



Rethinking the 60-40 Portfolio

By Josh Hile



JOSH HILE, CFA®, CPA

Josh is a Senior Investment Research Analyst specializing in global equities. He is a member of Laird Norton Wealth Management's Investment Strategy & Research team.

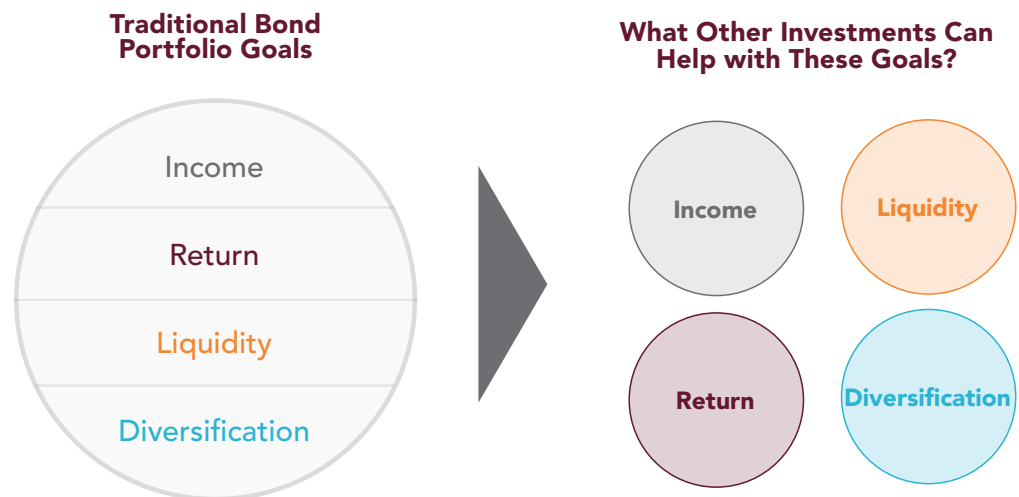
The 60-40 portfolio has been a staple of retirement planning for nearly half a century, and for good reason. Through markets good and bad, keeping 60% in the largest stocks around the world and the other 40% in high-quality bonds has generally been a win-win: decent return, lower risk. This year was especially good for long-term bonds as US interest rates tumbled due to Covid-19.

However, past is not prologue, and some fundamental aspects of the fixed-income market are now causing us to rethink the 60/40 allocation. In a nutshell: the total return on bonds going forward (income plus price gains) is not likely to be high enough to justify a 40% allocation. Specifically:

Paltry income. The Federal Reserve has said it intends to keep its key interest rate around zero at least for the next several years. Income from high-quality bonds, already at historically low levels, will continue to be paltry.

Limited price gains. When interest rates fall, bond prices typically rise as their current income becomes all the more attractive. But how much further can interest rates fall from where they are now? Federal Reserve Chairman Jerome Powell has said he does not want to see negative US rates. And as of now, below-zero rates are unlikely as the US economy recovers from Covid-19. An added concern: if US interest rates or inflation rise in the future, bonds would lose value.

We are not advocating that portfolios do away with high-quality bonds. They provide valuable diversification because historically they are one of the few asset classes that has a negative correlation with the stock market, and we think this will continue to be the case. However, given the low-for-longer interest rate environment, investors may need to add riskier assets with bond-like characteristics to their portfolios to capture the income and gains bonds once offered.



The benefits of a traditional fixed-income portfolio can likely be attained through strategic diversification into other types of assets over time.

Source: Wellington.



PERCENTAGE OF GOV'T BONDS WORLDWIDE YIELDING LESS THAN 1%



Source of Data: Bridgewater.

THINKING OUTSIDE THE BOND BOX

To boost portfolio income with some added diversification and downside protection, we are looking to invest or have already recommended investing in the following:

Infrastructure Equities: From toll roads to airport fees and utility bills, infrastructure generates a relatively steady stream of income, and can be a strategic, long-term way to play both offense (enhance return) and defense (lower risk).

