Alternatives

The traditional "40" is broken

The search for income has been well documented as global interest rates have played a continuous game of limbo for the past few years; how low can they go? But the implications of these low rates extend beyond low yields and investors' resulting meager source of income. In this note, we discuss what we believe is the biggest source of risk to the universal standard 60/40 portfolio, and what investors can (and should) do now to fix what is broken.

KEY TAKEAWAYS

- Bonds, and by extension balanced portfolios, face enormous headwinds.
- Declining rates have left portfolios bereft of income and more sensitive to interest rates than ever before.
- Fixed income no longer serves as a guaranteed equity hedge and should inflation re-enter the picture, bonds will be even more challenged.
- Investors need to find ways to fix their fixed income, either by diversifying their "40" or seeking alternative solutions.

A 40% allocation to a mixture of Treasuries and high-quality corporate bonds has historically served multiple purposes in a portfolio, including income, capital preservation and diversification. But we believe core fixed income is ill-equipped to meet these goals going forward. After a multidecade secular decline in interest rates and the massive fiscal and monetary response to the health crisis, rates are hovering near or below zero throughout the world. Not only do low rates starve income-seeking investors, but the historic risk-return assumption of bonds—the very basis for their inclusion in a balanced portfolio—has been fundamentally altered.

Income

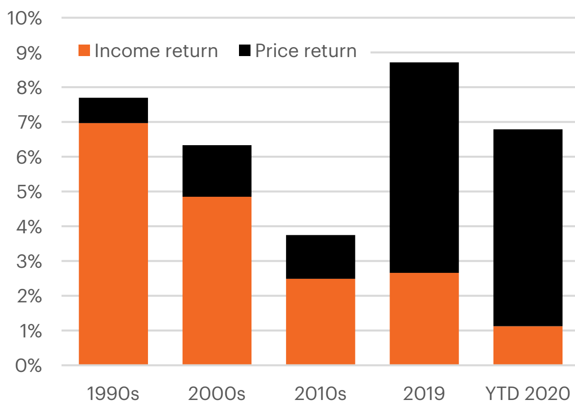
The search for income from core bond portfolios has been a burgeoning issue for years, and across the fixed income universe rates have bottomed. The Barclays Agg currently yields just over 1% (1.17% as of September 30). The Bloomberg Barclays Global Aggregate Bond Index (Global Agg) yield has sunk to 0.90% thanks in large part to record levels of negative-yielding international debt. And the 10-year U.S. Treasury boasts the highest yield in the developed world, at 0.68%. All of which begs the question: Where exactly is the *income* in core fixed income?

Rates have steadily declined for the past few decades—but have little room left to fall

Source: Bloomberg Barclays U.S. Aggregate Bond Index, 1/1/2000–9/30/2020.

Dwindling levels of yields have been masked by strong price gains as rates have steadily fallen over the past four decades. But rates collapsed from moderately low to downright shockingly low in early 2020 and have little room left to fall. Consequently, bond prices have little room left to rise. The declining rates that were a tailwind to fixed income performance for years now have little left to give and may become an enormous headwind should rates rise.

Barclays Agg return contribution

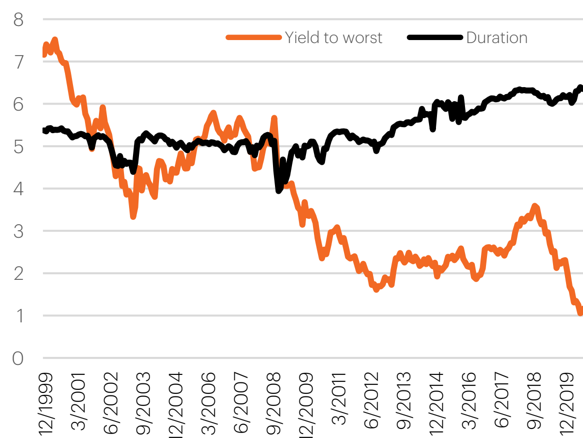


Source: Bloomberg Barclays U.S. Aggregate Bond Index, as of September 30, 2020.

