In Search of the 60/40 Stock/Bond Asset Allocation Origin—and Why It Matters

Presenter: Steve Foerster

Investment Innovation Conference – San Diego CA, November 16, 2023

IVEY Business School
WESTERN UNIVERSITY · CANADA

The ham butt story

- Moral: The "origin story" matters

Quest for the 60/40 origin story

Jan Van Eck
CEO, VanEck

Daniel Peris
Sr. PM, Federate-Hermes

- Jan: “Where and when did 60/40 originate?”
- Daniel: “I’m betting it’s post 1982 due to falling rates, but… maybe 1950s/1960s?”

A 60/40 mystery story—with a twist

- Who-dun-it?

- When-dun-it?

60/40 intuition

- When growth assets (e.g., stocks) decline in price when the economy weakens, fixed income assets (e.g., bonds) tend to appreciate
- Stocks tend to decline due to lower corporate profits → ↓ profits = ↓ stock prices
- Bonds tend to appreciate because central banks typically typically cut interest rates to prop up the economy → ↓ bond yields = ↑ bond prices
- Bonds can act like a portfolio shock absorber in the portfolio, protecting returns and reducing volatility

Recent media critiques of 60/40

Wall Street Journal, October 21, 2023

It's Time to Alter 'Set It, Forget It' Portfolio Strategies

By Spencer Jakab

ANALYSIS

Investors, you're not in Kansas anymore.

For four decades, patient savers able to grit their teeth through bubbles, crashes and geopolitical upheaval won the money game. But the formula of building a nest egg by rebalancing a standard mix of stocks and bonds isn't going to work nearly as well as it has.

Now, longer-term Treasury yields have hit their highest levels in 16 years, causing their value to plummet, and stocks are expensive. So investors need to lower their expectations and play defense.

The summer of 2020 was the point when the classic "set it and forget it" stock-and-bond portfolio was as good as it got. Investors who didn't panic earlier that year when Covid-19 crushed stocks cheered the quickest return to a bull market in history. Likewise, long-term Treasury yields plunged to a record, bolstering bond funds. A classic 60/40 stock-bond split owning that proportion of the S&P 500 index and 10-year Treasury notes earned a respectable 15.3% in 2020.

But there are few free lunches in finance. Squeezing those impressive returns out of a worldwide economic calamity added to the U.S. government's already considerable bill after the global financial crisis. Federal debt held by the public mushroomed from less than $5 trillion in mid-2007 to more than $21 trillion in 2020. Meanwhile, overnight interest rates were pushed down to a once-unthinkable zero percent, where they would stay until early 2022.

That combination attracted millions of new stock investors: Young people, stuck at home during the pandemic with extra savings, opened brokerage accounts and initially ran circles around their elders. The "buy the dip" mantra that had served investors so well took on an obscene modifier with the acronym "BTFD."

Suddenly the best investments were in companies that were earning little to no money but had a great story about how they would one day. By January 2021 an index of unprofitable companies maintained by Goldman Sachs had rallied nearly 300% in nine months. Junky investments had posted gaudy returns before, and it was usually a sign that money had become too cheap. It had never been free, though.

By last year, the massive budget deficits and zero-percent interest rates had stoked the highest inflation in 40 years. This forced the Federal Reserve to play catch-up through a series of rate increases.

The last time inflation became so high it stubbornly stayed there for years. The Fed finally broke its back by pushing overnight interest rates above 19% in 1981. Interest

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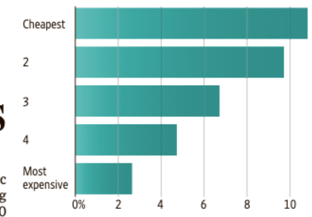
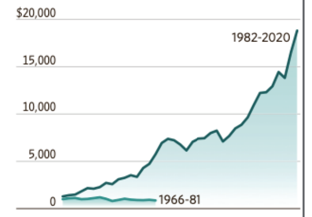
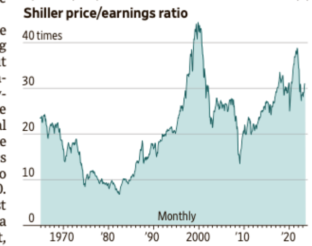