- *Portfolio Diversification and Downside Protection:* Market valuations for infrastructure assets have had low correlation to stocks, bonds and real estate. The relatively stable earnings streams of infrastructure assets tend to cushion against downside volatility.
- *Growth Opportunity:* In the coming decade, most of the \$49 trillion in estimated global infrastructure spending will likely come from private markets, since most governments will not have sufficient resources for massive new investment. The majority of these investments will be for essential services (i.e. power, roads, telecom, water) and therefore not as dependent on economic cycles.
- *Enhanced Income Potential:* Most infrastructure investments provide a relatively high dividend yield, given their relatively predictable cash flows.
- *Inflation Protection:* Many infrastructure assets have contracts that allow for inflation-adjusted pricing. Should the record amount of monetary stimulus eventually lead to inflation, these assets are likely to perform relatively well.



Select Real Estate: Our exposure to real estate has been minimal over the last few years on concerns about valuation. However, we continue to monitor the space and are looking closely for opportunities in the current environment. Certain types of REITs have suffered during Covid-19, especially those in commercial real estate (retail, offices, hotels, etc.). However, other property types are likely to continue seeing ongoing demand and relatively low vacancy rates, including data warehouses, industrial warehouses, and apartments in economically vibrant areas. Benefits of the category can include:

- *Attractive Yield:* By law, REITs must distribute 90% of their profits as dividends, which are usually paid quarterly.
- *Defensive:* REITs typically have long-term leases on the properties they manage, meaning they can ride out a certain amount of economic stress. While REIT profits would be hurt in a recession, many of them are buffered somewhat due to penalties for breaking a lease and most people and companies opting not to move during economic turmoil.
- *Inflation Hedge:* During times of rising prices, rents and property values tend to increase.

OTHER OPPORTUNITIES

To capture even higher yields and potentially higher total return, as well as further diversification, we are exploring and in certain instances have recommended investing in some of the following:

Private Market Debt: Private market debt has continued to grow since the 2008 financial crisis, when banks dramatically reduced lending to meet regulatory and capital requirement needs. Today, private funds are the main source of financing for private equity firms seeking to buy companies and eventually sell them at a profit or take them public. Private debt can be used to invest in real estate ventures or other projects. Recently, for example, we were able to source for accredited clients a proprietary private-debt investment with targeted yields significantly above market but with anticipated risk lower than that of equities.

Alternatives, mainly hedge funds and private equity: We believe hedge funds can provide returns that have low levels of correlation with other portfolio assets, and over time, this is likely to provide higher risk-adjusted overall returns. In private equity, we believe there are inefficiencies in the market that talented managers can exploit to provide significant value while capturing the illiquidity premium (the extra return from holding something that isn't easy to sell).

One-off Opportunities: At any one time, we are reviewing numerous opportunities that provide differentiated return streams and diversification to portfolios. Examples include:

- *Accounts Receivables Financing:* Many Asian suppliers for Amazon, Wal-Mart, Home Depot, etc. have limited working capital. As such, they need bridge financing to operate between the time they deliver their goods and when they get paid, usually three to six months later. That financing is provided by firms that buy the accounts receivable from the supplier and then get paid directly by the purchaser (i.e. Amazon) based on the contract terms. Bridge financing for accounts receivable typically provides a net 7% annualized return, paid quarterly and with relatively low risk (all companies purchasing the products have credit ratings of A- or higher).

