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Why the Smart Money is Moving Away from the Traditional 60/40 Split

This article highlights the evolution of asset allocation strategies and the growing role of private credit in achieving the diversification and risk management benefits originally proposed by Modern Portfolio Theory

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BY PAUL MIRON

The investment landscape has significantly transformed since the renowned American economist, Harry Markowitz, introduced Modern Portfolio Theory (MPT) in the 1950s. Central to MPT is the idea that diversifying across asset classes, particularly equities and bonds, can optimise returns for a given level of risk.

The MPT that Markowitz formulated, in essence, gave rise to the notion that a well-diversified portfolio should consist of 60% equities and 40% bonds, commonly referred to as the ‘60/40 split’. This has been the mainstream view adopted by fund managers and investors for decades, which has determined the flow of trillions of dollars of investment capital globally.

Simply put, a portfolio with 60% equities and 40% bonds is thought to provide investors with the ideal risk and reward characteristics. It delicately balances the higher returns of equities over the longer term with the predictable and stable income of bonds, enabling superior returns and smoothing out volatility within the portfolio.

The theory's foundation is that equities and bonds have either no correlation or a very slight negative correlation, which has been the case until recently.

Correlation measures the extent to which two variables move in relation to each other. Simply put, it tells us whether and how strongly two variables are connected.

For example, the table below shows the total return of different asset classes for 2022 and 2023. A positive correlation exists between all major classes over the 2022 and 2023 calendar years, which is not the outcome MPT predicts. The relationship between bonds and equities has evolved dramatically, challenging MPT’s fundamental assumptions.[1]

Index	2022*	2023
ASX 200	-2.97%	13.92%
MSCI World Index	-13.08%	19.49%
Governments Bonds	-12.18%	4.37%
Corporate Bonds	-6.40%	9.49%
REITs	-22.03%	14.68%
Real Estate†	-0.07%	8.91%

*All returns based on Total Return unless otherwise specified
†Based on property prices

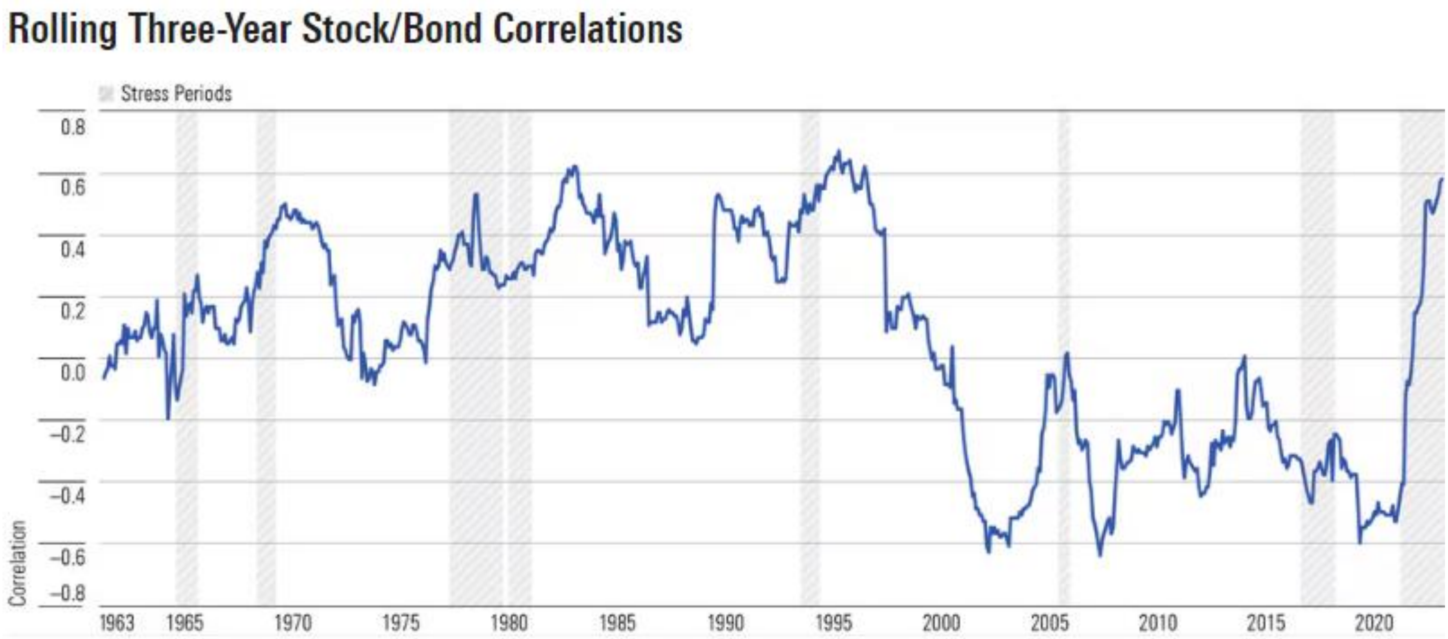
[1] https://www.forbes.com/advisor/investing/modern-portfolio-theory/

