Looking Beyond the 60/40 Portfolio

by: **Steve Wachtel, CFA**

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 ("AGG"), 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 intraday at 1.32%. This decline in rates created significant and consistent gains for treasury bonds, the largest component of the Barclays Bond Index.

Recently, 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. 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.

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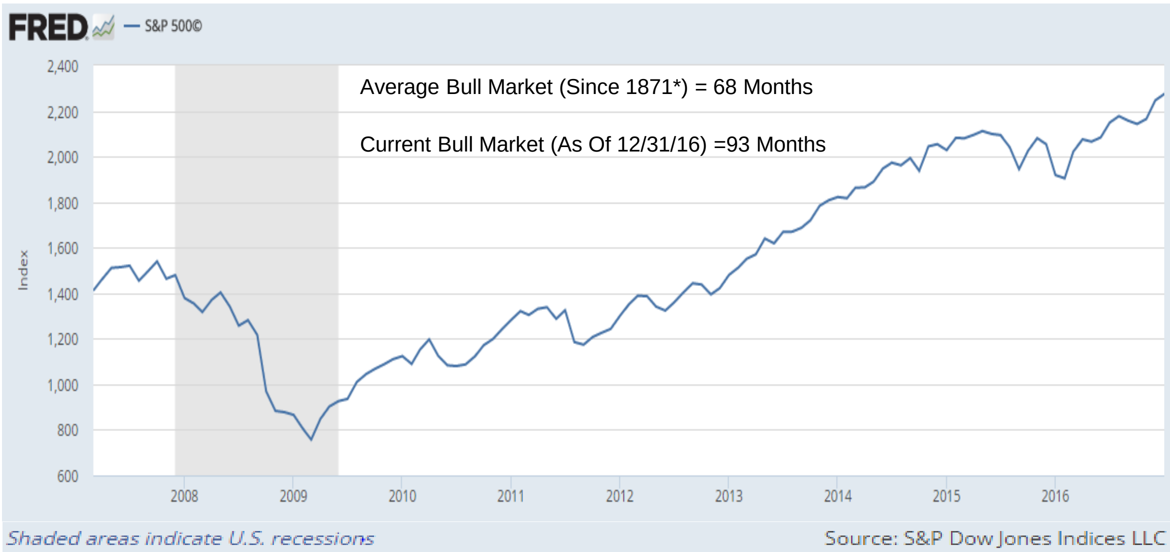
Another concern regarding future returns of a 60/40 portfolio is the expected return for the equity markets. As the graph below shows, the current Bull Market is entering its 9th year, whereas the average Bull Market has historically lasted less than six years.



*Source: Board of Governors of the Federal Reserve System (FRED); 2016 research.stlouisfed.org

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.

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This can be achieved with a more dynamic portfolio that maintains higher than a 60% equity allocation in normal times but has the 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, 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. Over the last six years, the S&P 500 has more than doubled while the rest of the global stock market, both developed and emerging, returned only 23.3%*. While there are many fundamental reasons for the U.S. outperforming, as these dynamics change it will become desirable to have some international exposure on the equity side of the portfolio.

In the fixed income portion of the portfolio, going forward 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.

**Compares the total return of the S&P 500 to that of the MSCI All Country World Excluding US for 2/28/2011 through 2/28/2017*

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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 3yr standard deviation. We believe this fixed income portfolio should outperform the AGG in most scenarios.

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Portfolio Manager
21 Yrs. Experience

About SSI

- Headquartered in Los Angeles, CA
- Founded in 1973
- 13 Investment Professionals
- 100% Employee Owned
- $1.4 Billion AUM
- 36 Employees

Compliance Statement

SSI Investment Management, Inc. ("SSI") claims compliance with the Global Investment Performance Standards (GIPS®).

Definition of the Firm

SSI was established in 1973 and is a Registered Investment Advisor based in Los Angeles, CA. SSI manages assets in domestic and global capital markets. SSI acquired the assets of Froley, Revy Investment Co., Inc. ("Froley Revy") and its composites as of March 1, 2009. SSI is 100% employee owned and is not affiliated with any parent organization nor does SSI have any subsidiaries. SSI applies quantitative disciplines and fundamental research in its management of alternative and traditional portfolios for institutional and high net-worth investors. SSI manages separate accounts, limited partnerships and acts as sub-advisor to both onshore and offshore funds.

