individuals with extended investment time-horizons.

- Why is this? Because as we get closer to retirement, the terminal value of our accounts when we need that money is critical. Target-dated funds attempt to address this short-coming with ever-growing allocations to fixed income, but that only works so long as risk remains low in that asset class, and that assumption is now also under scrutiny, as discussed further below.

2. Correlations Are Stable. MPT assumes that correlations among asset classes are stable. While historically this has been largely true due to significant frictions in trading that prevented rapid trading, the fact is that the optimum blend of stocks and bonds is always shifting, and only drifts back to 60/40 as a center point rather than as a constant true north.

- Furthermore, the modern era has made previously illiquid assets easily tradable, including complete balanced stock and bond portfolios that are now available as mutual funds and virtually free-to-trade exchange traded funds. While these funds are easy to buy when risk rises everything has an increasing tendency to get sold down at once. Consequently, the non-correlations that MPT relies on are less and less constant, with positive correlation increasingly the norm among all assets during times of stress.

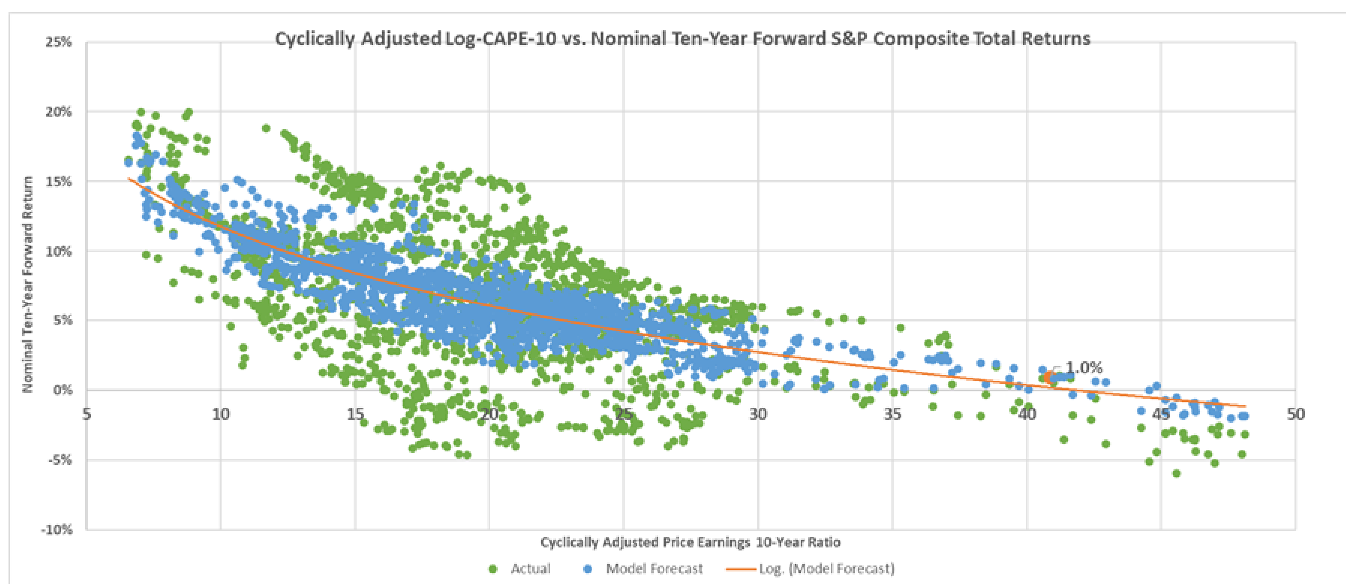
3. Diversified Assets Rise. It is a foundational assumption that assets will rise over time, or why else would we invest? With stocks and bonds currently highly priced, however, this assumption is worth challenging in the current MPT context. During the last forty years since the great inflation spike of the late 1970s and early 1980s, interest rates have been falling. Since bond prices move in the opposite direction to rates, this has been a tremendous secular tailwind to the performance of 60/40 portfolios. Now with rates near zero at all-time lows and the US

Federal Reserve signaling a hawkish turn very soon ahead, that tailwind will likely become a headwind. Indeed, in early 2022 markets have already witnessed a sharp change in character as bonds have been repricing against this new reality. This is the root of the current call for the 'death of 60/40', and it's an incredibly important consideration in the years ahead until interest rates are fully renormalized.

