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Asset allocation for tomorrow's uncertain economy

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Highlights

- In today's low-yield environment, the traditional 60/40 asset allocation is expected to generate lower returns in the next decade compared to the exceptional performance of the last 40 years.
- Multiple economic scenarios are also possible in the post-pandemic environment in which the traditional asset mix could under-perform.
- New investment tools could be useful for investors, such as absolute return strategies incorporating leverage and shorting to seek positive performance in rising or falling market conditions.
- Actively managing the asset allocation decision can also add value and reduce risk by shifting the asset mix with evolving economic conditions.

The traditional 60/40 asset mix in stocks and fixed income has served investors well since the early 1980s (Figure 1). Both equities and fixed income delivered high risk-adjusted returns compared to long-term historical averages. Importantly, bonds also provided strong diversification benefits while contributing outsized returns. This was an exceptional period for investors that may not be repeated in the next decade. At the same time, investors face heightened uncertainty about the post-pandemic economic environment and its impact on multi-asset portfolio returns. Alternative investment strategies and more active asset allocation approaches may help investors navigate these challenges.

Figure 1. | Performance of US stocks, fixed income and the 60/40 portfolio*
(annualized total returns and volatility in %)

	Average Total Return (%)			Volatility (%)		
	Stocks	Bonds	60/40	Stocks	Bonds	60/40
1920 – 2020	9.0%	5.5%	7.6%	18.3%	6.4%	11.5%
1980 – 2019	12.3%	8.1%	10.6%	14.8%	8.0%	9.6%
2020 YTD**	-0.3%	1.8%	0.5%	–	–	–

*Source: Market statistics are based on monthly total returns from January 2, 1920 to June 28, 2020 for the S&P500 index and 10-year US Treasury Note as a proxy for fixed income. Calculations are based on monthly rebalancing to the 60/40 asset mix to stocks and bonds.
**average monthly returns.

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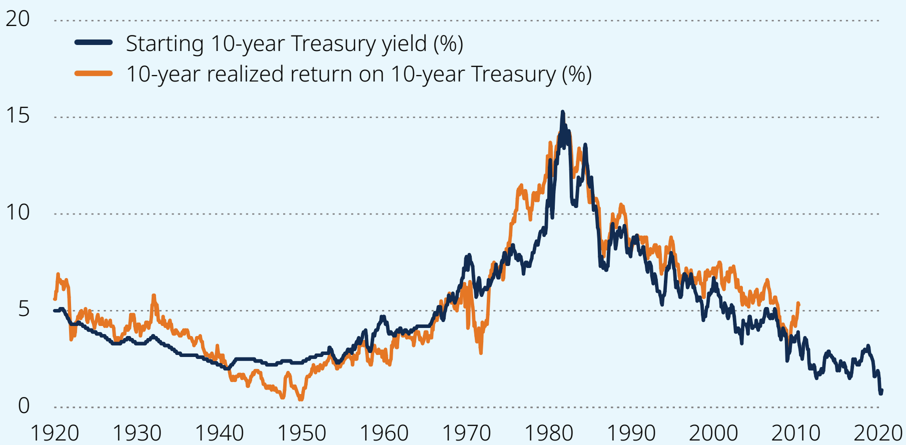
The outlook for the traditional 60/40 asset mix is less optimistic today because of low asset class yields and heightened uncertainty about the post-pandemic economy. As highlighted in our June commentary, equities and bonds tend to outperform when economic growth is higher than expected and inflation is lower than expected.[1] During the 'Great Moderation' after 1980, the 60/40 portfolio delivered strong risk-adjusted returns owing to the secular decline in inflation and interest rates, which also supported a higher fair value for stocks. Disciplined portfolio rebalancing in periods of market stress was also rewarded with long-term gains. However, expected returns in the next decade for many asset classes have declined relative to history. Bond yields have reached near record lows while equity earning yields also point to moderate returns compared to the last decade (Figure 2).

