

Global Multi-Asset Viewpoint

Difficult Decade Ahead for the Balanced Portfolio

GLOBAL MULTI-ASSET TEAM | MACRO INSIGHT | SEPTEMBER 2022

Summary

In the decade from 2010 to 2020, the “balanced” 60/40 portfolio (60% global equities, 40% global fixed income) returned +6.4% annually, or +4.6% in real terms, with a 0.8 Sharpe ratio. Both stocks and bonds performed exceptionally well, helped at least in part by the easy-money conditions of the post-Financial Crisis period.

The extraordinary risk-adjusted returns of the last decade—becoming even more extraordinary leading up to 2022—are unlikely to be repeated over the next 10 years. High starting valuations for both equities and bonds constrain future returns, and trend growth in most major economies will be slower. The diversification benefits of bonds in the balanced portfolio are likely to diminish as we expect bonds and stocks will become more positively correlated. We expect the balanced portfolio to return 4.5% per year, or 1.1% in real terms, with 0.1 Sharpe Ratio, based on a probability-weighted average of the two macroeconomic environments we consider most likely: a return of the secular stagnation environment of the 2010’s (30% probability) and a continuation of the higher inflation environment (70% probability).¹

¹When we refer to the balanced portfolio we mean 60% MSCI All-Country World Index (ACWI), 40% Bloomberg Global-Aggregate Total Return Index Value Unhedged USD. Our forecasted returns assume a 10-year time horizon from July 31, 2022 to July 30, 2032, in which we assume a linear path between July 31, 2022 and the end point in 10 years, and we do not include any manager alpha or transaction costs. We limit our analysis to publicly listed-assets, and our empirical analysis is based on data since 1970.

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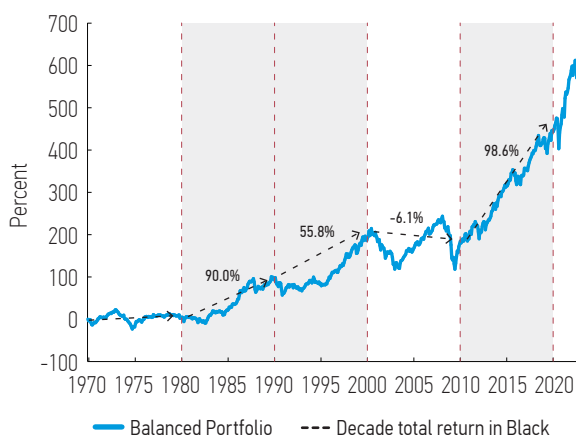


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Display 1: Balanced 60/40 Portfolio Performed Exceptionally Well in the Past Decade

Rolling 10-Year Total Return Excess of Cash for Balanced Portfolio



Source: MSIM GMA team, Haver. Data as of October 10, 2022.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results.

See Disclosure section for index definitions.

If the relatively benign secular stagnation environment of the 2010s were to return, balanced portfolio expected returns would still be modest by historical standards, at 5.4% per year or 2.8% in real terms. However, we think the probability that the higher inflation environment persists is substantial, and in this scenario we would expect the balanced portfolio to return 4.1% per year, or 0.3% in real terms. We believe it is worth considering rebalancing traditional balanced portfolios to emphasize assets with better expected returns and adding assets that would likely perform better in a high inflation environment. Such an adjustment could improve balanced portfolio expected returns by roughly 30 bps annually in nominal and real terms without a large increase in volatility in the macro environment we expect.²

The Balanced Portfolio Over Past 50 Years: Empirically-Based Observations

Although our approach is rooted primarily in a forward-looking assessment of fundamentals and given today’s valuation starting point, some historical context is nonetheless useful. As we have noted previously in the Global Multi-Asset *Viewpoint*, the winners of one decade rarely tend to be the winners of the next, and the balanced portfolio has been no exception: it has had decades of relatively strong risk-adjusted returns, only to be followed by decades of much more modest performance.

