Model portfolios – Why 60/40 doesn't work!

Reading the latest investment surveys from the largest fund managers in the world, there remains an air of uncertainty in the top echelon of decision makers - a perception that we are marching towards a more challenging investment landscape than the last decade. Its effects on a bastion of wealth management, the 60/40 model portfolio, will likely lead to a revamp of the theory underpinning this behemoth style of investing.

For now, the mood music in stock markets is turning increasingly pejorative when it comes to the prospect of economic growth in the next 12 months. This is framed against a cost of living crisis and the central banks becoming more aggressive in their desire to control the inflation narrative which continues to be buffeted higher and higher from geopolitical black swan events.

More recently, this negativity has crystalised with the inversion of the yield curve. Whilst I don't want to inflict yield curve theory on readers, the abridged description of an inverted yield curve is that it indicates investors are predicting that interest rates are going up in the short-term but then sharply back down again (because we hit a recession). One other actor in this grim recessionary forecast is oil, now trading over $100 per barrel. Why is this relevant? Well, not every recession has started with oil rising 50%, but every 50% rise in oil has led to a recession. Enough said.

When it comes to the 60/40 debate, this collection of recession indicators would have fund managers slashing exposure to equities and flocking to fixed income strategies to protect client returns. Not this time. Fixed income had its worst March since 2019 and its worst Q1 going back to the 70's. January for the S&P500 was its worst in history and the NASDAQ briefly touched a bear market. In short, equities and fixed income have been uncomfortably correlated which is the very antithesis of 60/40 investment architecture. However, given the anaemic returns on bonds and the obvious risks in owning fixed income in a rising rate environment, investors have no choice but to keep equity allocations at max power - which poses an entirely different set of challenges that I won't go into today.

Necessity, as the saying goes, is the mother of invention and there remain good alternatives on offer for model portfolios to regain some critical control over the diversification measures within their portfolios and, coincidentally, where TAM think the survival of the 60/40 model resides and true to form, this is exactly where TAM has been dedicating a lot of its exploratory research.

Commodities have been negatively correlated to both equities and fixed income in this market and have proven a great alternative in portfolios to offset some of the recessionary fears gripping the market. TAM has owned the Goldman Sachs commodity fund as well as the Blackrock natural resources funds which have both been essential hedges to the volatility in 2022's market.

When it comes to volatility, if you can't beat 'em join 'em. TAM has been an investor into funds focusing on benefiting from increases in volatility. Of late, equities and fixed income both tend to sell off when volatility spikes so owning a fund benefiting from rising volatility has been a tidy hedge to this weakness and one certainly not on many investors' radars as a replacement for fixed income.

Precious metals were in the doldrums during 2021 but have managed to sustain a rally back into vogue on fears around geopolitics and stagflation. Silver remains an interesting play on gold as its acceleration in the wake of gold strength can often be much more pronounced. Of course, this works both ways but given the trajectory of geopolitics and global growth indicators there remains a strong argument for precious metals as a hedge to runaway inflation.

Like it or not, the disruptive innovation found in digital currency and related infrastructure like blockchain has proven a surprising safe haven for those fleeing the equity market. Of course, the industry is in its infancy and much more sophisticated investment vehicles are needed, but the core observation is that it's been making promising signals as a diversifier. It could be worth mentioning that we (Eric) met with a crypto house to keep up with the trend recently.

Finally, thematic, ESG and smart beta ETFs can offer investors much more optionality to isolate elements of the equity market that still offer big value and it makes sense to tilt portfolios towards these rather than owning more generic index ETFs. This approach, for the confident manager, can deliver handsome levels of alpha at a time when markets seem to be unable to catch a break.

Yes, the naysayers will comment, these diversifiers have done well now but will likely revert back to insignificance - but we don't buy that. Watching all the paradigm shifts in this world, TAM maintain that tomorrow's market should pose radically different challenges to investing client assets. Not to mention that tomorrow's clients will likely adopt radically different ideals and goals when it comes to investing which will no doubt necessitate an investment tool box much wider than simply 60/40 equities and bonds. Perhaps the mainstay of tomorrow's model portfolio will be more akin to a 50/25/25 split.

TAM continues to explore these diverse combinations of asset allocations to try and deliver clients that critical element of alpha and diversification which are the hallmark of a good model portfolio and is arguably more critical now than it has been in a very long time.

If you would like to speak with us about anything in this note, or our discretionary investment management services in general, please get in touch with our UK Business Development Manager today.

If you would like to discuss our portfolios or current positioning further, please do not hesitate to contact me.

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