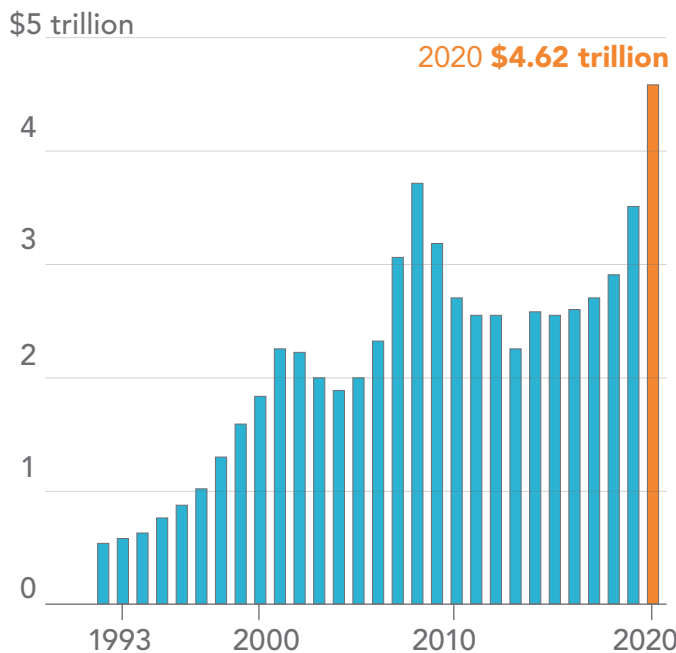


- *Carbon Sequestration Credits:* Many companies with high carbon output (utilities, airlines, and manufacturers) have regulatory or voluntary commitments to offset their emissions by paying for carbon capture. Basically, this means paying to plant more trees and/or protect forest land from development or degradation. Funds raise capital to implement the carbon sequestration and pay out income to investors.

THE CASE FOR GLOBAL EQUITIES

Given that inflation-adjusted returns are 0% or less for long-term bonds and cash, and there are limited investment opportunities worldwide, it is likely that equities will make up a greater portion of investor assets in the future. In practicality, a long-term investor who may have been in a 60/40 portfolio might want to consider a 70/30 allocation to make up for the extremely low returns on bonds and cash. This said, such a shift will increase the risk and volatility of the portfolio over time and should be made only after very careful consideration, if at all.

ASSETS IN US MONEY MARKET FUNDS



Assets in US money market funds hit an all-time high in June 2020, while ownership of stocks (directly and via all types of mutual funds) is at its lowest level in the past decade. Should US bond yields remain around 1% or less for years, a significant portion of the money market cash is likely to move into stocks eventually.

NOTE: Figures for 2020 are through June 10.
Source of Data: Refinitiv Lipper, Wall Street Journal.

Further, since corporate profits and dividends tend to rise over time along with prices, the shares of high-quality companies offer better protection against inflation than bonds, while providing a decent amount of dividend income. However, as noted earlier, such a shift must be made carefully over time due to market volatility and differences in valuations across geographic areas.

