MarquetteAssociates

The 60/40 Portfolio Revisited: Back from the Dead?

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Evan Frazier, CFA, CAIA, Senior Research Analyst

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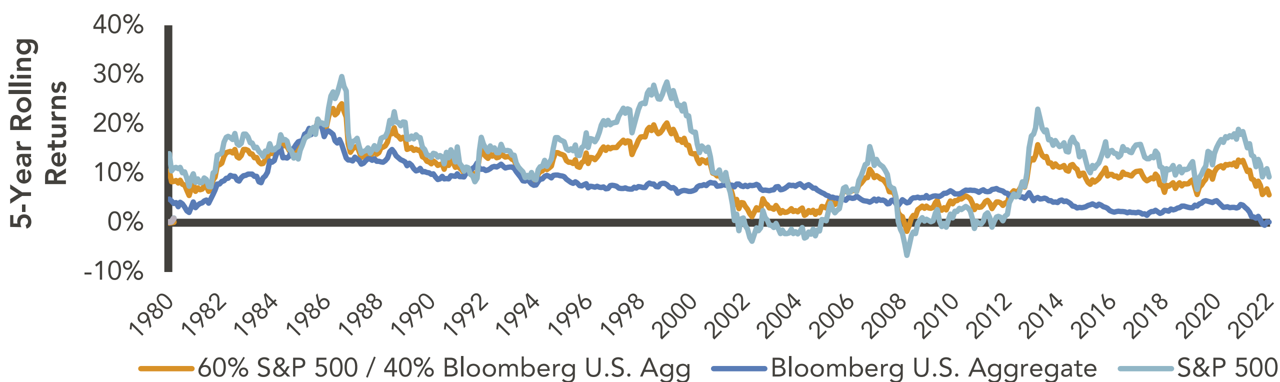
In response to an inquiry concerning rumors of his demise in 1897, American writer and satirist Mark Twain quipped, "The report of my death was an exaggeration." This quote may also apply in the case of the 60/40 portfolio and a white paper published by Marquette Associates in late 2021. The piece, entitled, "Is the 60/40 Portfolio Dead Forever?" examined the challenges faced by the popular model consisting of a 60% allocation to diversified equities and a 40% allocation to a broad basket of fixed income securities. These challenges included elevated equity valuations and the prospects of rising interest rates and slowing economic growth. Indeed, both stocks and bonds struggled mightily last year due to these and other headwinds, with 2022 one of the worst on record for the 60/40 portfolio. That said, and amid a strong start to 2023, there are reasons for optimism when it comes to the viability of the model to again generate attractive risk-adjusted performance. This white paper provides historical context for the 60/40 portfolio, details its current outlook, and outlines ways in which investors can augment the model to achieve desired return targets.

SETTING THE STAGE

The 60/40 portfolio rose to prominence among investors due to its ease of implementation and attractive pattern of performance that has historically offered both participation during robust market environments and protection amid periods of turbulence. These attributes are a function of the diversification benefits provided by the model, which are commonly referred to as "the only free lunch on Wall Street" and typically lead to a smoother return profile. Since 2012, the model has returned approximately 8.7% on an annualized basis, compared to roughly 12.5% and 1.1% for the S&P 500 and Bloomberg Aggregate Bond indices, respectively. One of the most compelling aspects of this performance, however, is the efficiency with which the model has delivered these returns. Over the same period, the 60/40 portfolio has exhibited a standard deviation of roughly 60% of the S&P 500 and a Sharpe Ratio (a measure of risk-adjusted return) that is more attractive than both equities and bonds. Exhibits 1 and 2 below outline the relatively smooth rolling returns for the model over the last several decades, as well as risk and return figures over the last ten years.