Duration

Implications of the low-rate environment extend beyond income generation and the lack of further price gains. Bond duration, or interest rate sensitivity, has increased throughout the 40-year secular decline in rates. The duration of the Barclays Agg has extended to a record 6.4 years, which has made the risk/return profile of bonds extremely asymmetrical.

Barclays Agg yield to worst vs. duration



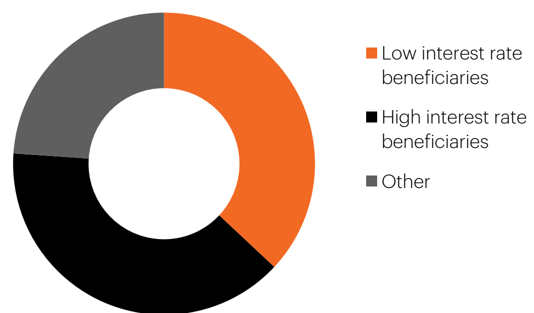
Source: Bloomberg Barclays U.S. Aggregate Bond Index, 1/1/2000–9/30/2020.

Potential returns for the Barclays Agg highlight this asymmetry. Rates can move up, down or stay the same. None of these options results in an overly favorable outcome for investors. If yields rise to 2.31%—where they began 2020—the Barclays Agg price decline would be roughly -7.3%. And unless rates go deeply negative, consistently replicating the Agg's recent returns is exceedingly difficult, if not impossible. In order to generate year-to-date gains of 6.8% again, yields would need to go to zero or slightly negative. As they say, past performance is no guarantee of future results. If rates remain rangebound, investors will collect their current income: a whopping 1.17%.

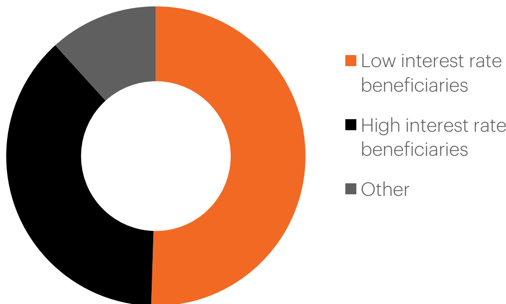
Unlike equities, which theoretically have unlimited upside, bond returns are inherently capped to interest throughout the life of the investment and the maximum capital gain if rates were to fall to zero. Given today's record-long duration, if rates rise, even by a small amount, investors face the prospect of large losses.

It's also not just bonds that have increased interest rate sensitivity. The dominance of tech and other sectors like consumer discretionary that benefit from the low-rate environment has changed the composition of equity markets. These sectors make up a much larger portion of the overall market than ever before, meaning many *equity* portfolios may also be extremely interest rate sensitive.

S&P 500 sector composition, 2000



S&P 500 sector composition, 2020

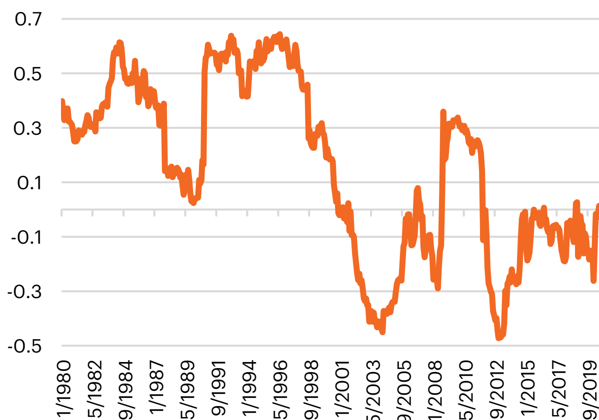


Diversification

For most of the past decade, bonds have been negatively correlated to stocks, making them a good equity hedge. Central banks have stood ready to cut interest rates during times of recession risk in an attempt to regain financial stability. So, if equity markets saw signs of turmoil, central banks stepped in and lowered rates, boosting bond portfolios in the process. We believe that this reaction function, and the expectation among investors that the Fed will continue these policies, in large part created the negative stock/bond correlation that has become the bedrock of portfolio diversification.

