WHAT TO DO WHEN TRADITIONAL DIVERSIFICATION FALLS SHORT

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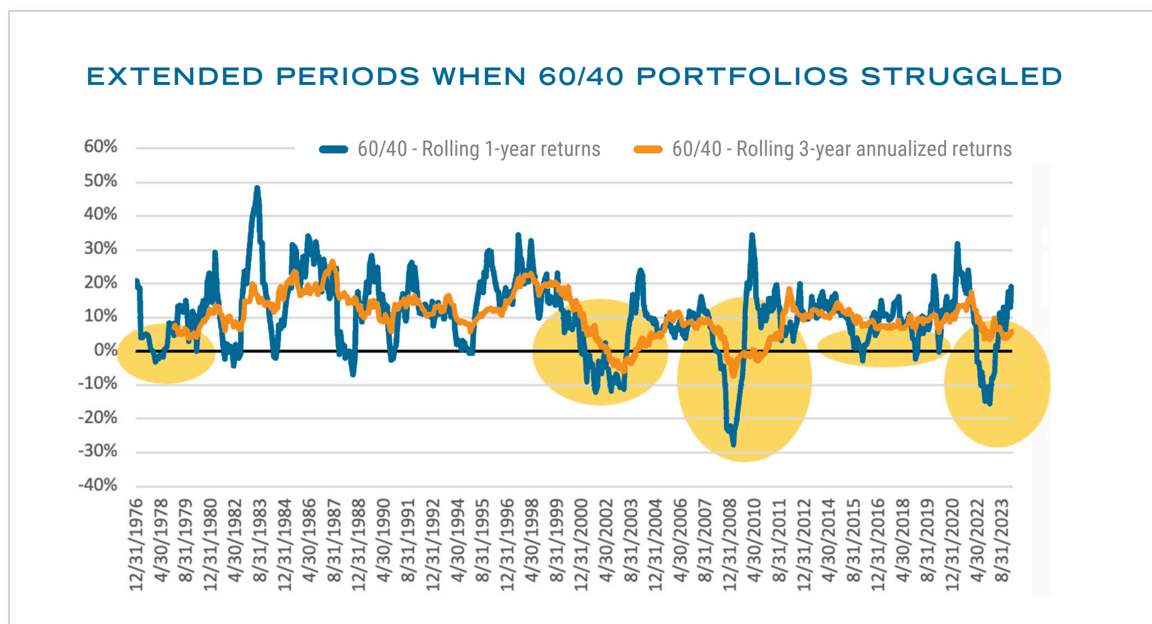
Stocks and bonds have long been the go-to portfolio combination in investing, but the pair also has a repeated history of falling short of investor expectations.

The stock-bond duo is so popular because they often diversify each other, showing different performance patterns. Yet, there are certain moments in the markets when stocks and bonds slip out of that complementary relationship. In fact, we would even say you can expect such failure points, once you see the underlying performance drivers between the two asset classes. We argue that portfolios are best served with a third source of diversification. A portfolio of equity-hedging strategies is our preferred way to diversify on that third dimension, while also allowing for growth.

KEY TAKEAWAYS

- **Stocks and bonds are an effective pairing to get portfolio diversification, but even this storied combo encounters periods of setbacks**
- **We see predictable patterns in those periods of stock+bond underperformance, suggesting that a third diversification tool would be valuable to investors**

EXTENDED PERIODS WHEN 60/40 PORTFOLIOS STRUGGLED



Source: Morningstar, Cary Street Partners' calculations. Performance reflects a mix of 60% S&P 500 Index total returns, 40% Bloomberg U.S. Aggregate Bond Index returns, rebalanced monthly. Rolling 3-year returns are annualized.

THE SIMPLE 60/40 GOALS

One of the most common formations for household portfolios is the so-called 60/40 – 60% stocks, 40% bonds. 60/40 has been embraced as a cost-effective and reliable route to a "moderate" portfolio, delivering a mix of growth and income while buffering the downside shocks that periodically plague stocks. The intended goal of 60/40 is that you'll get some growth from the stocks, and the bonds will guard against stock losses while also modestly compensating their holders.

THE 3 GOALS OF 60/40: WHAT THE STOCK/BOND MIX IS SUPPOSED TO DO

- ✔ **Growth from your stocks**
- ✔ **Protection from your bonds against the periodic drawdowns in stock markets**
- ✔ **Some steady coupon income from your bonds**

This combo is rooted in a broader idea that diversification is an optimal choice for investors. Indeed, a 60/40 combination is something of a shorthand way to implement the "efficient frontier," a concept established by academic research dating to the 1950s known as modern portfolio theory (MPT). MPT said that when investors hold a mix of different investments, they could optimize risk and return. In other words, when targeting a certain level of returns, diversified investors could minimize risk (defined as the variability of performance). Or conversely, for a target level of risk, they could maximize returns. It was a statistical framework that supported an intuitive idea — not all the eggs should go into one basket.

Stocks and bonds were the perfect candidates to implement this thinking. They were both plentiful and relatively accessible. Just as important, they had different profiles of performance. They did not often move in lockstep.

Bonds, as interest-bearing instruments, are supposed to be the "steady eddies," delivering coupon returns periodically. Many bonds offer low risk of default, making them an appealing option for wealth preservation.

Stocks, on the other hand, are much more volatile in their performance patterns. Some years they surge, other years they plummet. But over long-term periods, like three to five years or longer, stocks have historically proved to be a reliable vehicle for growth.

5 TIMES THAT 60/40 FELL SHORT

While 60/40 is a logical solution, the mix still has windows of poor performance. Market historians can point to a number of periods when 60/40 failed to deliver on its three promises.

