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Validea Capital Management

Alternatives to the 60/40 Stock/Bond Portfolio

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Alternatives to the 60/40 Stock/Bond Portfolio.

Why Investors Should be Thinking About this Now in Today's Market

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The Big Idea in 166 Words

The 60/40 stock and bond portfolio has been a winning investment strategy for the last 40 years for those investors looking to balance risk and return. As a result, it has become the dominant asset allocation for most investors in or nearing retirement.

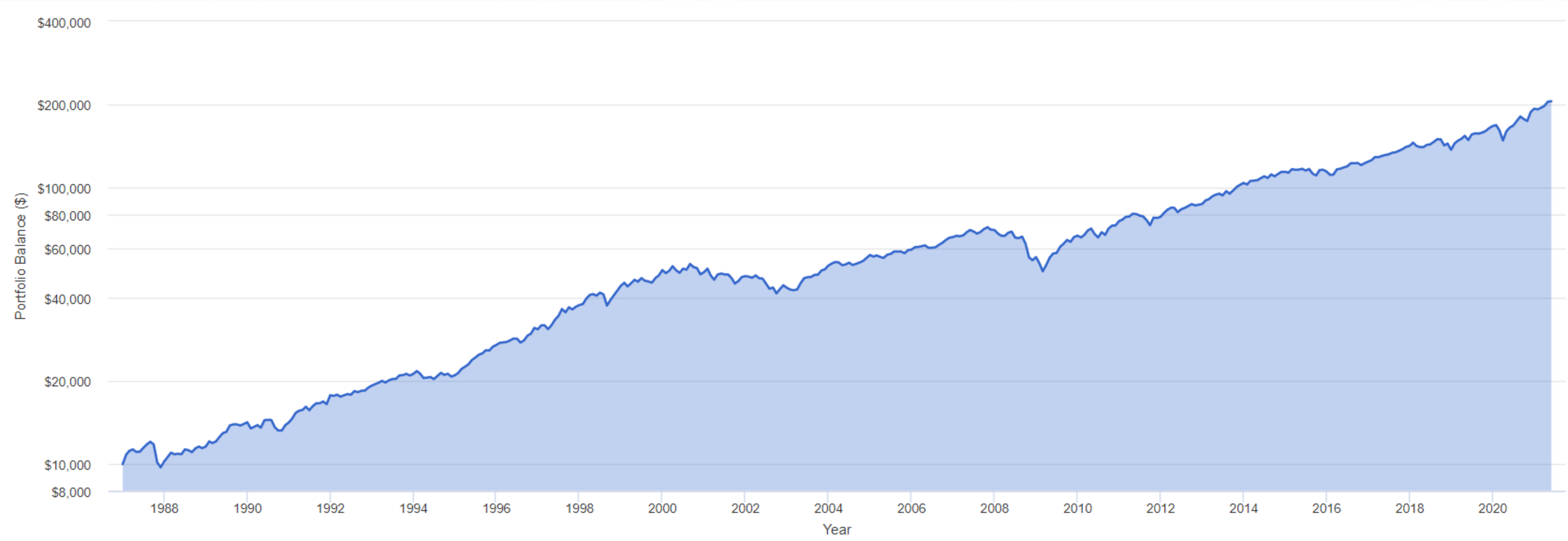
However, high stock valuations and low bond yields may be headwinds for the 60/40 over the next decade, and lower expected returns from the portfolio could pose significant problems for investors. Potential future inflation could also cause a situation where both stocks and bonds decline at the same time, increasing the risk for investors.

In today's webinar, you will learn:

- Why the future returns of the 60/40 portfolio may be lower than they have been in the past;
- How additional asset classes such as commodities, gold and real estate can work as complements to a stock and bond portfolio;
- How unconventional asset allocation strategies such as the Permanent Portfolio, All Weather Portfolio and Protective Asset Allocation can offer more broad protection against future uncertainty.

60/40: Just How Good Over the Last 30+ Years?

The 60/40 Stock/Bond portfolio has delivered in spades over the past 33 years, rewarding investors with a 9.2% annualized return over that period of time.



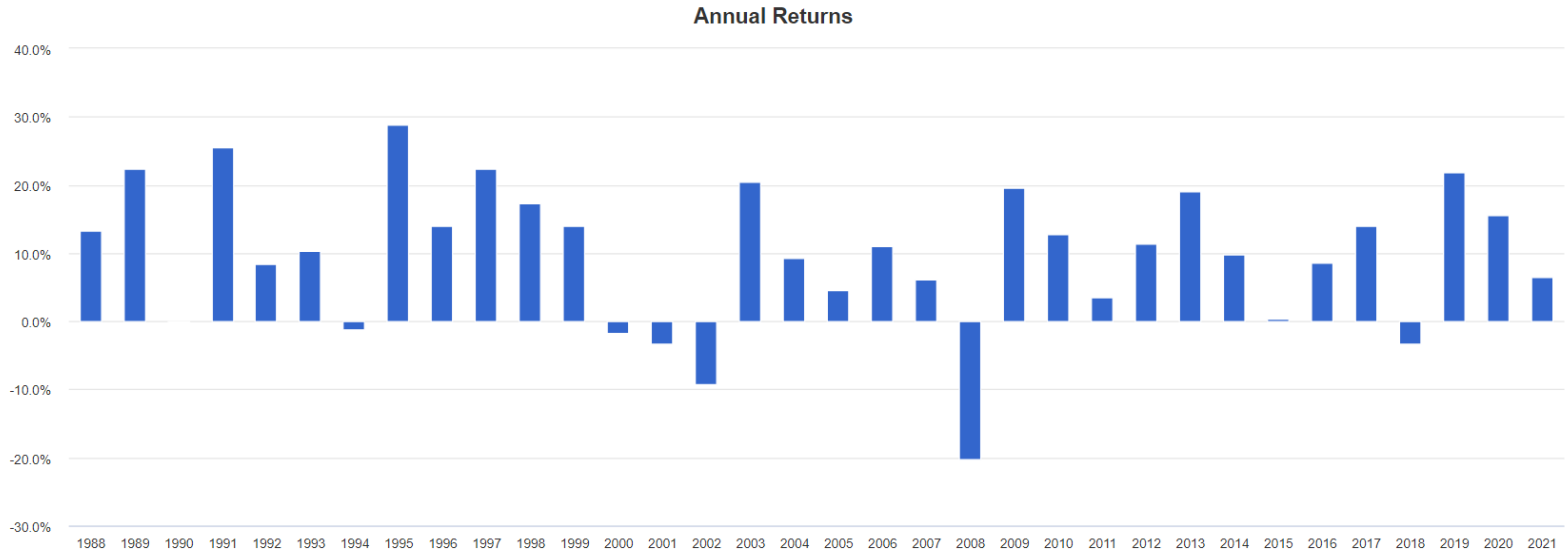
Period	Ret/Risk
1 YR	24.4%
5 YR	11.6%
10 YR	9.9%
Full	9.2%
3 YR Vol	11.6%
5 YR Vol	9.4%

