Is Portfolio Diversification Dead? An Update

A Forward-Looking 60%/40% Portfolio Replacement – Part II

In October 2022, we published "Is Portfolio Diversification Dead?" ***Our view is that diversification is not dead, and it remains the key to achieving long-term financial goals.*** The underlying risk exposures of the new 60/40 portfolio should be positioned in a way that a transition from the traditional 60% equity/40% bond investment portfolio to a portfolio of diversified factors better defining the types of equity, fixed and non-correlated portfolio exposures an investor should move toward. In this update we focus on the near-term market and economic and market challenges in this new environment of the long-term challenge of lower returns and higher volatility over the next 10+ years (Table 1.0).

Our original thesis still holds:

- ***Current valuations are still rich for stocks and less so for bonds***
- ***We believe inflation will be more persistent and that the Federal Reserve will need to establish 4% as the new rate of inflation target***
- ***Risks will be higher, and correlations will continue to move higher near-term***
- ***Capital flows will continue to feed longer-term real growth, especially in proprietary new technologies (innovation) that involves infrastructure capital investment.***

We mentioned in the earlier paper, that there are four pillars as the foundation of building a solid and diversified investment portfolio.

- ***Inflation proof***
- ***Short duration***
- ***Smart diversification***
- ***Long-term real growth prospects***

The Building Blocks of the New 60%/40% Portfolio

A Forward-Looking 60%/40% Portfolio - Update

We continue to 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% stock/40% bond portfolio. This portfolio aims to lower the probability of a significant performance drawdown and generate a positive Sharpe ratio to help achieve long-term compounded wealth.

Most asset classes have generated negative year to date returns, with bonds posting some of their worst losses in 40 years. Investors are anxious and concerned about the heightened level of global uncertainty. With this backdrop, investors should review and understand their risk exposures in their portfolios. Long-term investors that do not need to short-term access their investments should remain invested according to their long-term plan. Long-term plans were built with a guide to navigating short-term market fluctuations.

We believe better than average risk-adjusted returns are the best path to a successful long-term financial outcome. These results are built through strong risk management, including a basket of diversified investments, and the patience to sit through the daily fluctuations of the markets. History has not been kind to investors who deviate from their portfolio roadmap, and not had the patience to remain focused on the long-term financial plan. Most do not realize that the results of successful funds or portfolios has not been the typical experience of the average investor. This is due investor's short holding period and practice of getting into and out of the markets at the wrong time based on emotions. Jumping off the long-term financial roadmap often seems the easiest decision of investors in bear markets. Not knowing how and when to get back on the plan is the major reason investors actual return fall below their targeted return.

Historical bear market data reveals the median peak to bottom decline in stocks is -33%. The current bear market equity decline is approximately stocks -28%. This could suggest that there is room for additional declines in stocks (Table 1.1). Protecting wealth in these turbulent markets will require a focus on properly managing drawdown risk in efforts to minimize the effect on long term compounded wealth. Carefully constructing portfolios to balance several risks in addition to equity and fixed income risk will require a deeper dive into to the factors that are more likely to drive investment returns over this period of uncertainty. Some of these factors for stocks include high quality & low volatility and other underlying risk factor exposures such as credit, duration, inflation, valuation and earnings growth (Table 1.2).

The difference now is that we believe long-term expected returns on financial assets will be lower than in the past for stocks and bonds. Therefore, it is prudent to consider more defensive exposures for stocks and bonds (short duration real returns) over the next 1-3 years, maintain active exposure to those companies primed for superior long-term real growth (innovation and subsidized infrastructure re-build) and seek investments in transparent, lower cost alternative investments. With lower expected returns and higher volatility ahead, investors should also focus on costs, tax management, liquidity and transparency.

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

A Forward-Looking 60%/40% Portfolio Replacement – Part II

This approach remains in place with markets discounting a good deal of this outcome. We do believe there are a few tweaks necessary to the first approach to building this portfolio. Below we will discuss the current view on the four pillars as well as other forces we think will shape intermediate to longer term portfolio outcomes.

