

Investing Through Inflation

The 60/40 Portfolio – Elegant
but Potentially Fatal?

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 Portfolio – Elegant but Potentially Fatal?

Summary: The 60% equity / 40% bond model portfolio has become widely accepted. It appears to be an elegant model because it makes the complex task of portfolio management look easy. This paper discusses the foibles of this elegant model.

Elegance – often sought, rarely achieved. To praise a mathematician’s solution as ‘elegant’ is the highest praise. Elegance achieved is surprisingly simple and insightful yet effective and constructive. Throughout my career the investment industry has settled on a portfolio construct that rises to the definition of elegance. That which has become known as the 60/40 portfolio. Yet I write this article to bring to your attention that this elegant solution may be the equivalent of the equally beautiful and elegant Venus Fly Trap. Metaphorically the Venus Fly Trap is the 60/40 model and the unsuspecting investor is the soon to be terminal insect.

It's important to realize that the 60/40 portfolio (soon to be described fully) was not created to meet a specific need. It evolved as the industry and markets evolved and through the equivalency of natural selection the 60/40 model was derived. Remember though that natural selection created the lobster. Don't get me wrong, I love lobster. But seriously, what a freaky arthropod. Can anybody intuitively figure out how that evolved?

To understand how we got to this 60/40 elegant construct we have to follow three paths separately to where they converged.

- The first path is to follow how investors have interacted with the stock and bond markets over time.
- The second path is to follow how the investment advisory industry morphed.
- The third path is to follow how we individually became responsible for our financial freedom.

First Path: My career started in 1980 when I joined a brokerage firm. Not what we today call an investment dealer. I started at a broker. There was a retail division and an institutional division. The retail group serviced a few ‘wealthies’ but mostly it was speculative trading. Incited by commissions it was a churn and burn game. The institutional group, split between stocks and bonds, handled the trust accounts, pension plans, mutual funds and a few boutiques that were starting to sprout. The bond guys were king because bonds used to be the majority of a portfolio. The balance between the bond groups and

equity groups started to equalize shortly after the 1982 recession and the ensuing equity market recovery. Equities now play a larger role in a typical portfolio.

Second Path: The investment industry we know today has investment advisors and financial planners. The investment industry I started in had Wolf of Wall Street, Boiler Room brokers. In the early to mid-90's overseers and regulators came to grips and dealt with the inherent conflict of interest that arises from compensation tied to commissions. And so began the shift towards charging a flat management fee for services. Coincident with this development financial service companies (otherwise known as banks) began to diversify beyond deposit taking to offer the full suite of banking, insurance and investing. The banks bought the brokers. Sharks eating the chum. The banks had different objectives than the brokers they'd bought. If the old revenue model had been commissions that meant activity. If the new model was a flat fee that meant get big. Getting big meant getting conservative. Getting conservative meant a model that produced consistent returns with moderate volatility.

Third Path: My parents cautioned me early in my career not to jump around too much otherwise I'd never have a pension. They and their forebears relied on corporate pensions for their post working days. Come the 1980's corporations came to realize the burden of funding defined pension plans and began the shift of the responsibility onto the pensioners themselves. Governments aided with the introduction of tax incentives to encourage personal retirement savings. In Canada the Registered Retirement Savings Plan (401 k for Americans) was introduced in 1957 but had only \$10 billion on deposit by 1991. It's eventual acceptance and uptake was coincident with banks entering the financial services game and selling investment advice and services to clients taking responsibility for their retirement savings.

Three Paths Converged: Three paths, albeit not entirely independent paths, converged to the superhighway of financial planning, servicing and the associated products that we know today. The overarching objective is to assist investors on their path to financial independence in their retirement years. Prudence and conservatism are the guiding principles. The basic building blocks of prudence are cash, bonds and stocks. The witches brew of ultimate conservatism has become the 60/40 portfolio; 60% equities and 40% bonds. Bonds for income and certainty of principal repayment, otherwise known as safety. Stocks for the sizzle, the growth the wealth creation.

Elegance can make something complex look surprisingly simple. Where does my cautionary Venus Fly Trap warning come in? The elegance of

the 60/40 model results from its appearance of effectiveness. That's cryptic – let me explain. It's easy to confuse something as effective because it has been working. We don't lift the hood of our cars until an engine warning light comes on. And even then, we peer inside with no knowledge of what to do.

Since the emergence of the 60/40 model the 40% allocation to bonds has benefited from an uninterrupted decline in interest rates – good for bonds. Simultaneously, the 60% allocation to equities has benefited from a lovely sloping upward trendline. Admittedly not always a smooth ride but with an accommodating central bank in times of crisis it's a trend we've come to rely on. When the bonds or the equities have sputtered the other piece of the portfolio covered the slack. A concept known as offsetting correlations. The stocks telling the bonds "I've got your back" and vice versa.

The stellar track record of 60/40 and unquestioned perceptions as to how and why it works changes in an inflationary environment. Ladies and gentlemen, the engine light is flashing.

Phil Schmitt
President & CEO
Summerwood Capital Corp.

Contact me at;
info@summerwoodgroup.com
[LinkedIn](#)

