Your *Trust* Matters

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We called it: the 60/40 approach is alive and well

The recent revival in commentary about whether the 60/40 portfolio is a thing of the past prompted us to look at the numbers and our analysis of this approach when we examined it last year. Oh, what a difference a year makes! We reported in November 2022 that the age-old 60/40 Portfolio had *"experienced an uncharacteristic decline in 2022. Year-to-date through October 31st, the 60%/40% blend of the S&P 500 and Bloomberg Aggregate Bond has declined 16.7%. Since 2003, the portfolio has experienced negative full year returns on only two occasions, 2018 and 2008; -2.46%, -19.12%, respectively."*

The cause of the decline was the dual declines in both stock and bond values due to a variety of factors. Although unusual, simultaneous declines can occur. The rebound of bond yields after the Fed's Zero Interest Rate Policy (ZIRP), was steep and abrupt. The higher yields also increased the discount rate used to calculate the present value of revenue streams for equities, stressing stock valuations.

As we stand in December 2023, bond prices have stabilized and have again begun to provide the buffer to swings in the stock market as they have in the past. Equities, too, have rebounded to a double-digit gain YTD @ 22.51%. The blended return YTD for the 60/40 portfolio through December 15, 2023 is 15.61%.

Stock, Bond & 60/40 Portfolio Returns

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While the "haters gonna hate" (for all you Swifties), we think it's clear that the 60/40 portfolio is still the workhorse it always has been.

Setting your asset allocation purposefully and riding out the down markets as opposed to attempting to time the markets is an evergreen idea. As always, to dial into optimal asset allocation for your specific situation, we recommend updating your comprehensive financial plan to ensure your investment mix matches your objectives and risk tolerance. Please don't hesitate to contact us for further conversation.

If you want to take a closer look at what we said about the 60/40 portfolio last year, the following was the original narrative, published in November 2022:

2022: A Challenging year for the 60/40 Portfolio

Quick Take

The stalwart portfolio that has weathered most every market for decades has experienced an uncharacteristic decline in 2022. Year-to-date through October 31st, the 60%/40% blend of the S&P 500 and Bloomberg Aggregate Bond has declined 16.7%. Since 2003, the portfolio has experienced negative full year returns on only two occasions, 2018 and 2008, -2.46% -19.12%, respectively.

The dual dip of both stock and bond values has largely been a result of an uneven recovery from the COVID pandemic. The combination of supply disruptions due to logistical backlogs coupled with the sheer volume of monetary stimulus has stoked inflation in all areas of the economy. The rapid increase in inflation in a short period of time has negatively impacted stock and bond prices simultaneously.

As we stand in November, bond prices should stabilize and again begin to provide a buffer to continued swings in the stock market. The 60/40 portfolio will continue to be effective despite an unusual year in 2022.

Stock, Bond & 60/40 Portfolio Returns

A Deeper Look

To understand the recent market more fully, let's examine the components of the portfolio and how they work together. The two main parts of our portfolio are stocks and bonds. In very broad stokes, they are defined as:

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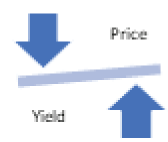
Stocks: A stock is a form of ownership in a company. It is a claim on future earnings. The value of a stock is derived from the expected future dividends and growth in the company, adjusted through time at a discount rate. The discount rate adjusts the future dividends and growth for expected inflation and risk.

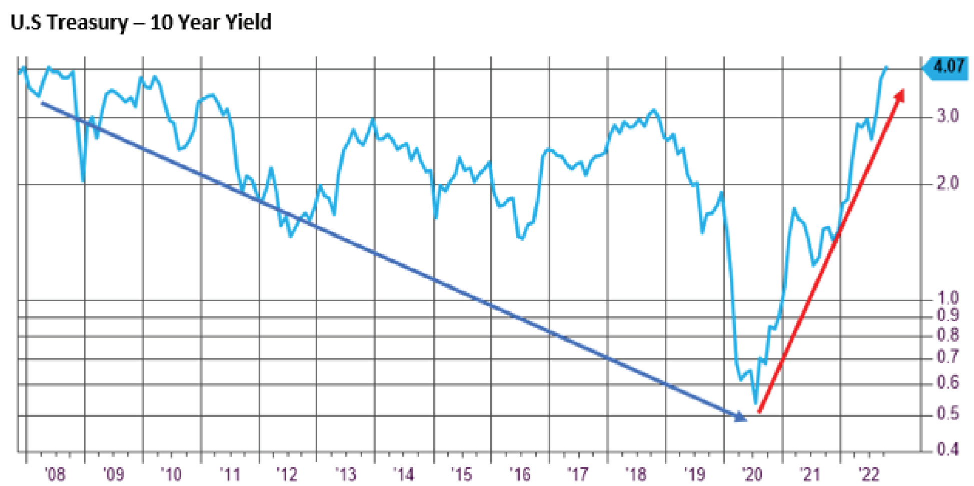
Bonds: A bond is a loan to a company or government, in return for a promise to repay the original amount with interest at a specific time in the future. The value of a bond is derived from the interest payment and principal repayment, adjusted though time at a discount rate. The discount rate adjusts the future cash flows for expected inflation and risk of default.

