Why the 60%/40% Portfolio Is Passé

Recent trends suggest that once-venerable approach to retirees' strategic asset allocation may be obsolete or, at least, counterproductive.

Retirees today, particularly those newly retired, may want to rethink risk entirely so they don't tarnish their golden years or, for that matter, outlive their money.

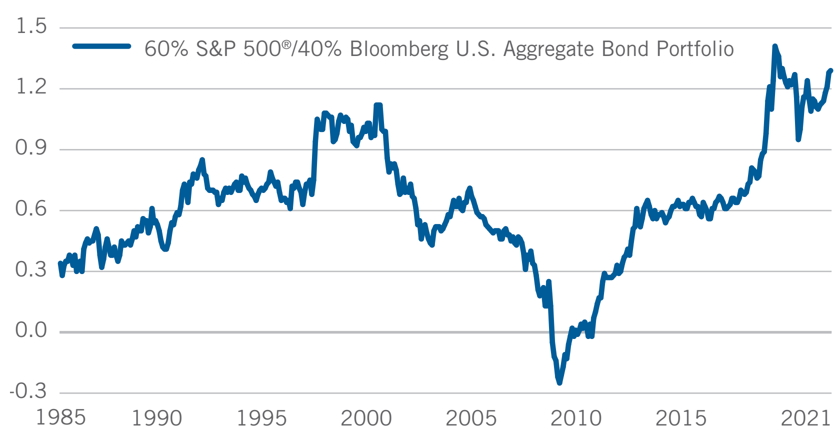
Consider the annualized performance of the 60%/40% portfolio over the last two decades, particularly the decade beginning in 2010, which posted an impressive 10% annualized return.

THE CURRENT DECADE HAS BEEN KIND TO A 60/40 INVESTOR

Return: 4.29%
Volatility: 9.46%
Sharpe Ratio: 0.29

Return: 11.24%
Volatility: 8.03%
Sharpe Ratio: 1.29

ROLLING 10-YEAR SHARPE RATIOS ON 60/40 PORTFOLIOS ARE AT ALL TIME HIGHS

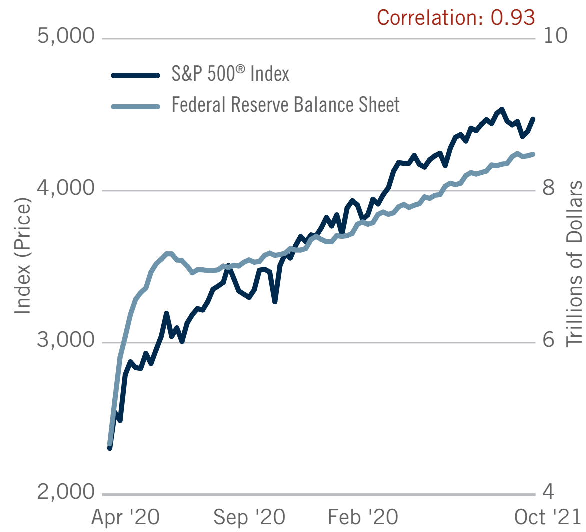


Past performance is not indicative of future results. Source: Morningstar Direct. Rolling 10-Year Sharpe Ratios from 12/31/1985–9/30/2021. See page 4 for definitions.

What contributed to this atypical and outsized performance? The answer is the “Great Experiment”—better known as four major rounds of quantitative easing (“QE”) over the better part of the last decade. This unprecedented accommodative support helped balloon risk assets. Artificial liquidity drove bond yields down and prices up. Meanwhile, equity investors drew strong comfort from a government backstop.

Since the Federal Reserve (“Fed”) announced “QE4” last year on March 20, 2020, in response to the COVID-19 pandemic, the correlation between the S&P 500® Index price return and Fed balance sheet expansion was 0.93. Similarly, the correlation seen during the rounds of asset purchases from November 2008 to January 2015 was 0.97. “Don’t fight the Fed,” as the saying goes. While many fiscal conservatives question how long this loose policy can continue, retirees are asking themselves what the return prospects look like from here.