https://www.portfoliovisualizer.com/

Past performance is not necessarily indicative of future results.

Historical Valuations & Yields

Showing how much has changed using Market P/E and 10 Year Yield from 1988 to 2021.



Year	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Mkt P/E	14.0	11.8	15.1	15.4	25.9	22.5	21.3	14.9	18.1	19.5	24.3	32.9	29.0	27.6	46.2	31.4	22.7
10 YR Yield	8.9%	8.5%	8.6%	7.9%	7.0%	5.9%	7.1%	6.6%	6.4%	6.4%	5.3%	5.7%	6.0%	5.0%	4.6%	4.0%	4.3%

Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Mkt P/E	20.0	18.1	17.4	21.5	70.9	20.7	16.3	14.9	17.0	18.2	20.0	22.2	23.6	25.0	19.6	24.9	35.2
10 YR Yield	4.3%	4.8%	4.6%	3.7%	3.3%	3.2%	2.8%	1.8%	2.4%	2.5%	2.1%	1.8%	2.3%	2.9%	2.1%	0.9%	1.4%

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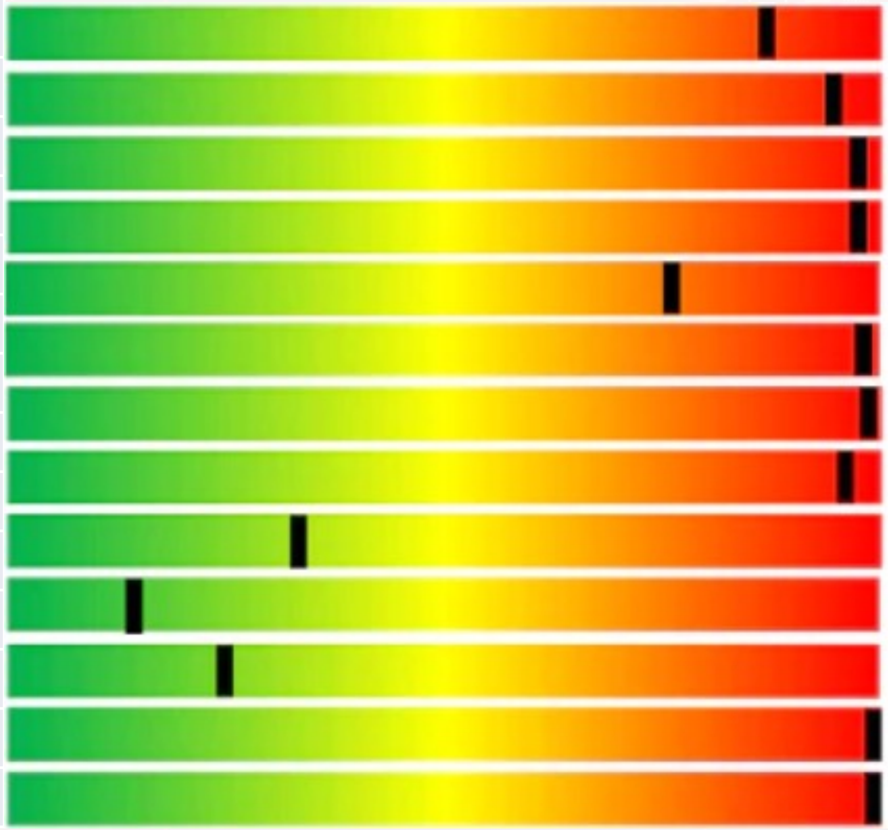
Stocks: Market Valuation

Based on almost every measure, stocks look very expensive.
Starting valuations play an important role in future returns.

Metric
S&P 500 Forward P/E
S&P 500 Trailing P/E
S&P 500 5-Year Normalized P/E
S&P 500 Price/Book
S&P 500 Price/Cash Flow
S&P 500 Dividend Yield
Shiller CAPE Ratio
Rule of 20
Equity Risk Premium (10-Year Treasury)
Equity Risk Premium (Baa Corporate Bonds)
Fed Model
Tobin's Q
Market Cap/GDP (Buffett Indicator)



