CONVEXITY INVESTMENTS LLC

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Is the 60/40 a Ticking Time Bomb?

One of the most common portfolios used today is the 60/40 portfolio. The 60/40 strategy involves allocation of 60% stocks and 40% bonds within a portfolio. Most investors hold some combination of stocks and bonds because they usually move opposite each other. If the stock market sells off hard, bonds typically perform well. The term "flight to quality" refers to investors selling their stock position when there is uncertainty in the market and moving their money into a safer investment, such as bonds. Over the last 40 years, bonds have had great returns and performed well during market crashes while providing great downside protection, which is a win-win for investors with a 60/40 portfolio.

It is important to understand the relationship between a bond's price and yield. An example is buying "Bond A" at $100 with a yield of 3%. If you invest $10,000 in "Bond A" your yield will be $300 per year. If there is a lot of demand for "Bond A", the price of the bond will increase. Now "Bond A" might increase to a price of $105, but the yield might drop to 2.8%. When prices go up in bonds, yields go down; yield and price are inversely correlated.

Bonds have been a fantastic hedge the last 40 years, if you were able to hold bonds as a hedge against stocks in your 60/40 portfolio. Since the 1980's the price of bonds have consistently increased, while providing protection during market crashes. When stocks have sold off sharply in times such as the Dot-Com Bubble, Global Financial Crisis, and COVID-19 Pandemic, bond prices have increased dramatically. This allowed investors in a 60/40 to see far less drawdown in periods of stress compared to an investor who was 100% stocks.

In 1981, the yield on the U.S. 10 year note was ≈16% at its height. The yield has since dropped down to ≈1.5%, which unless yields go negative, it assumed they have bottomed out. If we see a sharp increase in yields, this would result in bond prices going much lower and could wreak havoc on a 60/40 portfolio where an investor could see losses on both their stocks and their bonds.

Target date funds are a popular use case of the stock/bond portfolio because these funds let you select a year span for your retirement. The funds automatically allocate your portfolio based on the amount of working years you have left before retirement. Target date funds are very popular within 401K accounts. If your target for retirement is 30 years, you might have an allocation of 80% stocks and 20% bonds. As your working years continue, your target date fund will automatically transition you out of stocks and into bonds. Assets considered risky are slowly transitioned into more stable assets. Once you retire, your portfolio will be closer to 30% stocks and 70% bonds. It is important for investors to realize bonds are not a risk free hedge; bond prices can decrease dramatically.

The 60/40 portfolio has performed well because both stocks and bonds have had long bull markets the last 40 years, while also maintaining a negative correlation in recent market crashes. If either stocks or bonds enter into a bear market and bonds do not perform in contrast with stocks, it could leave investors confused why their portfolios perform poorly. It is critical to understand correlations can change in the market. Just because two asset classes have behaved a specific way in the past, is no guarantee that behavior will continue in the future.

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