Exhibit 1: 5-year rolling returns of the 60/40 model have been smoother than those of the S&P 500 index since the 1980s



Source: Bloomberg, eVestment as of December 31, 2022; 60/40 portfolio rebalanced annually

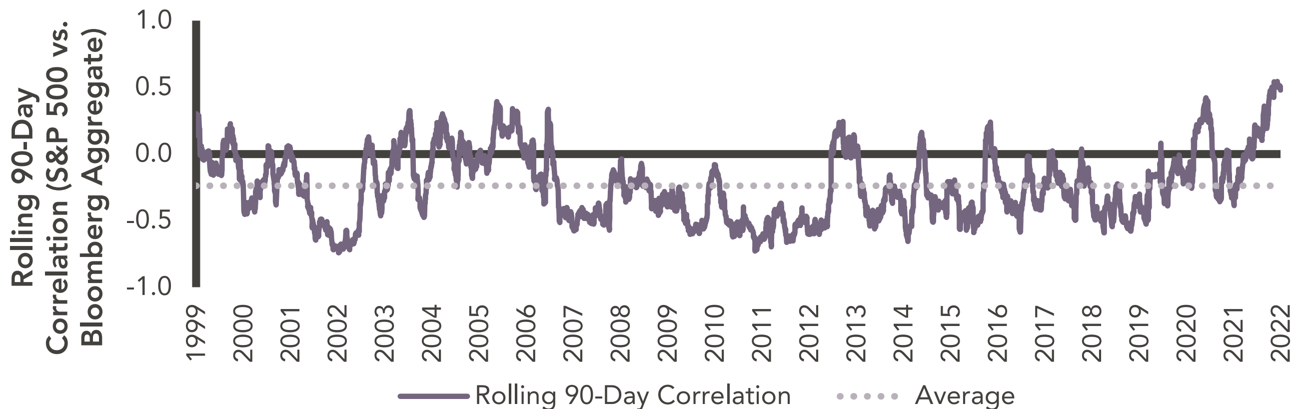
Exhibit 2: The 60/40 portfolio has delivered relatively efficient performance over the last decade

Last 10 Years	Annualized Return (%)	Annualized Standard Deviation (%)	Sharpe Ratio
60% S&P 500 / 40% Bloomberg U.S. Agg	8.7	9.2	0.9
Bloomberg U.S. Aggregate Index	1.1	4.1	0.1
S&P 500 Index	12.5	15.0	0.8

Source: Bloomberg, eVestment as of December 31, 2022; 60/40 portfolio rebalanced annually, risk-free rate represented by 3-month T-Bill

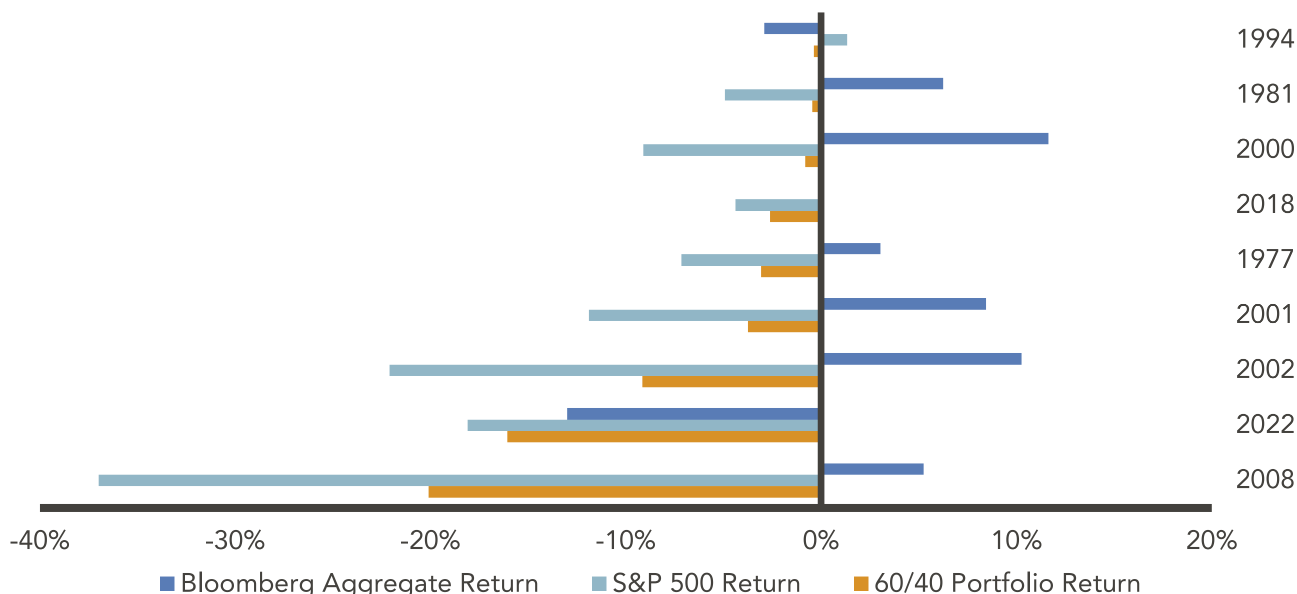
Recent performance of the 60/40 portfolio belies the attractive historical risk/return profile, as the diversification benefits normally provided by the model eroded as fixed income and equity securities largely moved in tandem throughout 2022. Specifically, as shown in Exhibit 3, rolling 90-day correlations between the S&P 500 and the Bloomberg Aggregate Bond indices climbed to a 20-plus year high in December 2022, with the full-year average of 0.15 well above the long-term average of -0.24. The significant increase in correlation was due to poor performance for both asset classes during the year. The S&P 500 index declined 18.1% in 2022 due to myriad investor concerns regarding the trajectory of inflation and restrictive monetary policy, among other factors. The reversal of lax financial conditions, which had buoyed most asset classes over the last several years, was also a headwind for fixed income indices, with bond prices falling as yields rose. The Bloomberg Aggregate Bond index declined 13.1% in 2022, its worst calendar year on record. As a result, the 60/40 portfolio notched a return of -16.1% for the year due to the lack of diversification benefits. To provide a sense of the extreme and aberrational nature of this performance, Exhibit 4 highlights the worst-returning years for the 60/40 portfolio since the 1970s, along with the returns for both the S&P 500 and Bloomberg Aggregate Bond indices.

