MORAN
WEALTH MANAGEMENT
Passionate • Personable • Performance Driven

July 14, 2020

Failure of the 60-40 Formula

Balance – a topic that seems to be on everyone's mind and essential for happiness and well-being. Work-life balance. Balanced diet. Life is very much a balancing act, and it seems we are always just a step away from a fall. When thrown off course, we are often unable to move forward on life's tightrope until balance is restored. The coronavirus crisis continues to add instability to many aspects of our lives, finances included, and we believe it may be time to address potential imbalances in investor portfolios.

A cornerstone of the Moran Wealth Management advisory process is establishing an appropriate asset allocation for our clients. One of the more conventional approaches to asset allocation is a 60/40 portfolio. The 60/40 portfolio divides assets between equities (60%) and bonds (40%) and is the starting point for many wealth advisors who recommend a percent based upon age (ie. a higher equity allocation is recommended for younger people with longer time horizons that can withstand more volatility). The 60/40 portfolio emerged from Harry Markowitz's Modern Portfolio Theory (MPT) work in the 1950's, winning him the Nobel Prize. Yet, Markowitz most likely never envisioned a world where someone has to pay to lend money. Today, just under 20% of all government bonds have a negative nominative yield – worldwide. Even more with yields less than the rate of inflation (Naumer). After almost 70 years of success, we believe the 60/40 portfolio investment approach has become too risky and structurally incapable of meeting its intended objectives. It needs revisiting.

In addition to near historic low yields we are experiencing in the bond markets, investors may also be taking on more risk than they originally intended. To fill their fixed income allocations, many passive investors use products such as funds or ETFs that track the Barclays U.S. Aggregate Index. The average duration of the index was 5.9 as of January 31, 2020, well above its pre-crisis average of 4.5 (Martin). Duration measures the sensitivity of the fluctuations in value of a bond as a result of interest rate changes. The general rule states that a longer duration indicates a greater likelihood that the value of a bond will fall as interest rates increase. If you have been holding a fund that tracks this index over the years, that investment may have more interest rate risk today than when first invested. Bond investors have experienced a combination of increasing interest rate risk and decreasing compensation for said risk. Some might consider these results 'return free risk' rather than a 'risk free return'.

A question we have recently been asked quite frequently concerns the disconnect between the market and the economy. As clouds continue to darken on Main Street, Wall Street has been singing a much sunnier tune. It is imperative for investors to keep bullishness in-check, particularly now that asset prices no longer reflect the underlying economic fundamentals which they are supposed to track. At the March low, we do not think anyone would believe that by June the S&P would have recovered most of its losses and the NASDAQ would be green for the year. We may likely experience volatility in equity markets as the extent of the impact of the coronavirus shutdowns becomes clearer during the initial stages of this economic recovery.

A 60/40 portfolio may not be as efficient an asset allocation to hedge against market volatility as in years past. Thankfully, stocks and bonds are not the only asset classes available to our clients. There are alternative investments that investors may choose,

many of which were not available to the average investor when Markowitz was devising the 60/40 portfolio. Possible potential benefits of adding alternatives to your portfolio include:

1) Decreasing asset correlations
2) Increasing current income
3) Strive to reduce risk and avoid-losses in a down turn
4) Maximizing risk-return trade-off
5) Preserving accumulated wealth against inflation and currency devaluation.

We believe investors who are concerned with historically low yields available from fixed income investments, above-average correlation between bonds to equities, and the prospect of bonds producing negative real rates of return after inflation should consider a small to moderate allocation in some of our alternative non- correlated investment styles. We believe this small adjustment to the traditional 60/40 mix may potentially improve both the balance between upside-capture and downside-risks and increase the probability of some clients meeting their intended investment objectives.

"Be moderate in order to taste the joys of life in abundance." - Epicurus

Tom Moran
Founder, Chief Executive Officer
Senior Portfolio Manager

Hank Brown
Financial Advisor

P: 239-920-4440 | F: 239-431-5239
Thomas.Moran@MoranWM.com | www.MoranWM.com
5801 Pelican Bay Blvd, Suite 110, Naples, FL 34108

Past performance is not a guarantee of future results.

All investing involves some degree of risk, whether it is associated with market volatility, purchasing power or a specific security, including the possible loss of principal. Stocks offer long-term growth potential, but may fluctuate more and provide less current income than other investments.

There is no guarantee that dividend-paying stocks will return more than the overall stock market. Dividends are not guaranteed and are subject to change or elimination.

Asset allocation and diversification are investment methods used to help manage risk. They do not guarantee investment returns or eliminate risk of loss, including in a declining market.

Index returns are not fund returns. An index is unmanaged and not available for direct investment.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

Bloomberg Barclays U.S. Aggregate Bond Index is composed of the Bloomberg Barclays U.S. Government/Credit Index and the Bloomberg Barclays U.S. Mortgage-Backed Securities Index and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities.

Investments in fixed-income securities are subject to market, interest rate, credit and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and/or principal. This risk is heightened in lower rated bonds. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity. Yields and market value will fluctuate so that your investment, if sold prior to maturity, may be worth more or less than its original cost.

The prices of small company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification, and competitive strengths to endure adverse economic conditions.

The opinions expressed here reflect the judgment of the author as of the date of the report and are subject to change without notice. The material has been prepared or is distributed solely for information purposes and is not a solicitation or an offer to buy any security or instrument or to participate in any trading strategy. Additional information is available upon request.

Investment products and services are offered through Wells Fargo Advisors Financial Network, LLC (WFAFN). Moran Wealth Management is a separate entity from WFAFN. 0720-02211

References

Martin, Collin (2020, February 06). *The Hidden Risks of Bond Benchmarks.* Charles Schwab.

Naumer, Hans Jörg (2020, June 16). *Who is Going to Pay In a Low/Negative Yield Environment?* Allianz Global Investors.