The ***first pillar*** is inflation (Table 1.3). Since our first paper most inflation reports have surprised on the upside suggesting that current levels of inflation October be here to stay for awhile. Fed funds rates are currently targeted at 3.25% and the market has mostly discounted two more hikes at 0.75% this year, take fed funds rates to 4.75% by year-end. The concern is that with the rate of inflation running around 8% per year, real fed fund rates are still negative. The Fed is behind the curve on this and there might not be much that they can do. The government has already provided massive subsidies to boost growth and global competitiveness, at a time when debt to GDP ratios are well over 100%.

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. With the recent rise in rates, bonds certainly look cheap, but the problem is that yields are more apt to rise to the upside.

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. In times of market stress, security prices for several assets all tend to move in the same direction, creating a concentrated risk portfolio. By understanding the long-term drivers of risk and return for equities, bonds and alternative assets, we can better construct a portfolio with factor exposures that have demonstrated independent positive outcomes away from the broad equity and bond markets.

The ***fourth pillar*** is real long-term growth. Real long-term growth is the long-term driver of real stock returns. We believe that opportunity continues to be in companies embracing and investing in innovative disruption for the long term, as well as those companies that are the beneficiaries of government subsidies incented and able to invest in infrastructure and alternate sources of energy and technologies.

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***?
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?
5. What ***other factors*** should be considered?

Appendix

Table 1.0 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 1.1 Bear Markets

Bear Markets (& Serious Corrections)

top	botom	#mo	Δ nom SPX	Δ real SPX	P/E high	P/E low	Δ P/E	Δ CPI (ann)	Δ Fed	Δ nom EPS	Δ real EPS	next peak	#mo	nom %chg	prev high	#mo	NBER
Jun-1872	Jun-1877	61	-47%	-31%	12.4	9.4	-24%	-5%	-190	-30%	-13%	Jun-1881	49	+140%	Mar-1980	95	recession
Jun-1881	Jan-1885	44	-36%	-26%	14.1	13.8	-2%	-4%	+120	-37%	-26%	May-1887	28	+39%	Jan-1999	215	recession
May-1887	Aug-1896	113	-35%	-17%	17.2	17.1	-1%	-3%	+260	-39%	-25%	Jun-1901	75	+123%	Jan-1999	143	recession
Jun-1901	Nov-1903	29	-26%	-31%	17.3	11.7	-33%	+3%	+210	+7%	-5%	Jan-1906	27	+57%	May-1905	48	recession
Jan-1906	Nov-1907	22	-37%	-40%	14.6	9.4	-36%	+3%	+220	-8%	-9%	Nov-1909	24	+63%	Nov-1909	46	recession
Nov-1909	Dec-1914	62	-28%	-29%	13.7	14.1	+3%	+0%	-70	-24%	-29%	Nov-1919	60	+31%	Oct-1916	84	recession
Nov-1919	Aug-1921	22	-35%	-36%	10.1	13.6	+35%	+1%	+60	-52%	-87%	Sep-1929	98	+410%	Feb-1925	65	recession
Sep-1929	Jun-1932	33	-87%	-82%	20.5	8.6	-58%	-8%	-330	-73%	-64%	Mar-1937	58	+348%	Dec-1954	308	recession
Mar-1937	Apr-1942	63	-60%	-65%	16.8	7.3	-56%	+2%	-10	-20%	-30%	May-1946	50	+158%	Feb-1946	109	recession
May-1946	Jun-1949	37	-30%	-46%	22.4	5.6	-75%	+9%	+79	+172%	+110%	Aug-1956	87	+271%	May-1950	48	recession
Aug-1956	Oct-1957	15	-23%	-24%	14.3	11.8	-18%	+3%	+98	-8%	-12%	Dec-1961	50	+90%	Sep-1958	26	recession
Dec-1961	Jun-1962	7	-30%	-28%	21.6	14.0	-35%	+1%	+13	+10%	+9%	Feb-1966	44	+84%	Oct-1963	22	recession
Feb-1966	Oct-1966	8	-24%	-24%	18.2	12.3	-33%	+4%	+70	+2%	+0%	Nov-1968	26	+51%	Nov-1968	34	
Nov-1968	May-1970	18	-37%	-41%	18.0	12.3	-32%	+6%	+139	-7%	-12%	Jan-1973	32	+77%	Nov-1972	48	recession
Jan-1973	Oct-1974	21	-50%	-57%	19.9	6.7	-66%	+11%	+205	+27%	+2%	Sep-1976	24	+78%	Dec-1982	121	recession
Sep-1976	Mar-1978	18	-20%	-27%	11.8	8.0	-32%	+7%	+121	+2%	+5%	Nov-1980	33	+64%	Apr-1981	55	recession
Nov-1980	Aug-1982	21	-29%	-36%	9.1	6.3	-31%	+8%	-473	-8%	-20%	Aug-1987	61	+233%	Oct-1982	23	recession
Aug-1987	Oct-1987	2	-36%	-36%	24.0	14.3	-40%	+5%	+12	+11%	+10%	Jul-1990	33	+71%	Jul-1989	23	
Jul-1990	Oct-1990	3	-20%	-22%	16.0	13.4	-16%	+10%	-47	-32%	-35%	Jan-1994	40	+64%	Feb-1991	7	recession
Jan-1994	Nov-1994	9	-8%	-10%	22.8	14.8	-35%	+3%	+272	+41%	+38%	Jul-1998	45	+169%	Feb-1995	13	
Jul-1998	Oct-1998	3	-22%	-23%	27.1	21.1	-22%	+2%	-102	-0%	-1%	Mar-2000	17	+68%	Dec-1998	5	
Mar-2000	Oct-2002	31	-51%	-53%	30.0	16.8	-44%	+2%	-425	-24%	-26%	Oct-2007	61	+105%	Jul-2007	89	recession
Oct-2007	Mar-2009	17	-58%	-58%	17.6	12.0	-32%	+1%	-378	-50%	-51%	May-2011	26	+105%	Apr-2013	67	recession
May-2011	Oct-2011	5	-21%	-22%	16.0	12.2	-24%	+3%	-4	+6%	+6%	Sep-2018	85	+174%	Feb-2012	10	
Sep-2018	Dec-2018	3	-20%	-20%	20.1	15.6	-22%	+0%	+24	+8%	+8%	Feb-2020	14	+45%	Apr-2019	7	
Feb-2020	Mar-2020	1	-35%	-35%	21.9	14.9	-32%	-3%	-124	-17%	-17%	Jan-2022	22	+120%	Aug-2020	6	recession
Jan-2022	?	10	-28%	-31%	24.9	17.1	-31%	+6%	+307	+6%	+1%				Sep-2022		
median - all cycles		19	-33%	-31%	17.5	12.3	-32%	+3%	+19	-8%	-12%		42	+87%		48	
median - recession		22	-35%	-36%	17.0	11.9	-32%	+3%	+42	-18%	-19%		46	+97%		60	
median - non-recessi		4	-22%	-22%	21.4	14.6	-28%	+3%	+18	+7%	+7%		30	+70%		11	

