SUMMERWOOD

New thinking for alternative investments

Investing Through Inflation

The 60/40 Model – What Could Go Wrong?

April 2022

Investing Through Inflation

A Series of Papers - Index

Overview

1. Investing Through Inflation – Introduction to A Series of Papers
2. Meet the Writer - Biography
3. There's More Than One Type of Inflation – Broadening the Discussion
4. Why Inflation ~~Is~~ Was Inevitable

Asset Building Blocks

5. Why Isn't Gold an Inflation Hedge?
6. Why Isn't Gold a Currency?
7. Why Gold Was the Bitcoin of the 1970's
8. What is Bitcoin? a) Digital Gold, b) Store of Value, c) Currency or d) All or None of the Above
9. What is an Intangible Intangible Asset?

Inflation Protected Portfolio Management

10. How the Fed Forced Investors to Take More Risk
11. The Models Aren't Wrong - They're Just Not Always Valid
12. The 60/40 Model – What Could Go Wrong?
13. The 60/40 Portfolio – Elegant but Potentially Fatal?
14. What's an Inflation Protected Portfolio?
15. Why a New Investment Management Firm is Needed for Inflation

Conclusion

16. A Series of Paper to Inform Investors the Program is Changing

The 60/40 Model – What Could Go Wrong

Summary: *The 60% equity / 40% bond model portfolio has become the backbone of portfolio management. Its apparent success cannot be taken for granted going forward. Since its mass adoption the primary driver of its success has been the lowering of interest rates. Can that be assumed to continue?*

As a friend, what's your obligation if someone you care about is walking towards what appears to be a cliff? It might only be an indention or could be nothing? For further context your friend has been having a beautiful, enjoyable 40-year walk. There's been some rough terrain but well enough handled that it hasn't ruined the outing. Oh, and you might have yelled WATCH OUT a couple of times already.

The 60/40 portfolio is the metaphorical cliff. I work in an industry that is dependent on models and dependent on those models working. It's not that I see danger everywhere. But I've made my living understanding when the models are not going to work and why.

The 60% equities / 40% bond model portfolio is constructed to deliver consistent, moderate growth. The 60% weight in equities is the growth component. The 40% weight in bonds is the anchor. There's an expected interplay between these two assets. Difficult times in the equity markets are offset by stronger returns in the bond portfolio and vice versa. In technical terms the two assets are considered to be negatively correlated which creates the consistent, moderate growth.

In a separate paper I've described the 60/40 model portfolio as 'elegant'. Its elegance lies in its simplicity while still allowing flairs of creativity. The investment industry controls the inputs into the model in terms of products and services and the markets determine the output in terms of returns. To understand the model's weaknesses, you have to understand both the industry and the drivers of the market returns. Only then can you determine What Could Go Wrong and why.

It's logical to start with the market drivers. CNBC, BNN, WSJ, FT, the alphabet of overbearing, earnest coverage of all market issues wants you to know what they know is important. I'm going to be blunt and skip the usual supportive rhetoric. Bullishness sells. These are for-profit organizations and ad revenue is dependent on viewership/readership and that's dependent on wanting to be engaged. There's no malicious intent as it's been a justifiable stance. Since 1982 large cap US stocks have returned 10,427%. That's not a typo. Bonds? US 20 year government bond total return, 3,328%! I kid you not. It's not only been easy to be bullish, it's been right.

The underlying assumption of the 60% weight in equities is dependent on the upward sloping line of equity market returns. That's dependent on an upward sloping line of annual increases in gross domestic product (GDP). GDP measures the growth in the economy and over the period the 60/40 model has been utilized it's been a positive growth environment. The 60% equity weight is dependent on it and has gotten it.

The 40% bond weight has more than held up its end of the bargain. You wanted an anchor? Bonds have been your friend. But wait. Doesn't 3,328% over 40 years equal 9.2% per year compounded? How have bonds done that? In 1982 a bond investor earned 13% in interest from a 20-year US government bond. Last year, 2021, she/he earned only 1.7% in income. In between those two periods it was the price appreciation of the bonds that created the majority of the returns, not interest earned. Of the 3,328%, 75% of that return is from bond price increases as interest rates dropped from 13% to 1.7%.

The investment industry also plays a role in the success of the 60/40 portfolio. It pains me but it's necessary to quote Warren Buffet's partner Charlie Munger; "Show me the incentive and I'll show you the outcome". The investment advisory industry is a fee driven industry. Fees are earned by advising assets and selling products. I mentioned earlier that the 60/40 portfolio's elegance provides for flairs of creativity. That was code. What it provides is the opportunity for an investment advisor to add their own spice to the broth. Products are specially created to add the flair. The 60/40 portfolio provides a steady and steadily increasing asset base for fee revenue plus a steady stream of products to feed into the model each with the opportunity to earn more fees. It's not duplicitous. It's the way the world works.

No doubt about it the portfolio allocation of 60% equities and 40% bonds has been working. So why am I howling at the moon? If my specialty is knowing the why's and when's then why and when will it not work?

First, the non-correlation between stocks and bonds can't be assumed to continue. The performance of the equity market has been driven by the lowering of the risk free rate of return to almost zero. The performance of the bond market has been driven by interest rates being lowered to almost zero. I don't need to model it out for you, if interest rates can't go lower than zero (not necessarily a safe assumption) then these two assets can no longer act independently and non-correlation cannot be assumed. If interest rates increase the performance of the bond portfolio will be negative. The anchor will have detached. If a primary driver of equity performance has been lower interest rates and interest rates don't go lower, the primary driver of equity returns will stall.

The Why? is because the assumptions underlying 60/40 model break in a rising rate environment. When? Rates rise in an inflationary environment as central bankers raise rates to stem further inflation. The 60/40 portfolio has been a stalwart. It is not designed for a rising rate environment. There hasn't been a rising rate environment since the model took root in investment portfolios. A new portfolio model is required but the investment industry is not prepared with the services and products to support a new model. Please, my friends, watch out for the cliff.

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