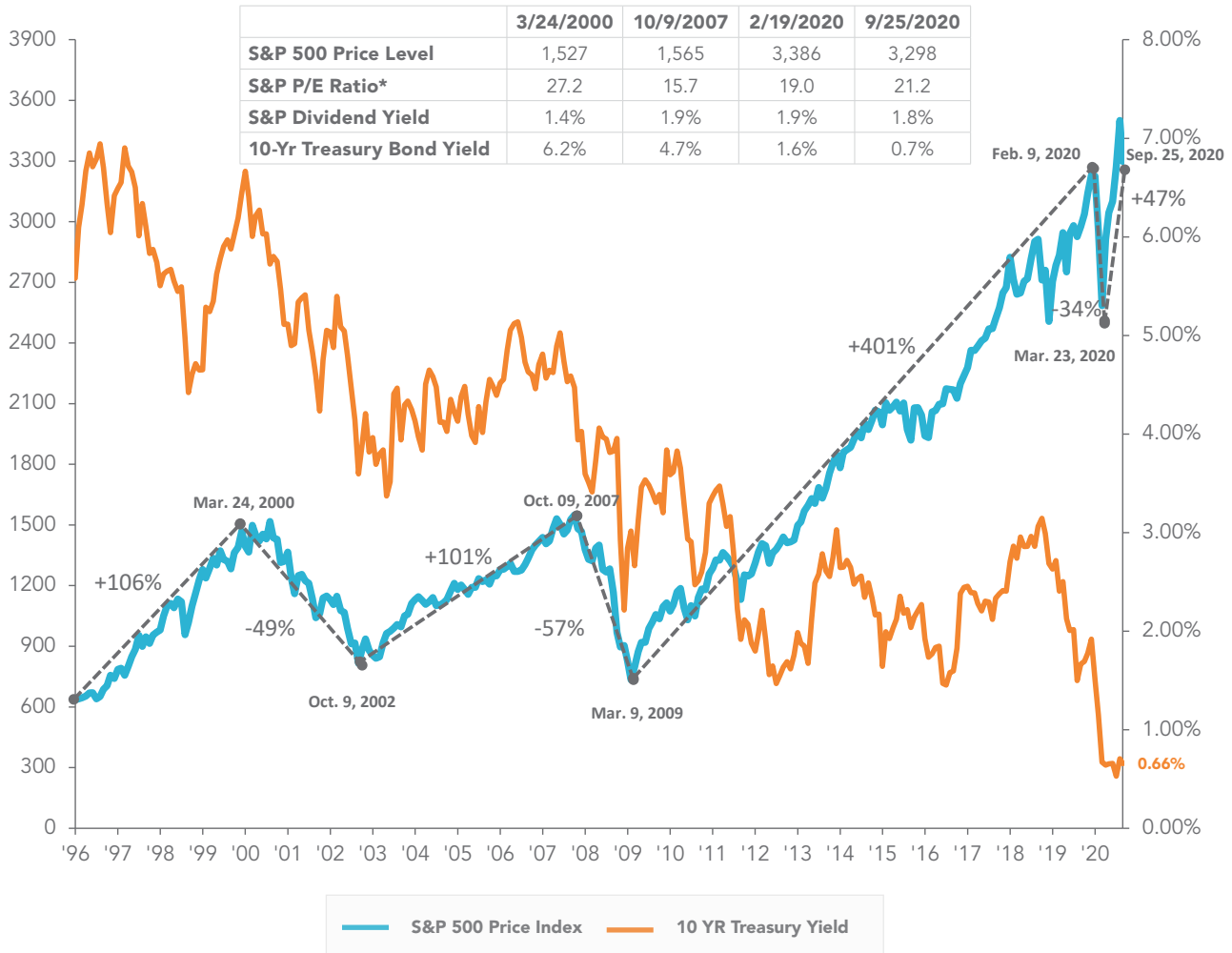
Going forward, we think that geographic diversification will become more important in a post-COVID world, especially given the potential for significant de-globalization (i.e. eroding of US/China relations) and increased fragmentation of economic regions. The latter could lead to countries being forced to



S&P 500 Stock Index

S&P 500 STOCK INDEX VS US BOND YIELDS

10-Year Treasury Yield



*Price-earnings ratio based on earnings forecast for next 12 months. Source of Data: JPMorgan Asset Management, Bloomberg,

pick sides between world powers. We believe this change will lead to differing economic conditions, more independent monetary policies, and distinct savings patterns that result in more stratified outcomes. Further, as the US and Europe's percentage of world GDP continues to shrink (a result of emerging markets' strong GDP growth), there is greater likelihood that equity market performance will decouple and become less correlated across regions. Markets in Asia, for example, might be on a prolonged uptrend while those in the Eurozone fall and vice versa.

THE DECADE AHEAD

High-quality bonds are still a must for virtually all portfolios for many reasons: reliable income, relatively stable returns, downside protection and liquidity. However, as return-seeking investors and to meet the goals of our clients, we will most likely consider a significant reduction in our traditional fixed-income allocation, while increasing bond-like assets that have slightly higher risk and less liquidity. Further, we will be looking for bond proxies in the equities market, with attractive yields, relatively stable earnings (downside protection), and some inflation protection. We believe these types of strategic shifts will create portfolios with a risk/return profile that better meets client goals in the coming decade.



