## A Brief History of the 60/40 Balanced Portfolio—Cradle to Grave in 40 Years

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Much has been written in recent months about the pending death of the 60/40 balanced portfolio due to its likely ineffectiveness going forward. Below we look at the reasons for why it worked from 1980-2010; why it hasn't worked too well for the past decade; why it mathematically cannot work in the current/forward environment; and, then we examine why and how investors should be using fixed income in a low rate world.

The 60/40 portfolio made a lot of sense when bond yields were high. Even though rates declined throughout the first 30 years—the yield on the Barclays Aggregate Bond Index started at 12% in late-1980 and ended at 3% in late-2010—bond yields provided a sufficient principal protection cushion and a higher rate than the dividend yield on stocks. That changed over the subsequent 10 years following the financial crisis, and now, thanks to the pandemic, the yield advantage and most of the principal protection have completely disappeared, as has the negative correlation with stocks.

### Why 60/40 Worked from 1980-2010

- **Strong Principal Protection—**the higher the yield, the greater the principal protection cushion. The Barclays Aggregate Bond Index had an average yield of 7.7% and an average duration of 4.5 years over the 30 years from 1980-2010—enough income to withstand a 0.40% increase in rates in any quarter and still post a positive return.
- **Huge Positive Carry—**bonds yielded 5% more than stocks, on average, over that 30-year stretch.
- **Negative Correlation—**for most of those 3 decades what was good for bonds was usually bad for stocks, and vice versa.

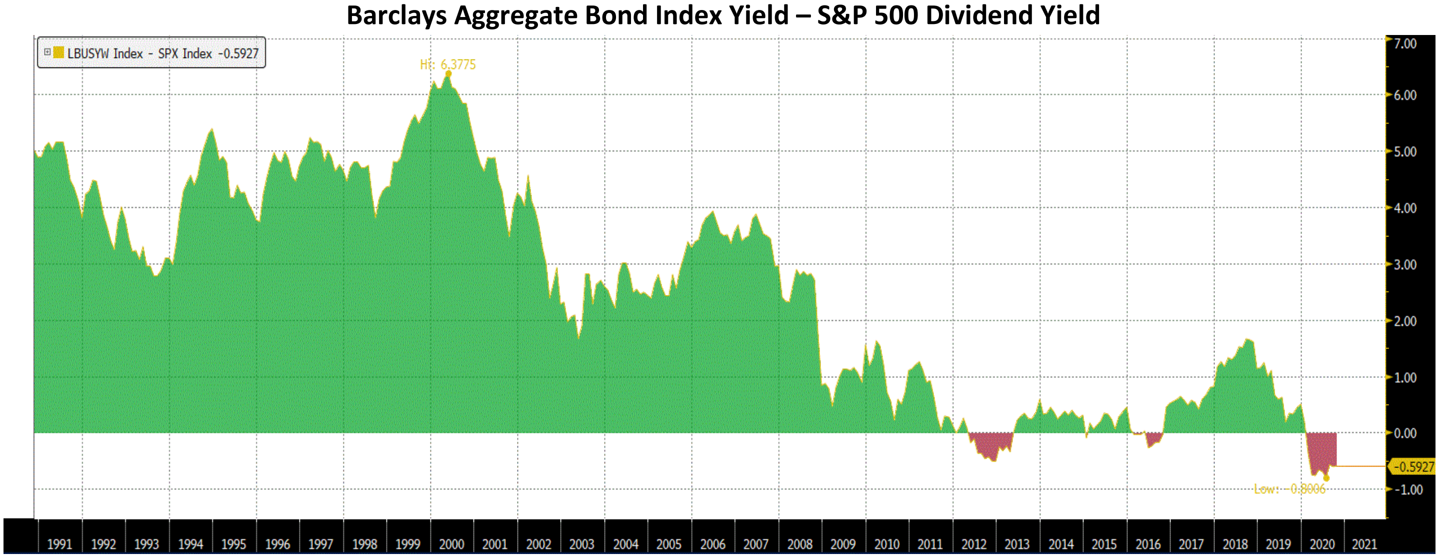
### Why 60/40 Hasn't Worked So Well Since 2010

- **Modest Principal Protection—**the Barclays Aggregate Bond Index has had an average yield of 2.4% and an average duration of 5.6 years over the past decade—a 0.11% rise in rates in any given quarter would completely erode the quarterly income.
- **Barely Positive Carry—**the Barclays Aggregate Bond Index has yielded, on average, only 0.5% more than the S&P 500 over the past decade.
- **Zero Correlation—**for much of the past decade what has been good or bad for bonds has not necessarily been bad or good for stocks—correlations between the two asset classes is now at zero.