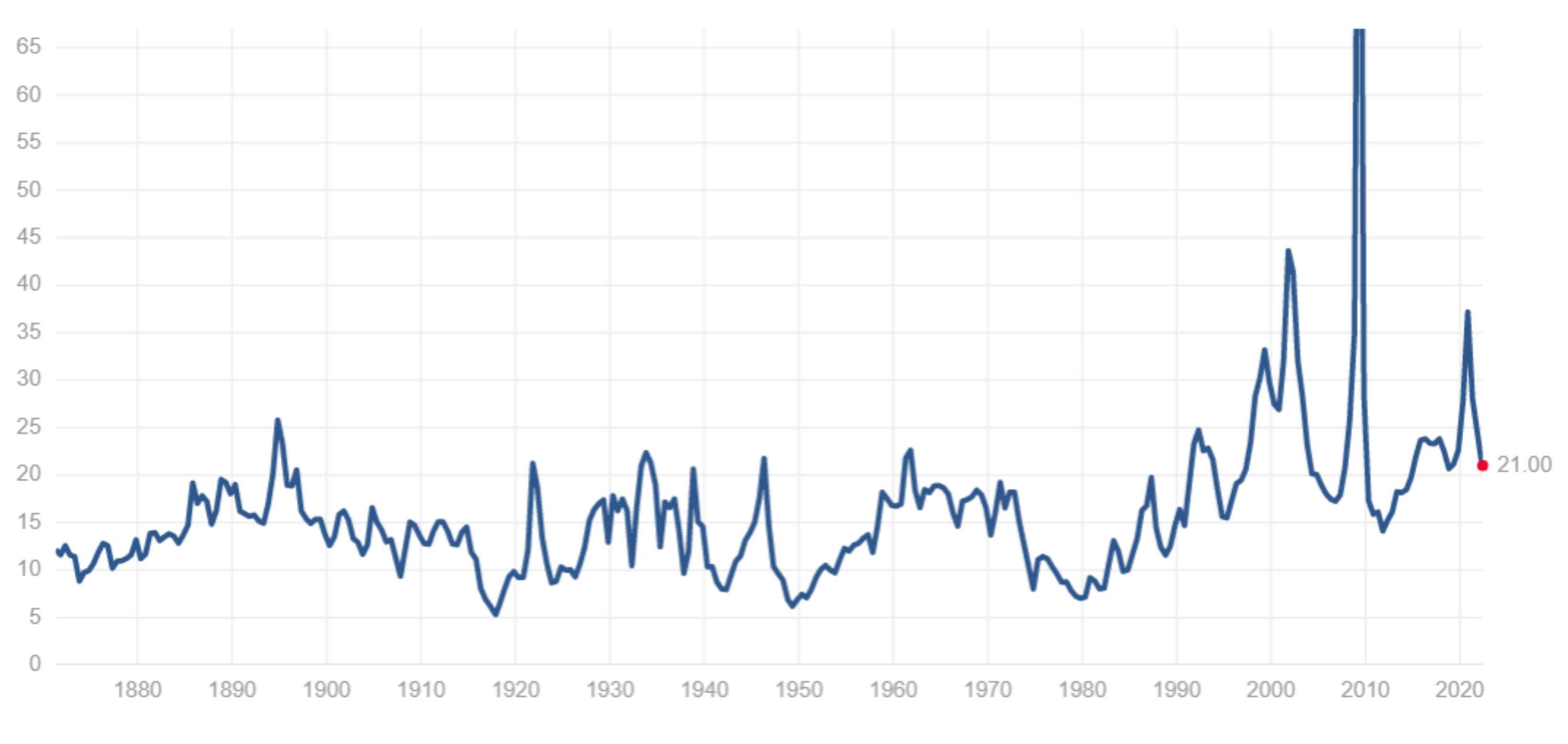
Relative to history the S&P 500 looks expensive to its history based on most traditional valuation metrics. **Pinged at the redline.**

Source, "2022 U.S. Market Outlook: Under Pressure" Charles Schwab, Nov., 2021

Past performance is not necessarily indicative of future results.

Valuations Trending Up Over Time

Valuations have been drifting higher over the last 50 years, but the current run in the market has valuations up significantly – market P/E of 21



Current S&P 500 PE Ratio: 21.00

Mean:	15.97	
Median:	14.89	
Min:	5.31	(Dec 1917)
Max:	123.73	(May 2009)

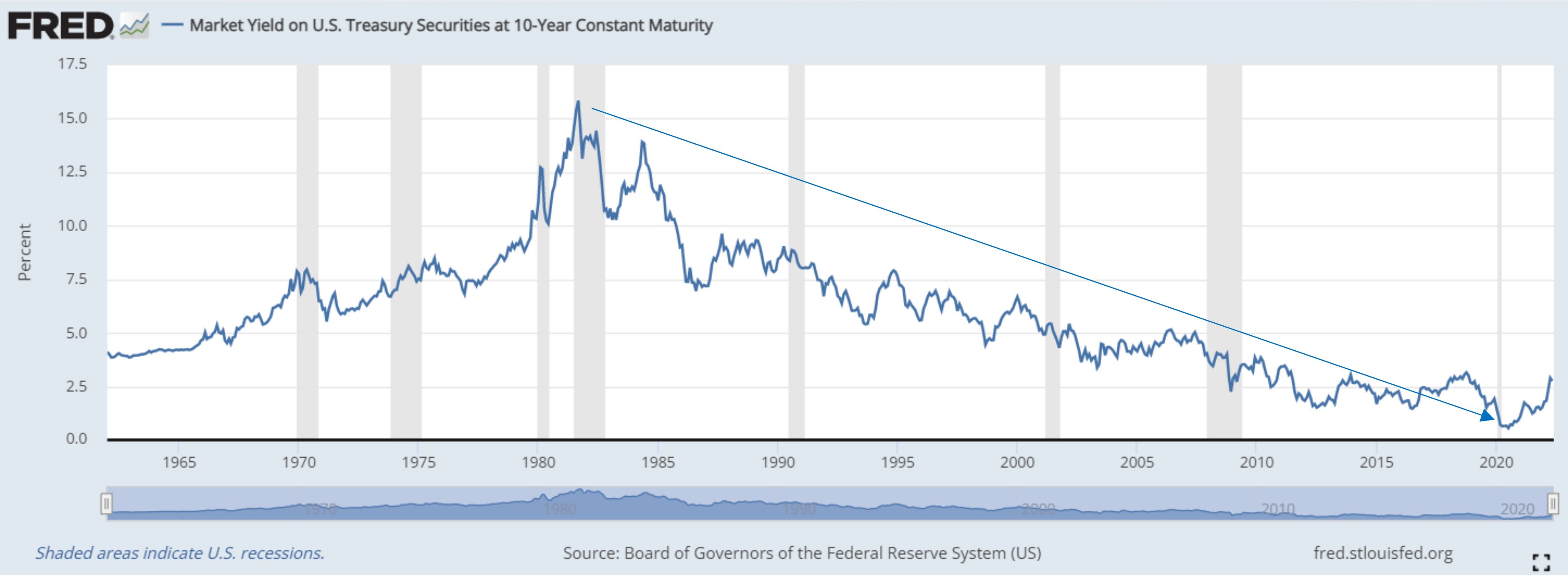
Source: Multpl.com, S&P 500 PE Ratio

Past performance is not necessarily indicative of future results.