Cyclically adjusted stock valuation vs. Treasury yields



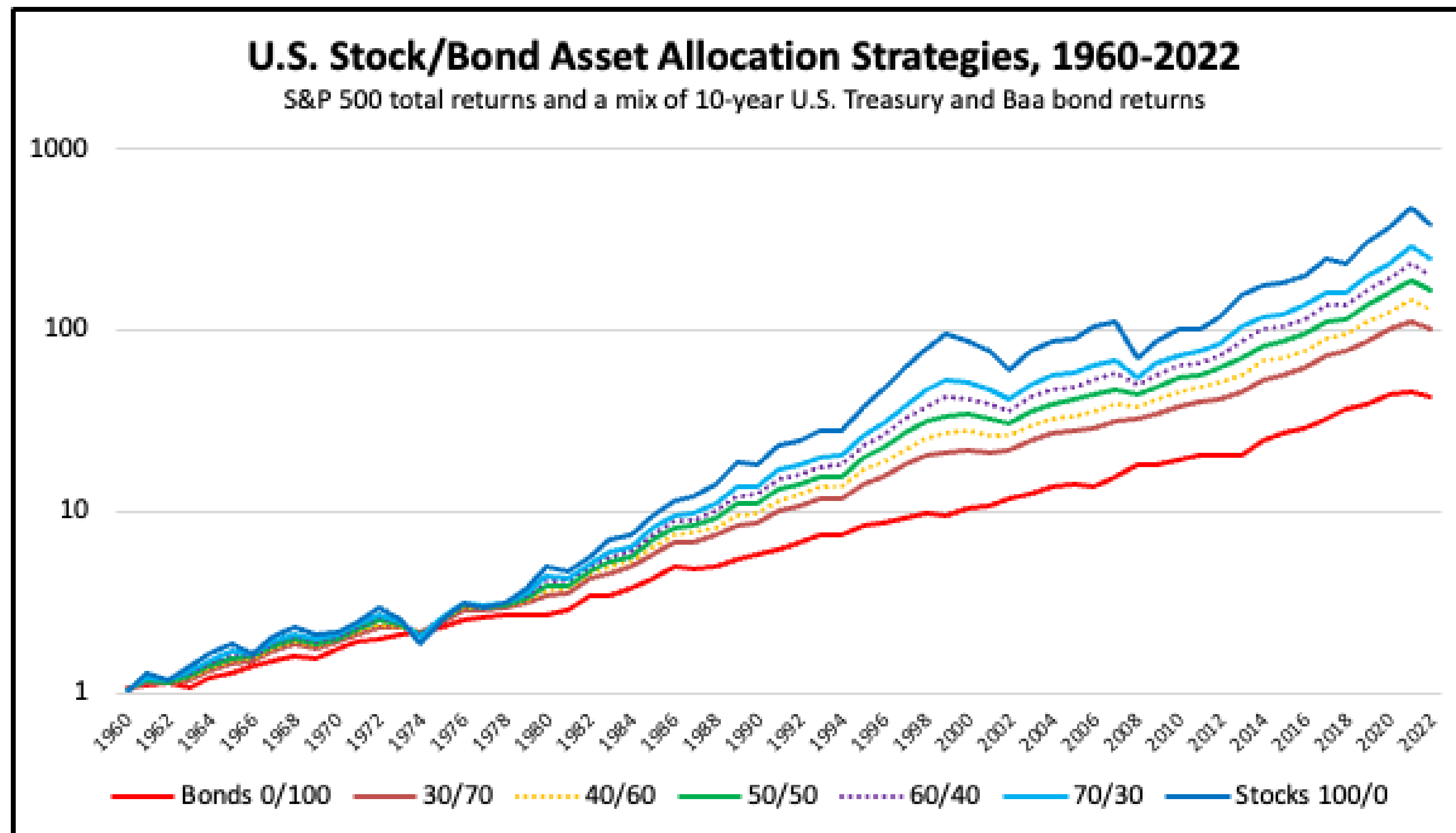
*S&P 500 and 10-year Treasury note

Sources: Professor Robert Shiller; Aswath Damodaran; WSJ calculations (real annual return, $1,000 invested); FactSet (Treasury yield)

