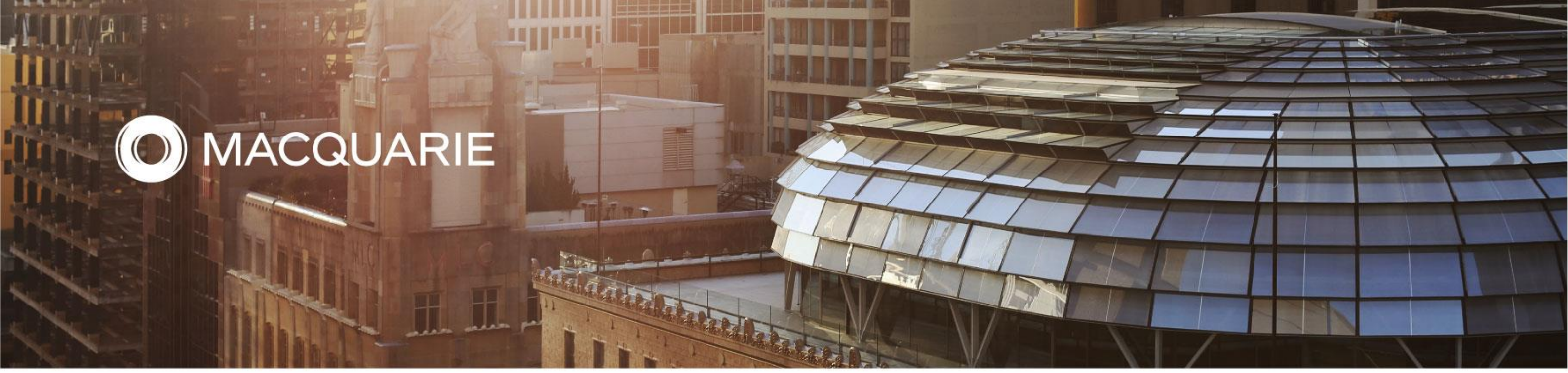


Investment Strategy Update #105

Why we still like a 60:40 portfolio

- The 60:40 portfolio has a long history of achieving its objectives of providing a reasonable *"through the cycle"* risk-adjusted return versus an *"equity only"* return. As bond yields have converged towards zero, criticism against the 60:40 portfolio mix has risen given concerns that it could no longer provide the necessary yield and/or diversification benefits for which it was set up to do.

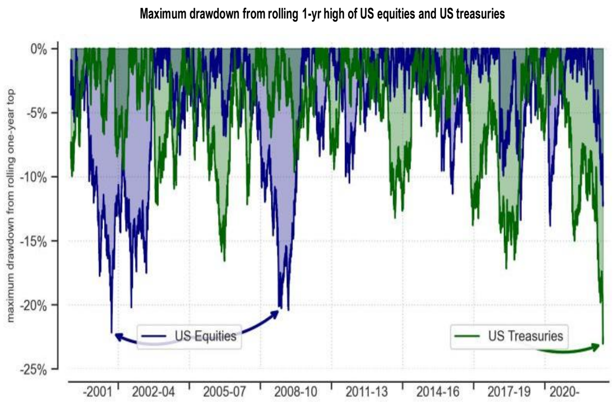
- We have long argued that the 60:40 portfolio mix is not dead. But that the risk-reward characteristics of portfolios have changed and depending on an investor's objectives, this might also require a different asset allocation mix (i.e., more growth assets to achieve a higher return or more defensive assets to provide greater downside protection).

- 1H22 has once again put the 60:40 portfolio mix in the spotlight. This time because both bonds and equities have been falling (at the same time) and hence the diversifying benefits of fixed income have not been available when they have been needed the most.

- Investors should not abandon the traditional portfolio mix just because there are times when it might not behave as expected. Over the short term, there will always be periods when financial markets do not conform to norms, but over the medium to longer term, we are confident that both bonds and equities will serve their traditional purposes. For equities this is to provide a major source of portfolio growth, and for bonds this is to provide both yield and downside protection.

- Every correction period has its unique characteristics. Over 1H22 this was the rapid (and largely unexpected) reset higher in bond yields. But this reset means bonds now provide both an attractive yield as well as yields being high enough to provide downside protection against rising recession risks. We do not advocate abandoning bonds or the 60:40 portfolio mix because of short term performance fluctuations. We think the longer-term attributes of a 60:40 portfolio remains firmly intact.

