Client's Corner

The 60/40 Portfolio: When You Need It Most, It May Not Work

ONE OF THE MOST ENDURING IDEAS IN BASIC INVESTMENT portfolio construction is the 60/40 portfolio.

This is generally taken to mean that you allocate your invested assets 60% to equities for their attractive record of long-term growth of capital, and 40% to bonds for their income, and especially for protection against the volatility of equities. This sounds reasoned, measured and above all prudent.

And the most beguiling thing about it is that, at first glance, you don't appear to be giving up all that much of the return of a straight equity portfolio. The reasoning is as follows: the nearly hundred-year compound annual return of mainstream equities—the S&P 500—has been 10%; that of the most directly comparable corporate bond index, six percent. Assuming these returns continue in the future, your 60/40 portfolio would compound at a blended 8.4%. Eight point four percent still seems like a very handsome long-term return, especially if you're convinced that it really does buy you a steady income and meaningful protection from equity volatility.

That bonds aren't down quite as much as mainstream equities may be cold comfort to investors who thought they couldn't go down *at all.*

Ah, but look a bit closer. To a long-term investor, nominal rates of return like 10% and six percent don't mean much—or at least they shouldn't. What matters most in the long run is your ***real*** (inflation-adjusted) return. And we know that over this same period, consumer inflation has run around three percent. The historic ***real*** equity return net of inflation can now be seen to have been seven percent, and that of bonds three percent.

Thus, a 60/40 portfolio, making all the same assumptions, would now produce a ***real*** return of 5.4%, or about a 23% haircut relative to the all-equity portfolio. That still may not seem too much to give up, until you think about what it could have become over a lifetime of compounding. But that isn't the essential question.

Which is, of course: What does the long-term investor really get in return for that sacrifice?

In terms of their capacity to produce income over time, bonds don't actually compare very well with equities. A six percent 30-year corporate bond you might have bought when it was issued in 1992 looked pretty good in terms of its current yield—which was about twice what equities were paying at the time. (The S&P 500 ended 1992 at 436, and paid a dividend for the full year of $12.39—a 2.8% yield.)

The difficulty arises from the fact that your 30-year bond matured fairly recently, still paying its six percent. But by last year, the S&P's dividend had nearly quintupled, to $60.40. (I need hardly add that the $1,000 you paid for the bond in 1992 was returned to you at maturity, while the S&P 500 went from 436 to a very beaten-up 4,000 as I write. But try to ignore that for the moment if you can; we're just focusing on income here.)

So if the notion of bonds as a superior income provider won't stand much scrutiny by a long-term investor, they had better be doing a bang-up job at the only other reason one has for going 60/40: protecting you from equity volatility.

Uh-oh.

In what the *Wall Street Journal*'s Jason Zweig recently christened the "Worst Bond Market Since 1842," bonds have simply gotten crushed in 2022—and for much the same reason stocks have: rapidly rising interest rates, belatedly struggling to quell severe inflation. That bonds aren't down quite as much as mainstream equities at this writing is, I suspect, cold comfort to the 60/40 investor, who may well have thought bonds couldn't go down much ***at all.***

This is anything but a fluke. The plain fact is that fairly often, when skittish investors have most urgently depended on bonds to be a bulwark against the vicissitudes of the equity market, the bonds have failed to oblige. At such times—like now—there has been no port in that season's particular storm.

The patient, disciplined equity investor will wait for the storm to blow out, as storms have always done in the past. While the disappointed 60/40 investor may be forgiven for asking, "Did I give up far too much for a safeguard that turned out not to exist?"

And that becomes an ***extremely*** good question.

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Sources: S&P 500 earnings history, NYU Stern School; Jason Zweig, "It's the Worst Bond Market Since 1842. That's the Good News," ***Wall Street Journal,*** May 5, 2022