Wall Street Journal, October 26, 2023

- Are we biased by these recent negative stories? → Let's review 60/40 results

Asset allocation strategies wealth creation

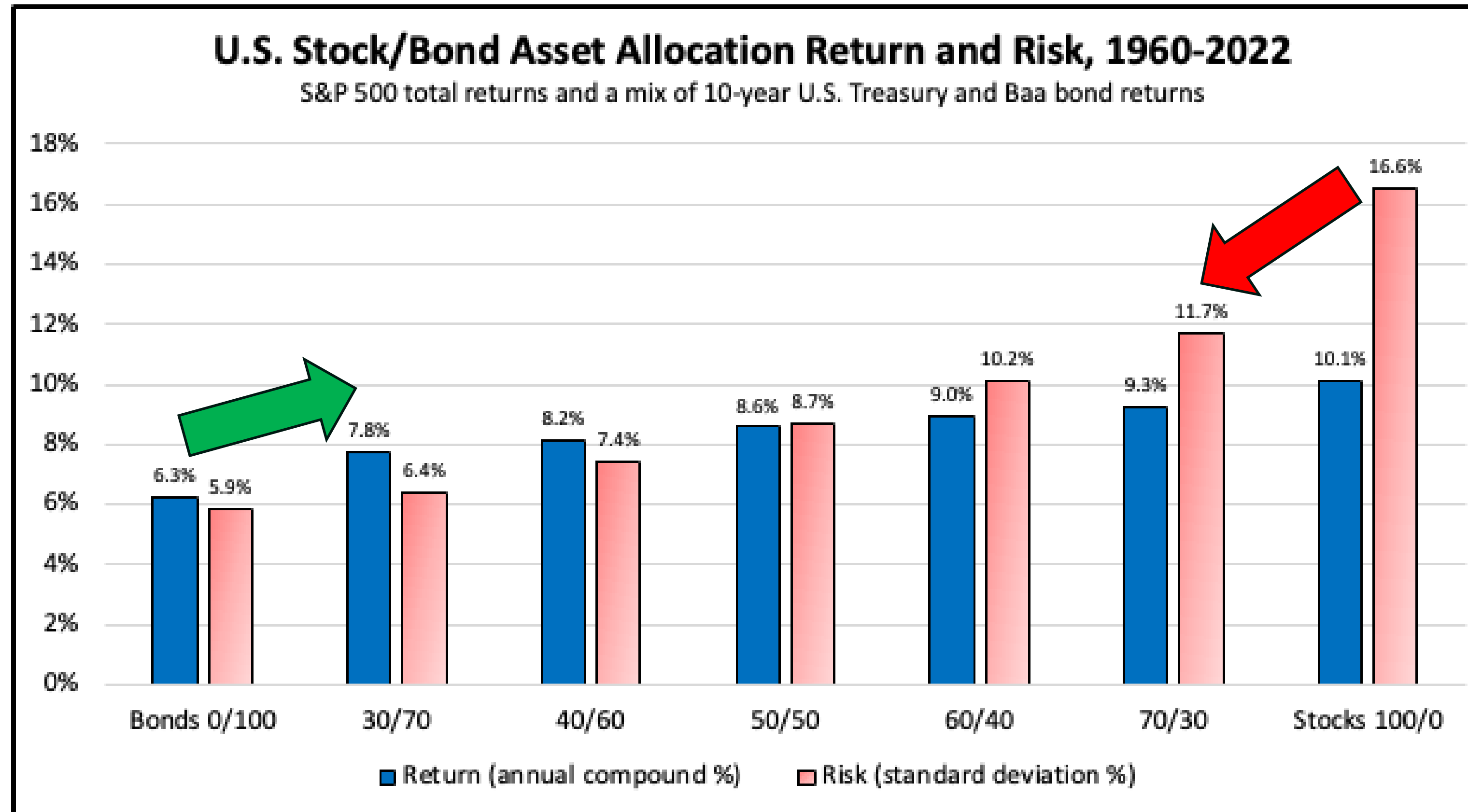


$388
$247
$204
$165
$131
$103
$44

No surprise: stocks do better than bonds; bond path is smoother

Data source: Aswath Damadoran website https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html

Asset allocation strategies return and risk

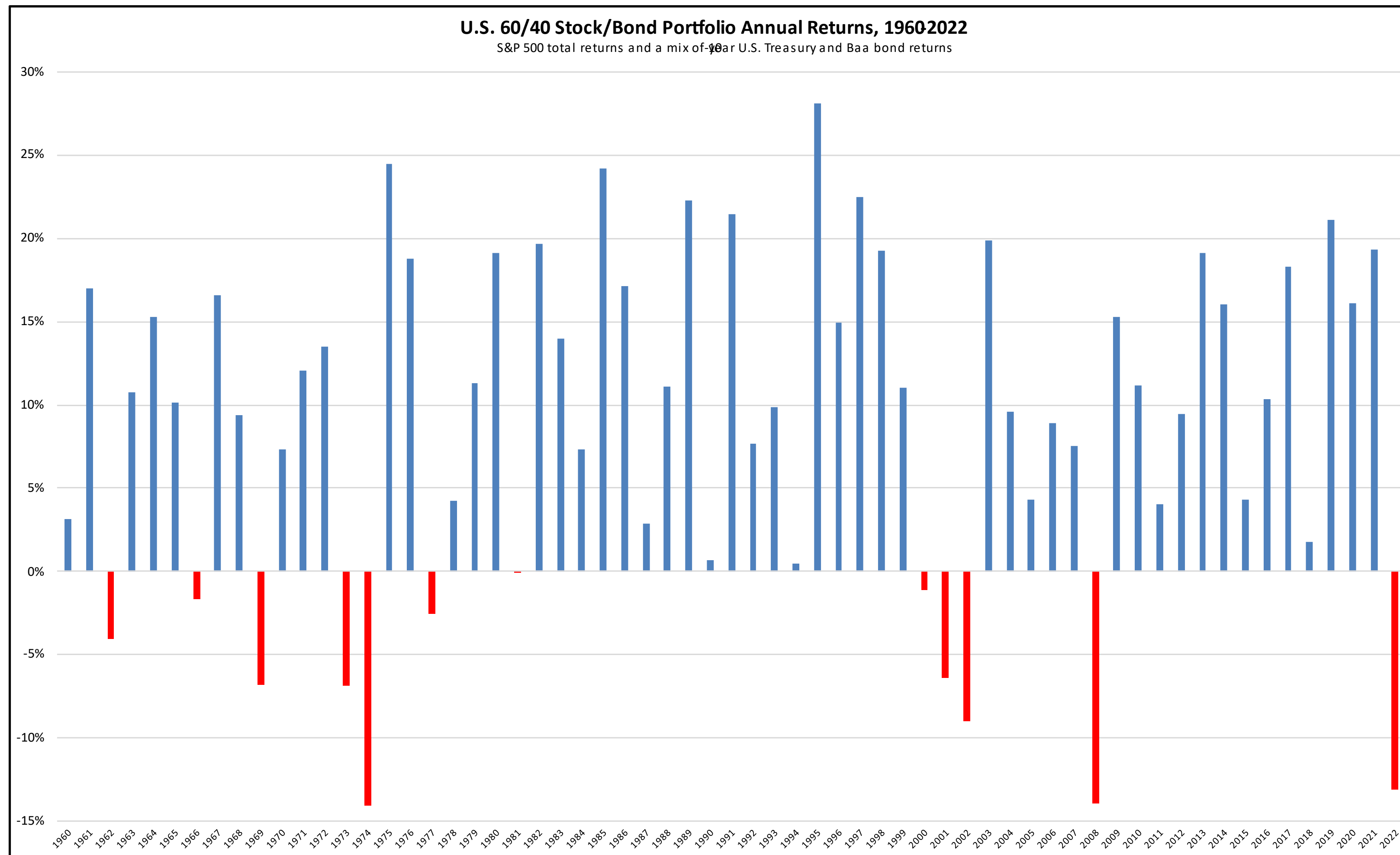


Adding some stocks really increases returns

Adding some bonds really reduces risk

Data source: Aswath Damadoran website https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html