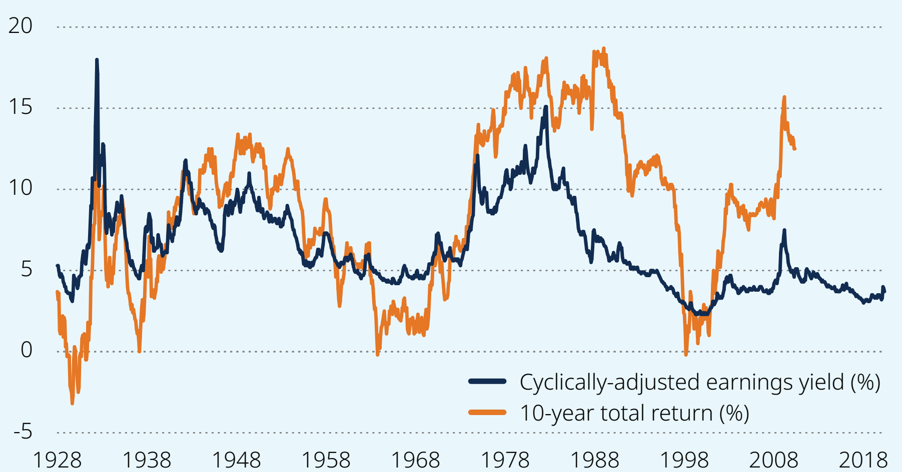
Figure 2. | Valuation indicators for equities and bonds point to lower long-term expected returns for the 60/40 portfolio

Low bond yields signal lower fixed income returns



Today's low bond yields point to lower 10-year expected returns compared to history

Equity yields are not high relative to history



Equity earning yields for US stocks point to moderate expected returns for equities in the next 10 years

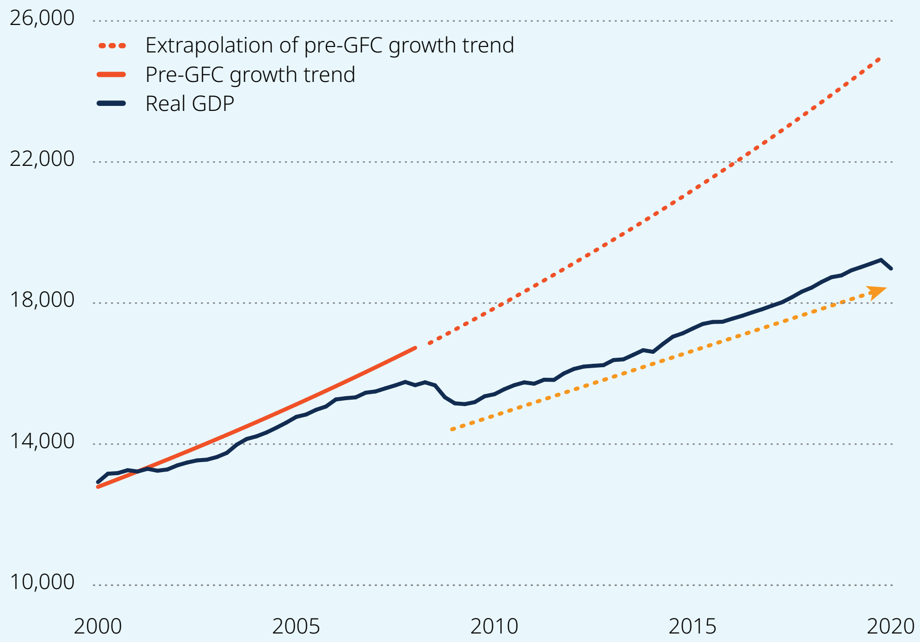
Source: Cyclically-adjusted earning yield for US stocks is derived from online data provided by Professor Robert Shiller at: http://www.econ.yale.edu/~shiller/data.htm as of June 28, 2020.

