*Caron's Corner Transcript – 3.6.2023*

## Finding a New Risk Balance When 60/40 is No Longer Optimal

- At the forefront of any risk balance discussion is the traditional 60/40 portfolio, which worked pretty well from 1980 to 2021.

- What made it work was that bonds, 40% of the allocation, achieved positive returns in 36 out of those 40 years.

- About 85% of bond returns are attributable to movements in interest rates, which trended lower from 1980-2021, such that bond returns were typically positive during that timeframe.

- Will it continue to work? We don't think so, as we do not expect interest rates to trend lower for the next 40 years.

- The solution is to adopt actively-managed strategies that pair the risks of assets held in a portfolio against each other in order reduce the overall volatility.

**Jim Caron**: This is Jim Caron Co-CIO of MSIM Global Balanced and Risk Control strategies. What I'd like to discuss this week is finding a new risk balance when the 60-40 portfolio is no longer optimal. Let me start by saying that I typically discuss fundamental economic drivers of policy and risk in markets, but today I'm going to take a different tack and discuss how we may want to select assets to construct a portfolio and actively manage or balance those risks. This will be the first in a series and will be discussed in more depth over time.

Anyway, any discussion about risk balanced starts with a look at the traditional 60% equity / 40% fixed income portfolio, and while this may be a gross oversimplification of a risk balance strategy, it is one that cannot be ignored, one that actually worked out pretty well for the past 40 years. Well, at least since 1980. The question today is if a 60/40 portfolio will work as well in the future and the answer is, we don't think so. So let's get into it.

When we think about the traditional 60/40 portfolio, it's important to define its objective. In my mind that objective was to reduce the volatility of returns over a longer-term investment horizon, by balancing risks between the assets investors held in a portfolio. The idea was to reduce downside risk - or large drawdowns - but also to participate in the upside, and if you could achieve that then you would be able to compound returns in a stable and predictable manner over time. After all, that's the goal for financial planning and the meeting long-term liabilities. There was definitely some usefulness in having a stable profile of longer-term returns, and the 60/40 portfolio helped achieve that.

When we ask "Did the 60/40 portfolio balance work and will it continue to work?" well, those are two different questions, so let's answer each one separately. To start, yes, it did work. In fact, it worked from 1980 to 2021 broadly speaking, and notice that I leave out 2022. But the question we really should be asking is what made it work from 1980 to 2021. Well, what made it work was that bonds, which represent 40% of the overall allocation, achieved a positive return in 36 out of those 40 years. Let me

say that again, bonds achieved a positive return in 36 out of 40 years, where the returns are based on the Bloomberg U.S. Aggregate Index. The down years were 1994, this was the big bear market (the worst of all time until 2022), where the U.S. Agg Index was down minus 2.5%. We were down in 2013, the taper tantrum, and down in 2018, basically flat, but after fees one could consider that it was a negative year for fixed income. Then we had 2022 and we all know that 2022 was a double digit negative for fixed income, but more on that later. On average bonds returned about 6.5% annually during that 1980-2021 period and roughly speaking the down years in equities were around 7% give or take. Putting the two together, a combination of holding stocks and bonds and a 60/40 balance worked out reasonably well and bonds compensated investors very nicely for equity risk.

But, let it not be lost on anyone that the driving force of the success of the 60/40 portfolio was the very consistent return in bonds. Which brings us to the question of whether this continue into the future, if it will continue to work well, and this puts the burden on the bond market and the interest rate cycle. Why? Because about 85% of bond returns were attributable to a movement in interest rates and since interest rates trended lower from 1980 to 2021, bond returns were typically positive. The better question might be whether one thinks that interest rates will trend lower for the next 40 years. Well, I certainly don't think so and this is where the static 60/40 balance risk allocation becomes challenged. If interest rates just trend sideways into the future - and let's just assume a range of 2 to 6% yields, then bonds will not be the steady hedge to equities they once were, invalidating a 60/40 static balance. If rates drift slightly higher, let alone a slight trend higher, then bonds really come into question as a hedge that provides stable returns when matched against equities. There's then nothing magical about a 60/40 balanced portfolio. In fact, that term 60/40 actually never existed prior to 1980 and only existed when rates started trending lower and people came up with the risk parity concept. More commonly, interest rates historically move in a cyclical sideways range, all else being equal. This means that there will be years when bonds and equities have positive correlations and there will be years when they have negative correlations. So what's the overall solution?

Well, the solution is to adopt actively managed strategies that bear the risks of assets held in a portfolio against each other in order to reduce the volatility of returns. That's the key reducing the volatility of returns that way, people can potentially compound their returns over time. In other words, one needs to be more concerned about how a manager is balancing the risks in one's portfolio through asset allocation decisions with the objective of reducing the volatility of returns. Here we are right back where we started. The goal is to reduce return volatility, limit drawdown risks and have a goal of stabilizing returns so they are predictable and can compound over time. This is achieved by balancing the risks in the portfolio and providing a framework and discipline to control the risk. We will be discussing this investment process for the foreseeable future because we believe the 60-40 static portfolio allocation and strategies along those lines will be suboptimal. Much more on this later.

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