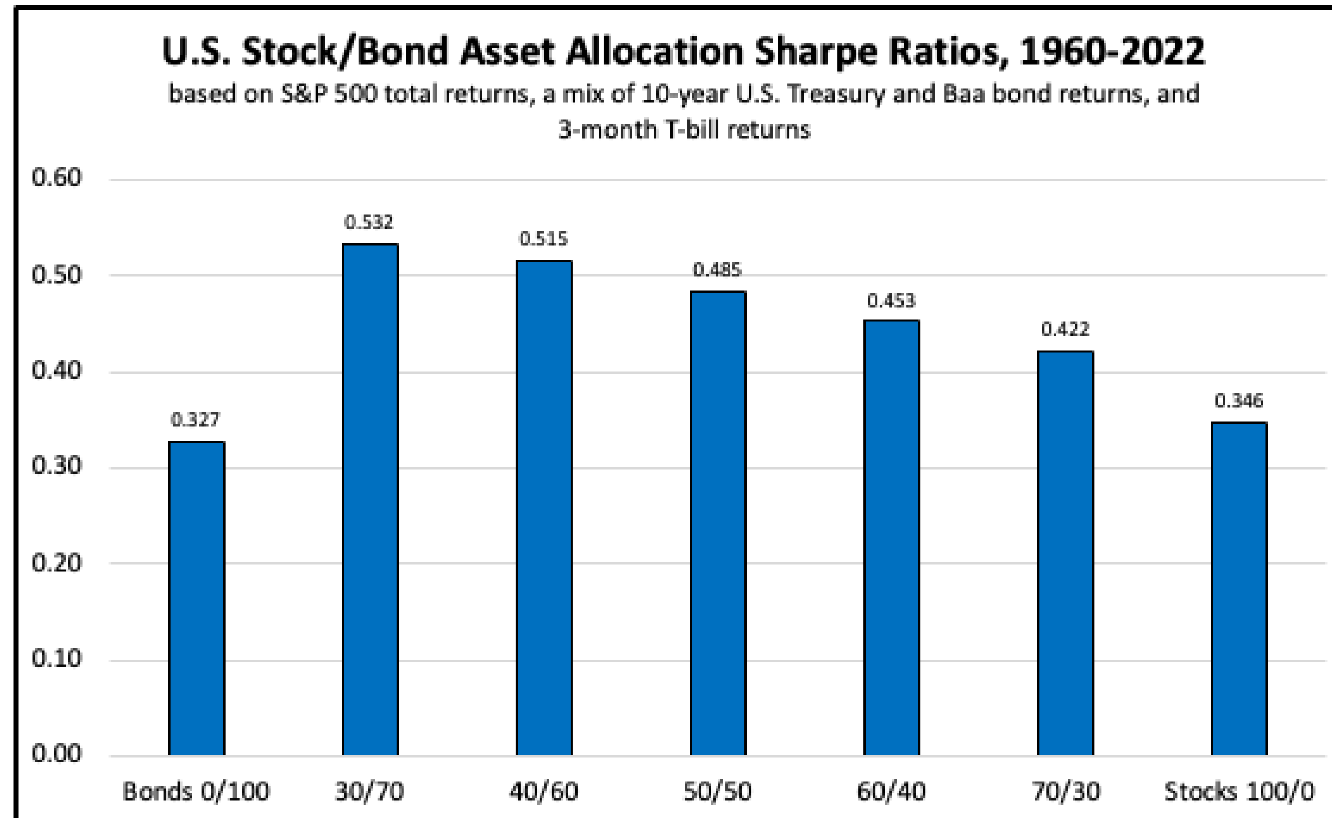
60/40 strategy annual returns



60/40: positive returns 81% of the time

Data source: Aswath Damadoran website https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html

