Is Portfolio Diversification Dead?

A Forward-Looking 60%/40% Portfolio Replacement

Is the traditional 60% equity/40% bond investment portfolio dead? We don't believe so. However, we think this portfolio could be most likely to underperform its long-term average rate of return at least for the next 20 years. For the next several years, we believe that portfolio construction should be built around inflation proofing, shortening duration, diversification, and long-term growth, focusing on innovation.

The backdrop for this thesis is as follows: 1.) current valuations are still rich for both stocks and bonds, 2.) we believe inflation will be more persistent and less transitory, 3.) risks will be higher, and correlations will move higher, 4.) and capital flows will continue to feed longer-term real growth, especially in proprietary new technologies (innovation).

This section will discuss the four pillars of portfolio construction we believe is necessary for any investor to have a well-diversified portfolio over the coming years that can offer better protection from more significant investment drawdowns.

The ***first pillar*** is inflation. Inflation is a measure of how much prices rise over time. Investors should invest in assets with low or negative real interest rates such as Treasury Inflation Protected Securities, to invest in an asset class that will not lose value due to inflation. History has shown that most equity and bond styles do not perform well in a higher inflationary environment. (Refer to Table 1.0)

The ***second pillar*** is short duration. Short duration means investing in assets with low sensitivity to interest rates and volatility, such as cash and government bonds. This type of investment can provide stability during high uncertainty and volatility periods when other asset classes do not perform well.

The ***third pillar*** is diversification which refers to the need for investors to spread their investments across different types of assets where their prices do not move in the same direction (diversification). Diversification means having a variety of investments in various sectors, so when one investment does poorly, it won't affect the other ones.

The ***fourth pillar*** is real long-term growth. Real long-term growth is the long-term driver of real stock return. We believe that opportunity continues to be in companies embracing and investing in innovative disruption for the long term (Refer to Table 1.1).

A practical guide to constructing the "new" 60/40 portfolio is based on the following portfolio construction ideas and asset allocations to balance risk between these four pillars or themes:

1. What assets will provide me some degree of ***inflation protection*** if inflation persists?
2. What assets have ***shorter durations*** and are less exposed to increases in interest rates?
3. If stocks and bonds are less attractive, what types of assets can I include in my portfolio ***(non-correlated)***?
4. As investors, we still want exposure to ***positive long-term real growth***; how do we do that?

The "New" 60%/40% Portfolio

We believe that investors should position most of their portfolios in defensive areas of the stock and bond market. The goal should be to target a level of total market risk (volatility) for a diversified portfolio expected to be much lower than a traditional 60/40 stock/bond portfolio. This portfolio also aims to lower the odds of a significant performance drawdown in the portfolio. (Refer to Table Embracing higher volatility to reach higher returns will only erode the positive impact of compounded returns over time.

Approximate risk exposures to the four pillars of construction (expected impact on risk-adjusted return) should be 40%-45% defensive, 20%-25% inflation-protected, 15%-20% shorter duration, and 15%-20% longer-term real growth. These exposures are derived from building forward risk estimates, return, and correlation (Refer to Table 1.2).

While we do not expect high inflation rates to persist over the long term, we believe they could continue into 2023. The length of this cycle should depend on how fast and how aggressively the Fed moves to raise short-term interest rates to soften demand and how quickly supply shocks revert to normal. We do not believe it is prudent to try and time the market based on our experience of managing money for over 35 years. We think investors should continue to favor equities vs. bonds but have exposure to both.

The difference now is that we believe long-term expected returns will be lower than in the past for stocks and bonds. Therefore, it is prudent to consider more defensive exposures for stocks (high quality; low volatility) and bonds (short duration real returns) over the next 1-3 years to maintain active exposure to those companies primed for superior long-term real growth.

Alternative investments should also be considered in the new 60/40 portfolio where the expected returns are positive, the risks are generally lower, and are less correlated to stocks and bonds. We suggest exposure to diversified commodities, M&A strategies, carbon credit allowances, senior loans, asset back securities, and hedged equity.

Alternatives investment exposure can be allocated between private and liquid investments depending on the investor's liquidity requirements and understanding of the underlying risks.

