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Is the 60/40 Portfolio Officially Dead? Here's What You Can Do Instead

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"Is this time different? Is a question we often hear. Just as Mark Twain said, "History never repeats itself, but it does often rhyme." What makes this market cycle different (or the same) and what it means for investors is explored. Will investors be able to rely on their traditional investment approach moving forward or will they have to venture into new areas to find return?"

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Where do we go from 60/40?

We have been sounding the alarm on the end of the 60/40 stock and bond portfolio for the last several years. However, it wasn't until the simultaneous decline in stocks and bonds this year that investors started to take notice. Well, it is official: the 60/40 traditional asset allocation to stocks and bonds is on track for its worst year since 1936.[1] It seems investors may finally understand the need to diversify outside of their stock, bond, and real estate heavy portfolios.

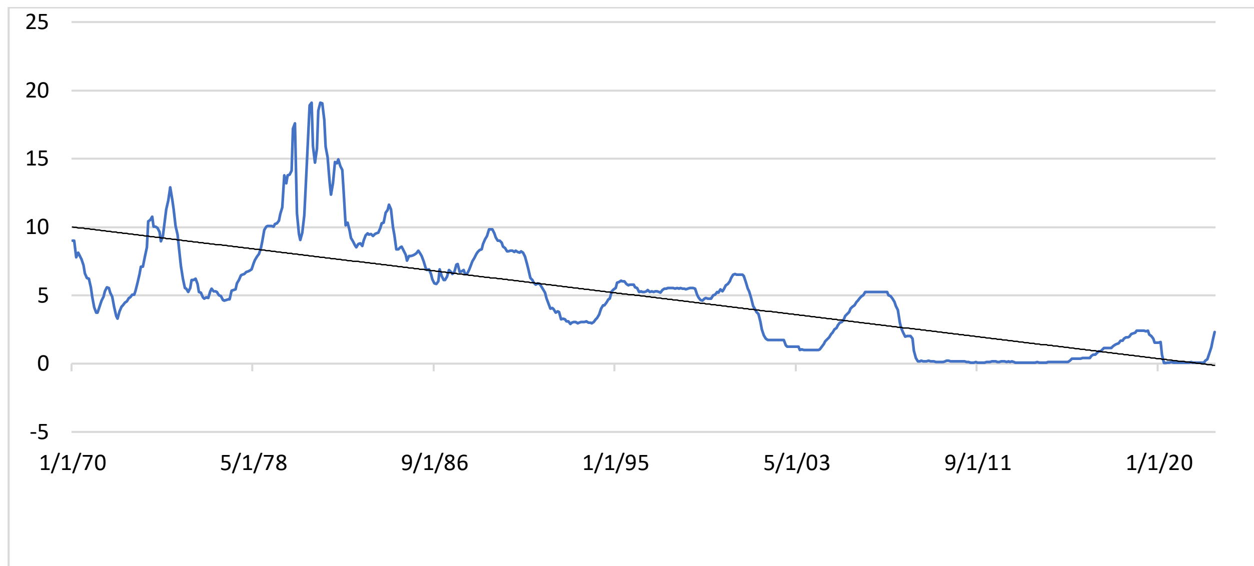
Establishing an appropriate mix of investments for an investor should be a dynamic process that is tailored to fit that specific individual or family. So why have the big banks pushed the static 60/40 approach as a one-size-fits-all panacea to asset allocation for as long as any of us can remember? Well, there is some logic behind it. For over 40 years, we have been in an environment where both Stocks and Bonds move opposite to one another across economic cycles. This provided investors diversification as it allowed stocks to drive portfolio growth with bonds providing a cushion to smooth out the volatility as market cycles played out.

We are now in an economic storm that is causing investors pain. Most failed to insulate their portfolios even as we saw the storm in the forecast. Now, the only bright light on the horizon falls on an investment strategy often overlooked and underappreciated. An area that has long been out of favor with investors; alternatives, specifically managed futures, are a class that has been relatively flat during arguably the longest bull run in stock market history. With little volatility and excitement in the futures space, investors either held onto their 60/40 portfolio or piled into stocks and forgot about diversification altogether. Now investors are on the hunt for yield and returns in an environment not conducive to traditional investment approaches.

Why Is It Different?

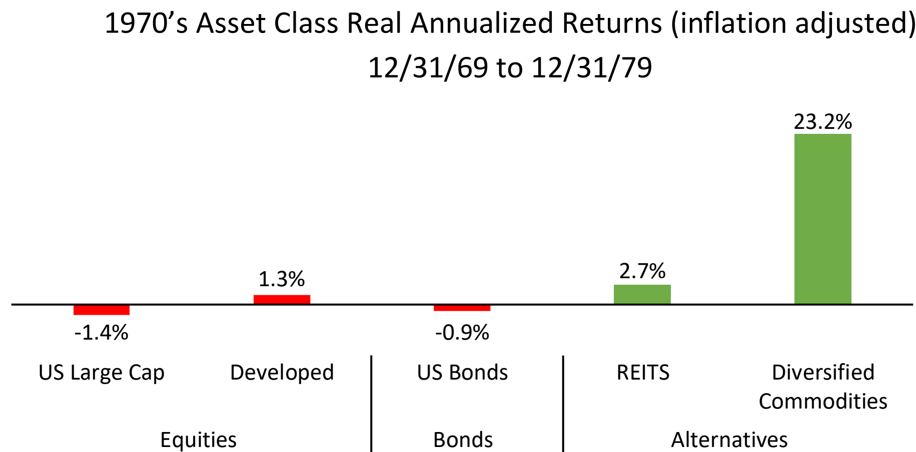
Well, as the song goes 'the times they are a-changin.' This time *is* different. Looking ahead, it is hard to see the Fed slowing their tack of interest rate rises anytime soon so long as inflation is running rampant. Below is the long-term trend line of The Federal Funds rate since the early '70s. We have been in a falling rate environment for nearly 50 years.