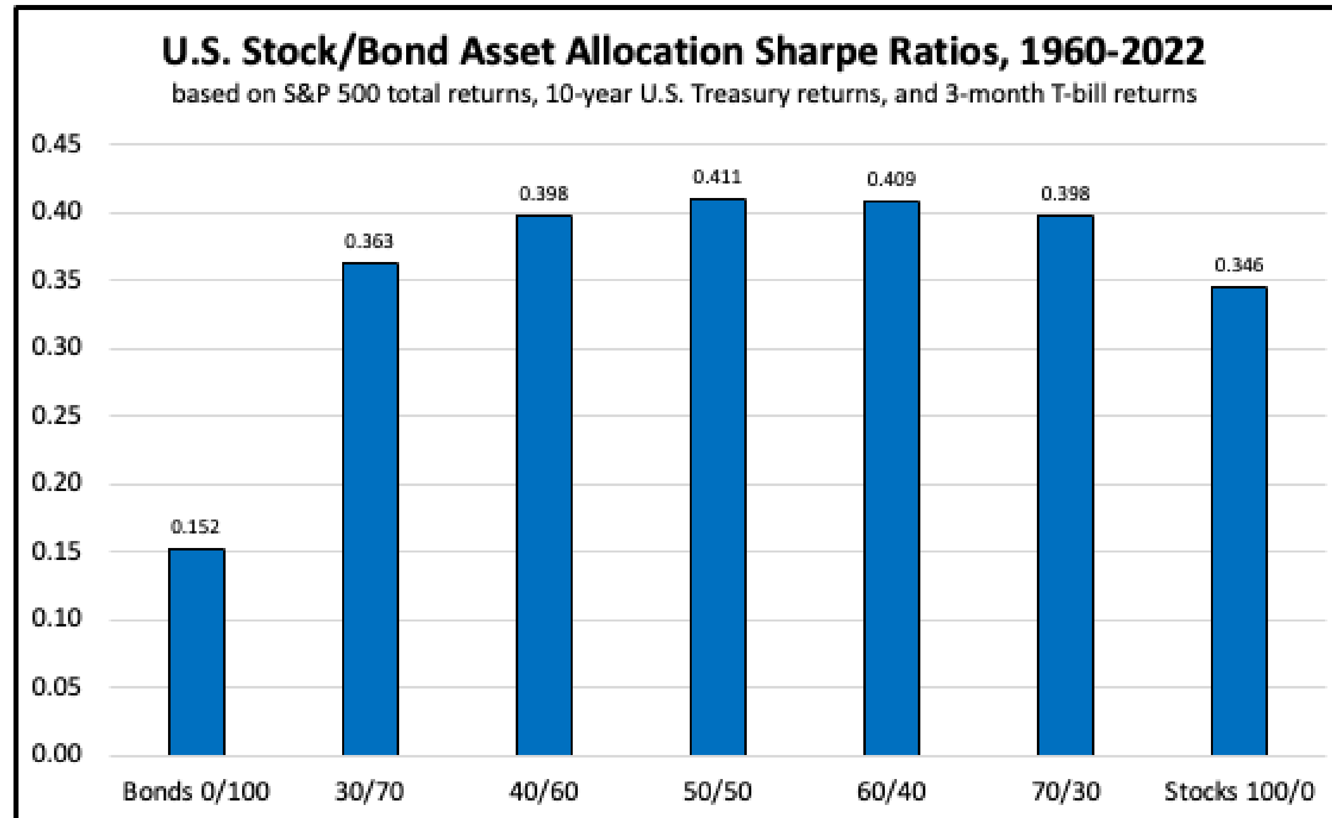
Sharpe ratios: S&P 500, 10-year Treasurys & Baa bonds



With corporate bonds and Treasurys, 30/70 dominated

Data source: Aswath Damadoran website https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html

Sharpe ratios: S&P 500, 10-year Treasurys only

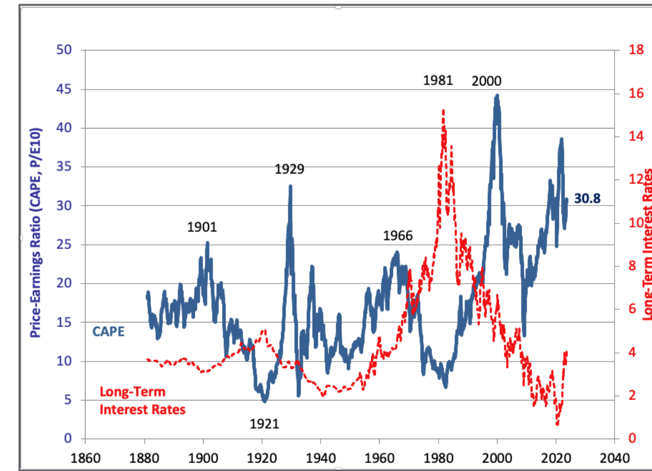


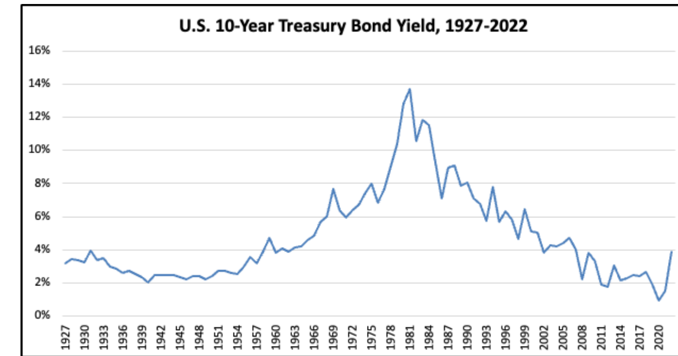
With Treasurys only, 60/40 was close to optimal

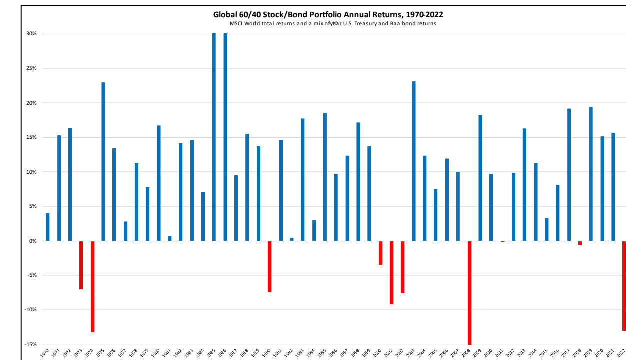
Data source: Aswath Damadoran website https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html

Some considerations

- Current level of market P/E [Shiller CAPE]
- Current level of bond yields
- Global versus U.S. stocks
- Composition of bond alternatives [more later]
- But don't confuse "strategic" vs "tactical"