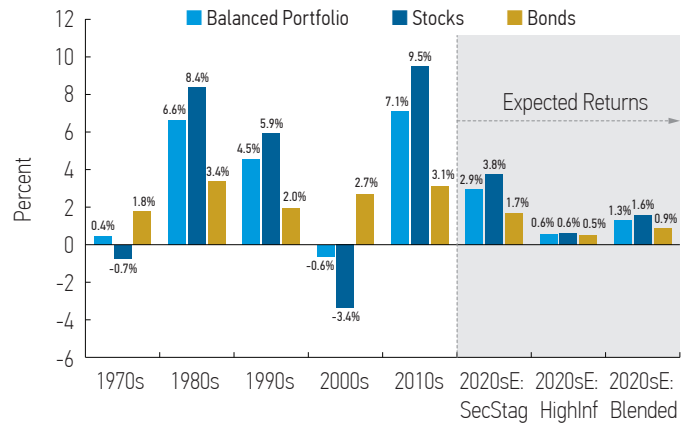
Display 2 shows the balanced portfolio’s returns by decade. It shows the starkly different characteristics of each decade: the “lost” 1970s and 2000s decades saw poor performance while the “good” decades of the 1980s, 1990s and 2010s saw superior returns. The balanced portfolio returned on average 6.1% over cash during the good decades in contrast to -0.1% during the lost ones. And it achieved an attractive Sharpe ratio of 0.6 during the good decades vs. zero during the lost ones (see *Display 3*). During the 2010s the balanced portfolio achieved particularly attractive risk-adjusted returns as its Sharpe ratio of 0.8 exceeded that of any other prior decade, helped by the lower correlation between stocks and bonds. Clearly, the returns were not monotonic as some intra-decade variability can be observed. Despite some variability, peaks and troughs of 10-year rolling returns appear to have followed a calendar decadal pattern (see *Display 1*).

We note that equities have not only accounted for the dominant share of risk in the balanced portfolio but also have been the main factor affecting performance variation. Equities underperformed cash during the lost decades of 1970s and 2000s, while bonds generated positive returns above cash in every decade since the 1970s.

Good decades shared many characteristics while lost decades saw reversals of many of the same trends. Good decades tended to be characterized by 1) lower macro volatility and more

Display 2: Balanced Portfolio Will Likely Return Substantially Lower Under Higher Inflation Scenario

Historical Balanced Portfolio Returns (Annualized)



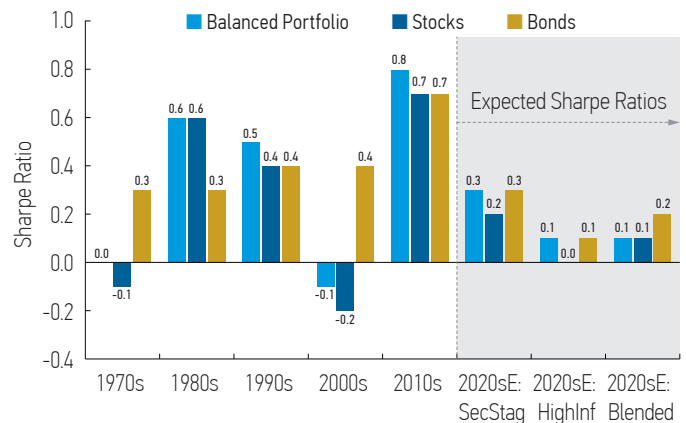
Source: MSIM GMA team, Haver. Data as of October 10, 2022.

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Expected returns are hypothetical in nature, are not a guarantee of performance and there can be no assurance any such target return was ultimately achieved by such an investor.

Display 3: This Trend Applies to Stocks, Bonds and Balanced Portfolio on a Risk-Adjusted Basis

Historical Balanced Portfolio Sharpe Ratios



Source: MSIM GMA team, Haver. Data as of October 10, 2022.

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² Based on probability-weighted average of the two macroeconomic environments we believe are most likely: Secular Stagnation and High Inflation, defined herein.

pronounced deceleration of inflation; 2) a re-rating for equities from below-average starting valuations; 3) outperformance of U.S. assets (both equities and the dollar), with the dollar also starting out cheap and subsequently appreciating; 4) outperformance of large cap stocks over small caps; 5) subdued relative performance of value relative to its long-term trend.

During the good decades, volatility of GDP growth on average declined by 0.6% as compared to the previous decade. This was typically reversed subsequently as GDP volatility increased by 0.4% during lost decades. Inflation followed a similar pattern, improving (i.e. decelerating) in each of the good decades by -1.8%, on average, as compared to the preceding decade. During the lost decade of the 1970s, inflation rose by 4.9% as compared to the 1960s and while in 2000s it slowed by -0.4%, this deceleration was substantially smaller than the -1.8% deceleration in good decades.

Equity valuations tended to expand and bond yields to fall during good decades. On average, the good decades started with below-average equity valuations, with the good decade average trailing P/E at 16.3x or the Schiller P/E at 15.5x for U.S. equities. This was on average 2% cheap relative to the historical average valuation at the beginning of each decade.³ During good decades, equities tended to rerate, on average by 57% in absolute terms and ended up 29% overvalued relative to the historical average valuation at the end of each decade. This usually set them up to reverse the process during lost decades and derate, on average, by -25% per year.