After the pandemic, multiple economic scenarios are possible in which the traditional portfolio mix could under-perform. As long-term investors, we believe in building balanced portfolios across different possible economic environments rather than a single type of environment. In the June commentary, we described four possible economic environments characterized by higher vs. lower growth and higher vs. lower inflation. Each of these scenarios has different implications for asset class returns. The 60/40 portfolio is expected to outperform in environments with higher-than-expected growth and lower-than-expected inflation. In contrast, the 60/40 is expected to under-perform in a “Stagnation” scenario with persistently low growth and in a “Stagflation” scenario with persistently high inflation and low growth. A better balance of portfolio exposures to different asset classes can lead to a smoother ride through shifting economic conditions.

A prolonged Stagnation scenario would increase the chance that the traditional 60/40 asset mix under-performs in the next decade relative to historical performance. In this scenario, global output would recover more gradually than expected due to scarring from the economic lockdown, such as skills atrophy from prolonged unemployment and greater business failures as prolonged cash crunches lead to insolvencies (Figure 3). In this scenario, equity and credit markets would struggle while defensive assets like government bonds would outperform. Since equities are the dominant contributors to total portfolio risk and return, the traditional 60/40 portfolio would be expected to under-perform overall in this type of environment. Moreover, interest rates are already near record low levels so the scope for a further decline in yields appears to be limited, suggesting that bonds may provide less effective diversification benefits going forward.

Figure 3. | Today’s severe economic downturn may amplify the already weak recovery from the 2008 Global Financial Crisis

(US real GDP in trillions of US dollars)



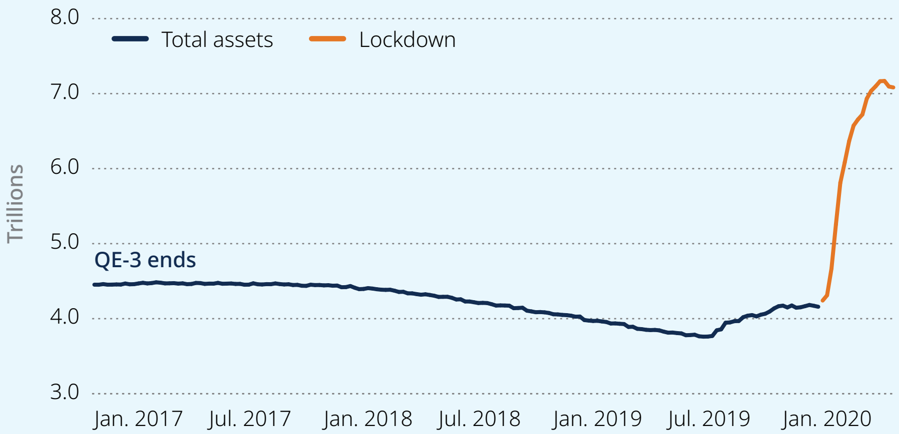
After the 2008 Global Financial Crisis (GFC), the average growth rate in US real GDP slowed sharply (see drop in yellow dotted line). The pandemic-related downturn may further slow the sluggish post-2008 growth trend.

Source: Real GDP of the US provided via Bloomberg as of June 28, 2020. The upper dotted red line is an extrapolation of the pre-GFC crisis based on the estimated trend during 1947 Q1 to 2008 Q2. The lower dotted yellow line illustrates the flatter trend after the GFC, reflecting slower average growth vs. history.

A Stagflation scenario would lead to weaker expected performance for the traditional 60/40 portfolio because nominal government bonds would also underperform due to higher inflation. The risk of rising inflation largely reflects aggressive economic policies in response to the most severe economic downturn since the Great Depression. In the US, the Federal Reserve has expanded its balance sheet in just a few months by more than the entire period of Quantitative Easing after the Global Financial Crisis (Figure 4). Government budget deficits have also risen sharply, stabilizing demand in the lockdown. Inflationary pressures currently remain subdued because of opposing disinflationary forces from the economic downturn and a sharp decline in "money velocity".[2] As the economy re-opens gradually for business, a slower-than-expected recovery with a rebound in money velocity could trigger greater inflationary pressures. Low growth and high inflation in this scenario would lead to weaker expected returns for both stocks and fixed income. In this type of environment, fixed income would fail to provide diversification gains.