Recent bond drawdown comparable to equities during previous crises

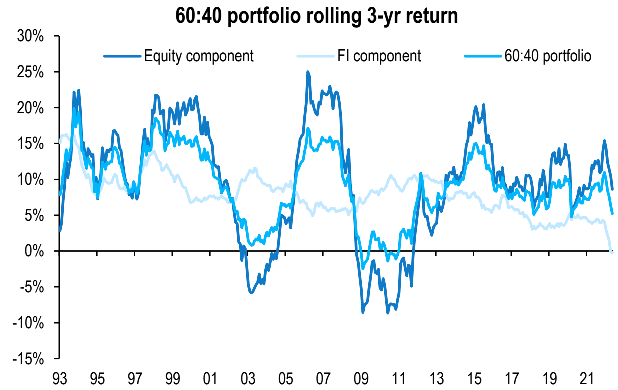


Source: Oxford Economics, June 2022

A recap - why a 60:40 portfolio mix?

The 60:40 (growth / defensive) asset allocation mix originated in the 1950s and was popularised in the 1970s with several key goals in mind - the potential to generate consistent returns over time while reducing the risk and volatility of an equity-only portfolio through the inclusion of lower-volatility defensive assets.

A 60:40 allocation helps smooth out returns and volatility



Source: Morningstar, MWM Research, June 2022

Through time, a 60:40 asset allocation mix has successfully provided investors with a reasonable risk-adjusted return versus equity market return, during both periods of relatively lower volatility and periods of normalisation (higher volatility).

60:40 returns have outperformed on a risk-adjusted basis

	Equity return	Sharpe ratio	60:40 return (%)	Sharpe ratio
1990 - 1999	13.3	0.5	12.4	0.7
2000 - 2009	4.8	-0.1	6.3	0.0
2011 - 2019	9.5	0.8	8.3	1.1

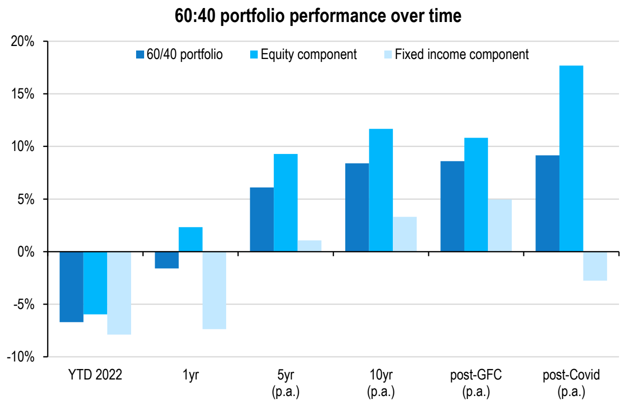
Source: Factset, MWM Research, June 2022

Importantly, it has allowed investors to avoid the full drawdown impacts of numerous bear markets in risk assets, such as the tech collapse in 2000 and the global financial crisis in 2008, due to an allocation in bonds, while providing exposure to upside during less volatile times. ***In other words, the 60:40 portfolio has stood the test of time.***

Why is the 60:40 portfolio performing so poorly?

The validity of the 60:40 portfolio has faced a significant test in 2022 as both equity and bond markets suffered simultaneous and severe drawdowns, overturning fixed income's historical role as a portfolio ballast during equity market falls.

Both bonds and equities have suffered declines in 1H22



Source: Factset, MWM Research, June 2022

Equity market (and other risk assets) returns are undergoing a significant valuation contraction after years of near zero rates having pushed valuations well above historical norms and driven above average returns. At the same time, bond yields have reset higher in a once in a multi-decade sell-off as central banks hasten to get in front of the inflation fight. As a result, returns to a 60:40 portfolio have deteriorated significantly, falling -6.7% year to date alone. This is already near on par with other historic crisis periods such as the GFC which saw a balanced portfolio fall ~9% (annualised).

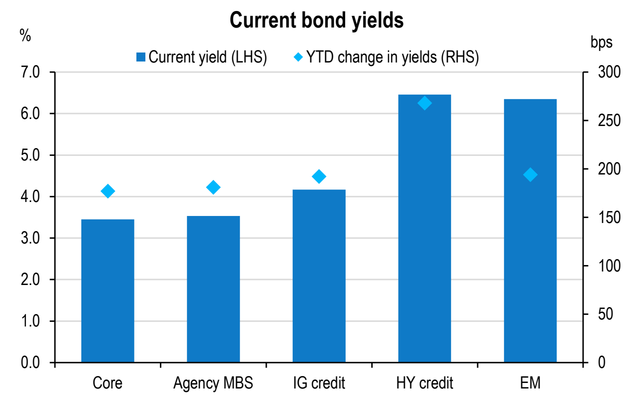
For investors, this is not normal because the economic cycle remains intact. However, to some extent this is a reversal of unsustainable returns that have been generated through the low/zero interest rate environment that has prevailed over the past decade and more.

