THE DEATH OF 60/40

"For the great majority of mankind are satisfied with appearances, as though they were realities, and are often more influenced by the things that seem, than by those that are." - Niccolo Machiavelli

60/40 is the conventional playbook for asset managers. It refers to the time-honored portfolio allocation of 60% equities and 40% fixed income. In this piece we explore what *The Death of 60/40* means: In the current investment environment, this traditional strategy may be critically flawed over the next several years. It simply isn't compensating investors adequately for the risk they're taking on nor is it likely to help them achieve their financial goals. Whether 60/40 is truly dead or not, only time and the markets will tell.

In the meantime, we've made the strategic choice to pursue alternative allocations and approaches that should better reward our clients. This quarter's letter discusses how most financial assets are priced on current interest rates, which are near their historic lows.

We also delve into how risk-reward tradeoffs are built in terms of specific risks, called *risk premia*. Right now, pursuing the risk premia that should add value to your portfolio requires a different kind of mindset—one that's unafraid to investigate innovative, unconventional approaches.

START AT THE BEGINNING: RISK EXPOSURES FROM CASH TO STOCKS

Prudent investing follows a tradeoff decision of risk versus reward. You first start with cash, a great method of protecting your capital in the short run. But it earns nothing as an investment and will lose its purchasing power against the tide of inflation.

You could buy short-term Treasury Bills (T-bills), which allow investors to continuously roll their investments into the next T-bill such that they can expect a longer-term return that keeps up with inflation. The yield that T-bills provide is often called the "risk-free rate." At today's rate of ~1% interest, an investor would be forgiven for also calling it a return-free rate.

The next stop up the risk ladder? You can take on some interest-rate risk ("term risk") and buy longer-term Treasuries. Fortunately these securities have very little risk of default, but if interest rates rise, their value will decline. The 10-year Treasury has historically paid 1.3% more than inflation (1878-2016), which means that in today's market it should be yielding in the low 3% range.

Sorry folks, the 10-year is hovering in the low 2% range. Looking out further, the 30-year Treasury provides little comfort, given that its investors are currently locking in a sub-3% return! For buying a 30-year bond instead of a 10-year bond, you're only being compensated about an additional .5%. Bottom line, adding interest rate risk (term risk) isn't adequately compensated these days.

Moving away from US Treasuries, an investor could buy a high-quality corporate bond instead and take on default risk. This is the risk that the lender will not be able to make their payments and/or return the principal. With corporates, an investor is adding default risk in addition to interest-rate risk.

By doing so, one would expect to be compensated at a rate greater than what Treasuries offer. But in today's market, the spread for BBB-rated debt (investment grade) over Treasuries is hovering between 1% and 1.5%, depending on timeframe. Nothing to get too excited about.

Another option is to move further down the credit scale into high-yield bonds, which pay more, given their even greater cyclicality and likelihood of default. While high-yield bonds still look reasonably attractive on a return basis (i.e., the increased potential return over Treasuries), there's a limit as to how much default risk you want to add to a portfolio.

Next up, stocks. Expected returns are higher than their aforementioned fixed-income counterparts, even though some markets (particularly U.S. stocks) seem a bit highly priced. For instance, the Shiller Cyclically Adjusted Price-Earnings ratio (CAPE) is nearing a level breached only a couple of times: in the months leading up to the Great Depression, and the last half of the 1990s' great bull-run. Of course, when you buy stocks, you're also accepting a significantly greater amount of growth risk (usually called equity risk), cyclicality, and plain old price volatility.

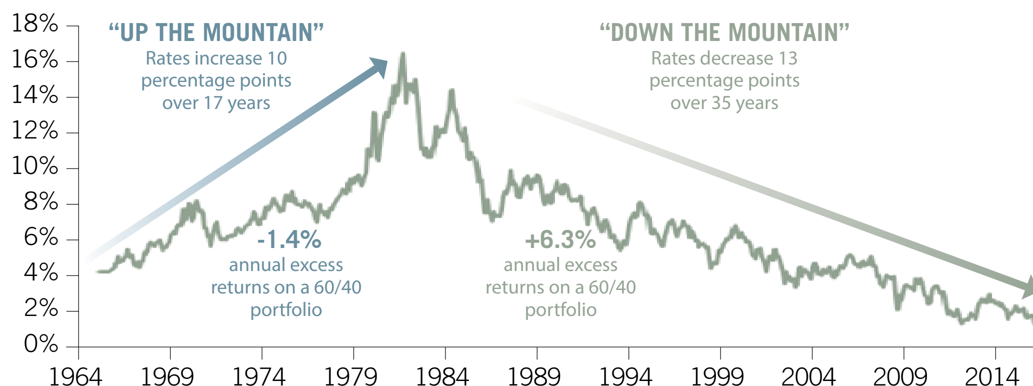
HANG IN THERE (THE NEWS ISN'T ALL BAD)

Before you decide to throw in the towel on investing in bonds—or head for the exits on stocks—there are clearly a host of reasons for why we're where we are today. The world of low interest rates is a double-edged sword. While it's painful for investors to accept the low rates of return in their savings accounts, it's a boon to those using debt to grow a business, buy assets, or even

buy back their own shares. Further, when rates are low, the value of a business' future earnings is worth more in present dollars.