Exhibit 3: The correlation between the S&P 500 and Bloomberg Aggregate indices moved well above its long-term average in 2022



Source: Bloomberg as of December 31, 2022

Exhibit 4: 2022 marked the worst year for the 60/40 portfolio since 2008



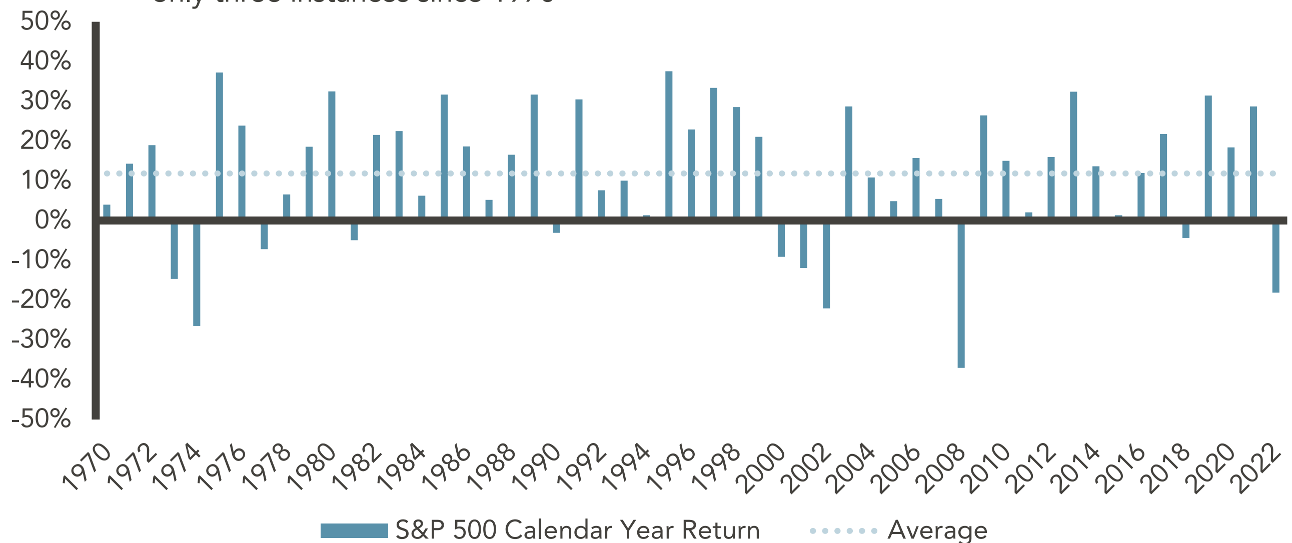
Source: Bloomberg, eVestment from 1976 through 2022