Declining Federal Funds Rate 1970-2022[2]



Among the many tools and models the Fed uses to influence policy is The Taylor Rule. This concept states that to control higher-than-targeted inflation, the federal funds rate must be increased at a level greater than one-for-one. So, if inflation plateaus at 6% for example, the federal funds rate would have to land around 9% to have a positive effect on lowering inflation. That 9% figure is something bond investors should be worried about. While monetary policy is reversing course, fiscal policy is steaming ahead with its easy money approach to keeping our economy inflated (and our president in office?). We believe investors will not be able to rely on their bonds to smoothen out the ride as they have before. It was not that long ago that the fed funds rate peaked at over 20% in 1981 after Paul Volcker aggressively raised rates to bring down inflation. We then saw a decade of poor performance across stock and bond markets. Could we see something similar in the 2020s? While double digit interest rates may seem like a far cry away, it is important to look back where we came from. So many investors have either not lived through an inflationary environment, or they forgot the detrimental effects it can have on the wider economy.

We can further compare the environment now to the last time we had rampant inflation, the 1970s. The chart below shows inflation adjusted annualized returns across equity, bond and alternative markets during the '70s:



Past results are not necessarily indicative of future results. Source: Bloomberg. US Large Cap – S&P 500 TR, Developed Equities – MSCI EAFE TR, REITS – FTSE REIT TR (since 12/31/1971), Diversified Commodities – BCOMTR. Source: Bloomberg LP and SummerHaven

This was the last meaningful period where both stocks and bonds fell in tandem. The real estate sector didn't do too well either. Why? Because real estate often correlates with equities, just with a lag. Inflation causes commodities to rise intrinsically, but the inefficiencies of supply and demand factors within commodity markets are the real driver of their performance. Think back again to the '70s and the energy crisis. It was the shortages, the wars, and the political crises (sound familiar?) that drove the energy complex then. This contagion quickly spread to other commodity sectors and supply chains and soon affected the whole world. Now we face the same set of factors caused by different events. Shortages caused by the global pandemic, the war in Ukraine, the changing political landscape in China and so much more.

This also shows why alternatives and commodities were relatively flat during the last bull run. The just-in-time supply chain theory was at its peak and the world was relatively stable geopolitically. Stocks like stable and efficient economies while commodities benefit during times of stress.

At the time of this writing, both SPY and AGG, the two major indices for stock and bond markets are each down year to date 23.30% and 15.89% respectively. This would provide investors with a return of -20.34% year to date if allocated 60/40.

What Can Be Done Differently?

This leaves investors with seemingly nowhere to run and nowhere to hide. That is except for a modest allocation to alternatives like commodities, currencies, precious and commercial metals, oil and gas, and more. These types of assets through a managed futures strategy traditionally don't correlate positively or negatively against stocks. What does the price of Cocoa in Ghana have to do with the moves Tesla and Apple are making? The answer is nothing, and that is exactly the point of having exposure to different classes of investments. Diversified not only through asset class, but also geography. The objective is to reduce portfolio risk while potentially increasing return. This is possible through an allocation to non-correlated and well diversified return streams.

60/40 was once a reliable approach to investing for the long term. It is now the new snake oil of the investment world. With the hindsight gained through the '70s, investors should recognize the risk that a 60/40 portfolio carries in today's environment. Expect inflation not to be transitory, rates to continue rising, and economic inefficiencies to exist for some time. This drop in stocks could just be the tip of the iceberg. Don't let your portfolio sink like the Titanic. There are too many investors who rely on their portfolio for income that can't wait for their portfolio to revert to their mean on the other end of the cycle. They need the capital now and they need it protected.

At the same time 60/40 is on track for its worst year ever, the primary benchmark for trend following Managed Futures strategies, the SG Trend Index is up **34.85% YTD** and is headed for its best year this century.[3] Investors shouldn't be afraid to learn more about or venture into a space like alternative investment classes. A new approach may involve some risk, but rarely does one realize the risk in staying with their current approach. No one said making money is easy nor comfortable. Especially not anymore. Gone are the days where stocks go up forever. Volatility is here to stay. It is time for investors to seek out non-correlated exposure by finding managers that offer an alternative like managed futures.

[1] Romero, D. (2022, September 6). *The 60/40 strategy is on pace for its worst year since 1936: Bofa*. The WealthAdvisor. Retrieved September 28, 2022, from https://www.thewealthadvisor.com/article/6040-strategy-paceitsworstyear1936bofa?mkt_tok=NDQ2LVVIUy0wMTMAAAGGtxLOI0PKaNmfl5fT9G23lQDJOOzBe2L6Mvnz_HD3G7pWyTh8CWgPi6RQY8Cx5OpIF_8TQzvBmls8dJgGUPZ16s0KdZxhV17mcz_FYE1UZXa0

[2] Federal Funds Effective Rate." *FRED*, 1 Sept. 2022, https://fred.stlouisfed.org/series/FEDFUNDS.

[3] *Barclayhedge indices*. BarclayHedge. (n.d.). Retrieved September 28, 2022, from https://portal.barclayhedge.com/cgi-bin/indices/displayHfIndex.cgi?indexCat=SG-Prime-Services-Indices&indexName=SG-Trend-Index

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