Is the 60/40 portfolio still relevant?

As we consider the headwinds of the environment with low expected equity returns and bond returns potentially negative what are the expectations for a traditional 60/40 portfolio?

We believe the historical roles of stocks and bonds remain the same. Stocks are the primary asset class for appreciation and bonds are the asset class that can provide predictable cash flow and offsets the volatility of stocks. As we say, you want to own enough bonds in your portfolio to mute any swings in market value, so that you can sleep better at night.

Our long-term expectations for equity returns are in the 8%-10% range, which are in line with earnings growth. This is lower than the 11.8% average annual return for the S&P 500 from 1975-2020, but still quite respectable. Bond returns are a bit more challenging in the short term given that rates are low but have been moving higher. Expectations for bond returns incorporating investment grade and non-investment grade bonds should be in the 3%-5% range. The expected return, taking the mid-point of our expectations, would be about 7% for a 60/40 portfolio.

What opportunities are available to add different sources of return to the 60/40 portfolio?

We believe that tactical management can provide a different source of returns, or more specifically, the potential for better risk control. Tactical asset allocation shifts have the potential to limit downside risk by moving away from asset classes that have poor relative strength and moving into asset classes that are performing better.

How do we look to manage risk in a portfolio in a rising rate environment?

Ironically, while rising rates can cause some pain in the short term, those higher yield levels provide higher future expected returns as we lock in those higher yields and cash flow. We believe actively managed fixed income portfolios allow for the thoughtful positioning of portfolios along the yield curve and can take advantage of dynamically shifting rates.

Typically, short-term rates move higher to a greater degree than long-term rates in an environment created by the Fed tightening monetary policy. This happens because the Fed directly controls short-term rates, and a tighter Fed reduces the likelihood of future inflation. In each of the last three rate hike cycles, short-term rates moved up significantly and long-term rates barely moved.

Additionally, all bonds do not perform the same in a rising rate environment. We believe that Treasuries are the least attractive type of bond in a rising rate environment because they only have one lever that moves their prices, which is interest rates. Corporate and municipal bonds have historically been able to outpace Treasuries in a rising rate environment because the credit spread typically narrows if interest rates are rising because the economy is strong. In fact, high yield bonds have historically performed better in years when interest rates have risen than they have in years when interest rates have declined. We believe that actively managing the allocation within credit in bond portfolios can potentially lead to more protection against rising interest rates.

How do we balance the need for return, income and managing risk?

We believe that asset allocation is the primary way to balance return, income, and risk. Stocks have historically provided the highest level of returns over the long term, but they also have more volatility than bonds. Bonds, on the other hand, can provide a predictable stream of income with lower levels of volatility. Blending stocks and bonds together in an overall portfolio can provide a balance between capital appreciation, income, and volatility. Remember, a bond held to maturity can provide a known cash flow and return over the full period (assuming the issuer does not default). Bond prices will

fluctuate along the way, but the cash flow is locked in by the terms of the bond. Tactical asset allocation shifts can aid in balancing the return and risk by shifting away from asset classes that are underperforming relative to other asset classes, thus limiting downside risk.

Should alternatives (and specifically liquid alts) be considered part of the baseline portfolio and what role do they play?

We believe that alternatives can provide a source of returns that are less correlated with the general stock and bond markets. As a result, liquid alternatives can dampen volatility in the overall portfolio.

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Treasury yield is the return on investment, expressed as a percentage, on the U.S. government's debt obligations. Looked at another way, the Treasury yield is the effective interest rate that the U.S. government pays to borrow money for different lengths of time.

The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities.

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