Appendix

Table 1.0

Summary Performance in US Inflationary Regimes

	Specific Inflation Regimes								Combined Regimes		
	US Enters WW2	End of WW2	Korean War	Ending of Bretton Woods	OPEC Oil Embargo	Iranian Revolution	Reagan's Boom	China Demand Boom	Inflation (19%)	Other (81%)	All (100%)
	Characteristics										
Start Month	April 1941	March 1946	August 1950	February 1966	July 1972	February 1977	February 1987	September 2007			
End Month	May 1942	March 1947	February 1951	January 1970	December 1974	March 1980	November 1990	July 2008			
Length (months)	14	13	7	48	30	38	46	11			
Total Price Level Change	15%	21%	7%	19%	24%	37%	20%	6%			
Strategy	**Real Return (total)**								**Real Return (annualized)**		
(P) Commodities—Energies	*–3%*	*2%*	*–6%*	*–16%*	*264%*	*57%*	*201%*	68%	41%	–1%	3%
(A) Trend—All Assets	20%	23%	19%	135%	196%	100%	65%	17%	25%	15%	16%
(A) Trend—Commodities			1%	54%	173%	33%	132%	25%	20%	8%	10%
(P) Commodities—Industrial				115%	38%	–6%	306%	3%	19%	4%	7%
(A) Trend—Bonds				79%	54%	149%	6%	6%	15%	9%	10%
(P) Commodities—Aggregate		12%	6%	26%	85%	38%	84%	21%	14%	1%	4%
(P) Commodities—Gold					*166%*	154%	–18%	27%	13%	–1%	1%
(P) Commodities—Precious				28%	29%	185%	–27%	33%	11%	–2%	1%
(A) Trend—Equity	20%	23%	24%	77%	23%	–13%	13%	–3%	8%	11%	10%
(P) Commodities—Softs				–41%	243%	15%	11%	15%	8%	–3%	–1%
(A) Equity Factor—C-S Mom.	–15%	–18%	7%	35%	38%	44%	41%	26%	8%	4%	5%
(P) Commodities—Agri		12%	6%	–23%	197%	–21%	6%	33%	7%	–3%	0%
(A) Trend—FX					–14%	16%	42%	6%	4%	4%	4%
(A) Equity Factor—Quality (QMJ)				14%	–1%	–12%	40%	7%	3%	3%	3%
(P) Fixed Income—TIPS				–3%	13%	–2%	11%	6%	2%	3%	3%
(A) Equity Factor—Investment (CMA)				–7%	31%	–9%	24%	–10%	2%	2%	2%
(P) Long Equities—Energy Sector	–14%	–10%	25%	–19%	–19%	31%	31%	2%	1%	8%	6%
(A) Equity Factor—Profitability (RMW)				4%	–24%	–8%	18%	6%	–1%	2%	2%
(A) Equity Factor—Value (HML)	–4%	–17%	3%	–8%	36%	–11%	–3%	–7%	–1%	2%	2%
(P) Real Estate—Residential	–17%	4%	–4%	–2%	–7%	11%	0%	–13%	–2%	2%	1%
(A) Equity Factor—Low Vol (BAB)	–24%	–6%	–3%	28%	–13%	9%	–7%	–22%	–3%	8%	6%
(P) Fixed Income—2-Yr. Treasury	–13%	–17%	–6%	–1%	–7%	–17%	11%	0%	–3%	2%	1%
(A) Equity Factor—Size (SMB)	–11%	–23%	–4%	45%	–43%	32%	–26%	–4%	–4%	1%	0%
(P) Fixed Income—10-Yr. Treasury	–11%	–17%	—6%	–13%	–12%	–31%	8%	5%	–5%	4%	2%
(P) Fixed Income—High Yield	–4%	–11%	0%	–18%	–21%	–38%	–10%	–8%	–7%	6%	4%
(P) Long Equities—Market Composite	–24%	–27%	24%	–7%	–46%	–14%	12%	–17%	–7%	10%	7%
(P) Fixed Income—Investment Grade	–7%	–12%	–3%	–23%	–20%	–43%	–5%	1%	–7%	6%	3%
(P) Fixed Income—30-Yr. Treasury	–17%	–17%	–6%	–20%	–28%	–41%	13%	2%	–8%	5%	3%
(P) Long Equities—Consumer Durables	–16%	–32%	24%	–30%	–62%	–27%	–28%	–36%	–15%	13%	7%

NOTES: The real total returns of assets analyzed in the article, through the eight US inflationary regimes shown in Exhibit 1 as well as the annualized return during inflationary, noninflationary, and all periods. In the first column, the strategy is denoted as active or passive by (A) or (P), respectively; returns for energies and gold in gray italics are spot returns for which we do not have futures data. These are not included in the combined regime calculation. The data vary by start date. Further details are provided in the body of this article and in Appendix A.

