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# Achieving balance is not as easy as 60/40

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A simple and traditional balanced portfolio, which allocates 60% to equities and 40% to bonds (a 60/40 allocation) irrespective of the cycle, has produced more than satisfactory returns for global investors over the last two decades. Importantly, however, these returns have been fuelled by declining interest rates and increased liquidity injected by central banks. There was a negative correlation between bonds and equities over this period, so that bond prices increased when equity prices fell. Pessimistic sentiment usually coincided with expectations of falling interest rates and a flight to the safety of government bonds. This has meant that balanced portfolios often outperformed equity portfolios over this period. The persistent performance and wealth creation over the past decades have caused investors to forget that capital markets are cyclical.

However, in the last few months the wisdom of the traditional 60/40 allocation for investing over the next decade has been questioned, particularly in the developed market environment. Applying the straightforward 60/40 allocation relies on the historically divergent returns of equities and bonds. The forward-looking correlation is likely to become less predictable given the copious amounts of fiscal stimulus to counter the effects of COVID-19. In addition to the breakdown of the historical correlation, the low starting bond yield combined with the high duration (interest rate risk) pose a further risk to the diversification benefit. Future developed market bond and equity valuations will be heavily reliant on the changes in interest rates. Should the average yield rise ever so slightly, bonds and equities are likely to fall in unison.



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Does the same apply for investors in emerging economies such as South Africa (SA)? Will the convenience and simplicity of the 60/40 rule continue to reap benefits?

The table below shows that SA government bonds have had positive returns during slowdowns, whereas United States treasuries (government bonds) offered exceptional real returns during recessions in rand terms. In addition, the ability to adjust the asset allocation in each stage would have added significantly to returns. Although the static 60/40 asset allocation removes the risk of poor timing decisions, the benefits derived from the flexibility to reallocate between the broader range of asset classes cannot be overlooked. Asset class mix and portfolio weights are determined based on not only their unique features, but also on the value added to the portfolio in the current stage of the business cycle.

**Real annualised total returns in ZAR terms over the last 20 years**

| | Expansion | Slowdown | Recession | Recovery |
|---|---|---|---|---|
| MSCI World | 6.1% | 4.1% | 0.5% | 8.1% |
| Bloomberg Global Bond index | 0.8% | 5.4% | 13.7% | 10.7% |
| S&P 500 | 4.9% | 4.6% | 5.2% | 10.6% |
| US 10 yr | -2.6% | 2.9% | 18.0% | 8.0% |
| US Cash | 1.5% | 0.1% | 12.4% | 2.6% |
| | | | | |
| All Share | 13.1% | 10.4% | -11.2% | 11.0% |
| SA Inc | 11.0% | 10.3% | -14.7% | 10.0% |
| SA Bonds | 3.0% | 6.2% | 3.6% | 2.6% |
| SA Cash | 2.2% | 2.5% | 1.1% | 1.0% |
| | | | | |
| Gold | 7.7% | 4.8% | 20.1% | 10.1% |
| CRB Metals index | 26.6% | 3.1% | -12.6% | -1.2% |

*Point in the cycle determined by the SARB Composite Leading Cycle Indicator. Green shading highlights the top 2 performing asset classes, red shading highlights the worst relative performance. Source: RMB Morgan Stanley, MSCI Bloomberg, JSE, CRB, Thomson Reuters, Datastream*

Considering only the local market, SA continues to benefit from positive real bond yields. The starting yield, particularly for government bonds, screens as attractive and cushions against the political, credit and inflationary risks. However, regardless of how attractive the yield screens in comparison to the risk, much will depend on the views of bond investors. It won't matter if they adopt modern monetary theory that the high debt burden is not a concern, or whether they punish the government for the lack of structural reform and excessive debt.

As South Africans can invest globally, it is clear that if investors are to generate decent returns at moderate risk levels going forward, they will need to be adaptable and adjust their portfolio to the market's peaks and valleys. While historical performance can be analysed, one should be careful not to slavishly follow allocations where the logic is based on a time past. A well-diversified portfolio should feature liquid alternatives. Combined with bonds and equities, these are able to complete the job of providing income, growth and protection against inflation and equity market fluctuations. Alternatives such as commodities and equity long/short hedge funds offer uncorrelated returns which can help to mitigate against large drawdowns in equity markets.

Equity long/short hedge funds have historically outperformed traditional long only equity funds with lower risk as measured by standard deviation of returns. Not only do the Sharpe ratios indicate a vastly better result, a positive skew can be observed when assessing the historical returns of the top quartile funds. Extreme returns generally

happen on the upside as opposed to the downside – an advantageous characteristic when considering catastrophic risk. These funds are able to produce positive returns in both rising and falling equity markets (due to their combination of long and short positions and protective structures) and therefore have the ability to produce asymmetrical returns, which is especially valuable in times of heightened uncertainty.

## Glacier Research would like to thank Tumi Loate for her contribution to this week's Funds on Friday.

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Tumi joined 36ONE in November 2017. Prior to this she worked as an audit and financial engineering group manager at KPMG within the financial services division. She obtained her BAccSci degree and MBA cum laude and was awarded the Thuthuka and Chevening scholarships.