4. Markets Are Always Rational. As a corollary to point three above, recall the late 1990's when Federal Reserve Chairman Greenspan stated that stocks were facing a period of "irrational exuberance." It happens that stocks overshoot their long-term trends, and like bonds, that has arguably occurred just recently with US stocks advancing nearly +90% above their recent 2020 spring lows as governments across the globe flooded economies with fiscal and monetary stimulus to ward off Covid-shutdown related recessions.

While not quite as extreme, like the late 1990's stocks may also now need a cooling period to revert to their normal price versus earnings valuation levels. Current valuation metrics suggest ten-year forward rates of total return in the US stock market could be in the low- to mid-single digits when including inflation, and nearly flat excepting inflation.

Illus. 4. Historical & Modeled Current Valuation Levels versus Future Returns
(Monthly Data Jan. 1881 to Jan. 2022)



Source: Proprietary calculations based upon the work of Professor Robert J. Schiller – Yale Economics.

The proprietary chart above may look complex, but it is simply a lookup table of sorts comparing levels of historical valuation (here price versus smoothed corporate earnings based on the work of Yale Professor Robert J. Schiller) on the horizontal or 'x' axis, with ten-year forward compounded returns less inflation on the vertical or 'y' axis.

Unsurprisingly, when valuations are high, stocks tend to record lower future returns. When valuations are attractively low, stocks tend to outperform ahead. Current conditions in early

2022 indicate valuation levels in the low 40’s, suggesting compound annual returns in the low single-digits ten years forward excluding inflation effects.

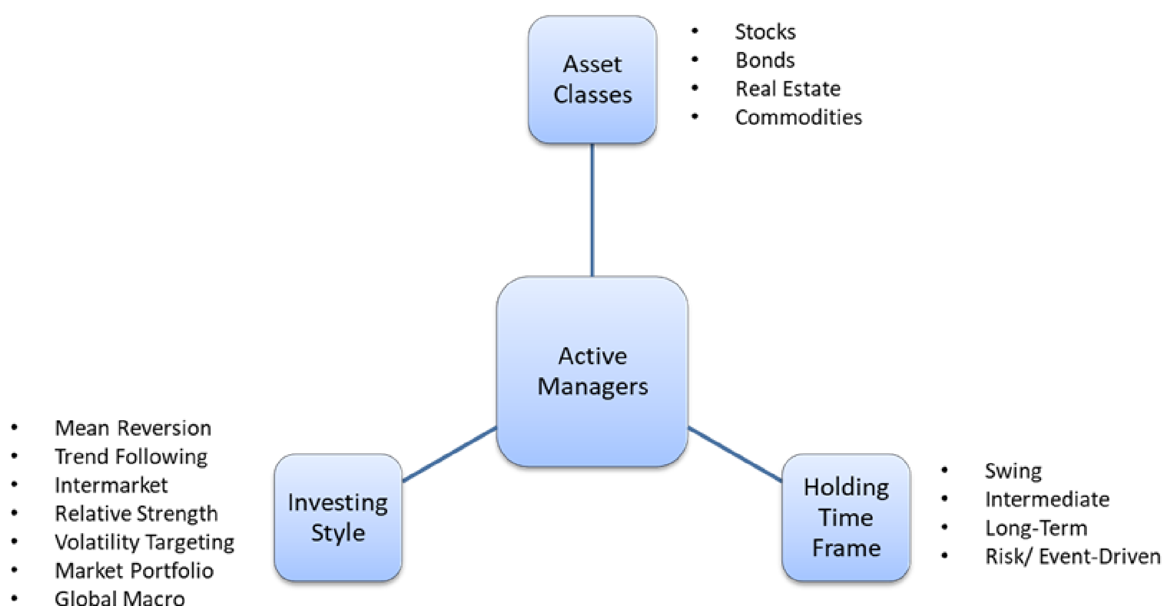
While this paper is not predicting an immediate “bear market” by any means, with return expectations potentially quite low for the next five- to ten-years for stocks and bonds alike, it should be clear that the next ten years in investing will probably not be as easy for strategic buy-and-hold investors as the last ten years were.