Policies

SSI's policies for valuing portfolios, calculating performance, and preparing compliant presentations is available upon request.

The Composite & Benchmark

SSI's Flexible Allocation Strategy (composite created May 1, 2009) invests in a portfolio primarily of Exchange Traded Funds but may include Exchange Traded Notes and other Mutual Funds. The exposure to various asset classes including, but not limited to, equity, fixed income and cash may range from 0-100%. The composite contains fully discretionary accounts including those no longer with the firm. SSI believes a performance comparison versus the Balanced Index is appropriate. Prior August 1st, 2015, the Balanced Index was 50% of the total return of the S&P 500 and 50% of the 90-Day Treasury Bill ("Balanced Index"). Subsequent to August 1st, 2015, the Balanced Index will be 60% of the total return of the S&P 500 and 40% of the Barclays Aggregate Bond Index. Portfolios in this composite may have asset allocations that are different from the allocation of the Balanced Index. These allocations may generally range from 60% equities & 40% Barclays Aggregate to 75% equities & 25% Barclays Aggregate. The volatility of this strategy may be greater than the Balanced Index due to changes in asset allocation. The return, if any, is dependent upon SSI's discretionary management. The Barclays Aggregate Bond Index is made up of government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market and the maturities of the bonds in the index are more than one year. Any other indices shown are not necessarily comparable to SSI's Flexible Allocation Strategy. These are widely recognized market indices that are shown for informational purposes only. Investors should be aware that individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect actual investment performance. The composite name was formally known as SSI Flexible Equity Strategy from 5/1/2009 – 4/30/2015 and on 5/1/2015 the new composite name became the SSI Flexible Allocation Strategy. Benchmark rebalancing frequency: monthly.

Investment Management Fees

Returns are presented gross and net of management fee. Actual results of an individual account may be materially different from the performance shown herein because of differences in inception date, transaction and related costs, restrictions, fees and other factors. All performance is based in U.S. dollars and reflect, on a percentage basis for each of the periods indicated: the actual net increase (decrease) of all SSI Flexible Equity Strategy portfolios, dollar-weighted, including adjustments for unrealized gains and losses, the reinvestment of dividends and other earnings, the deduction of some investment costs, the deduction of mutual fund costs, and are time-weighted to adjust for additions and withdrawals, and (b) the net increase (decrease) of the Balanced Index.

Net performance is reduced by SSI's actual investment management fees and model fees (2011-2012). 1% annual fee is used for any model fees. Gross performance does not include deduction of SSI's investment management fees.

If performance is gross of management fees, client's actual return will be reduced by the management fees and any other expenses which may be incurred in the management of an investment advisory account. See SSI's Form ADV, Part 2A for a complete description of the investment advisory fees customarily charged by SSI. As an example, an account with an initial $1,000,000 investment on January 1, 2003, earning a recurring 5% semi-annual gross return (10.25% annualized), and paying a .5% semi-annual management fee (1% annual fee) would have grown to $1,340,096 on a gross of fees basis and $1,300,392 on a net of fees basis by December 31, 2005 (3 years).

List of Composites

A list of the Firm's composite descriptions and/or compliant presentations are available upon request. Please contact juliea@ssi-invest.com.

Additional Disclosure

The benchmark for the Flexible Allocation Strategy has historically been 50% S&P 500 / 50% T-Bills (May 1, 2009-July 31, 2015). As the Strategy has evolved, the portfolio has averaged an equity level closer to 60%. The remaining 40% has been made up of a variety of fixed income investments. In accordance with Global Investment Performance Standards (GIPS®), the benchmark must reflect the investment mandate, objective, or strategy of the composite. As a result, a benchmark of 60% S&P 500 / 40% Barclays U.S. Aggregate Bond Index is used beginning August 1, 2015.

SSI acquired Froley Revy and its composites as of March 1, 2009. Prior to the acquisition, Froley Revy claimed GIPS compliance for the periods of 1983-2008 and was independently verified by Ashland Partners & Co.

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