Whither the 60/40 portfolio?

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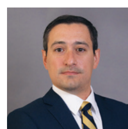

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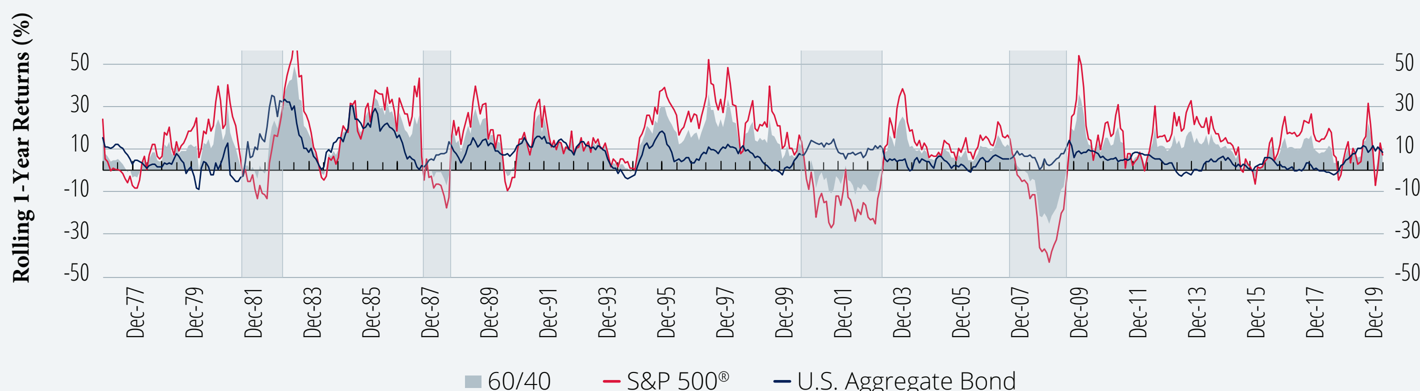
- The diversification benefits gained by adding bonds alongside stocks in a 60/40 portfolio has historically been driven more by interest rate risk than credit risk.
- Meanwhile, interest rates have been in secular decline since the early 1980s and are now below 1%; this has caused some to speculate whether the great bond bull market may finally be over.
- If true, this may cause investors to rethink the traditional 60/40 balanced fund and consider whether they need to take action to create a more tailored solution to better match their specific needs.

A "balanced fund" of 60% equities and 40% bonds has been a staple of prudent investing for decades. But recent events, including enormous and well-coordinated monetary and fiscal responses to the COVID-19 pandemic, have pinned interest rates near zero, threatening to undermine one of the core tenets of balanced fund investing. In this research note, we highlight some historical drivers of balanced fund returns and contemplate whether we are in fact facing a regime change in the bond market.

Balanced fund performance

The chart below shows rolling one-year performance of the S&P 500®, the Bloomberg Barclays U.S. Aggregate Bond Index (the Agg) and a combination of the two in a 60/40 balanced portfolio.[1] It highlights visually why this pairing has been so powerful through time: a low (and often negative) correlation between stocks and bonds, and positive returns on average for each. For decades, when equities have struggled, bonds have been there to mitigate the damage (and vice versa).

Bonds have softened the blow during equity market drawdowns



Source: Morningstar

The benefits of diversification have been so powerful that the whole of a 60/40 portfolio has indeed been greater than the sum of its parts, at least in the risk-adjusted return space. As shown in Table 1 below, a 60/40 portfolio has historically allowed investors to maintain equity-like returns while also reducing risk and considerably improving risk-adjusted performance.

Declining interest rates have been a driving force behind bond market returns

INDEX/PORTFOLIO	ANNUALIZED RETURNS[2]	SHARPE RATIO[3]
S&P 500®	11.39%	0.46
Balanced fund	10.10%	0.59
U.S. Aggregate Bond	7.26%	0.51

Table 1: Based on the period since inception of the Bloomberg Barclays Aggregate Bond Index through June 2020.

The Agg contains both corporate and government bonds, meaning much of its return profile can be decomposed into credit-risky and credit-riskless securities. By analyzing these return streams independently, we can make inferences about various risk exposures relative to each other and to equities.

Thankfully, the index provider makes this easy for us by publishing returns for both the credit-sensitive and rate-sensitive components of the index. As shown in the Table 2 at right, investors in U.S. government debt — who were theoretically exposed only to interest rate risk — achieved annualized returns that were only marginally less than those who were exposed to both interest rate and credit risk in the U.S. Aggregate Bond and U.S. Credit indices.

At the same time, the U.S. Government Index maintained a negative correlation to equities while the Agg and U.S. Credit displayed slightly positive correlations, allowing us to infer that interest rate risk has been a primary source of the diversification benefits that have historically accrued with a traditional 60/40 portfolio.