Bonds: A 40 Year Bull Market for Bonds

It's been a bull market for long-term bonds since 1980. While rates could go lower, and the Fed could stay lower for longer, rates could be set to increase looking out on the horizon.

A 40 year Bull Market for bond investors – U.S. 10 Year bottomed at 0.57% in Aug 2020 and now stands at 2.75%, which is **still low by historical standards**.



Source:

Past performance is not necessarily indicative of future results.

Bonds: How Rates Impact Prices

Increasing rates hurt bond investor returns while falling rates help bond investors.
Let's use two different examples to see the impact.

- **Current Interest Rate:** 3%
- **# of Payments Until Maturity:** 18
- **Coupon Payment:** $3,750
- **Future Bond Face Value:** $250,000

Increase in rates

Today's Interest Rate	% Increase	Market Value
4%	-7.5%	$231,250
5%	-14.4%	$214,000
6%	-20.6%	$198,500

Decrease in rates

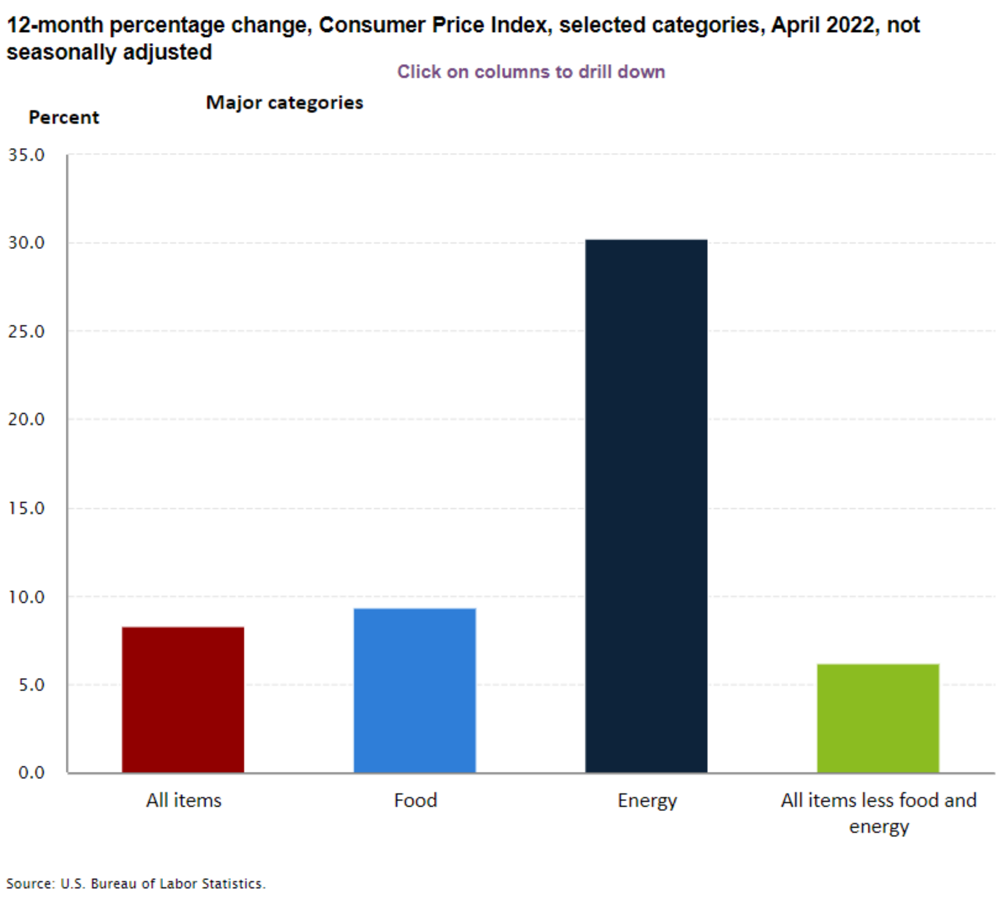
Today's Interest Rate	% Increase	Market Value
2%	8.1%	$270,250
1%	17.1%	$292,750
0%	27.0%	$317,500

Source: TheBalance.com, "Why Do Bond Prices Go Down When Interest Rates Rise?"

Past performance is not necessarily indicative of future results.

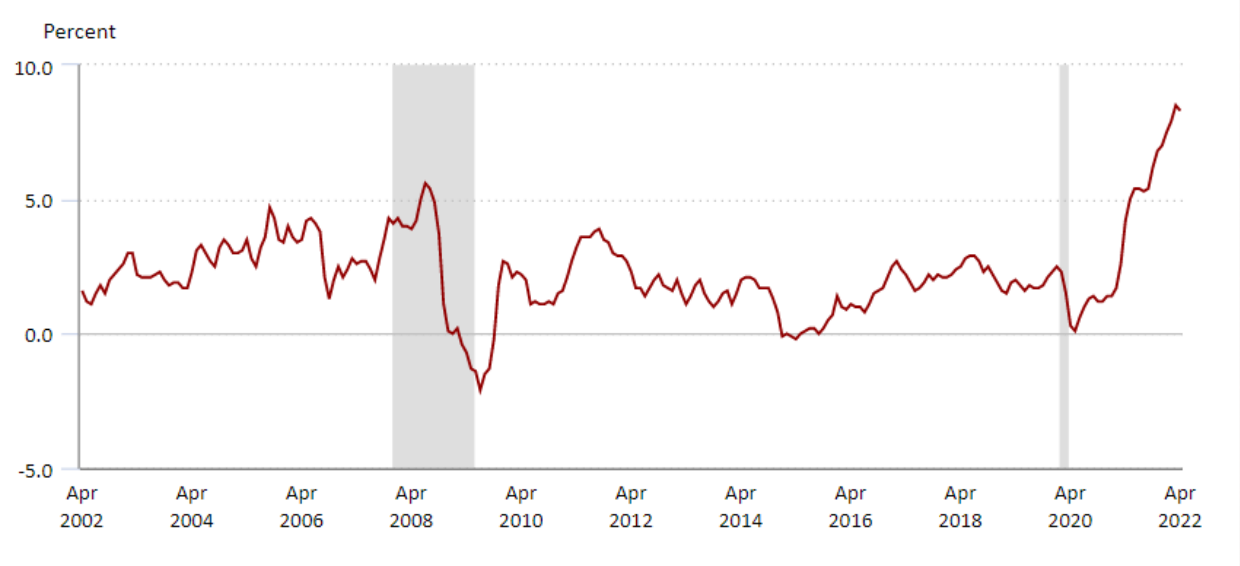
Signs of Inflation?

