ECONOMIC & MARKET OUTLOOK

A MULTI-ASSET PERSPECTIVE

Restoring balance: Checking in on the 60/40 portfolio

In 2022, the standard 60/40 portfolio (60% stocks and 40% bonds) did not provide investors with the expected benefits of diversification. A historic inflation surprise, followed by rapid central bank hiking, drove both stock and bond valuations to the downside.

This year, **investor allocations appear ripe for rebalancing from a 60/40 starting point** due to several potential factors, including, but not limited to portfolio drift over the last economic cycle, correlations restored to historical norms, and recent price action.

Most importantly, after a decade of low and stable rates and inflation, **we may be entering a new macroeconomic regime of moderate rates and inflation**. In this environment, investors may benefit from a different set of tools than those that succeeded in the last cycle.

In this piece, we make the case for **rebalancing stocks and bonds, reallocating to shorter duration instruments, and further diversifying within each asset class.**

INVESTMENTS

Investment best practice suggests that diversification between stocks and bonds can cushion portfolios against the markets' ever-present ebb and flow. However, that diversification benefit is liable to deteriorate when both stocks and bonds are influenced by a shared economic or market development.

In 2022, there was no place to hide from central banks' fight against inflation. Interest rate increases and quantitative tightening drained liquidity from the global marketplace. The result? A bear market in both stocks *and* bonds.

We expect stock-bond correlations to normalize this year as inflation moves from a surprise to a way of life. Such an environment suggests investors should assess their portfolios for portfolio drift as a lower correlation between stocks and bonds improves expected risk-adjusted returns. "Sticky"— high but decelerating — inflation also speaks to the markets potentially entering a new macroeconomic regime defined by higher rates and less supportive monetary policy. Recent price action has also provided investors with a favorable rebalancing window.

In this paper, we make the case that the convergence of these factors creates a fitting moment for investors to consider reallocating and rebalancing their portfolios. While each investor's starting point and goals are different, the cumulation of these ideas points to rebalancing on the margin from stocks to bonds, reallocating towards shorter duration assets, and further diversifying within asset classes.

Reasons to Rebalance and Reallocate

2022 was a challenging year for investors because there were few places to hide from the Fed's fight against inflation. Rate hikes and declining market liquidity led to bear markets in both stocks and bonds. In fact, the correlation[1] between stocks and bonds last year was at its highest since 2007. We do not believe this trend will continue. Instead, we believe the last several years have led investors astray from fundamentals and that a return to the classic 60/40 portfolio — the standard mix of 60% equities and 40% bonds — may be appropriate as an allocation baseline.[2]

Why 60/40? The 60/40 portfolio is designed for investors suited to moderate risk and moderate returns. On average, over time, the 60/40 portfolio has been the optimal allocation for long-term risk-adjusted returns. However, every investor's needs and goals are different; the ideas in this paper should be adapted accordingly. At the end of this paper, we provide a sample 60/40 allocation with diversified stock and bond sleeves. A more conservative investor, for example, may choose a 50/50 weighting of stocks and bonds, and in this case, the allocations of the stocks and bonds sleeves in the sample 60/40 portfolio can be sized for a 50/50 portfolio.

Why only stocks and bonds? Why not alternatives or commodities? The standard 60/40 model is constructed with only stocks and bonds, typically the S&P 500 and the Bloomberg U.S. Aggregate Bond Indices. We wanted to investigate whether diversifying within both the stock and bond sleeves could improve upon the standard 60/40 model while remaining within the asset-class bounds of the 60/40 model — stocks and bonds. However, a significant amount of research has been written on how to diversify outside of stocks and bonds. We've provided examples of this type of research — see our 2023 Outlook.