INDEX	ANNUALIZED RETURNS[2]	SHARPE RATIO[3]	CORRELATION TO S&P 500[4]
U.S. Credit	7.86%	0.48	0.29
U.S. Aggregate Bond	7.26%	0.51	0.13
U.S. Govt	7.00%	0.48	-0.05

Table 2: Correlation from inception of the Agg, January 1976 through June 2020.

A regime shift?

As the chart on the next page illustrates, interest rates have been in decline for much of the last 40 years. Yields on the 10-year U.S. Treasury Bond have fallen from approximately 15% in the early 1980s to their current level below 1%. That has provided a secular tailwind for the absolute performance of all bonds, credit-risky or not.

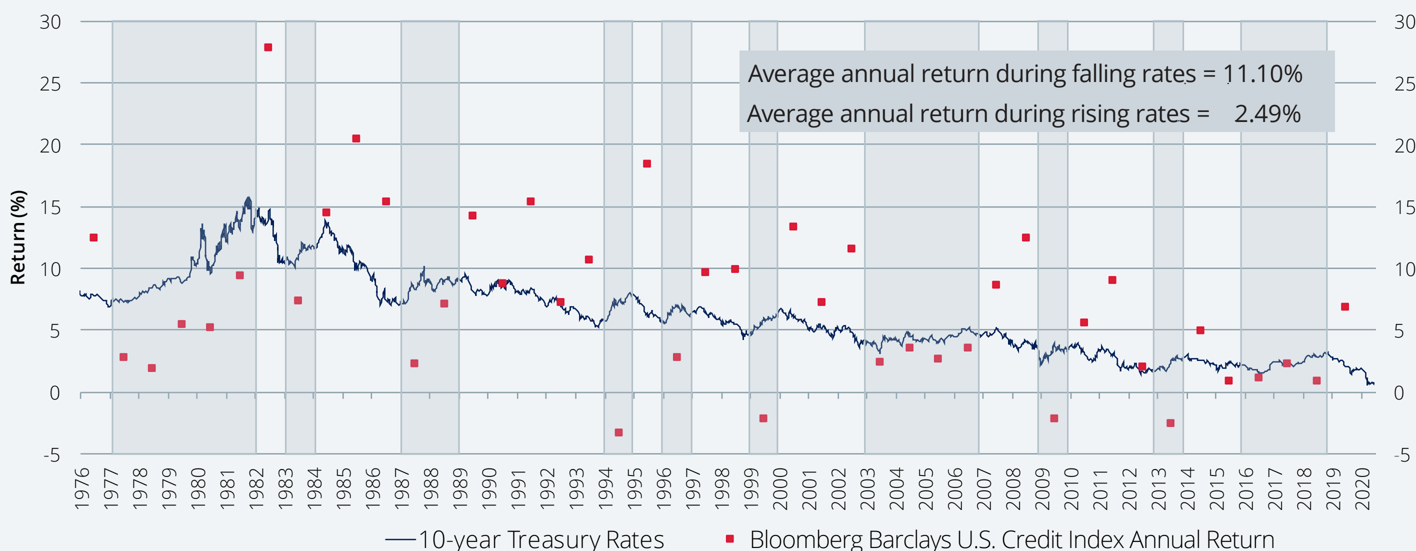
But therein lies the problem: If declining interest rates have indeed been a primary driver of both returns and the diversification benefits in a traditional 60/40 portfolio, what happens when interest rates are pegged near zero? If, as some have argued is the case today, rates have nowhere to go but up, then owners of a 60/40 balanced fund may suddenly find that a key component of the strategy is no longer able to function the same way that it has for nearly half a century.

So, whither the 60/40 portfolio?

While we at Great-West Investments™ are not prepared to declare the balanced fund obsolete, we do acknowledge that its past success is due in no small part to characteristics of the fixed-income market that may be significantly diminished the nearer we come to the zero bound on rates. But, the good news is that there may be a few things that investors

might consider to add stability to their balanced portfolios, such as including more fixed-income sub-asset classes (like non-U.S. exposure) or abandoning a robotic 60/40 allocation in favor of a more active and tailored approach that more closely matches one's individual risk and return objectives. In any case, the current economic and capital market environment is unprecedented. Investors would be well served to question whether time-tested relationships are likely to remain that way.

Interest rates have been in secular decline for the last 40 years



Source: Morningstar Direct; GWI calculations

1 Morningstar Direct; GWI calculations. Rolling one-year returns and their combination in a 60/40 proportion in one-month steps.

2 Morningstar Direct; GWI calculations. Annualized returns from quarterly data.

3 Morningstar Direct; Board of Governors of the Federal Reserve System (FRED); GWI calculations.

4 Morningstar Direct; GWI calculations.

Calculated by taking annualized quarterly return less a risk-free rate proxied by a three-month Treasury bill over the same period, with the total then divided by the standard deviation of portfolio returns.

S&P 500® Index is a registered trademark of Standard & Poor's Financial Services LLC and is an unmanaged index considered indicative of the domestic large-cap equity market.

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