Inflation: *"Too much money chasing too few goods."*



Highest level of annual inflation (i.e. price increases) we've seen in decades.

12-month percentage change, Consumer Price Index, selected categories



Performance Under Various Inflation Regimes

Deflation & High Inflation = bad for stocks
High Inflation = bad for bonds

S&P 500 Ann. Total Returns at Various Inflation Levels (1928 - 2020)					
Inflation Quintile	Inflation Range	S&P 500 Nominal (Ann.)	S&P 500 Real (Ann.)	% Positive Nominal	% Positive Real
Quintile 1	-10.3% to 0.9%	4.6%	6.5%	56%	61%
Quintile 2	0.9% to 2.0%	15.0%	13.4%	79%	74%
Quintile 3	2.0% to 3.0%	13.8%	11.1%	89%	84%
Quintile 4	3.0% to 4.7%	10.8%	7.1%	84%	79%
Quintile 5	4.7% to 18.1%	4.0%	-3.5%	56%	39%
COMPOUND				@CharlieBilello	

The **lowest** real equity returns have occurred in <u>deflationary</u> (quintile 1) and <u>high inflation</u> (quintile 5) environments while the **highest** real equity returns have occurred in periods of <u>low</u> (quintiles 2/3) to <u>moderate</u> (quintile 4) inflation.

10-Year US Treasury Total Returns at Various Inflation Levels (1928 - 2020)					
Inflation Quintile	Inflation Range	10-Year Nominal (Ann.)	10-Year Real (Ann.)	% Positive Nominal	% Positive Real
Quintile 1	-10.3% to 0.9%	4.3%	5.7%	89%	94%
Quintile 2	0.9% to 2.0%	5.0%	3.5%	79%	68%
Quintile 3	2.0% to 3.0%	3.8%	1.2%	79%	53%
Quintile 4	3.0% to 4.7%	8.7%	5.0%	89%	58%
Quintile 5	4.7% to 18.1%	2.3%	-5.0%	72%	11%
COMPOUND				@CharlieBilello	

The **lowest** real bond returns have occurred in <u>high inflation</u> (quintile 5) environments while the **highest** real bond returns have occurred in <u>deflationary</u> (quintile 1) and <u>moderate inflation</u> (quintile 4) environments.

Source: "Stocks, Bonds, and Higher Inflation", CompoundAdvisors.com, May 5, 2021

Past performance is not necessarily indicative of future results.

Expected Future Returns

Projecting below average nominal returns for stocks and low bond returns over the next 7-10 years. Best case would 60/40 would be 4.0%, worst case would be 2.44%.

Equities	Return projection	Median volatility
U.S. equities*	**2.8%–4.8%**	16.8%
Global equities ex-U.S. (unhedged)*	**5.7%–7.7%**	18.4%
U.S. value	**2.8%–4.8%**	19.0%
U.S. growth	**–1.2%–0.8%**	17.5%
U.S. large-cap	**1.9%–3.9%**	16.3%
U.S. small-cap	**2.3%–4.3%**	22.2%
U.S. real estate investment trusts	**1.8%–3.8%**	19.2%
Global ex-U.S. developed markets equities (unhedged)	**5.1%–7.1%**	16.3%
Emerging markets equities (unhedged)	**4.3%–6.3%**	26.8%

Fixed income	Return projection	Median volatility
U.S. aggregate bonds*	**1.9%–2.9%**	4.6%
U.S. Treasury bonds*	**1.6%–2.6%**	4.8%
U.S. credit bonds*	**2.4%–3.4%**	5.8%
U.S. cash*	**1.5%–2.5%**	1.1%
Global bonds ex-U.S. (hedged)*	**1.8%–2.8%**	3.9%
U.S. high-yield corporate bonds	**2.3%–3.3%**	10.3%
U.S. Treasury Inflation-Protected Securities	**1.2%–2.2%**	4.6%
Emerging markets sovereign	**2.5%–3.5%**	10.5%
U.S. inflation	**1.6%–2.6%**	**2.3%**

Source: Market perspectives: May 2022, Vanguard

The charts displayed are for illustrative purposes only and are not intended to portray recommendations.

Should We Give Up All Hope On Stocks & Bonds?

Investors depending on the 60/40 may want to be thinking of a few things as they look to grow their investments over time.

Absolutely not!

1. Diversification;
2. Alternative strategies;
3. Your return expectations;
4. Your savings rate;
5. Your withdrawal rates – i.e. the 4% rule.
6. Importance of "Rebalancing Effect"