The Changing Nature of Bonds in Portfolios

In the 1960s, bonds were seen as stable, low-risk investments that provided a predictable income stream, making them the ideal counterweight to the higher risk/return option of equities. Investors typically held bonds to maturity, capitalising on their fixed interest payments. Interest rates during this period were relatively predictable, reinforcing the role of bonds as a safe haven during downturns in the equity markets.[2]

However, over the decades, the role of bonds in portfolios has shifted. Active bond management has become more prevalent, with managers *trading* bonds rather than holding them to maturity. This approach introduces new risks, such as increased interest rate risk, especially now, where rates are more volatile and less predictable. As a result, bonds have become more correlated with equities, diminishing their effectiveness as diversifiers in traditional 60/40 portfolios.[3].

A recent study by Christine Benz and Karen Zaya of Morningstar mapped out the correlation between equities and bonds over the past six decades.



Source: Morningstar Direct. Data as of Dec. 31, 2023. The rolling three-year correlation is between the IA SBBI US IT Government Index and the IA SBBI US Large Stock Index.

Higher interest rates and inflation also contribute to a change in the correlation between bonds and equities, which have recently converged into a significant and strong positive correlation.[4] This positive correlation erodes the benefits of diversification.

The 60/40 portfolio suffers during times of interest rate stress, which we are currently experiencing. A black swan event could easily lead to a disastrous financial outcome for the portfolio due to it lacking the intended defensive characteristics. This only provides further ammunition to declare the 60/40 portfolio dead.

This is the primary reason more prominent asset managers and fund managers, such as Blackrock, are looking for alternatives to 60/40 portfolios and moving into endowment portfolios,[5] with greater allocation towards infrastructure, as well as real estate private credit and equity.[6]

Implications for Modern Portfolio Construction

The shift in the bond-equity correlation and the evolution of private credit illustrates the need for a more nuanced approach to portfolio construction. Investors can no longer rely on the simplistic 60/40 model, as the protective relationship between equities and bonds has weakened. Instead, a more diversified and dynamic approach, incorporating a range of alternative asset classes, such as private credit, are necessary to achieve the risk-adjusted returns that MPT originally envisioned.

[2] https://www.robeco.com/en-au/insights/2024/05/new-research-into-the-stock-bond-correlation-shows-when-they-correlate-and-when-they-don-t
[3] https://www.aqr.com/Insights/Research/Journal-Article/A-Changing-Stock-Bond-Correlation
[4] https://www.morningstar.com/portfolios/what-rising-interest-rates-mean-stockbond-correlations
[5] https://www.disruptionbanking.com/2023/10/31/the-60-40-model-is-dead-is-larry-fink-right/
[6] https://coredatainsights.com/cd-views/portfolio-design-models/

The increasing awareness and popularity of private credit among fund managers and investors is primarily due to its use as a substitute for bonds. It is relatively uncorrelated to equities and offers the added benefit of absolute returns.

Daily Liquidity: Be Careful What You Wish For

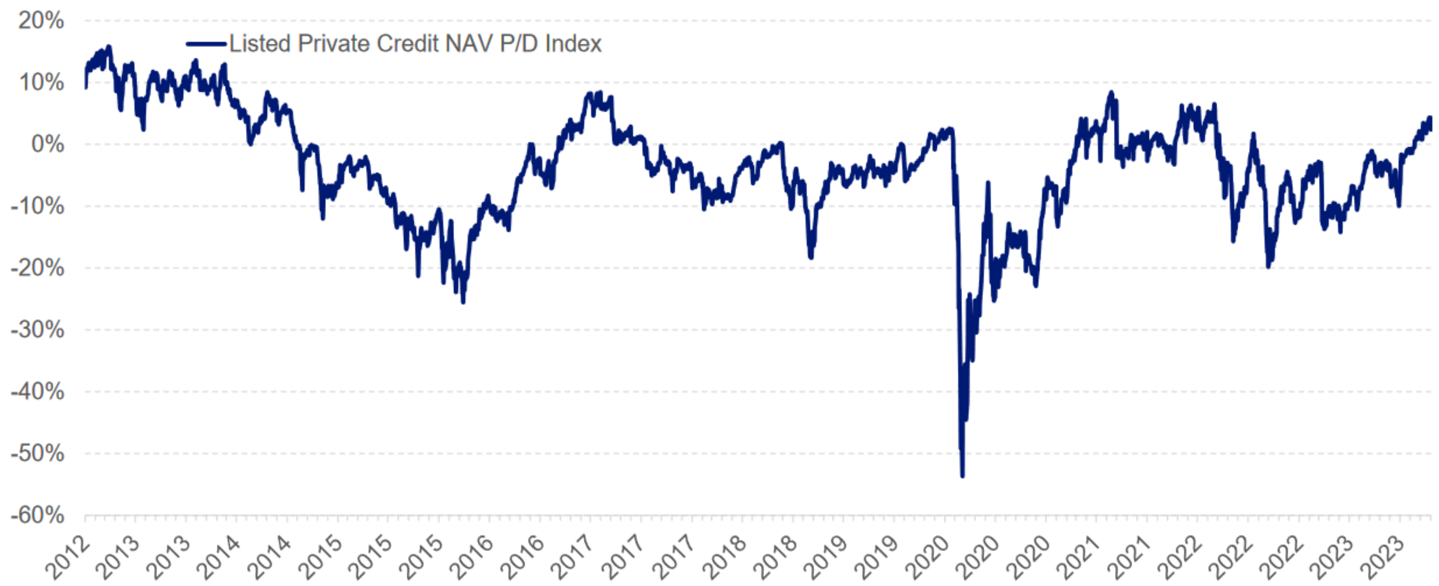
One of the most significant adjustments and challenges for asset managers when delving into alternatives and incorporating them into their portfolio modelling is the requirement for daily liquidity. Most alternatives, such as property, private equity, and private credit, do not operate in the secondary markets that offer daily liquidity, as do listed equities and bonds. Additionally, the time horizons of the underlying assets, such as private credit, private equity, and infrastructure, vary from months to years and are linked to the underlying assets.

