What next for the 60/40 portfolio?

Re-examining the case for alternative assets

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The 60/40 balanced portfolio has been the cornerstone and benchmark of institutional portfolios for most of the past 30 years, providing growth, yield, inflation protection and downside protection in one neat package. Not many investors are still around who have first-hand experience of any other environment. But as interest rates test new lows and equity valuations become increasingly stretched and volatile, that immutable go-to portfolio appears less attractive looking forward.

It was our pleasure recently to host a panel of distinguished industry experts to discuss the outlook for the 60/40 portfolio, what can take the place of this trusty workhorse and what additional tools investors have available. Below are some of the key talking points.

The outlook for equity markets

- Recent Central Bank activity represents a significant tailwind for equity markets: there is an opportunity cost to not being invested in equity markets at the moment.
- A correction can always happen, but the Fed seems to have headed off an equity market crash and suppressed volatility in the near-term. So, "don't fight the Fed"…
- …but don't trust it either! It is risky to assume their current strategy is sustainable indefinitely; besides which, they are humans who can always change their mind.
- Consensus is that sustained equity bear markets are not a thing of the past, and we are still likely to see "two-way" equity markets in future.

The role of fixed income in investors' portfolios

- Some investors have never known anything other than a negative correlation between equities and bonds, and may doubt that relationship could ever breakdown.
- But the negative correlation only holds up until it doesn't. There is a risk that bonds won't provide the diversification benefits they have in the past.
- Investors using bonds to hedge their equity exposure at the moment also face the problem that they are trying to hedge something expensive (equities) with something else very expensive (bonds).
- Even if you assume the negative correlation is going to continue forever, there is an important distinction to be drawn between correlation and beta. Given current low interest rates, the correlation may hold up but the magnitude of the move, and the impact on investors' portfolios, is going to be smaller than may be desired – unless you "load up" on rates.

The spectre of inflation, and its implications for institutional portfolios

- If inflation occurs, it will eat into the real returns from fixed income; indeed it has the capacity to affect every aspect of institutional investors' asset allocation and to impact returns across all beta asset classes.
- In one sense, inflation could be considered a good thing: it is likely to create trading opportunities and an environment that is ripe for active management.
- However, it depends on your perspective: public pension plans (for example) tend to approach asset allocation on a 3-5 year cycle, and inflation expectations are an important input to that. The ship cannot be turned easily, such that if there is an inflationary shock, it is hard to be responsive to that.
- Investors are starting to become more focused on the prospect of rising inflation, and considering the types of asset class/strategy that are likely to provide protection in such an environment.

Active vs. passive management

- Active management has its place, provided the manager has the ability to add an edge in the particular market or asset class. But it is important to be selective: alpha-rich environments lend themselves to being active, but in other areas it makes sense to be passive.
- The volatility of February and March has created some interesting opportunities for active managers.
- Actively-managed, positively-convex strategies that are volatility friendly represent an interesting opportunity to capture alpha in the current environment.
- However there have been winners and losers. 2020 has been a good year to test how diversifying some actively-managed "diversifying" strategies actually are, and has shown which managers have a genuine "edge".

The case for alternative assets

- Expected low returns for equities and low rates in the coming years mean alternatives can have a role to play in institutional investors' portfolios, both as a generator of returns and as diversifiers.
- Some alternative strategies also provide embedded inflation protection.
- Genuine alpha does exist, but it's incredibly hard to find and harvest.
- 2020 has seen significant dispersion across alternative strategies and even within strategies.
- Focus on people and process when selecting alternatives managers. Come up with an investment thesis for an alternatives allocation, and check frequently to ensure it remains true.
- Diversification is key: "diversify your diversifiers".

With thanks to our panellists:

- **Elizabeth Burton** (Chief Investment Officer, Employees' Retirement System of the State of Hawaii)
- **Darren Wolf** (Global Head of Investments - Alternative Investment Strategies, Aberdeen Standard Investments)
- **Jackie Rosner** (Managing Director, PAAMCO Prisma)

Moderated by **Martin Lueck** (Co-Founder and Research Director, Aspect Capital)

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