THE FUTURE AIN'T WHAT IT USED TO BE

Equities

While the 60/40 portfolio has not served investors well over the last year, recent changes in market dynamics could serve as tailwinds for both absolute and risk-adjusted returns going forward. First, to the extent a continued slowdown in inflation and moderation in Federal Reserve interest rate hikes results in a "soft landing," equities may begin to recover from last year's difficulties. Indeed, stocks have generally been strong to start 2023, and this type of resurgence after challenging periods has been common throughout history. Since 1970, as shown in Exhibit 5, there have been only three instances of the S&P 500 index recording a negative return in two consecutive calendar years. This occurred most recently during the Dot-Com Crash of the early 2000s, as well as during the recession of the 1970s. The figures displayed below, while not indicative of an immediate reversal within equity markets, suggest last year's return of -18.1% is historically unlikely — especially if the United States avoids a deep recession — and that stock indices trend up over time.

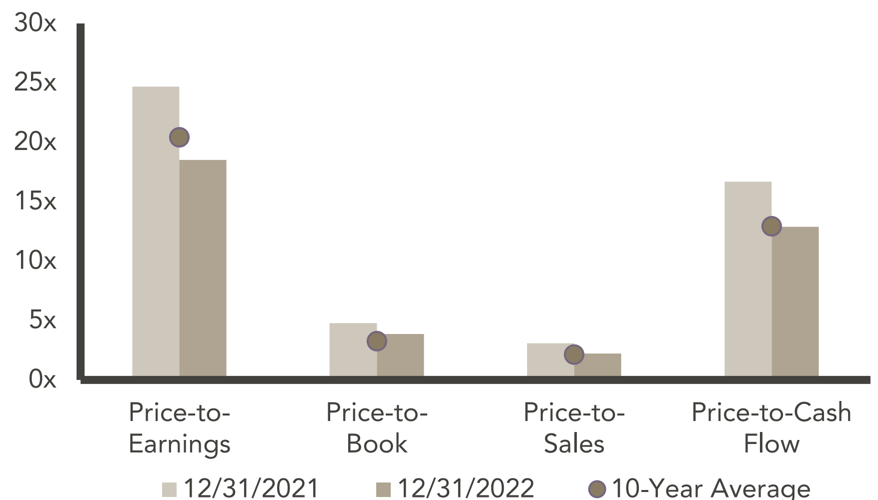
Exhibit 5: The S&P 500 index has notched negative returns in two consecutive calendar years in only three instances since 1970



Source: Bloomberg as of December 31, 2022

The S&P 500's negative return in 2022 can be primarily attributed to valuation compression. After starting the year at roughly 24.7X, an extreme level relative to the history of the index, the benchmark's price-to-earnings multiple contracted by more than 25% amid an uptick in interest rates. The multiple sat at 18.5X at the end of last year — below its long-term average of 20.4X. The story is similar across most valuation metrics *(Exhibit 6)*, including price-to-book, price-to-sales, and price-to-cash flow, all of which have seen significant compression.