Why are we still comfortable with a 60:40 portfolio mix?

The recent rise in equity/bond correlations and subsequent decline in both asset classes returns has led many to pronounce the death of the 60/40 portfolio. However, we still see a place for it in investor portfolios for a number of reasons:

- **Its role of risk reduction remains intact:** As long as bonds remain less volatile than equities, a 60:40 can still play a crucial role in risk reduction and diversification within portfolios. Correlations and/or volatility would need to rise materially in order to erode the risk-reward ratio of the 60:40 portfolio compared to an equities-only allocation.

Bond yields are now more appealing versus dividend yields



Source: PIMCO, Bloomberg, MWM Research, May 2022

- **Bonds prices are now at a much stronger starting point:** Although bonds have been vulnerable recently given the extraordinary rise in yields, we believe the reset higher in bond yields is mostly complete (although it will depend on where inflation goes from here). We think bond yields are close to a peak and two-way volatility will result as they range trade. At some point, aggressive monetary policy tightening will force markets to rebalance their fears away from high inflation and towards weaker economic growth, which should further support bond prices.

- **Bonds are an important downside hedge:** With bonds now providing an attractive yield, there is less support for the TINA trade. We think bond yields are at a level that now provides substantial downside protection for rising recession risks. Not only can fixed income investors get an attractive yield, but they also stand to gain should growth risks increase and bonds rally (i.e., bonds are now insurance against growth risks).

Bonds have protected against equity losses during past recessions

Recession start	Equity/bond correlation	Equity returns (%)	Bond returns (%)
Dec 1969	0.47	-19.48	5.33
Nov 1973	0.02	-15.19	-3.54
Jan 1980	0.17	-5.56	5.35
Jul 1981	0.41	-11.21	12.93
Jul 1990	0.66	-8.29	3.61
Mar 2001	-0.16	4.81	0.68
Dec 2007	-0.61	-19.29	4.49
Feb 2020	-0.42	-12.35	4.14

Source: PIMCO, Bloomberg, MWM Research, May 2022

Can we strengthen the attributes of a 60:40 portfolio?

Asset allocation provides investment discipline and a degree of psychological comfort against uncertainty. An investor's objectives will determine their portfolio mix and the 60:40 portfolio is ultimately simply a benchmark from which to start this process (in other words this depends on investors objectives but the components of a 60:40 portfolio remain are still doing their role).

The 60:40 asset allocation mix is not dead, but, the risk-reward characteristics of this portfolio can change through time, and as such be tweaked to better fit the current investment backdrop. Against an environment of lower expected returns, elevated volatility and ongoing uncertainty, we believe the diversification and risk mitigation attributes of the 60:40 portfolio can be further strengthened by incorporating any of the following factors:

- **Increasing exposure to alternative assets:** For investors looking to mitigate downside risks, defensive and/or non-traditional assets can offer protection against equity market risk and tail risk. Alternative assets aim to generate risk-adjusted returns through the cycle and have low correlation with other asset classes (equities, fixed income, commodities), providing an opportunity to diversify portfolio returns. We prefer strategies such as long-short equities or multi and macro hedge fund strategies.

- **Increasing exposure to inflation-hedged assets:** In an environment of stickier and elevated inflation, real assets (real estate and infrastructure) can post positive returns when rates are rising given their link to improving economic growth. Inflation generally has a positive impact on real assets due to their ability to pass through inflation costs to customers. Real assets can also improve the risk/return profile of a portfolio given lower volatility of returns and lack of correlation with traditional assets. Within real estate, we prefer industrial and office real estate. Within infrastructure we prefer regulated or patronage assets.

- **Increasing the 'quality' level of assets:** Against a slowing global growth backdrop, strong structural growth over cyclical growth will be an important characteristic. Quality stocks and bonds have characteristics that provide investors greater assurance that dividends and coupons will be paid, regardless of the state of the market or business cycle, with high-quality companies well positioned to pass through costs.

  Investors who have a medium to long term outlook should maintain a bias towards growth at a reasonable price (GARP) strategies with the option of supplementing these with tactical allocations to value strategies, but not the other way around. Likewise, we remain defensive and patient in overall credit risk. While spreads have widened modestly, macro uncertainty and recession risks have also risen more significantly.

Macquarie WM Investment Strategy Team

The report was finalised on 20 June 2022.

Recommendation definitions (Macquarie Australia/New Zealand)
Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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