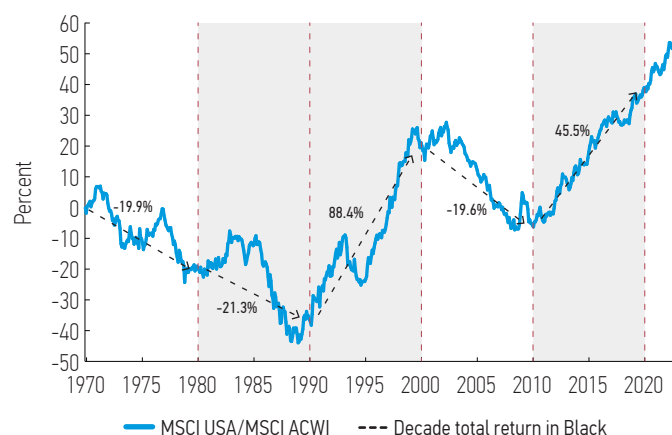
Bond yields tended to compress more aggressively during good decades, declining by -2.2% on average, as compared to +0.1% during lost decades. However, the 1970s were very different from the 2000s due to different inflation environments: bond yields rose +3.4% to 11.1% during the 1970s versus falling -3.1% in the 2000s.

U.S. assets tended to outperform during good decades (see *Display 4*). U.S. equities outperformed MSCI ACWI equities on average by 2.7% per year during good decades (though this was not uniform: U.S. equities outperformed in the 1990s and 2010s but underperformed in the 1980s).

Large capitalization stocks consistently outperformed small caps during good decades, by 1.8% per year on average. This was consistently reversed during lost decades when large caps underperformed by 6% per year. Similarly to the start of the 1970s, which followed a large cap bubble in the so-called Nifty Fifty stocks in the 1960s, market cap concentration today is also high. The top 10 stocks today account for 29% of U.S. market cap, compared to 33% in early 1970s, which is much higher than the 50-year average of 22%. The tech sector has tended to

Display 4: U.S. Assets Tended to Outperform During Good Decades

U.S. Equities vs. Global Equities



Source: MSIM GMA team, Haver. Data as of October 10, 2022.

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follow the decadal pattern somewhat closely also, outperforming the broader market by 3.6% per year during good decades and underperforming by 4% during lost ones. Though similarly to U.S./non-U.S. equity performance, the 1980s were an exception in which tech did not outperform during a good decade.

Equity styles have also tended to follow the technology and U.S./non-U.S. equities pattern: the value style outperformed the market during lost decades (when tech underperformed), to a greater degree. On average, global value stocks (selected based on a proprietary MSIM Global Multi-Asset team methodology) outperformed by 8.9% per year during lost decades versus outperforming by just 3.5% during good decades.

The probability of a mean reversion over the next decade appears high. This is not only based on the historical pattern of returns discussed above but also, and most importantly, on the pattern of changes in valuations. Today's elevated valuations for U.S. assets (both U.S. equities and the U.S. dollar) suggest a more subdued return outlook for the balanced portfolio during this decade. Bond valuations and performance are particularly constrained by relative proximity to the zero lower bound. Additionally, if recently-experienced higher inflation and higher growth volatility are sustained, as seems likely for a number of reasons we have discussed in previous Global Multi-Asset *Viewpoint* publications, the probability of a lost decade ahead for the balanced portfolio looms large.

³ Calculated from 1947.

Role of Bonds as Diversifiers

While equities have tended to be the dominant source of return (and risk) in the balanced portfolio, bonds have provided some diversification benefits as well as competitive returns.⁴ Over the past 50 years they exhibited a higher Sharpe ratio than equities. In the 2010s, their best decade, they returned 28% or 2.5% per year, with a 0.7 Sharpe ratio, comparable to equities. In addition to their equally attractive risk-adjusted returns, bonds served as an effective hedge against deflation risks. In the low inflation environment since the 2000s, bonds not only performed strongly but also improved risk-adjusted returns of the balanced portfolio due to their lower correlation to equities than historically.⁵ Helped by this lower correlation, the volatility of the balanced portfolio in the 2010s was 8.7%, somewhat lower than the historical average of 10.5% or 9.0% during the 1990s despite the volatility of both stocks and bonds being similar to the 2010s.

Outlook for the Traditional Balanced Portfolio

We expect the traditional balanced portfolio to return 4.5% annually over the next 10 years, or 1.3% relative to cash, and to generate a 0.14 Sharpe ratio. This assessment is based on a probability-weighted average of the two macroeconomic scenarios that we consider most likely: 1) Secular Stagnation, and 2) High Inflation. Our forecast for the balanced portfolio assigns a 30% probability to Secular Stagnation and a 70% probability to the High Inflation scenario.

Secular Stagnation is a continuation of the trends experienced during the 2010s: slow trend growth, low inflation and, as a result, limited valuation mean-reversion. In the U.S., we assume trend GDP growth of 1.5%, inflation at 2%, real short-term rates at 0.5% and the real 10-year Treasury yield at 1%. Under the High Inflation scenario, we assume that trend growth remains the same and real earnings growth is similar to the Secular Stagnation scenario, but we expect more pronounced mean-reversion of equity valuations. Nominal bond returns would likely be similar (and generally on a 10-year horizon would tend to approximate the starting yield), but would be worse in real terms.