ABOUT THE AUTHOR

Josh Hile is a Senior Investment Research Analyst within Laird Norton Wealth Management's Investment Strategy and Research Group. He is responsible for analyzing developments in global equities markets and providing recommendations to LNWM's Chief Investment Officer, as well as conducting ongoing due diligence and monitoring of equity asset managers, including mutual funds, separately managed accounts and limited partnerships. Josh is a Chartered Financial Analyst® (CFA®) and a Certified Public Accountant. He earned his MBA at the University of Washington.

ABOUT LAIRD NORTON WEALTH MANAGEMENT

With more than \$5 billion in assets under advisement, Laird Norton Wealth Management is the Northwest's premier wealth management company. Founded in 1967 to serve the financial management needs of the Laird and Norton families, the firm now provides integrated wealth management solutions to more than 600 individuals, families, business leaders, private foundations and nonprofit organizations.

801 Second Avenue, Suite 1600, Seattle WA 98104 206.464.5100 800.426.5105 lairdnortonwm.com

DISCLOSURE

All investments involve a level of risk, and past performance is not a guarantee of future investment results. The value of investments and the income derived from them can go down as well as up. Future returns are not guaranteed and a loss of principal may occur. All investment performance can be affected by general economic conditions and the extent and timing of investor participation in both the equity and fixed income markets. Fees charged by LNWM will reduce the net performance of the investment portfolio.

The information presented herein does not constitute and should not be construed as legal advice or as an offer to buy or sell any investment product or service. Any opinions or investment planning solutions herein described may not be suitable for all investors nor apply to all situations. All opinions expressed are those of Laird Norton Wealth Management and are current only as of the date appearing on this material.

Any accounting, business or tax advice contained in this presentation (or communication, including attachments and enclosures) is not intended as a thorough, in-depth analysis of specific issues, nor a substitute for a formal opinion, nor is it sufficient to avoid tax-related penalties.

Some investments may not be publicly traded and they may only allow redemptions at certain times conditioned on various notice provisions and other factors as more fully described in the related offering and subscription documents provided at the time of the investment. Due to the nature of these types of investment funds, hedge funds, fund of funds, and similar partnership-like investment vehicles, they should be considered illiquid. In addition to restrictions on redemption, they often include holdback provisions that may delay a full redemption for several months or longer. There is no guarantee that the amount of the initial investment can be received upon redemption. Due to the nature of the tax reporting that may be available from these types of investments, clients should expect to extend the filing of their tax returns.

A benchmark is an unmanaged index, and its performance does not include any advisory fees, transaction costs or other charges that may be incurred in connection with your investments. Indices are statistical composites and are shown for informational purposes only. It is not possible to invest directly in an index. Indices are unmanaged and are not subject to management fees. Any benchmark whose return is shown for comparison purposes may include different holdings, a different number of holdings, and a different degree of investment in individual securities, industries or economic sectors than the investments and/or investment accounts to which it is compared. Comparisons of individual account or portfolio performance to an index or benchmark composed of indices are unreliable as indicators of future performance of an actual account or portfolio. Actual performance presented represents past performance net of investment management fees unless otherwise noted. Other fees, such as custodial fees or transaction related fees may not be reflected in the actual performance results shown.

Certain information herein has been obtained from public third party data sources, outside funds and investment managers. Although we believe this information to be reliable, no representation or warranty, expressed or implied, is made, and no liability is accepted by Laird Norton Wealth Management or any of its officers, agents or affiliates as to the accuracy, completeness or correctness of the information herein contained. In addition, due to the nature of an investment or the date of the creation of the attached presentation, some values shown or used in the calculation of performance may be based on estimates that are subject to change.

All data presented is current only as of the date thereon shown. Laird Norton Wealth Management is comprised of two distinct entities that may offer similar services to clients. Laird Norton Trust Company is a State of Washington chartered trust company. Its wholly owned subsidiary, Laird Norton Tye Asset Strategies, LLC, is an Investment Advisor registered with the Securities and Exchange Commission. Such registration does not imply any level of skill or expertise.