In summary, MPT incorporates several questionable assumptions. There are market cycles in which diversification is less favorable or even undesirable, and now may likely be one of them. This makes the outlook for 60/40 portfolios problematic for the moment and is at the root of calls for the “death” of these allocations.

What Is an Investor to Do?

Just because the outlook for buy-and-hold 60/40 portfolios may be muted on a long-term secular basis does not mean there will not be many cyclical opportunities along the way to capitalize upon the natural ups and downs of markets. However, since timing can be difficult, we caution against binary all-in/out approaches and favor the use of additional tools to successfully navigate such times.
Modern markets demand modern solutions. From our perspective, the key is to engineer portfolios that replicate the spirit of the original MPT approach but with a modernized twist to “smooth out the ride” while attempting to protect capital and fulfill investor's long-term return requirements.
We propose that one approach to accomplish this goal is to dynamically adjust portfolios using asset class selection yes, but also timing and style variants able to employ the judicious use of cash, levered and inverse positioning.

Illus. 5. Tactical Approach as a Form of Manufactured Non-Correlation



Elaborating upon each of these available approaches or investing styles goes beyond the scope of this article. Suffice to say here that we believe multiple quantitative or rules-based strategies that apply

diversified methods and time-frames overseen by multiple managers may better allow for true and robust diversification far exceeding the bounds of the traditional asset class-only approaches. With the current market environment calling into question the foundations of the 60/40 portfolio paradigm, now may be just the time to investigate these more modern approaches to replace or supplement traditional 60/40 static allocations.

Key Takeaways

- • 60/40 stock and bond portfolios are based on 70-year-old theory called "Market Portfolio Theory"
- • There are numerous shortcomings to the assumptions behind this MPT theory
- • Current market dynamics may be unfavorable to 60/40 portfolios for the immediate future
- • More modern, multi-manager tactical approaches may be better suited to these conditions by employing alternative means of seeking to preserve capital and accommodate investing goals

Additional Information about TFA Funds

The TFA Funds managed by Tactical Fund Advisors, LLC utilize a multi-manager method to portfolio management. TFA believes such an approach improves diversification and can "smooth out the ride" through market cycles. Instead of a single investment manager's approach to markets and belief system, the TFA Allocation Funds provide investors with multiple managers, multiple strategies, and multiple investing methodologies all working across multiple time frames.

If you would like to learn more about risk-managed, multi-strategy funds designed to dynamically adapt to changing market regimes in answer this whitepaper's question - "What Is an Investor to Do?" during these challenging times, please review our website, www.tfafunds.com, or contact us at:

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Investors should consider the investment objectives, risks, charges, and expenses of the Fund carefully before investing. The prospectus contains this and other information about the Fund. You may obtain a prospectus at tfafunds.com or by calling the transfer agent at 888-838-9488. The prospectus should be read carefully before investing. Mutual Fund investing involves risk. Principal loss is possible. The Fund is distributed by Matrix 360 Distributors, LLC, member FINRA/SIPC, see https://brokercheck.finra.org and www.sipc.org for more information.

Like any other investment strategy, a tactical investing approach entails risks, including the risk that client accounts can still lose value and the risk that a defensive position may, at any given point in time, prevent client accounts from appreciating in value.

Drew K. Horter, President
Founder

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