Our focus today is on #1 & #2

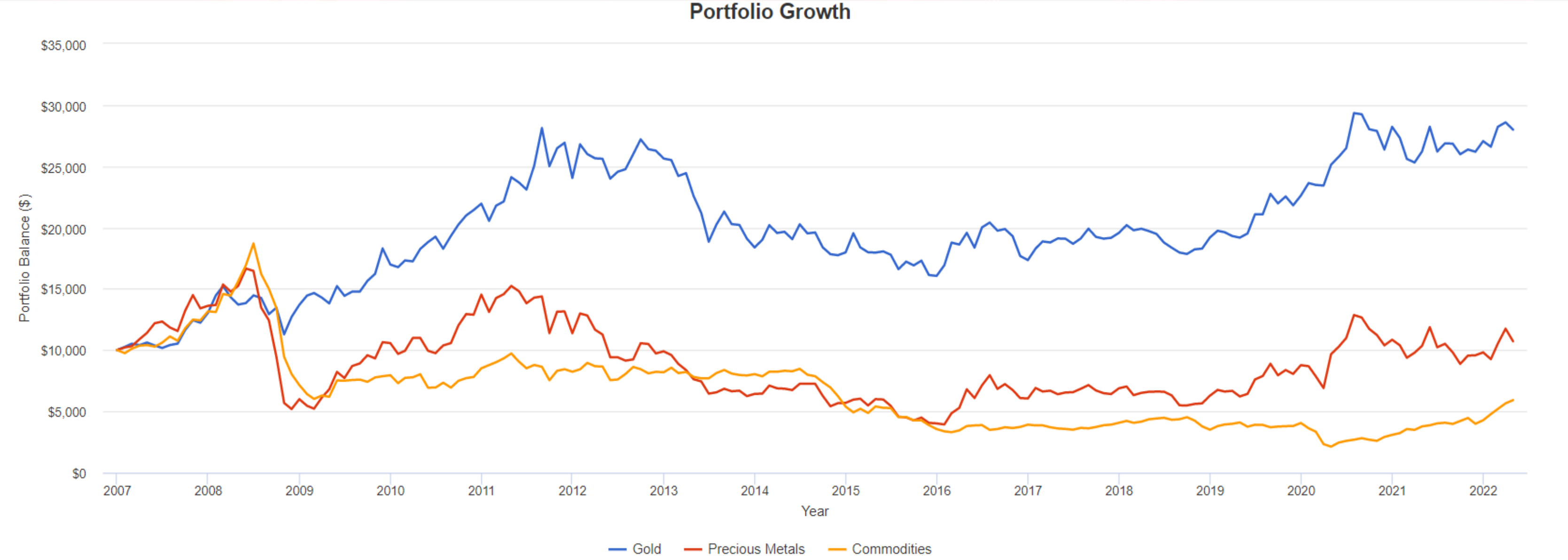
Looking At Alternative Asset Classes

A look at alternatives to traditional stock and bond investments

Asset Class	Examples	Added Diversification	Inflation Hedge	Cash Flow	Potential Benefits / Reasons
Gold	Gold	Yes	Yes	No	Hedge against the dollar and inflation. Seen as a safe haven and a diversifying investment. Has proven itself as preserver of wealth through thousands of generations.
Precious Metals	Silver, Platinum	Yes	Yes	No	Most have intrinsic value, they carry no credit risk, and they cannot be inflated. They can provide benefit during market downturns and aren't closely correlated with the other markets like the stock market.
Other Commodities	Oil, Nat Gas, Lumber	Yes	Yes	No	Offer diversification outside of stocks and bonds, act as a potential hedge against inflation and have the ability to produce strong returns in commodity upcycles.
Real Estate	REITs	Yes	Yes	Yes	Cash flow and dividends, hedge against inflation (hard asset) and appreciation potential.

Painful Past 14 Years For These Assets

Portfolio	Initial Balance	Final Balance	CAGR	StDev	US Mkt Correlation
Gold	$10,000	$27,988	6.94%	17.30%	0.06
Precious Metals	$10,000	$10,715	0.45%	33.41%	0.50
Commodities	$10,000	$5,910	-3.37%	23.98%	0.51



Past performance is not necessarily indicative of future results.

Commodities Go Through Super cycles

Chart 1: US commodity price index 1795 to present

Red dots: major inflation peaks, Blue dots: major inflation troughs

Chart shows rolling 10 year returns, and drives home how volatile commodities can be. They have a tendency to go through big moves to the upside and downside.

Source: Janus Henderson, "Are we entering the next commodities super cycle?", Aug. 2020

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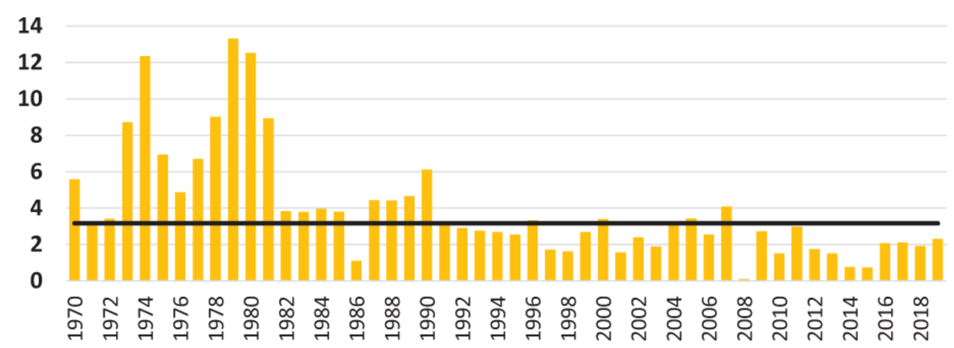
Commodities & Periods of High / Low Inflation

FIGURE 1

Annual Inflation: % Change in the Consumer Price Index (CPI)



	Large U.S. Stock	Small U.S. Stock	Non-U.S. Stock	U.S. Bonds	U.S. Cash	Real Estate	Commodities
Low Inflation Years (25 years with below-median CPI)							
Avg Nominal Return (%)	13.21	13.06	9.99	6.31	2.45	11.51	(2.43)
Avg Inflation-Adj Return (%)	10.96	10.80	7.82	4.24	0.45	9.30	(4.43)
High Inflation Years (25 years with above-median CPI)							
Avg Nominal Return (%)	10.82	12.84	11.68	8.85	7.15	15.02	21.80
Avg Inflation-Adj Return (%)	4.81	6.59	5.66	2.92	1.20	8.70	15.06

Source: Lipper and Steele Systems, calculations by author.