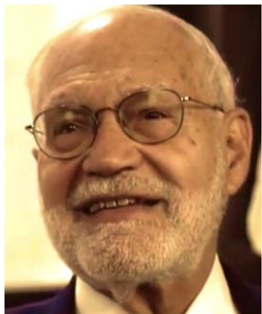






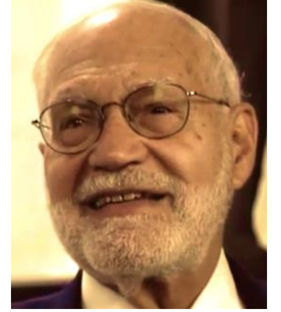
Now back to quest for the 60/40 origin story

- October 2022 to November 2023

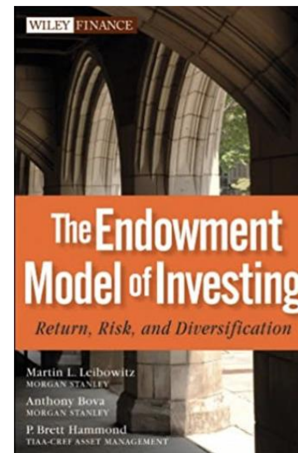


Marty Leibowitz

Bond researcher and investment professional



- He noted that his work on the “convergence of risks” argued that 60/40 “provided the best balance across three different types of risk considerations. Also, the various papers that led to my book *The Endowment Model* made a point that, in terms of beta sensitivity to equities, even the most seemingly diversified portfolios tended to have a risk posture equivalent to that of the 60/40 model.”



Keith Ambachtsheer

Director Emeritus of the International Centre for Pension Management and co-founder of CEM Benchmarking

- "My guess is because it got you through a 1930s-type depression."

by Keith P. Ambachtsheer

Pension Fund Asset Allocation: In Defense of a 60/40 Equity/Debt Asset Mix

A pension plan sponsor may take either a "legal termination" or an "economic going-concern" view of its pension liabilities. Both views are valid, but the two have significantly different implications for the sponsor's balance sheet risk and for the appropriate asset-mix policy for a defined-benefit pension plan.

In the legal termination context, the goal of the pension fund is to ensure that enough money is available to pay the accrued pension debt, in nominal terms. By matching asset and liability durations—that is, by holding a long-duration, all-bond portfolio—the sponsor can minimize the risk that plan assets will fall short of the termination liability. But actual plan sponsor behavior suggests that most sponsors take a going-concern view of pension liabilities. In this context, the relevant risk is that actual returns will not match anticipated returns, with excesses or shortfalls having significant impact on the sponsor's contribution-rate risk.

When it is economic going-concern liabilities that are being invested against, an all-bond portfolio makes little sense; although it may preserve portfolio wealth in some economic scenarios (such as the 1929–32 deflation), such a policy will seriously erode the real value of pension assets in other periods (e.g., the 1978–81 inflation). The appropriate asset-mix policy for minimizing risk over the long term calls for a 40 to 70 per cent investment in equities and other risky assets.

"…the old 60/40 equity-debt rule of thumb…"
FAJ 1987

upper bound: early-1980s

Tim Shufelt

Globe & Mail financial reporter

- “That comment wasn’t based on any single source, but more of an extrapolation based on a survey of the available research. It seems like the split first emerged in common practice in the early 1960s based on the work of Markowitz and Sharpe.”

B8 | REPORT ON BUSINESS | THE GLOBE AND MAIL | MONDAY, SEPTEMBER 11, 2023

GLOBE INVESTOR

The 60/40 portfolio rises again

While many declared it dead, by most measures the former hero is up by double digits this year

TIM SHUFELT
INVESTMENT REPORTER

INSIDE THE MARKET

This time last year, the financial commentariat was happily murdering one of its former heroes.

The 60/40 portfolio was widely declared dead after failing its faithful in spectacular fashion, ending its six-decade run as a mainstay of retirement planning for rank-and-file investors.

And yet, the same investing prototype is up by double digits this year, by most measures. This revival is proving, once again, the incredible durability of the 60/40 portfolio, though it may need to be tweaked for a such a peculiar economic era.

Since its conception in the early 1960s, the model of building a portfolio with roughly 60 per cent in stocks and 40 per cent in bonds has served investors very well. Estimates based on U.S. data peg the average annual return of the typical 60/40 model at around 8 per cent or 9 per cent, with less volatility than in either the stock or the bond market.

The basic idea is that the stock component provides the bulk of your returns, while the bond portion acts as a stabilizer when some sort of shock throws financial markets into a panic.

Every once in a while, the whole concept breaks down. It’s in these moments that investors start to look askance at the old-school 60/40.

Take last year, when runaway inflation shifted the axis of the financial world. The stock market bubble popped, taking U.S. stock benchmarks down by 20 per cent to 30 per cent. But the big problem for investors aligned to the 60/40 style was what happened in the bond market. In short, it was the worst year ever. That’s not hyperbole. The longest-dated U.S. Treasuries declined by nearly 40 per cent in 2022, which is unprecedented in 250 years of bond market history, according to data compiled by Edward McQuarrie of Santa Clara University.

Rapid-fire rate hikes brought on a bond bear market for the ages. The iShares 20+ Year Treasury Bond ETF is now down by 43 per cent, wiping out a decade of investment returns. That is a seismic move by bond market standards.