50+ YEARS OF INTEREST RATES IN 2 DISTINCT REGIMES

10-YEAR TREASURY YIELD



Note: The performance of the S&P 500 Total Return and the 10-Year Constant Maturity Treasury are used to estimate the nominal returns of the 60/40. Excess returns are over the 3-month Treasury yield.
Sources: Bloomberg, FRED.

As the chart above illustrates, the 10-year Treasury yield has walked "down the mountain" since 1981 - from a peak of more than 15%. This has been a tailwind for nearly all investments. Remember, pretty much everything prices off of interest rates: The lower the rate, the more valuable [expensive?] the investment.

Since the 1981 peak, that 60/40 reference portfolio consisting of a 60% S&P 500 stocks and 40% 10-year Treasury allocation has beaten 3-month Treasuries, on average, by a whopping 6.3% per year. Many investors have forgotten the headwind that same 60/40 portfolio faced moving "up the mountain" when interest rates rose 10% from 1964 to 1981. In that period the 60/40 lost 1.4% per year relative to 3-month Treasuries.

The traditional 60/40 portfolio has done so well, for so long, that many investors don't even consider alternatives. Indeed, the notion that we've been in the "valley" since the end of the Great Recession has created a sense of complacency in the average investor.

So are U.S. stocks expensive? Maybe. Does that mean we're due for a bear market tomorrow? Absolutely not. Just because news channels seem to be constantly announcing that stocks hit yet

another all-time high, recall that they've always done that —and always will—just not every day and with occasionally a long time in between.

Let's not forget that as global investors at HH, we're not stuck with investing in U.S.-only instruments. The world is our oyster, and stock markets in developed Europe and the Emerging Markets are begging to be served up with a nice mignonette sauce.

The risk to advisors who stay the course with a traditional 60:40 portfolio is small, because even though their clients may experience a large portfolio loss (from stocks) or inadequate returns (60:40), other advisors' clients are likely to be in the same boat.

In this situation, the advisors who do something different from the crowds bear the greatest risk—in not following crowd behavior. In order for our clients to succeed in today's markets, we're willing to take on "Maverick Risk": We believe new and different thinking is required.

OUR COMMITMENT TO ALTERNATIVE RISK PREMIA—AND REDUCING PRODUCT COSTS

At the beginning of this letter, we snuck in the term risk premia, the building blocks of return. As a reminder, we start with the risk-free rate of T-bills and can add potentially return-enhancing elements like "term" risk, "default" risk and "growth/equity" risk.

Any investment is an amalgamation of these risks; stacking them together builds your expected return. Thus, the expected return of that 60/40 portfolio we keep talking about builds to approximately 3.4% (using JP Morgan's Long-Term Capital Market Assumptions over the next 5 years). Take out inflation and implementation costs, and investors may not be left with much to show for their effort and risk exposure.

In our last few Quarterly Letters, we have discussed the handful of alternative risk premia we've been adding to our portfolios. We won't march you through an extensive recap of them here. As a quick refresher: We've been adding in *tilt, illiquidity, reinsurance, non-commercial credit,* and *variance risk exposures*. (If you'd like to learn more about which investments in your portfolio are associated with these risks, your Regional Director or Wealth Advisor would be happy to have that conversation with you.)

Further, we have spent significant time and effort reducing product costs, particularly those in more efficient markets. Every dollar saved is another dollar compounded. Adding up these premia and cost-containment efforts, we could reasonably expect our reference "balanced" client portfolio to have an expected return north of 6%. Of course, clients' personal allocations and corresponding expected returns will vary depending on their unique needs and risk appetites.

It should be noted that risk premia are not fixed. The term we use is "non-stationary": All that means is that these change over time. One classic example is the growth or equity risk premium. It has been positive and persistent around the world for more than a century; holding U.S. stocks instead of short-term Treasuries has paid an average premium of ~5.5% (1900-2015)—but it isn't always 5.5%. This premium can be negative, and can be negative for years at a time.

We expect variability to also exist in the alternative risk premia referenced above. There will be times when the catastrophe risk premium is negative, or the variance risk premium works against us. The good news is that alternative risk premia are not likely to be tied directly to the traditional risk premia in a traditional 60/40 portfolio of stocks and bonds. And keep in mind that just because traditional risk premia seem low now, this does not mean they will stay that way.

PERMANENT HIBERNATION?

We may have gone a little jargon-y here. Our apologies—like the scorpion, it is our nature.

But despite the esoteric financial terminology, we hope we've been able to convey two relatively simple concepts. The first, that most traditional assets price on prevailing interest rates, which are subdued right now. And the second, that the risk-reward tradeoff can be disaggregated into units, called risk premia. Right now, many expected returns from traditional risk premia these are also subdued.

Combine the two concepts and put them in the current investment environment: What we expect with a relatively high degree of certainty is that the traditional 60/40 portfolio that has worked in the past isn't likely to work as well in the future.

That's not to say that it won't work again—eventually. In the meantime, we're focused on limiting the risks in our clients' portfolios that we believe are not being adequately rewarded at this time. We're also actively seeking out new risk premia that we expect to earn competitive returns.

Maybe the 60/40 isn't dead. Maybe it's in remission, or suspended animation. Maybe it's hibernating. But "The Hibernation of 60/40," unfortunately, just doesn't roll off the tongue, and so the current title stuck.

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