However, as global yields have now plummeted to zero or even negative levels, this relationship has begun to break down. We believe this trend will continue as investors question the economic benefit of holding bonds with such low levels of yield and, in almost a self-fulfilling prophecy, bonds fail to continue hedging stocks.

Negative stock/bond correlation: Not a sure thing



Source: S&P 500, Bloomberg Barclays U.S. Aggregate Bond Index, 1/1/1980–9/30/2020.

Inflation

The debate over inflation has taken center stage once again following the massive injections of fiscal and monetary stimulus we've seen throughout the year.

We'll refrain from making an outright call as to when we may see inflation rise, but rather remind investors that should it resurface, inflation would represent yet another risk to bond portfolios. A substantial increase in inflation could necessitate an interest rate hike, which could see bond portfolios suffer substantial losses from duration sensitivity. But even modest levels of inflation can harm bond investors by diminishing their portfolios' purchasing power.

Fix-ed income

With rates nearing zero and the economic benefits of holding traditional bond portfolios dwindling, we believe complacency is no longer an option. The risks have become too great to ignore. Not only has income diminished to a startlingly low level, but bonds may no longer hedge equities and face an increasingly asymmetric duration risk and challenges posed by potential inflation.

If core fixed income is no longer able to serve as the one-stop shop for income and hedging, investors may need to use multiple products to accomplish these goals. The formula is less prescriptive than "the 40," but bonds are not the only source of carry and stability in the investable universe.

Find your new "40"

Products exist today to fill the gap in portfolios left by core fixed income. For example, investors can look to alternative credit strategies that access less-liquid or inefficient areas of credit markets to generate a return premium. These investments can take advantage of price inefficiencies and often employ flexible strategies to invest across capital structures and asset classes throughout market cycles. Examples include special situations or distressed debt, structured credit and long/short credit.

Additionally or alternatively, investors can turn to investments backed by hard assets. This collateral helps provide stability and aids in capital preservation. These investments also generally seek a yield premium in illiquid, private markets and further mitigate risks through negotiated structural

protections. Examples include private real estate debt, real estate private equity and direct lending.

Beyond these options, investors may even broaden their horizons to equity or commodity markets. Dividend-paying stocks or carry-generating investments in these markets may provide a reliable source of income and stability. Liquid alternatives access these and other nontraditional sources of return to deliver outcome-oriented solutions, many of which are being designed specifically to address the need for a bond alternative.

For years, bonds have been viewed as the "safe" investment. But the current crisis has accelerated certain long-term trends and illuminated the very immediate challenges core fixed income now faces. Calls for the end of the traditional 60/40 portfolio have sounded for years. We believe investors must now answer them.

Robert Hoffman
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As Managing Director of Investment Research, Robert leads the team that analyzes the fundamentals behind market movements, macroeconomic trends and the performance of specific industries—as well as their potential impact on investors. His nearly two-decade tenure in the financial services industry includes experience as a loan portfolio manager and senior credit analyst focused on corporate loan issues. Robert serves as the firm's primary subject matter expert on the corporate credit markets and select alternative investment solutions, developing targeted communications and educational resources.

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Kara is an associate on the Investment Research team at FS Investments, where she leads research efforts on the corporate credit sector and helps develop strategic education on liquid alternatives. She holds a BBA in Finance and a BBS in Accounting and has experience investing private credit funds and in public accounting. Kara sits on the advisory board of ECHOES Around the World and volunteers with FS Investments' financial literacy and education programs.

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Unless otherwise stated, all references equities refer to the S&P 500, and references to the Barclays Agg refer to the Bloomberg Barclays U.S. Aggregate Bond Index.

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