Figure 4. | Inflation risk from unprecedented monetary easing

(Federal Reserve total assets in trillions of US dollars)



Fed balance sheet expands by about $2.8 trillion since March

Sources: Federal Reserve total assets obtained from Bloomberg as of June 28, 2020.

We believe that investors should consider active approaches for asset allocation to help navigate the shifting post-pandemic environment as well as alternative investment strategies to help achieve their investment goals. Traditional asset allocation and investment approaches have served investors well as economic conditions have been supportive for both equities and fixed income. Looking ahead, a more active approach to asset allocation may help investors manage through uncertain economic environments. New investment tools may also help investors with strategies aiming for positive absolute returns in both rising and falling markets while reducing total portfolio risk.

- **Fixed Income still plays a key role in a well-balanced portfolio:** Despite today's low yields, government bonds balance a portfolio's exposure to a range of possible economic environments. For instance, Stagnation scenarios with lower-than-expected inflation and growth would likely result in a further decline in long-term bond yields. With equities under pressure, fixed income exposures would be expected to contribute positively to total portfolio returns when needed most. Canadian and US long-term bond yields are still in positive territory so there remains modest room for a further decline in yields in the event of a downturn. However, low bond yields imply that diversification benefits come at a higher opportunity cost today because of the lower expected contribution from bonds to total portfolio returns. Leverage may help address this issue.

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- **Leverage can *reduce* total risk:** Leverage is often viewed as adding to investment risk. However, prudent use of leverage can actually reduce total portfolio risk compared to a traditional asset allocation. Defensive asset classes like fixed income generally offer lower expected returns and lower volatility than equities. As a result, the expected return and risk of an asset allocation with well-balanced exposures to fixed income and inflation-sensitive assets may be too low relative to the investor's target. For this reason, many investors rely on a high allocation to equity to achieve their return target, resulting in an asset mix that is less balanced to differing economic environments. In principle, prudent use of leverage can help investors achieve their target return with less reliance on equity. In this way, they can achieve a better balance of equity and fixed income exposures, allowing for smoother portfolio performance in different potential environments. While leverage can help achieve better balance, it requires robust risk management. As individual investors have limited access to leverage, absolute return strategies could be a valuable new tool.
- **Absolute return strategies can fill the gap:** By typically incorporating leverage and permitting security shorting, absolute return strategies aim for positive performance in both rising and falling market conditions. In this way, absolute return strategies generally have lower correlation to traditional stocks and bonds. Some absolute return strategies with high target returns and risk can compete with traditional equity in the asset allocation decision. Given their lower correlation, absolute return strategies may help investors achieve smoother portfolio performance over the market cycle. However, selecting a strong investment manager is important both for their skills as an active investor and robust portfolio construction.
- **Active asset allocation aims to add value and reduce risk:** Asset allocation is generally the single greatest determinant of expected total return and risk for a portfolio. Actively managing the asset mix over time can add value and reduce risk. Given the range of potential post-pandemic environments, active asset allocation may become an increasingly valuable tool. The key is to avoid outsized shifts in asset allocation that dominate all the other drivers of value-add in the portfolio, such as security selection decisions by traditional equity and fixed income managers.

Given the uncertain post-pandemic economic environment, adopting new portfolio tools and asset allocation approaches could help individual investors manage in today's lower yield environment with heightened uncertainty.

[1] https://www.mackenzieinvestments.com/content/dam/mackenzie/en/insights/mi-todd-mattina-monthly-commentary-may-en.pdf

[2] Velocity is the ratio of nominal GDP to the measure of money. The classical Quantity Theory of Money hypothesized that money printing by a central bank would lead to higher inflation in the long term because velocity and real GDP are determined by real economic fundamentals. More money chasing the same quantity of goods should push up inflation to clear markets.

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