FED QE VS. STOCK PRICES
3/20/2020–8/20/2021



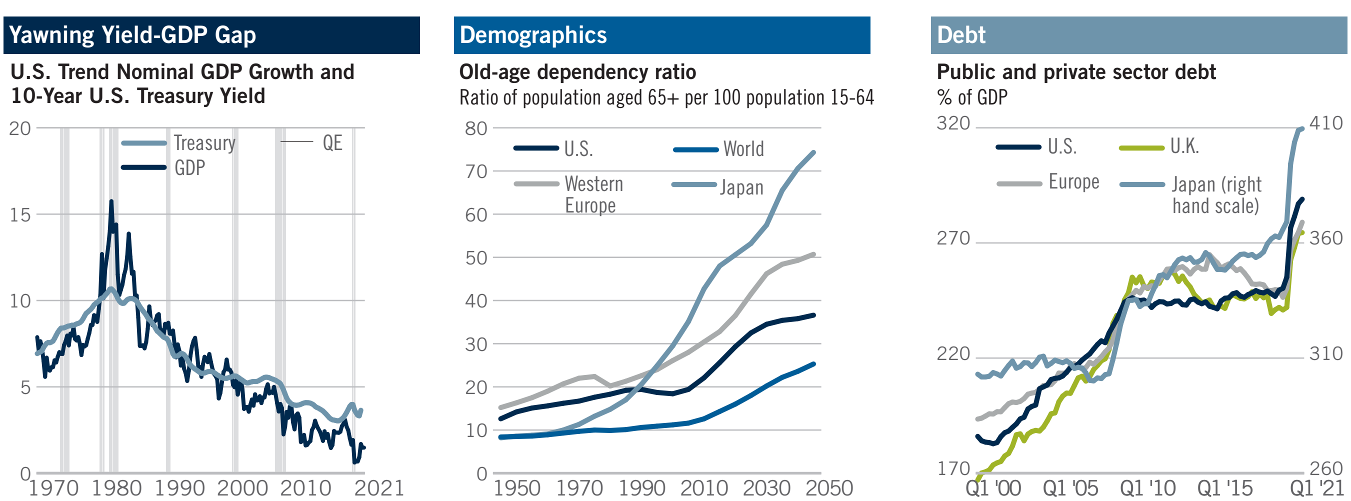
Past performance is no guarantee of future results. Source: Allianz Global Investors US LLC.

Why Returns Must Be Lower

The financial headwind of our age can be summarized as debt and demographics. Global debt levels are at historic highs not seen since World War II. Today, the U.S. deficit sits north of $28 trillion, with a projected year-end debt/GDP ratio of a staggering 137%. Debt is like an anchor that weighs down future growth prospects. All the borrowing helped fund recent consumption, but it has borrowed from future consumption and growth. Corresponding nominal GDP rates are correlated with nominal bond yields, as shown below in the chart on the right. Lower growth rates contribute to lower interest rates, and lower interest rates may mean lower fixed income return potential.

In addition to mounting deficits inhibiting future growth, adverse demographic trends (i.e., an aging population and shrinking work force) are at work. Growth is a simple equation. It’s a function of productivity gains plus labor force output. With fewer laborers, there will be less output and lower growth, all things equal. Additionally, with more retirees, on balance, searching for perceived “safe havens,” interest rates should stay grounded resulting from a savings glut chasing a shortage of attractive investment opportunities. Again, limiting yields and providing a supportive argument for those in the “lower for longer” camp.

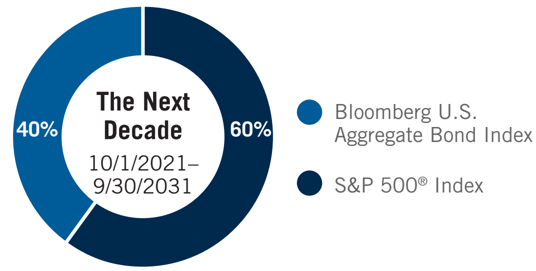
YIELDS LIKELY TO STAY LOW DUE TO STRUCTURAL FACTORS



Debt & US Trend Nominal GDP Growth & 10yr US Treasury Yield Source: Refinitiv Eikon Datastream, Allianz Global Investors GmbH. Demographics Source: United Nations Department of Economic and Social Affairs, Population Division.

Scrambling Nest Eggs

Between elevated equity valuations, rock bottom yields in traditional fixed income, and longer lifespans, investors planning for retirement face a conundrum.



Return: 5.00%
Volatility: 10.90%

Source: Allianz Global Investors and risklab.

Many in the financial world are lowering their portfolio return assumptions for the decade. For instance, risklab, the global quantitative research team of Allianz Global Investors, has projected a 5% annual return for a 60/40 portfolio.

While some might consider such a projection overly optimistic, that would be only half the return of the prior decade. Clearly, this may not provide enough portfolio growth to support 25 to 30 years of retirement. Retirees may need to rethink the 60/40 starting line, or at the very least, rethink how they express risk in portfolios. As a recent Goldman Sachs report put it, "Even if valuations remain at elevated levels, supported by continued low and negative real yields, we would expect less than half the real 60/40 returns of the last cycle."

In any case, we believe there is a short-term risk for owning stocks and long-term risk for not owning stocks. All roads lead to taking on more volatility to pursue the long-term returns people need to maintain spending through retirement or risk growing poor safely.

What should investors contemplating retirement consider in this environment? Consider these potential allocations:

- Outsource the complexity of equity exposure with a multi-faceted income and growth strategy.
- Equity substitutes like high yield and convertibles.
- Multi-sector approaches to the world's credit markets.
- Hedge inflation with REITs.
- Differentiated alternatives like merger arbitrage and managed futures.
- One-stop strategies covering global equity markets.
- Or, diversify market cap exposure with small- and mid-cap stocks.

To learn more about strategies that may help address longevity risk, please contact us at 800-243-4361 or visit virtus.com.

Sharpe Ratio—A statistic that measures the efficiency, or excess return per unit of risk, of a manager's returns. It is calculated by taking the portfolio's annualized return, minus the annualized risk-free rate (typically the 30-Day T-Bill return), divided by the portfolio's annualized standard deviation. The greater the Sharpe Ratio, the better the portfolio's risk adjusted return.

The **Bloomberg U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis. The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

IMPORTANT RISK CONSIDERATIONS

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Past performance is no guarantee of future results.

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