Merely listing these alternatives on secondary markets to create daily liquidity has unintended consequences. These include increasing risks, eroding the benefits of absolute investing, and not capturing the benefits associated with a lower correlated portfolio.

Research conducted by VanEck mapped price changes of listed private credit funds over time. The graph below shows that the price is highly correlated with the general market and not necessarily linked to the fund's performance. As a result, the positive elements of low correlation for a portfolio, and asset preservation qualities that the asset class holds, can possibly be eroded by offering daily liquidity.

Just because daily liquidity is offered does not mean that there is a deep and functional secondary market for true price discovery to occur. Hence, despite there being no issues with the underlying asset value, it is likely that investors will be forced to take a discount on capital whenever they wish to gain liquidity.

It is also observed that during COVID-19, investors under extreme stress could have sold for 55% of the Net Asset Value without any information as to whether there was a deterioration in the loan book. This reinforces that liquidity comes at a cost when you need it most.



ource: LPX AG, Data Basis 31 January 2024, expressed in percentages

Relative Vs Absolute Investing

For the past few decades, the psychology of 'relative investing' has been the norm. Relative investing refers to measuring portfolio performance compared to a benchmark. The objective is to outperform a specified benchmark even if the absolute return is negative. Success is measured by how well the performance stacks up against the benchmark and other funds.

Absolute return investing has become increasingly prominent and focuses on generating positive returns regardless of market conditions. With the suitability of the traditional 60/40 split being questioned, does this open a further debate about investing on an absolute returns basis versus relative investing?

We believe this is a worthy debate as focusing solely on absolute returns completely turns traditional thinking on its head when it comes to diversification and benefiting from the full array of new products and asset classes that have emerged.

Stephen A. Schwarzman is the Co-founder and CEO of Blackstone and his number one rule for investing is: **"Don't lose money."** This principle is deeply rooted in his capital preservation and risk management philosophy.

Schwarzman believes that understanding the risks and avoiding significant losses is critical to long-term success in investing. This rule aligns with the broader wisdom often attributed to Warren Buffett, who famously said, "Rule No. 1: Never lose money. Rule No. 2: Never forget Rule No. 1."

By adhering to this principle, Schwarzman has guided Blackstone through multiple market cycles, focusing on generating sustainable returns while protecting the downside. Blackstone is now one of the world's largest and most successful alternative funds.

The Rise of Alternative Asset Classes

The changing dynamics between bonds and equities have prompted asset allocation managers to explore alternative asset classes to achieve the diversification benefits originally intended by MPT. Private credit has emerged as a compelling alternative, offering several advantages over traditional fixed income:

- **Higher Yields:** Private credit typically offers higher yields than traditional bonds.
- **Lower Correlation with Public Markets:** Unlike bonds, which have become more correlated with equities, private credit often remains insulated from public market volatility, preserving the diversification benefits sought in MPT.
- **Customised Risk Profiles:** Private credit investments can be structured to meet specific risk-return objectives, providing a level of customisation that is increasingly difficult to achieve with traditional bonds.

At Msquared Capital, we recognise these structural changes and the growing importance of private credit in modern portfolios. Our investment strategies are designed to provide diversification benefits, stable income, and lower correlation with traditional asset classes, making them an ideal addition to any sophisticated asset allocation strategy. As the investment environment evolves, integrating private credit can help investors navigate the complexities of today's markets and achieving the risk-adjusted returns that remain central to Markowitz's pioneering work.

Paul Miron is Co-founder and Managing Director of Msquared Capital, a private credit fund manager based in Sydney and Melbourne.