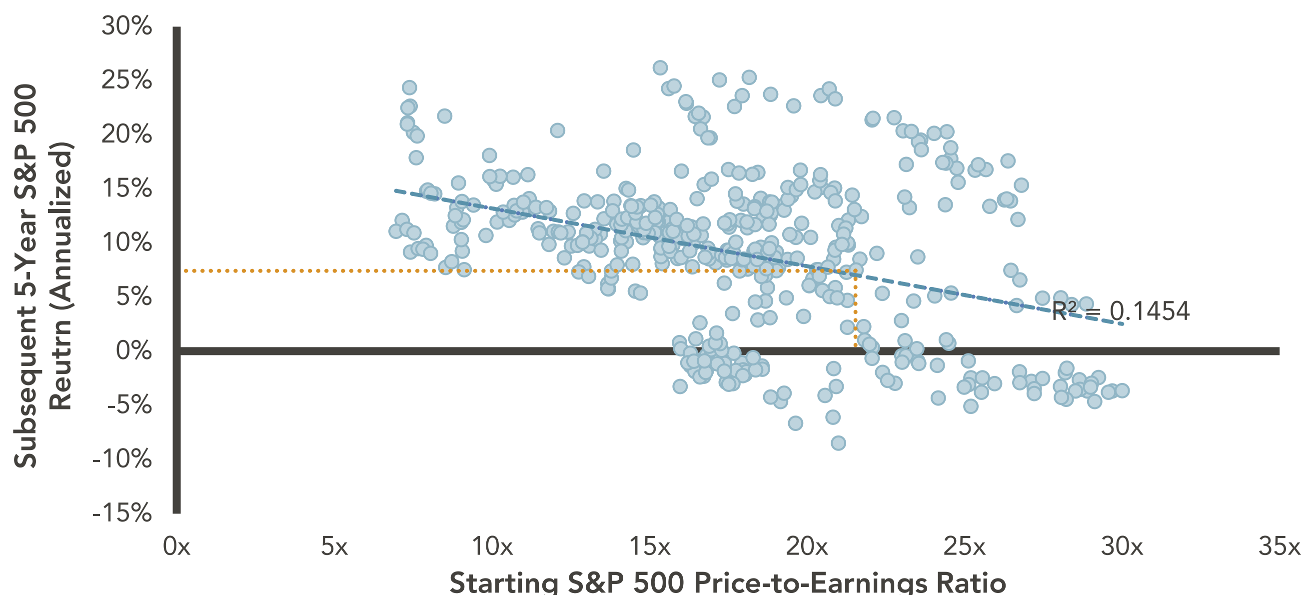
Exhibit 6: S&P 500 price multiples contracted significantly in 2022



Source: Bloomberg as of December 31, 2022

It is important to outline the relationship between multiples and performance for equity indices throughout history. As displayed in Exhibit 7 below, there is an association between the price-to-earnings ratio of the S&P 500 and the subsequent 5-year annualized return for the benchmark that indicates that lower and average-sized multiples generally portend stronger performance. Exhibit 7 also shows the line of best fit for these data points, which can serve as an indication of future returns given a certain level of valuation. The current price-to-earnings ratio for the S&P 500 index of 18.5X corresponds to a future 5-year annualized return for the benchmark of around 8.6%, according to the regression model. While certainly not meant to serve as an explicit predictor of performance, the relationship does provide some clarity on what might be reasonably expected from the S&P 500 index over the long term given a certain valuation starting point.

Exhibit 7: Lower and mid-sized multiples have historically portended higher go-forward returns for the S&P 500



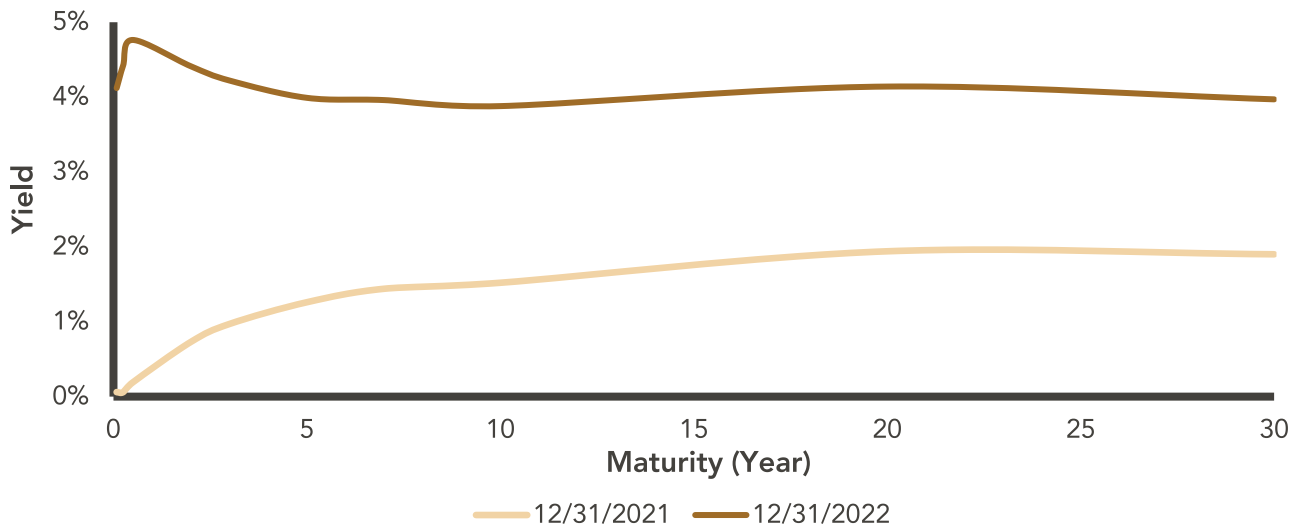
Source: Bloomberg from 1979 through 2022 using monthly data. Orange dotted lines plot December 31, 2022.