Table 1.1 S&P Kensho New Economies Index – Disruptive innovation

FUNDAMENTALS	KNEX	S&P 500
Trailing 12-Month Price to Earnings	17.26	22.09
Forward 12-Month Price to Earnings	17.60	20.14
Price-to-Book Ratio	2.56	4.27
Price / Cash Flow	11.45	15.96
Estimated 3-5 Year Earnings Per Share Growth (%)	15.60	13.92
Historical 3-Year Sales Growth (%)	20.81	20.10

KNEX VS	ACTIVE SHARE (%)
S&P 500	84.67
Russell 2000	88.26
Nasdaq 100	89.52
Morningstar Exp. Tech.	85.32
S&P 1500	84.31
S&P 500 Growth	89.35

Source: S&P Dow Jones Indices LLC. Data as of March 31, 2022. Charts and tables are provided for illustrative purposes.

Table 1.2 Lower Returns and Higher Risk Ahead

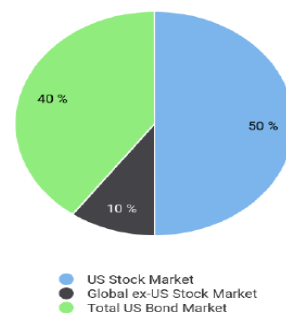
	Defensive Balanced	Balanced	Growth	Opportunistic	Focused
Long Term Equity Allocation	30.00%	40.00%	60.00%	80.00%	100.00%
Long Term Fixed Allocation	70.00%	60.00%	40.00%	20.00%	0.00%
LT Expected Return	*3.00%*	*4.00%*	*5.00%*	*6.00%*	*6.50%*
Realized Return (20 yrs)	5.30%	5.50%	6.50%	7.50%	8.38%
LT Expected Risk	*8.00%*	*13.00%*	*16.50%*	*18.00%*	*20.00%*
Realized Risk (20 yrs)	4.50%	6.80%	9.80%	13.90%	17.00%

Source: Palladiem, LLC, Portfolio Visualizer. Expected risk and return derived from Palladiem's proprietary risk factor model. Real risk and return derived by a weighted total index return of combinations of the S&P 500 and the Bloomberg Barclays Capital US Aggregate Bond Index.

Table 1.3 The Old 60/40 vs. The New 60/40 Portfolio

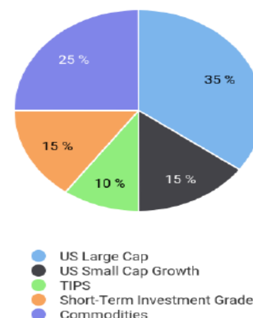
The Old 60/40 Portfolio

Asset Class	Allocation
US Stock Market	50.00%
Global ex-US Stock Market	10.00%
Total US Bond Market	40.00%



The New 60/40 Portfolio

Asset Class	Allocation
US Large Cap	35.00%
US Small Cap Growth	15.00%
TIPS	10.00%
Short-Term Investment Grade	15.00%
Commodities	25.00%



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Index definitions:

"U.S. Large Cap" represented by the S&P 500 Index.
"U.S. Small Cap" represented by the Russell 2000 Index.
"International" represented by the MSCI Europe, Australasia, Far East (EAFE) Net Return Index.
"Emerging" represented by the MSCI Emerging Markets Net Return Index.
"U.S. Aggregate" represented by the Bloomberg Barclays U.S. Aggregate Bond Index.
"U.S. Government" represented by the Bloomberg Barclays U.S. Government Bond Index.
"U.S. Corporate" represented by the Bloomberg Barclays U.S. Credit Bond Index.
"U.S. High Yield" represented by the Bloomberg Barclays U.S. Corporate High Yield Index.
"Non-U.S. Developed" represented by the S&P International Treasury ex U.S. Index.
"Emerging Market Debt" represented by the JP Morgan GBI-EM Global Core Index
"REITs" represented by the FTSE North American Real Estate Investment Trust (REIT) Equity REITs Index.
"Commodities" represented by the Dow Jones Commodity Index .
"Managed Futures" represented by the Credit Suisse Managed Futures Index.
"Global Macro" represented by the Credit Suisse Global Macro Index

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