> The relationship between stocks and bonds has undergone some important changes. Persistent inflation may mean that higher rates are here for longer than expected, which could limit the upside for bonds, even if the stock market falls on hard times.

With stocks and bonds in unified free fall, there was little to protect investors with supposedly balanced, conservative portfolios. The Bloomberg US 60:40 Index declined by about 17 per cent last year. That’s not supposed to happen.

Attitudes toward the 60/40 soured pretty quickly. “Is the 60/40 portfolio dead? I would say probably,” Mark Wiedman, BlackRock’s head of international and corporate strategy, told The Globe and Mail last September.

Investors yanked money from balanced funds at a record pace. In Canada, the category had $30-billion in net redemptions last year, according to the Investment Funds Institute of Canada.

“It certainly looked like the 60/40 didn’t work last year,” said Sadiq Adatia, chief investment officer at BMO Global Asset Management. “But that’s because nothing worked last year. It was a one-in-50-year event.”

Last year left the reputation of the 60/40 portfolio in tatters. But there are three important takeaways. First, no single year’s return should matter to longer-term investors. The performance of diversified portfolios tends to smooth out the longer the time frame. Already the Bloomberg US 60:40 Index is up by 11 per cent this year, erasing the bulk of last year’s losses.

Second, the risk of a major bond market drawdown is not the same as it was in early 2022. Central banks can’t push rates from 0 per cent to 5 per cent again.

Lastly, bond yields can do much more heavy lifting today than they have for several years. About 80 per cent of all fixed income is now yielding more than 4 per cent, BlackRock president Robert Kapito said in the company’s last earnings call.

“We’re calling this a once-in-a-generation opportunity,” Mr. Kapito said. “You can actually earn attractive yields without taking much duration or credit risk.”

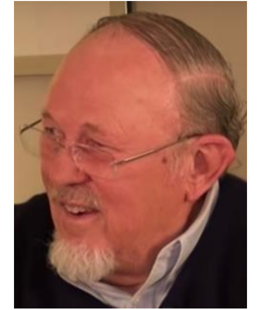
While there is life in the 60/40, the relationship between stocks and bonds has undergone some important changes. Persistent inflation may mean that higher rates are here for longer than expected, which could limit the upside for bonds, even if the stock market falls on hard times.

As a result, David Stonehouse, head of North American and specialty investments at AGF Investments, suggests some modifications to the 60/40. Keep the core stock-bond split, but take 10 per cent from each to allocate to real assets, such as commodities and real estate, as well as alternatives, such as private debt and derivatives, he said in a note.

“While 60/40 clearly does not deserve to be banished to the dustbin of asset allocation history, we believe it might benefit from some tweaking,” he wrote.

“Since its conception in the early 1960s…”
G&M Sept 11/2023

Bill Sharpe



- "My recollection is that in the 1960s and 1970s we thought that the relative total values of the stock and bond markets could be roughly 60/40 and probably used that ratio for examples."

- "But my recollection could be as faulty as those of the AI programs."

by W. F. Sharpe

Bonds versus Stocks
Some lessons from capital market theory

The apparent end of the bear market in bonds and relatively high interest rates have led some investors to conclude that bonds are now the superior investment medium. On the other hand, stocks continue to command a large following. Theoretically, neither should completely dominate the other: some combinations of bonds and stocks should prove superior to either taken alone. We shall first summarize the theoretical argument, and then examine some relevant data.

In the last decade increasing use has been made in both academic and investment institutions of the "capital asset pricing model" of Sharpe [6], Lintner [2] and Mossin [4], developed from the portfolio selection model of Markowitz [3]. The theory is described in detail in Sharpe [8] and more concisely in Vasicek and McQuown [9]. Only the major implications will be summarized here.

The approach is based on a *portfolio view*. The investor is assumed to be concerned only with the prospects for his overall portfolio. Securities are evaluated in this context.

A key aspect of the theory is the treatment of *risk*. Only the risk of the overall portfolio is considered important. As a corollary, the appropriate measure of an individual security's risk is its contribution to portfolio risk.

When evaluating alternative portfolios, investors are assumed to prefer those with the greatest expected return for given risk. The appropriate amount of risk and return will, of course, depend on an investor's personal circumstances. But a high-risk portfolio will not be considered unless it offers a high expected return as well. The formal theory measures risk by the standard deviation of portfolio return,[1] but under plausible assumptions, this can be shown to be closely related to more familiar measures of risk.

These considerations lead to a view of the future such as that shown in Figure I. Each point in the shaded region represents a portfolio of risky securities. Were only these alternatives available, the investor would select one of those along the upper left-hand border, depending on his tastes, circumstances, etc. However, other possibilities exist. Point P represents the (riskless) interest rate. By splitting his funds between the combination of risky securities plotted at point M and a security giving this interest rate, prospects along line PM can be attained. By borrowing funds to purchase combination M on margin at this rate, prospects along the segment MN can be attained. The preferred strategy is to select combination M of risky securities, with riskless investment or personal leverage used as required to obtain the most desirable risk-return combination along line PMN.