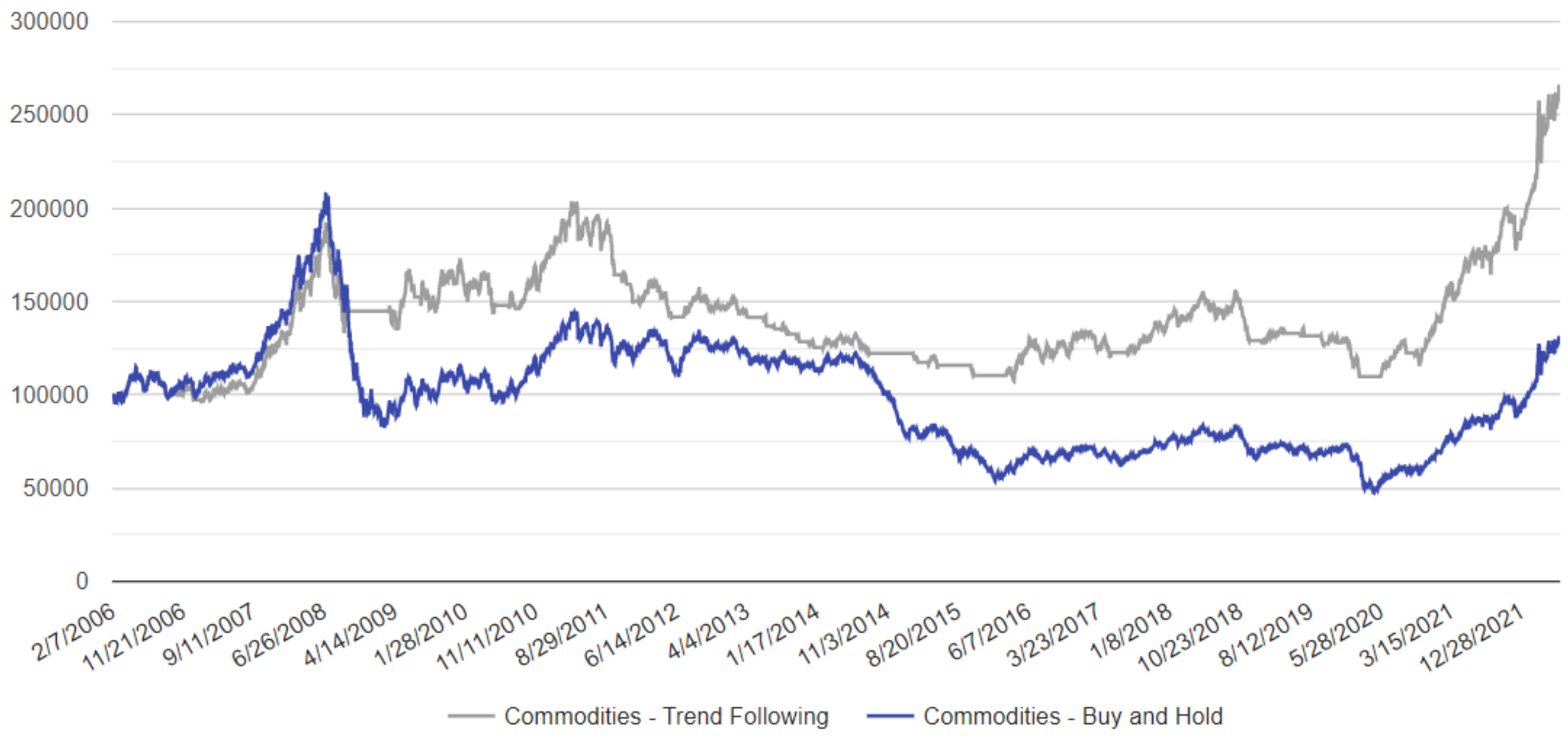
Source: Inflation: The Dormant Dragon, AAII Sept, 2020

In low inflation periods, commodities underperform significantly. In high inflation periods, commodities outperform materially.

We have been in a falling or very low inflation environment. If this changes and inflation become more persistent, commodities could be a strong performing asset class.

Past performance is not necessarily indicative of future results.

Commodities & Trend – Can We Manage the Drawdowns in Commodities Intelligently? YES



Annual Timing Return:	6.0%
Buy and Hold:	1.5%

Five Year Timing Return:	16.8%
Buy and Hold:	14.3%

Three Year Timing Return:	26.0%
Buy and Hold:	22.8%

Max Loss:	47.1%
Max Loss Buy and Hold:	77.0%

Past performance is not necessarily indicative of future results.

Four Strategies that Incorporate Alternative Assets Along with Stocks & Bonds

- Strategy 1: Permanent Portfolio
- Strategy 2: All-Weather Portfolio
- Strategy 3: Protective Asset Allocation
- Strategy 4: Generalized Protective Momentum

The list displayed are for illustrative purposes only and are not intended to portray recommendations.

Strategy 1: *Simple Asset Class Diversification For All Economic Regimes*

Strategy, Evidence & Investment Thesis

Returns do not represent actual money management returns.

Fundamental Investing Insight

Investors can build a portfolio that offers long-term growth, income, and protection from inflationary and deflationary environments using a combination of stocks, bonds, and gold.

Strategy	Source/Evidence	Investment Thesis
The strategy invests 25% of its assets each in stocks, long-term treasury bonds, short-term treasury bonds, and gold. Our modified version will invest only in the assets that are currently in an uptrend among the four in the universe. If no assets are in an uptrend, it will invest 100% of its assets in short or intermediate-term bonds.	The concept was developed by Harry Brown and written about in his book, *Fail-Safe Investing: Lifelong Financial Security in 30 Minutes*. From 1976 to 2016, a hypothetical permanent portfolio back-test produced a return of 8.6% annually with a standard deviation of only 7.2% per year.	The combination of uncorrelated and different asset classes helps limit drawdowns and volatility, helping the investor following this type of strategy generate steady returns over time.

Strategy 1: The Inputs

builds off of a strategy outlined in *Fail-Safe Investing: Lifelong Financial Security in 30 Minutes written by Harry Brown*

An Asset For Any Type of Environment	**Allocate across four very different types of assets classes** Stocks for growth, prosperity and declining inflation. Gold for high inflation. Long-Term Bonds for falling rates, or deflation. Cash/ST Bonds: safest asset.
25% Allocation	**Allocate equally across assets** Invest 25% in each
Annual Rebalancing	**Rebalance the Portfolio** The portfolio is reviewed and rebalanced annually, with positions coming back to equal weight each year.