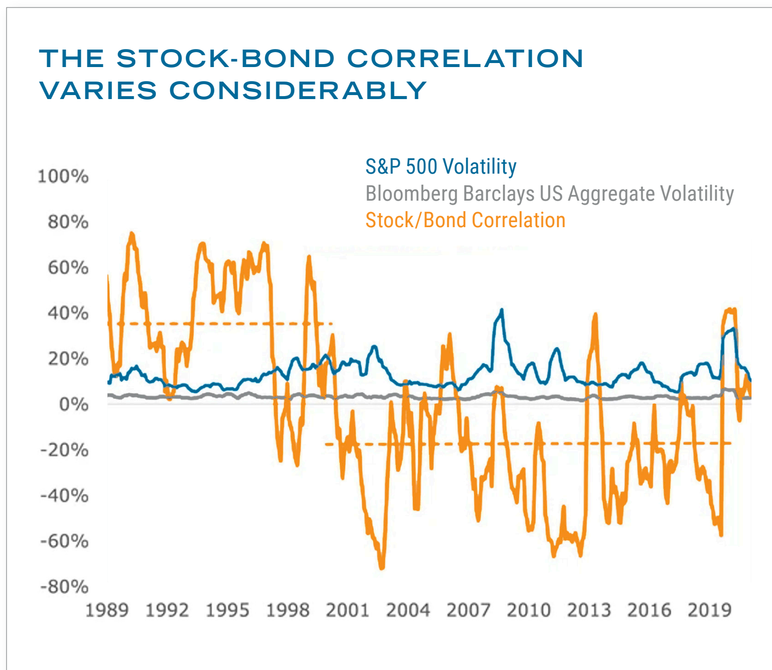
- **Late 1970s/early 1980s stagflation.** Inflation surged in the 1970s, driving interest rates up to record high levels as well. As policymakers worked to contain the supply-side inflation shock, stocks underperformed in the late 70s while bonds struggled in the early 80s. The extended period of bond underperformance weighed on 60/40 returns.

- **The protracted bear market of 2000-2003 after the dot-com bust.** From about 2000 to early 2003, stocks experienced an extended bear market after the implosion of dot-com values. In this environment, a 60/40 portfolio also struggled. Stock bear markets are commonly one year or less. When the losses go on for longer, it's especially harmful for investors who are drawing down on their accounts at the same time – retirees. If an investor can leave investments untouched to eventually recover, the damage is minimized. But any investor making withdrawals from a declining account is "locking in" losses and missing out on the opportunity of recovery.
- **The Great Financial Crisis (GFC) of 2008-2009.** Stocks took a huge hit in the GFC, though it proved short lived as they recovered relatively quickly. However, the crisis also hit some bonds, particularly corporate issues, in an episode of high correlation between stock and bond drawdowns.
- **Post-GFC in the late-2010s.** The decade after the GFC was not a great one for bonds, generally. Ultra-low interest rates, which dominated most developed economies, drove a period of low returns for investment-grade bonds. High-priced, low-yielding bonds also posed a lot more downside risk to investors, setting the stage for protracted losses in bonds after the pandemic.
- **Post-pandemic.** The inflationary trends that took hold during the pandemic, coupled with high-priced, low-yield bonds, contributed to an especially severe period of underperformance in bonds as the Federal Reserve Bank hiked interest rates in 2022 and 2023.

SEEING THE PATTERNS

The five examples above each reflect a different scenario, yet they are all marked by an extended period where a 60/40 portfolio did not deliver appealing performance.

So what is the shared pattern in these cases? One key point is that stock and bond returns can exhibit positive correlation for extended periods, which matters most to investors in declining stock markets. This reveals an important point about bonds: they are not guaranteed to hold



Source: Russell Investments

their value. Bonds can deliver losses. Their role as the protector and steady-eddy in a portfolio is actually somewhat shaky. Bonds can suffer losses whenever interest rates rise, but they can also suffer in the same environments that hurt stocks, like the GFC.

In the dot-com example, stocks endured such protracted losses that bonds could not offset the impact. This is another problem that 60/40 is not poised to address.

OUR SOLUTION TO THE PREDICTABLE DIVERSIFICATION PROBLEMS

If bonds are less protective than their portfolio assignment suggests, and stocks are not guaranteed to recover quickly, what other tools do investors have to add diversification to portfolios?

Diversification is about different sources of returns. There are lots of investment choices which have lower performance correlation to stocks and bonds, but not all can offer a different source of return.

After investigating the range of investments that have historically offered low correlation to stocks and bonds while also delivering appealing returns, we have identified our preferred strategy as a hedged equity portfolio. As we define it, this type of portfolio relies primarily on a mix of option-writing strategies along with a tactical investment vehicle. These elements can be combined to boost the likelihood that the strategy can perform well in any market environment.

THE BENEFITS OF HEDGED-EQUITY STRATEGIES

We see this approach as a unique tool for adding diversification to stock and bond holdings, yet capturing reliable sources of return as well. The underlying investments do have relationships to stock performance, but they also have uncorrelated return patterns that promote diversification.

Compared to other investment options, this strategy is also appealing for its liquidity and low cost of implementation. In contrast, other touted diversification tools are often subject to lockups and much higher fee structures.

We believe hedged-equity strategies represent a thoughtful approach to solve the specific problems posed by a 60/40 portfolio. Stocks and bonds continue to offer long-term appeal for investors, and the addition of a third, carefully chosen investment tool can potentially diversify investors in those predictable market situations where the stock and bond building blocks face dual headwinds. As investors have experienced so recently in the post-pandemic era, an extended period of bond underperformance can put the 60/40 portfolio at a disadvantage.

TO LEARN MORE ABOUT OUR APPROACH TO HEDGED-EQUITY STRATEGIES, CONTACT US OR VISIT OUR WEBSITE.

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