Of course, valuation is only one factor contributing to equity returns, and a few notable risks could impact the outlook from here. First, corporate earnings are likely to face pressure in the coming months. Given concerns about a possible economic downturn, analysts have begun to lower earnings projections across most sectors. Bottom-up 2023 EPS estimates for the S&P 500 declined by 2.5% from December 2022 to January 2023, with the index now only expected to grow earnings 3.0% this year. At the macro level, geopolitical turmoil, ongoing labor market strength, and/or renewed inflation pressures that result in additional rate hikes could also hamper the near-term outlook for equities.

Fixed Income

There is perhaps more reason for optimism regarding the prospects of fixed income over the coming years. As noted, interest rates climbed precipitously in 2022 as the Federal Reserve grappled with inflation levels not seen in decades. Specifically, the effective fed funds rate rose from roughly 0.1% at the beginning of the year to around 4.3% at its close. This marked the largest twelve-month increase since 1981, with additional increases expected in the coming months (though asset prices may already largely reflect the effects of these future increases). Yields of tenors across the term structure followed a similar trajectory during the period, with the 10-year and 30-year notes finishing 2022 at 3.9% and 4.0% after starting the year at 1.5% and 1.9%, respectively. Exhibit 8 on the next page shows the shape of the Treasury yield curve at both the beginning and end of 2022.

Exhibit 8: Rates rose across the Treasury curve over the course of 2022



Source: Bloomberg as of December 31, 2022

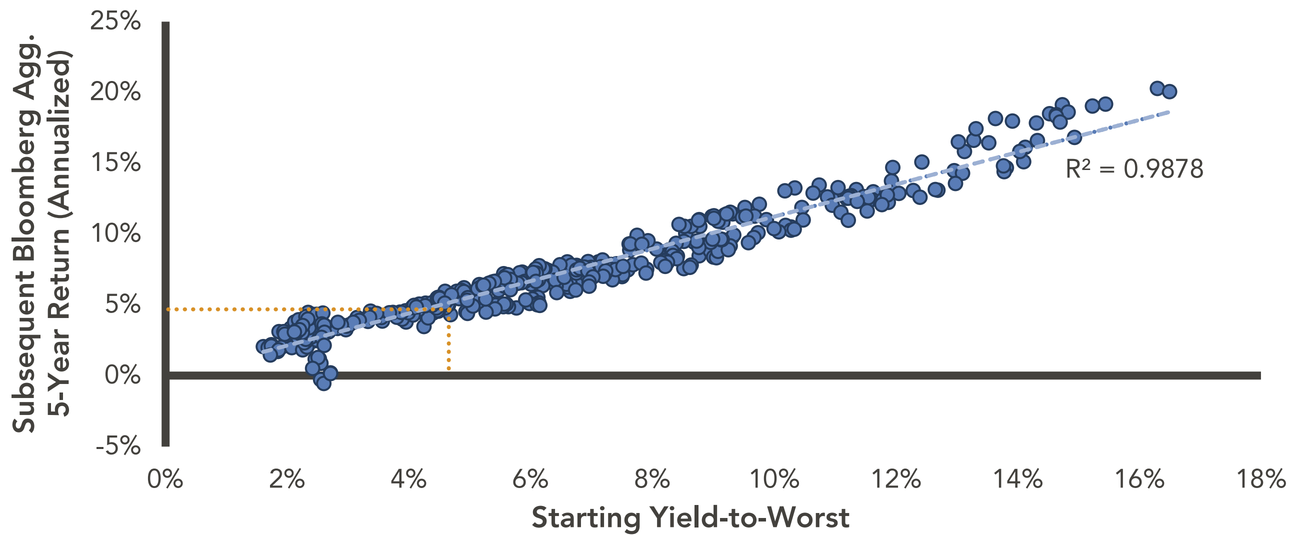
As a result of these dynamics, yields offered by fixed income securities are now much more attractive than they have been over the last decade and are back to fulfilling their income-generating role in investor portfolios. At the beginning of 2022, the bellwether fixed income index — the Bloomberg Aggregate Bond index — exhibited a yield-to-worst of 1.8%. That figure increased to 4.7% over the year and now sits well above the long-term average for the benchmark.