Drift: Portfolios have drifted towards stock-heavy allocations

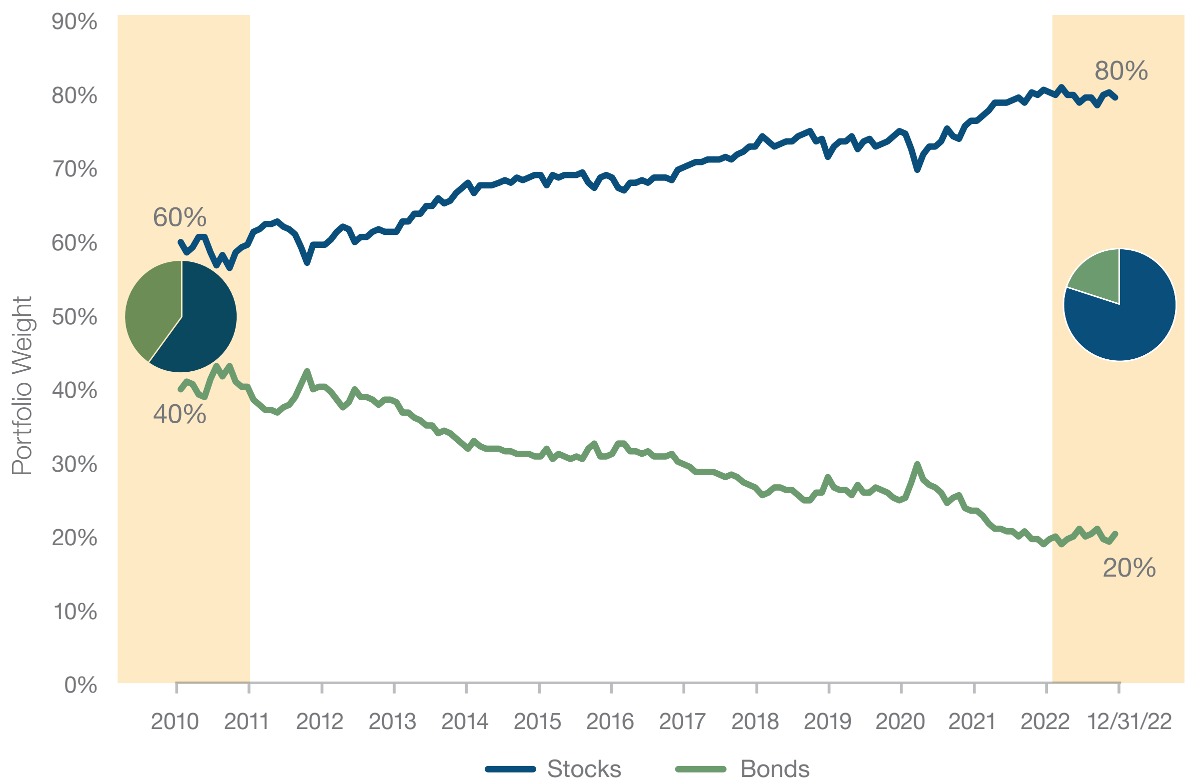
Most investors will have heard the phrase "set it and forget it." The general idea is that reaching long-term financial goals may best be served by determining an appropriate allocation and sticking with it.

There's one often overlooked caveat to that perspective: drift. Portfolio drift occurs when an asset allocation deviates from its target allocation due to changes in market conditions. For example, if an investor initially allocated to a 60/40 portfolio in a period when interest rates were low, and stocks outperformed bonds, that investor's portfolio would, years later, be well overweight stocks and far underweight bonds. The main point here is that this allocation is not what the investor initially chose.

Below we illustrate the evolution of a 60/40 portfolio, set up in 2010 and untouched through today. With stocks outperforming bonds in this environment, the original 60/40 portfolio would now be an 80/20 portfolio *(we'll describe below why we believe this may not be an appropriate allocation for the macroeconomic environment ahead)*. While this extreme example is implausible, it helps to illustrate the importance of keeping a portfolio well-balanced and aligned with the investor's goals and risk tolerance.