Strategy 2: *Going Beyond Basics With More Asset Classes To Manage Risk*

Strategy, Evidence & Investment Thesis

Returns do not represent actual money management returns.

Fundamental Investing Insight

Investors can construct a portfolio that performs well in varying economic environments, including both high and low inflation, and high and low economic growth using a combination of uncorrelated asset classes.

Strategy	Source/Evidence	Investment Thesis
This strategy invests in US stocks, intermediate and long-term bonds, commodities and gold. It is considered a simple form of risk parity since it overweights lower risk bonds relative to the higher risk asset classes and seeks to even out each asset class's contribution to overall portfolio risk.	A more simplified version of risk-parity-based All Weather Fund from the leading hedge fund Bridgewater Associates and its founder Ray Dalio. Since its inception in 1996 to the end of 2019, Bridgewater's All Weather has returned 7.8 percent per year on average.	The combination of uncorrelated and different asset classes and weighting provide the portfolio with the ability to do well in any economic season, or type of environment. The objective is to generate steady returns, limit drawdowns and volatility, and allowing the investor following this type of strategy to stick with the strategy over time.

Strategy 2: The Inputs

builds off on a strategy extracted from the writing and interviews of Ray Dalio of Bridgewater Associates

Mix of Assets for Different Economic Seasons

Allocate across five very different types of assets classes

- US stocks
- long-term treasuries
- intermediate-term treasuries
- commodities
- gold

Risk-based Allocations

Allocate across assets

30% US stocks
40% long-term treasuries
15% intermediate-term treasuries
7.5% commodities, diversified
7.5% gold

Annual rebalancing

Rebalance the Portfolio

The portfolio is reviewed and rebalanced annually, with positions coming back to target weights

Strategy 3: *A Tactical Variation On The 60/40 Stock/Bond Portfolio*

Strategy, Evidence & Investment Thesis in Today's Market

Returns do not represent actual money management returns.

Fundamental Investing Insight

Investors looking for additional diversification and protection from major market declines relative to a traditional 60/40 portfolio might want to consider expanding their horizons beyond stocks and bonds and utilizing trend and momentum.

Strategy	Source/Evidence	Investment Thesis
This strategy invests in the asset classes with the highest momentum from a diverse group of 12 asset classes. It invests in the six assets with the most momentum, and will move aggressively toward a crash protection asset when the assets in the selection universe enter downtrends.	In the paper, "Protective Asset Allocation (PAA): A Simple Momentum-Based Alternative for Term Deposits", the research tested the strategy from 1970-2015. Back-test produced better raw and risk-adjusted performance vs. the market and 60/40 portfolio with significantly less risk.	Absolute and relative momentum can help investors boost returns and help protect from major declines when compared to static asset allocation approaches.

Strategy 3: The Inputs

Selection Universe	**The model selects from among 12 different asset classes** S&P 500, Russell 2000, NASDAQ 100, European Equities, Japanese Equities, EM equities LT treasury bonds, High yield bonds, Corporate bonds, Commodities, Gold, Real estate
Which Ones to Hold	**Of the 12, it holds the top six performing assets based on momentum** Model uses 12 month look-back momentum. What asset classes have done the best over the past 12 months.
Portfolio Rebalancing & Construction	**Frequent changes and not overweighting one asset class** The portfolio is reviewed and rebalanced monthly, with positions coming back to equal weight each month.
Crash Protection Overlay	**Ability to flex in and out of risk assets when needed in an effort to minimize major drawdowns** Six or more of the assets need to have negative momentum – at this point model moves to 100% crash protection positioning

Strategy 4: *A Tactical Asset Allocation Strategy Using Momentum + Correlation Analysis*

Strategy, Evidence & Investment Thesis in Today's Market

Returns do not represent actual money management returns.

Fundamental Investing Insight

Investing in a diversified set of asset classes that have both strong momentum and limited correlation with each other can produce superior risk adjusted performance to a standard 60/40 portfolio.

Strategy	Source/Evidence	Investment Thesis
This strategy invests in the assets with the best combination of momentum and lack of correlation with each other among a diverse group of 12 asset classes. It invests in the six assets with the highest score using a system that combines momentum and correlation, and will move aggressively toward a crash protection asset when the assets in the selection universe enter downtrends.	This strategy builds off of the "Protective Asset Allocation", which was tested 1970-2015 and showed better raw and risk-adjusted performance vs. the market and 60/40 portfolio with significantly less risk in the back test.	Using momentum and focusing on limiting correlation among portfolio holdings can help investors boost risk-adjusted returns and help protect from major declines when compared to static asset allocation approaches.

Strategy 4: The Inputs

Selection Universe	**The model selects from among 12 different asset classes** S&P 500, Russell 2000, NASDAQ 100, European Equities, Japanese Equities, EM equities, LT treasury bonds, High yield bonds, Corporate bonds, Commodities, Gold, Real estate
Which Ones to Hold	**Of the 12, it holds the top three performing assets based on momentum & correlation** Model uses 12 month look-back momentum. What asset classes have done the best over the past 12 months. Also holds the asset classes that are less positively correlated to other assets in the universe.
Portfolio Rebalancing & Construction	**Frequent changes and not overweighting one asset class** The portfolio is reviewed and rebalanced monthly, with positions coming back to equal weight each month.
Crash Protection Overlay	**Ability to flex in and out of risk assets when needed in an effort to minimize major drawdowns** Six or more of the assets need to have negative momentum – at this point model moves to 100% crash protection positioning

Parting Thoughts …

- The 60/40 Stock/Bond allocation has rewarded investors handsomely over the long term. It's simple and it's cheap.
- But the next 10-20 years may not be as fruitful given valuations, yields and inflation risk.
- Investors can complement their stock and bond investments with other asset classes, some of which should do well if we get inflation.
- Simple all asset models or strategies that utilize absolute and relative momentum can be alternatives for some investors.
- Lower returns will have many implications on return assumptions and withdrawal rates for retirees or those nearing retirement.

Questions / Learn More

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