Looking Beyond the 60/40 Portfolio

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A 60% stock / 40% bond portfolio has been generally accepted as the standard allocation for many decades. For the most part, it has served the investment community well as solid gains from its widely used benchmarks, the S&P 500 and the Barclays US Aggregate Bond Index, resulted in the 60/40 model outperforming most mutual funds and hedge funds. However, as we look forward, there are several challenges facing the traditional 60/40 model. In fact, its risk/return profile is likely to be less attractive than several other portfolio structures.

One of the problems with the traditional 60/40 allocation is that the fixed income side of the portfolio cannot recreate the gains it has enjoyed over the last 35 years. As you can see from the graph below, the yield on the 10yr US Treasury peaked in 1981 at 15.8% and essentially moved in one direction until July'16, when it bottomed at 1.36%. This decline in rates created significant and consistent gains for treasury bonds, the largest component of the Barclays Bond Index.

Source: Bloomberg

Since mid-2016, rates have begun to move higher. During the second half of 2016, the Barclays US Aggregate Bond Index suffered a decline of 2.5%, including interest payments.

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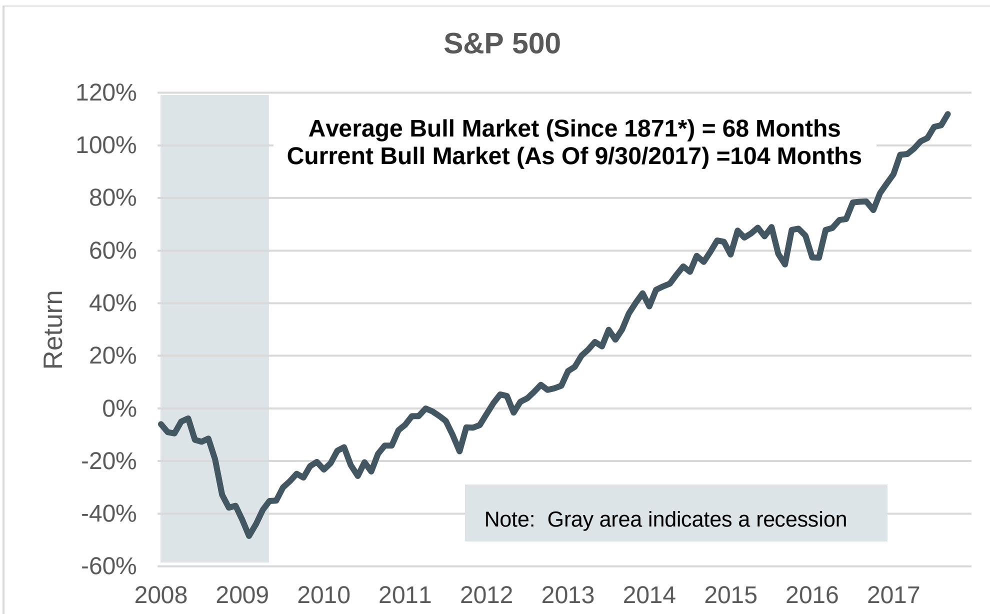
With rates about flat so far in 2017, the AGG has returned a positive 2.93% through 10/27/17. The set-up here, does not look attractive. With yields so low, gains from treasury bonds are expected to be minimal even if rates stay at the current, relatively low, levels. Conversely, if interest rates do continue to move up and reverse even a small portion of the move from the last 35 years, investors are likely to suffer losses which could be significant.

Another concern regarding future returns of a 60/40 portfolio is the expected return for the equity markets. As the graph below shows, the current Bull Market is entering its 9th year, whereas the average Bull Market has historically lasted less than six years.



Source: Bloomberg

In addition, equity valuations are relatively high by historical standards. The forward 12 month Price-to-Earnings ratio of the S&P 500 is 18.5x, its highest level in 15 years. Of course, the Bull Market could continue and valuations can become even richer as investors focus on historically low interest rates and potential future structural changes such as less government regulation and corporate tax reform. Whether that's the case or not, it is clear that the setup for the S&P 500 is less attractive than it was in 1981 when the P/E ratio was only 9.0x.

Now that we've reviewed the challenges that the 60/40 portfolio faces, we will list some alternative portfolio structures that we believe will lead to better risk adjusted returns going forward. The most important element of this is downside protection on both the equity and fixed income sides of the portfolio. This can be achieved with a more dynamic portfolio that maintains higher than a 60% equity allocation in normal times but has the

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flexibility to significantly lower the equity allocations during times of market stress. Stress can be measured by various factors such as credit spreads, risk of recession, geopolitical events, and central bank liquidity. The point here is that outside of recessions, adverse geopolitical events (such as war), and overly restrictive central banks, it usually is beneficial to have a healthy equity allocation.

Another way to enhance the 60/40 model is to incorporate equity investments that have a risk/return profile preferable to the S&P 500. This can include domestic market segments, as well as, international exposure. SSI uses our proprietary quantitative model to identify attractive regions, sectors and style factors (such as value, quality, and small-cap.) We then apply extensive fundamental analysis in these areas and build an equity portfolio with higher return expectations and similar risk characteristics to the S&P 500.

Over the last decade it has paid to be strictly in the U.S. stock market because it has outperformed almost all other geographies, most by a very large margin. Since 2010 through 1H'2017, the S&P 500 returned 141.2% on a total return basis. The rest of the global stock market, both developed and emerging, returned only 33.3% (as measured by the returns on the MSCI All Country World Index). While there are many fundamental reasons for the U.S. outperforming, relative performance going forward is likely to be very different and opportunities overseas should not be ignored.

In the fixed income portion of the portfolio, there appears to be attractive alternatives to the Barclays US Aggregate Bond Index. This index has a high allocation to treasuries and government agency bonds. They offer very low coupon rates and there is a high probability that capital appreciation will be low or even negative if rates move higher. Floating rate securities and credit oriented investments can provide a higher yield and hold up relatively well in a rising interest rate environment. Although credit exposure must be monitored, in the current non-recession, solid growth environment these investments can perform quite well, while acting to diversify the portfolio, increase yields, and lower duration risk. In the bond portion of the SSI Flexible Allocation strategy, we currently hold 5 bond ETFs. Combined, these ETFs provide a higher yield than the AGG, have a significantly lower duration, and have a lower standard deviation (3yrs). We believe this fixed income portfolio should outperform the AGG in most scenarios.

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