The Dangers of Portfolio Drift

The evolution of a 60/40 portfolio without rebalancing, January 2010 through December 2022



Sources: New York Life Investments' Multi-Asset Solutions, Bloomberg, 12/31/2022. Stocks are represented by the S&P 500 Index and bonds are represented by the Bloomberg U.S. Aggregate Bond Index. Past performance is no guarantee of future results. An investment cannot be made directly into an index. Index definitions can be found at the end of this piece.

Correlation: Last year's correlation challenge is likely past

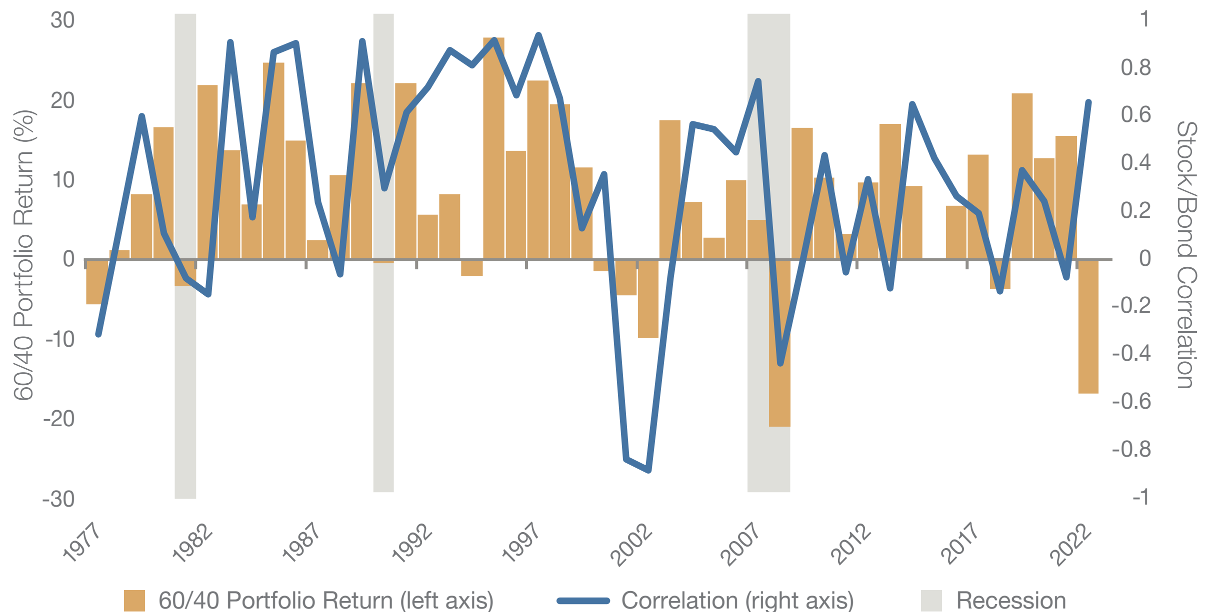
Combining imperfectly correlated assets is a basic tenet of portfolio construction. Investors seek *individual* asset types they expect to add value over time, and they allocate to a *mix* of less-correlated assets which they expect will deliver superior risk-adjusted returns. Though a foundational concept in the investment management industry, this information bears repeating because, in 2022, both stock and bond prices were influenced by the same thing: an upside inflation surprise driving a strong and sudden uptick in interest rates. Research suggests[3] that it's not only macroeconomic factors that matter here, but also the unexpected nature of those factors.

We don't believe high stock-bond correlation will continue in 2023. Last year was marked by an inflation rate not seen in four decades, catching many off guard. While we don't know the trajectory of inflation from here, we don't anticipate it will be as *surprising* to investors in 2023 as it was last year.

Additionally, it's worth noting that a positive stock-bond correlation need not indicate poor results for the 60/40 portfolio. In fact, there have been several years where both 60/40 portfolio returns and stock-bond correlation were both positive.