Figure I plots *prospects*. Different investors will view prospects differently and thus arrive at different conclusions regarding the composition of portfolio M. Some will choose to hold a disproportionately large amount of a given security, while

William F. Sharpe is Professor of Business, Stanford University, and Advisor, Computer Applications Department, Merrill Lynch, Pierce, Fenner and Smith, Inc. *Comments and suggestions of Paul Cootner, Alan Kraus, Robert Litzenberger and James Van Horne of Stanford University and Guy Cooper, Gilbert Hammer and Lawrence Tint of Merrill Lynch are gratefully acknowledged.*

1. Footnotes and references appear at end of article.

"Why not bonds *and* stocks in proportion to their market values?"
FAJ 1973

Marty Fridson

Author, financial historian

- “I’m afraid I just heard of it as an industry convention at some point that I can’t pin down. At some point the Harvard Endowment began comparing its performance to the 60/40 alternative, but I believe that was much more recent.”
- “ERISA [The Employee Retirement Income Security Act of 1974] merely said managers had to be prudent, but I wonder if there was ever some sort of safe harbor in regulations or legal precedents, where managers figured they were insulated against lawsuits if they went with a 60/40 allocation?”

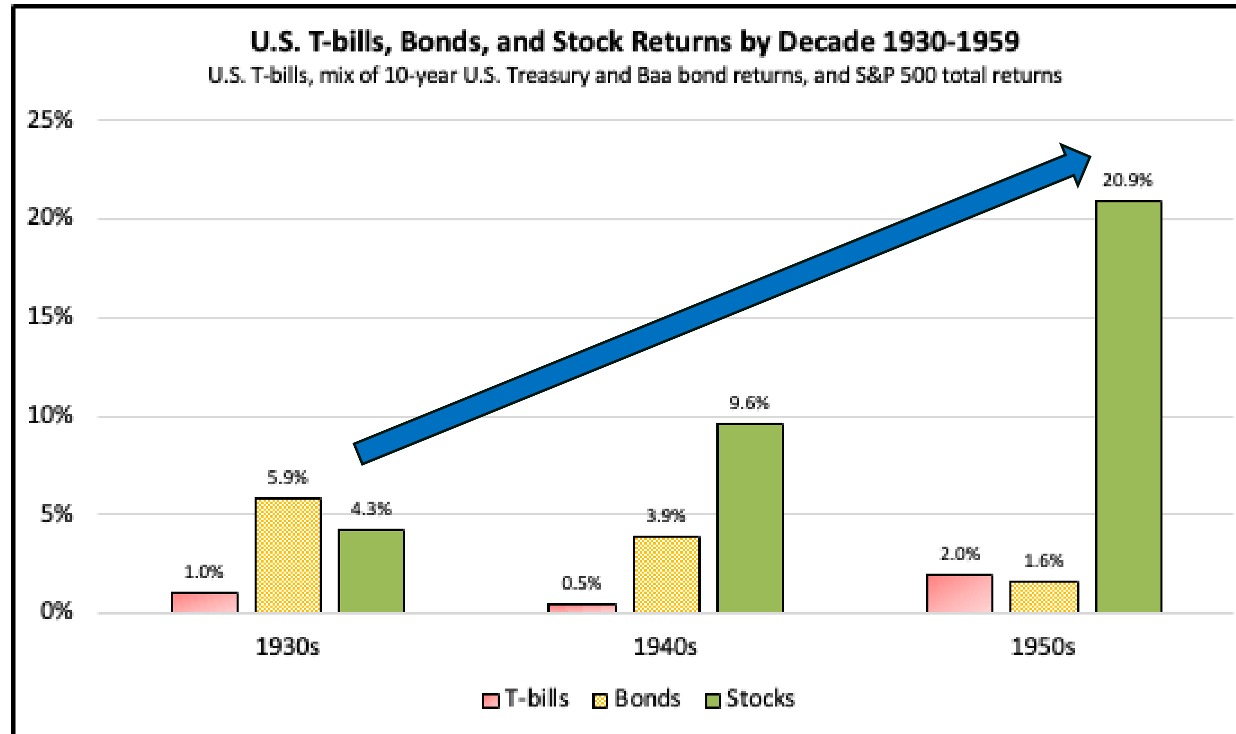
Edward McQuarrie

Professor Emeritus, Leavey School of Business at Santa Clara University

lower bound: mid-1950s

- 1952 JF article by George Moffitt, “Management Achievement of Open-End Investment Companies”: balanced funds were still 50-50
- CREF (stocks) was added to TIAA (bonds) in 1952 to create TIAA-CREF; in 1967 the 50% max in CREF was increased to 75%
- *Wiesenberger Investment Companies Yearbook* series (started in 1944) show balanced funds like Wellington didn’t deviate from 50-50 until the early 1960s when they shifted to 60-40
- Conjectured that the strong stock performance in the 1950s caused more of a tilt toward stocks

Asset returns in the 1930s, 1940s, and 1950s

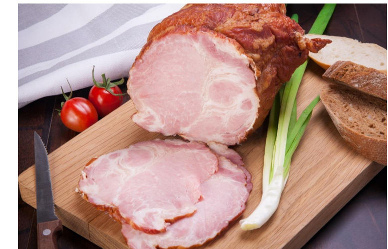


- Indeed, stocks performed quite well in the 1950s

Conclusion (so far)

- **Who**-dun-it? → Balanced portfolio managers, perhaps motivated by Sharpe et al.

- **When**-dun-it? → Early 1960s
- **Why** this matters?
  - Recognize that any empirical studies pre-1960s are really out-of-sample
  - The strategy did (and still does) make sense
- **However,** you might want to re-think the “ham-butt” strategy



Thank you!

Questions?