Exhibit 9: The Bloomberg Aggregate Bond index now offers a yield-to-worst well above both that exhibited at the start of 2022 and its long-term average

Source: Bloomberg as of December 31, 2022

As lower equity multiples are generally associated with higher go-forward returns, in fixed income, higher yields have typically portended higher returns. A similar regression analysis on the Bloomberg Aggregate Bond index suggests an extremely strong linear relationship. Without taking into account the effects of important factors like duration, the yield-to-worst for the benchmark as of December 31, 2022 of 4.7% implies a subsequent 5-year annualized return of 4.3%. Again, this model, highlighted in Exhibit 10 on the following page, is not meant to be predictive, but rather illustrative of the historical relationship between yields and future returns for the index.

Exhibit 10: There is a very strong historical relationship between the yield-to-worst for the Bloomberg Aggregate Bond index and its subsequent 5-year return



Source: Bloomberg from 1979 through 2022 using monthly data. Orange dotted lines plot December 31, 2022.

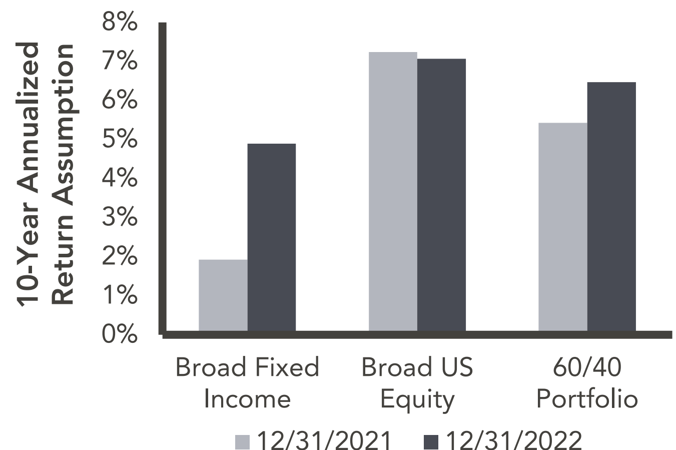
Similar to equities, the bond market also faces risks that could impact future returns. First, while the Federal Reserve has signaled the likelihood of fewer rate increases in 2023, fixed income performance may be challenged if higher-than-expected rates are required to cool inflation or the labor market. Additionally, with credit spreads generally near long-term averages, spread widening could weigh on fixed income performance if economic conditions deteriorate.

WHAT TO DO NOW?

As described, dynamics have changed within both equity and fixed income markets over the last year such that the 60/40 portfolio may be poised for a resurgence. However, the question remains: Can this simple model help investors achieve desired return targets or do modifications need to be made?

As of the end of 2021, according to Marquette's asset class return forecasting software, a 60/40 portfolio exposed to broad equity and fixed income indices was projected to return roughly 5.4% on an annualized basis. This assumption fell short of most institutional requirements and forced investors to consider adding riskier or less liquid options to their portfolios. At the end of 2022, the 10-year forward return assumption for the 60/40 portfolio had increased to nearly 6.5%. Interestingly, this increase was entirely driven by the change in the forward assumptions for fixed income returns, which more than doubled. This change indicates that bonds, once a low-volatility diversifier, may contribute significantly more to portfolio returns in the decade to come than years previously. Exhibit 11 highlights these differentials at right.