SECULAR STAGNATION: we expect the traditional balanced portfolio to return 5.4% or 2.9% above cash, with a 0.3 Sharpe ratio (see *Display 2*).

- In this environment, we would expect global equities to return 6.2%, or 3.8% above cash (or 3.7% in real terms) achieving 0.25 Sharpe ratio. We would expect U.S. equities to mildly underperform and return 3.0% or 0.5% in real terms as real earnings growth contributes 2.7%, dividend yield 1.5% and valuation detracts -3.6% per year. By contrast, expected returns for non-U.S. equities would likely be substantially higher, for two main reasons: valuation would likely detract less from

performance than in the U.S.—approximately one third of what we expect in the U.S.; and the U.S. dollar would likely depreciate (by approximately 20% on a real effective basis) such that this would substantially offset valuation compression for non-U.S. equities.

- We expect global bonds to return 4.2% or 1.7% above cash (or 1.6% in real terms), achieving a 0.31 Sharpe ratio. U.S. nominal Treasuries would likely produce the weakest expected returns of 3.2%, or 0.6% in real terms. Most other segments of the bond market would be expected to perform better, despite low starting yields in both nominal and real terms, helped by FX appreciation relative to the U.S. dollar.
- The relatively low, by historical standards, correlation between stocks and bonds observed over the past 10 years would be likely to persist under Secular Stagnation as inflation would remain low.

HIGH INFLATION: In this scenario, the expected return for the balanced portfolio would likely be 4.1% per year, or 0.6% above cash and 0.3% in real terms, achieving a poor Sharpe ratio near zero. The expected volatility of the balanced portfolio would likely be somewhat higher than in the Secular Stagnation scenario, at 9.0%, due to a lower diversification effect from bonds.

- We assume inflation would settle at 3.0% towards the end of the decade and stock/bond correlation would be positive, with all other asset cross correlations also reverting to what they were before the year 2000. Real long-term interest rates (U.S. 10-year) would be lower in this scenario, at 0%. Assumptions about real GDP and earnings growth are similar to the Secular Stagnation scenario and valuation mean-reversion would likely be more pronounced.
- Incidentally, both global stocks and bonds would be expected to generate similar returns in the overall portfolio. U.S. equities would likely underperform global equities more substantially under this scenario as valuation derating would detract 7.6% per year vs. 3.6% under Secular Stagnation.

The low return and poor Sharpe ratio of 0.1 for the 2020s suggest it will be a lost decade for the traditional balanced portfolio. Although returns will likely be somewhat better than during previous lost decades, they will still be relatively poor.

Adjusting the Strategic Composition of the Balanced Portfolio

If the probability of sustained high inflation is indeed higher this decade, the balanced portfolio could be better prepared with a number of possible strategic adjustments. We highlight a few of these possible adjustments below:

⁴ Diversification does not eliminate the risk of loss.

⁵ Bonds' correlation to equities was 34% since 2000s vs. 41% in prior decades.

1. Reduce global stocks and bonds allocation by 8.7% and 5.8%, respectively.
2. Add non-traditional diversifying assets: commodities (2.5%), gold (4.0%), real estate equities (2%) and commodity and infrastructure equities (6%).
3. Within equities, increase allocation to non-U.S. equities.
4. Within bonds increase allocation to international governments bonds, EM debt, US mortgaged backed securities, and inflation-linked bonds.

The adjusted balanced portfolio would be expected to have similar volatility to the current portfolio but would have somewhat higher returns potential, especially in the High Inflation scenario. On a probability-weighted basis, the adjusted portfolio expected return would be 29 bps higher (adjusted portfolio expected return 4.8%, or 1.6% over cash and 1.4% in real terms) compared with the traditional balanced portfolio

expected return of 4.5% per year, or 1.3% over cash, and 1.1% in real terms.

Conclusion

A lost decade of near-zero real returns looms for the balanced portfolio. High starting valuations and a high probability of a less favorable macro environment are the main headwinds ahead. The adjustments to the strategic allocation we are proposing to consider could modestly improve the results, and could help to avoid negative real returns in a High Inflation scenario. However, they are no panacea in that the returns of an adjusted balanced portfolio will still likely be modest by historical standards. Our proposed adjustments are constrained by maintaining similar levels of expected volatility to the traditional balanced portfolio. If higher returns are to be achieved, larger adjustments along the lines of what we have proposed would be required. This would inherently entail taking more risk and a more volatile portfolio, but this is an option some investors may consider.

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