Data source: FMRCo, Bloomberg, Haver Analytics, FactSet. Data as of 10/17/2022. Past performance is no guarantee of future results.

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Table 1.2 The New 60/40 Portfolio – An Update

	Asset Class	Pillar	Factor	% Allocation
Equity	US Equity Equal Weighted Index	Real Growth & Diversification	Valuation	15.00%
	US High Dividend Low Volatility	Diversification	Valuation & Defensive	5.00%
	International Equity Developed Index	Real Growth	Market Exposure	5.00%
	Non-US Small Cap Developed Markets	Real Growth & Diversification	Valuation & Earnings	5.00%
	Global Innovation	Innovation & real growth	Earnings	5.00%
	Total Equity			*35.00%*
Fixed Income	Senior Loans	Real growth & Short Duration	Credit & Short Duration	10.00%
	Short term TIPS	Inflation protection & Short Duration	Short Duration	10.00%
	Asset Backed Securities	Real growth & Short Duration	Credit& Short Duration	10.00%
	Total Fixed Income			*30.00%*
Alternative	Diversified Dynamic Roll Commodity Index	Inflation & diversification	Carry & non-correlated	5.00%
	Global Macro Credit	Diversification	Diversification	5.00%
	Hedged Equity	Diversification	Valuation & Earnings	10.00%
	Long/Short Systematic Managed Futures	Inflation & diversification	Diversification	5.00%
	Merger Arbitrage	Diversification	Diversification	10.00%
	Total Alternative			*35.00%*
	Total			100.00%

Table 1.3

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.

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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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