Note: You may have noticed that the values of both stocks and bond both subject to changes in interest rates. We will revisit this a little later in the paper.



Bond prices and changes in interest rates move in opposite directions. When interest rates increase, bond prices fall. To illustrate this inverse relationship, let's look at a simple example bond with a single payment a year from now. If we buy bond with a face value of $100 and the prevailing interest rate today is 3%, we buy our bond at 97% of the face value or $97. If held until the final maturity a year from now, we will receive the full $100. Now let's assume that you have encountered an unexpected expense and we need to sell our bond the next day. During that day, the prevailing interest rate increased to 4%, up a full 1%. The potential buyer has a choice to buy our bond to earn 3% or buy a new bond for 4%. Obviously, the buyer would prefer the 4% bond, leaving us with no buyers. We would have to lower our price so that the total return matches the 4% available on the market. To do so we would lower our price by 1% to 96% of face value, which would offer the buyer a competitive 4% return which matches the rate now available in the market. In our case, because we sold the bond prior to maturity we realized a loss of $1.

U.S Treasury – 10 Year Yield



Bond funds are effectively a portfolio of individual bonds with various interest rates and maturities. As interest rates change, the price of the fund is the weighted average of the bonds within the portfolio. The sensitivity of a bond funds price relative to changes in interest rates can be loosely estimated by the average maturity of the bonds in the portfolio. The longer the average

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maturity, the higher the negative impact felt by rising rates. From 2008 to mid-2020, the falling yield on the 10-year Treasury was a tail wind for bond prices. In contrast, the sharp reversal over the past 24 months has introduced a stiff headwind for bond values resulting in negative returns as yields rose.

Building the Right Mix

Assets are chosen for a portfolio for many reasons. One of the most important is how they will react to economic events relative to each other. It is desirable to build a portfolio with assets that at least somewhat offset the fluctuations of the other assets. This is popularly known as diversification.

Historically, the two primary asset classes that have exhibited diversification benefits have been Stocks and Bonds. In fact, over the past 15 years, stock and bond returns have produced positive results in 13 of those annual periods.

In most years, a 60/40 portfolio has offset some of the zigs and zags in the market, generated income, increased in value and provided a relatively smooth ride. 2022 has been a little different.

What happened in 2022?

The Covid-19 pandemic impacted all areas of the world economy. Two of the most powerful factors were: 1) the disruption of the global supply chain and 2) the amount of liquidity that was injected into the world economy. The combination of these factors has fueled a significant level of inflation in a very short period of time.

As mentioned earlier, the impact of a rapid increase of inflation, especially unexpected inflation, had negative impacts on almost all asset classes.

For both stocks and bonds, an increase in the level of interest rates increases the discount rate by which other cash flows are adjusted back to the present value. In the simplest terms, it increases the denominator of the fraction, subsequently reducing the value. Much like 1÷1 =1,1÷2=0.5, this concept is applied on a larger scale. As interest rates rise, the discount rate (the denominator) increases even as the earnings (the numerator) stays the same, which lowers the current value of the asset. Additionally, as interest rates rise, the cost of borrowing increases, projects become less profitable, and the pace of business slows. As the prospect of future earnings slows, so does the willingness of investors to bid up prices in the stock market. The Price-to-Earnings (P/E) is the multiple of earnings that an investor is willing to pay for a dollar of corporate earnings. Companies that have prospects for faster growth generally command a higher P/E. In times of economic stress, the investors' enthusiasm to pay higher multiples for future earnings diminishes.

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In the early part of 2022, S&P 500 earnings estimates remained relatively static @ $235 per share and the decline in the market was driven by a decline in investor sentiment. The Price-to-Earnings ratio on the S&P500 fell from 22 to 16. Over the course of the past two months, the focus has shifted to the actual impact on earnings. In an inflationary marketplace, both parts of our valuation come under pressure as interest rates rise (where, Price = Earnings per Share X Price-to-Earnings multiple).

Conclusion

The markets have largely adjusted to the higher interest rate regime. For stocks, the market P/E has fallen and forward earnings estimates have reset lower. For bonds, yields have risen and prices have fallen. The Federal Reserve is expected to pause at around 5% for the Federal Funds rate, which means that there are likely one or two additional rate hikes to endure. These expected future rate hikes have largely been priced into current valuations.. The table has effectively been reset.

As inflation peaks and starts to decline the discount rate applied to future earnings will also fall, boosting valuations. The factors that have negatively impacted both parts may turn in the coming months, thus proving a tailwind. The 60/40 portfolio should now be positioned to generate income, provide moderate growth and dampen some market volatility. As always, to dial into optimal asset allocation for your specific situation, we recommend updating your comprehensive financial plan to ensure your investment mix matches your objectives and risk tolerance. Please don't hesitate to contact us for further conversation.

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