### Why 60/40 Mathematically Cannot Work in the Current Environment (as of 10/31/20)

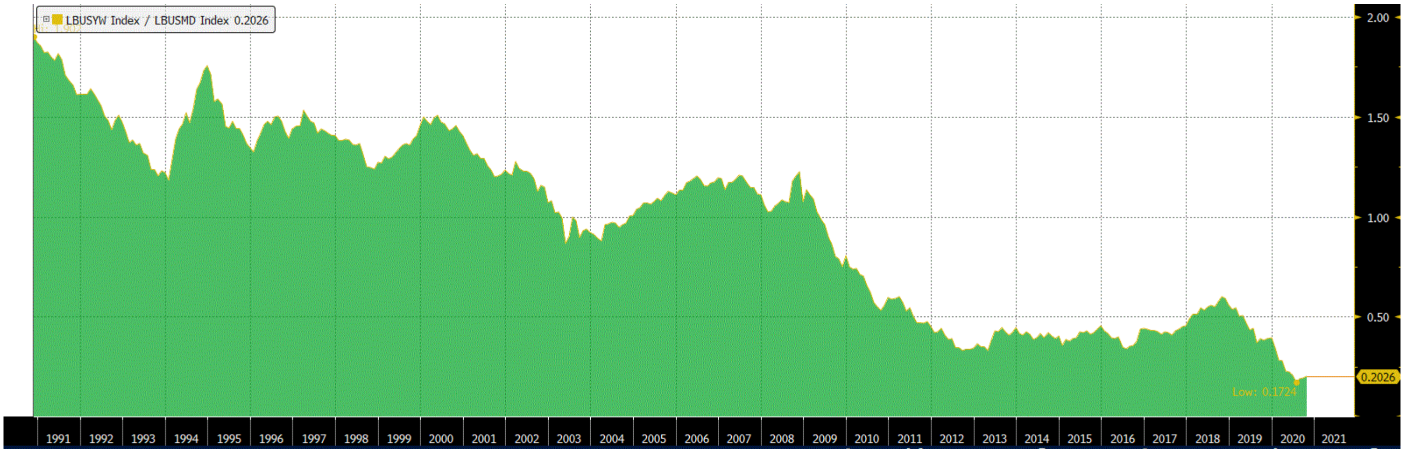
- **Minimal Principal Protection—**the Barclays Aggregate Bond Index closed last month with a yield of 1.2% and a duration of 6.1 years—a 5 basis point quarterly rise in rates will cause a negative return.
- **Negative Carry—**the S&P 500 has a dividend yield that is 0.5% higher than the yield on the Barclays Aggregate Bond Index—every dollar allocated to bonds from stocks is reducing an investor's expected annual income.
- **Positive Correlation—**investors have become hyper-sensitized to central bank activities—what is good for bonds is good for stocks, and what is bad for bonds is bad for stocks.

**Barclays Aggregate Bond Index Yield – S&P 500 Dividend Yield**




*Source: Bloomberg, as of 10/31/20*

**Annual Rise in Rates the Bond Market Can Withstand and Remain Positive**




*Source: Bloomberg, as of 10/31/20*

**Back to Basics: Why Invest in Fixed Income?**

The days of bonds zigging when stocks were zagging (i.e. negative correlation) ended 10 years ago when the Fed first expanded its balance sheet from under $1 trillion to $4 trillion due to quantitative easing (i.e. actively buying Treasuries and mortgage-backed securities in the secondary market). With its balance sheet now at $7 trillion (the Fed has added corporate and municipal bonds to its quantitative easing activities), and growing, we have only moved further away from negative correlations. In short, fixed income investing is not likely to provide a counterbalance to equity exposure in the current or forward market.

Historically, fixed income was used as a reliable source of steady income with a high probability of principal protection. Unfortunately, as the previous two charts illustrated: the investment grade bond market is offering less income than the stock market, and the principal protection for the overall bond market is almost non-existent. Traditional fixed income investing will be challenged to satisfy investors' income needs and principal protection needs, but, non-traditional alternative strategies may offer a solution. Following is an alternative fixed income suggestion which could meet the needs of yield-starved investors in the current and forward environment.

**Alternative Fixed Income Solution: Taxable Credit and Tax-Exempt Closed-End Funds (as of 10/31/20)**

Closed-end funds utilize leverage (which today has minimal cost given short-term rates pegged at 0%), and frequently trade at discounts to their true net asset value. Taxable credit CEFs typically take on more credit risk than the overall market, whereas tax-exempt CEFs usually take on more duration (interest rate) risk; but, both offer yields that are multiples (taxable CEFs yield 6x and tax-exempt CEFs yield 4x) of the Barclays Aggregate Bond Index.

| | **Taxable CEFs** | **Tax-Exempt CEFs** |
|---|---|---|
| Distribution Yield | 8.4% | 4.9% |
| Average Quality | BB-/B-rated | A/A-rated |
| Levered Duration | 3.6 years | 11.6 years |
| Weighted Average Discount | -11.7% | -6.0% |
| Historic Average Discount | -3.1% | -3.7% |

**Why the Alternative Fixed Income Solution Could Work in the Current and Forward Environment**

- **Strong Principal Protection—**this is precisely the monetary backdrop (Fed pinned at 0% short-term rates for the foreseeable future and supporting underlying bond markets through quantitative easing purchases, coupled with targeted fiscal stimulus) we saw from the end of 2008 thru 2012 that allowed all CEF discounts to narrow nearly 10%, while overall Treasury yields declined modestly and credit spreads continued to narrow to pre-crisis levels.
- **Huge Positive Carry—**taxable credit CEFs yield 6.6% more than equities and tax-exempt CEFs yield 3.1% more than equities.
- **Correlation—**with 6x and 4x the yield of the overall bond market, investors can allocate considerably less of what they otherwise would have invested in traditional bonds. What isn't allocated to fixed income CEFs can be invested in other low volatility, non-correlated assets such as: cash, CDs, precious metals, equity index put options, etc.