

Does the 60/40 Portfolio Still Make Sense?

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The 60/40 portfolio (comprised of 60% equities and 40% fixed income investments) has been used as a basis or starting point in the portfolio construction process for many public and private entities for decades. We interviewed Floyd Simpson and Don Grant to consider if maintaining such a portfolio is logical, given the recent volatility in the capital markets and elevated inflation levels.

Floyd is a director in PFM Asset Management's (PFMAM) outsourced chief investment officer (OCIO) business. He works with clients across the country to develop and implement multi-asset class strategies for their portfolios and is also a member of PFMAM's Investment Committee. Don is a senior managing consultant responsible for facilitating institutional client relationships and business development efforts for the firm's OCIO business.

How did the 60/40 allocation or portfolio become a standard within the industry?

Grant: Historically, pension funds needed to obtain an 8% discount rate so that the funds were sufficient to fulfill benefit payments. The optimal blend between equities and fixed income that provided for that 8% return has long been thought to be a 60% allocation to equities and a 40% allocation to fixed income securities. That said, the true origin came from a 1952 paper that discussed the proper way to create and optimize a portfolio. It was entitled "Portfolio Selection" and written by Harry Markowitz, who ultimately went on to win the Nobel Prize in Economics.

Does the 60/40 portfolio make sense given inflationary pressures?

Simpson: Yes. However, I would suggest that there should be some moderation of return expectations going forward, because the past few years have been an almost ideal environment for that type of portfolio. After all, interest rates were extremely low and there was an elevated appetite for risk.

Based on our research, over the past 20 years, the rolling three- and five-year correlation between domestic equity and fixed income has been negative. This year, the correlation between equities and fixed income has been positive, as economic growth has challenged equities and elevated inflation has negatively impacted fixed income securities. However, with inflation moderating

and earnings growth likely to be better than expected over the next two years, the current headwinds for the 60/40 portfolio are starting to subside.

One thing to consider is that the 60/40 portfolio could see small "tweaks," including adding more credit risk on the fixed income sleeve or allowing for broader ranges in the Investment Policy Statement (IPS) to allow for tactical shifts.

How are public pension plans weathering the storm? And can you discuss current trends in pension funds given this difficult environment?

Grant: As of 2021, public pension plans had an aggregate funding ratio of about 84.8%. According to the Equable Institutes Annual State of Pensions Report in 2022, analysts estimate that the aggregate funded ratio for U.S. public pension plans will decline to 77.9% in 2022. If we pair that expectation with a 2015 Milliman Public Pension Funding Study stating that defined benefit plans are seeing growing numbers of retired/inactive members, while active membership remains virtually unchanged, in the near-term there could be possible strains on pensions if future contribution payments are not met.

Of course, the focus should be more on the longer term because liabilities are long-term. Based on PFMAM's 2023 Capital Market Assumptions, we think the 60/40 portfolio will return 6.8% over the next 30 years.¹

¹ Our 2023 Capital Market Assumptions are available upon request.

What should clients be mindful of during the portfolio construction process?

Grant: To “stay the course.” Remember that consumer sentiment is coming off decade lows and valuations are at multi-year lows. In addition, based on the “Bull-Bear” spread, there is still a healthy amount of pessimism within the market, which could mark a good entry point for equity allocations.

It also seems that investors have perhaps forgotten that for the past three years, the basic 60/40 portfolio comprising of the Russell 3000 and Bloomberg Barclays Aggregate Bond Index fund has (per Bloomberg) returned an average of 17.47%.² In turn, causing valuations to trend higher than average, despite earnings growth on average being subpar.

If a plan is looking at making changes, some aspects worth focusing on are:

- ▶ Lowering the discount, increasing the pension plan contribution, or a change within parameters of the plan.
- ▶ Boards should reconfirm near-term budget expectations while keeping in mind they still have an obligation to meet long-term liabilities. Again, no single year should warrant a substantial change based on short-term thinking that can impair long-term results.

² Average annual return 1/1/2019-12/31/2021, Bloomberg.

What are some of the themes you uncovered when researching the viability of the 60/40 portfolio? How does that overlay with what PFM Asset Management has done with clients?

Simpson: When we were researching the viability of the 60/40 portfolio, we came across a number of articles both for and against this format.

A couple of interesting points or popular themes that came from our research include:

1. The addition of alternatives is not a “silver bullet,” and to maximize this allocation a plan or endowment must have: scale, patient capital, access to attractive assets³, access to skill, and the ability to add economic value to your assets.
 - ▶ If alternatives are added, a balanced approach with a focus on macroeconomic diversification based on global trends have the potential to add value.
2. Manager selection is more critical than perceived by many.
3. Fees and asset allocation matter.
4. Tactical allocation can add value.

³ Attractive assets are either public or private securities that are priced below value.



It should also be noted that the last few items mentioned are the most critical ones based on our internal research. In addition, various academic papers point towards allocation and fees being among the top considerations, with other aspects being more complementary in nature. To be clear, manager selection and alternatives are crucial, but again are more complimentary, while allocation and fees are the main focal points and where we spend much of our time with clients.

If readers have any questions about this topic, they can reach out to their PFMAM relationship manager. They may also email simpsonf@pfmam.com or grantd@pfmam.com.

To learn more or discuss in greater detail, please contact us:

Floyd Simpson, CFA, CAIA, CFP

Director

simpsonf@pfmam.com

Don Grant

Senior Managing Consultant

grantd@pfmam.com

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