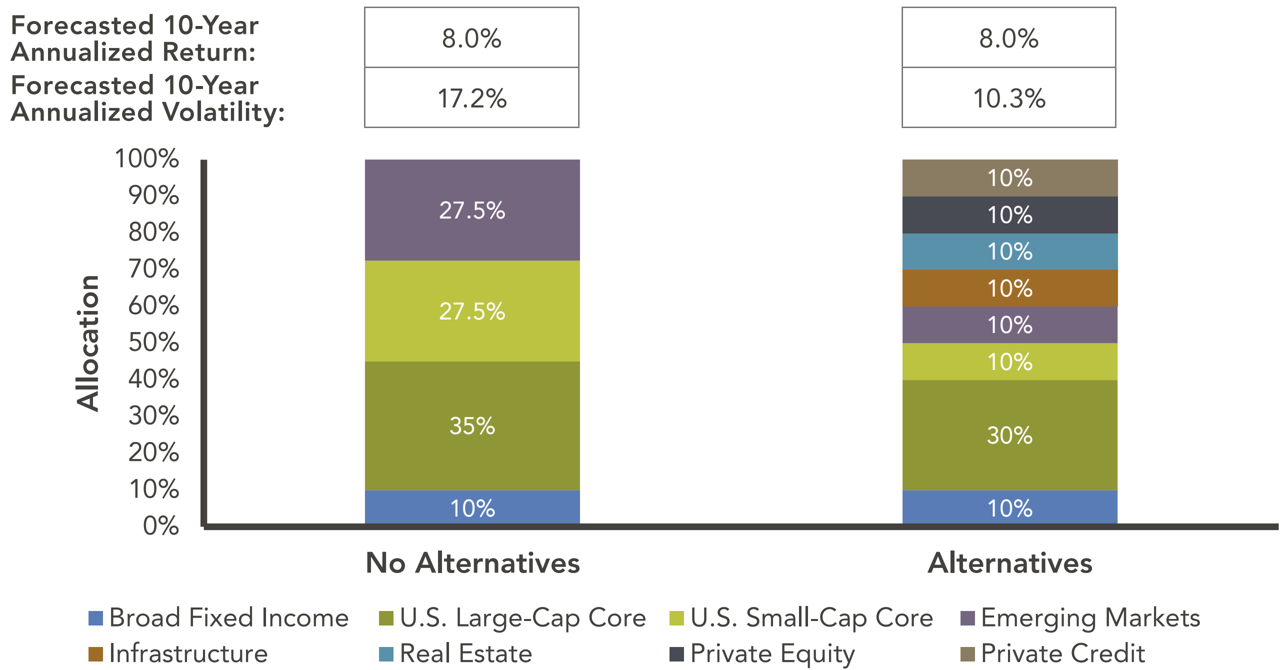
Exhibit 11: Forward return assumptions for the 60/40 model have increased over the last 12 months



Source: Marquette Associates Asset Allocation Software as of December 31, 2022. The 10-year return assumptions are simulated capital market returns. It is important to note that these values are present output from the software simulations and not deterministic views of future capital market performance.

While proponents of the model should be encouraged by these new forecasts, it is clear that riskier or more illiquid asset classes still have a role to play in helping investors achieve desired returns. To that point, portfolios with allocations to alternatives like infrastructure, real estate, private equity, and private credit may allow institutions to reach their return goals while also reducing overall portfolio volatility. Exhibit 12 provides an example of what is required to reach an 8% annualized rate of return over the next decade with and without exposure to private markets.

Exhibit 12: Alternative asset classes can help investors achieve 8% annualized returns with lower forecasted volatility



Source: Marquette Associates Asset Allocation Software as of December 31, 2022. The 10-year return assumptions are simulated capital market returns. It is important to note that these values are present output from the software simulations and not deterministic views of future capital market performance.

CONCLUSION

While negative market sentiment and elevated correlations hampered the performance of the 60/40 portfolio last year, there is renewed optimism for the model going forward. First, fixed income securities finally offer attractive yields after the end of the long-running "TINA" era (There Is No Alternative to equities due to low interest rates). This means that, barring significant rate increases from here, bond indices are likely to exhibit stronger performance going forward, which would serve as a boon to the 60/40 model. While the near-term outlook for equity market performance is somewhat less clear, a reversion to the mean in correlations between equities and bonds would at a minimum improve the diversification benefits of the traditional model. Should headwinds come to pass, it may be said that reports of the death of the 60/40 portfolio were greatly exaggerated.

PREPARED BY MARQUETTE ASSOCIATES

180 North LaSalle St, Ste 3500, Chicago, Illinois 60601 PHONE 312-527-5500
CHICAGO BALTIMORE MILWAUKEE PHILADELPHIA ST. LOUIS WEB marquetteassociates.com

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