"Nothing worked in 2022." High stock-bond correlation resulted in lower returns.

60/40 portfolio returns vs. stock/bond correlation

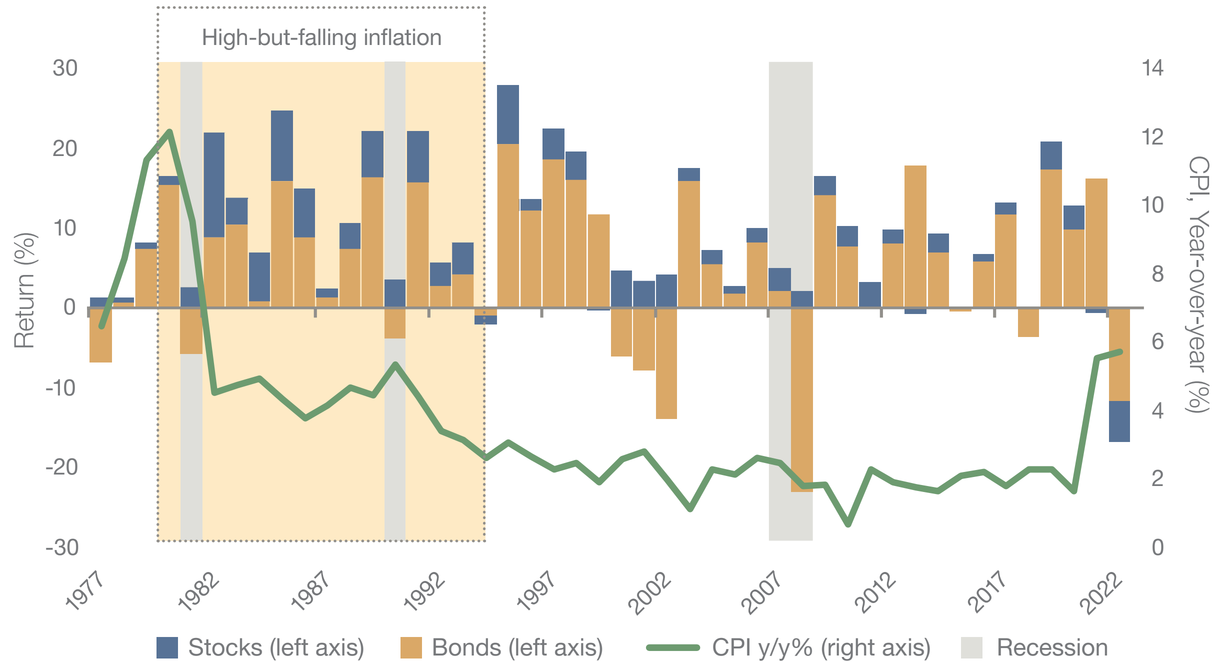


Sources: New York Life Investments' Multi-Asset Solutions, Bloomberg, NBER, Macrobond, 12/31/22. Portfolio: 60% S&P 500, 40% Bloomberg U.S. Aggregate Bond Index. Correlation based on monthly changes over trailing 12 months, annual average. Past performance is no guarantee of future results. An investment cannot be made directly into an index. Index definitions can be found at the end of this piece.

It is also worth noting that bonds were the main contributor to the performance of 60/40 portfolio returns during the last period of high-but-falling inflation, even as stock-bond correlation was positive.

Bonds have historically outperformed equity when inflation is high but falling

Stock and bond contributions to 60/40 portfolio vs. inflation



Sources: New York Life Investments' Multi-Asset Solutions, U.S. Bureau of Labor Statistics, Bloomberg, NBER, Macrobond, 12/31/22. CPI: Consumer Price Index. Stocks: S&P 500 Index. Bonds: Bloomberg U.S. Aggregate Bond Index. Past performance is no guarantee of future results. An investment cannot be made directly into an index. Index definitions can be found at the end of this piece.

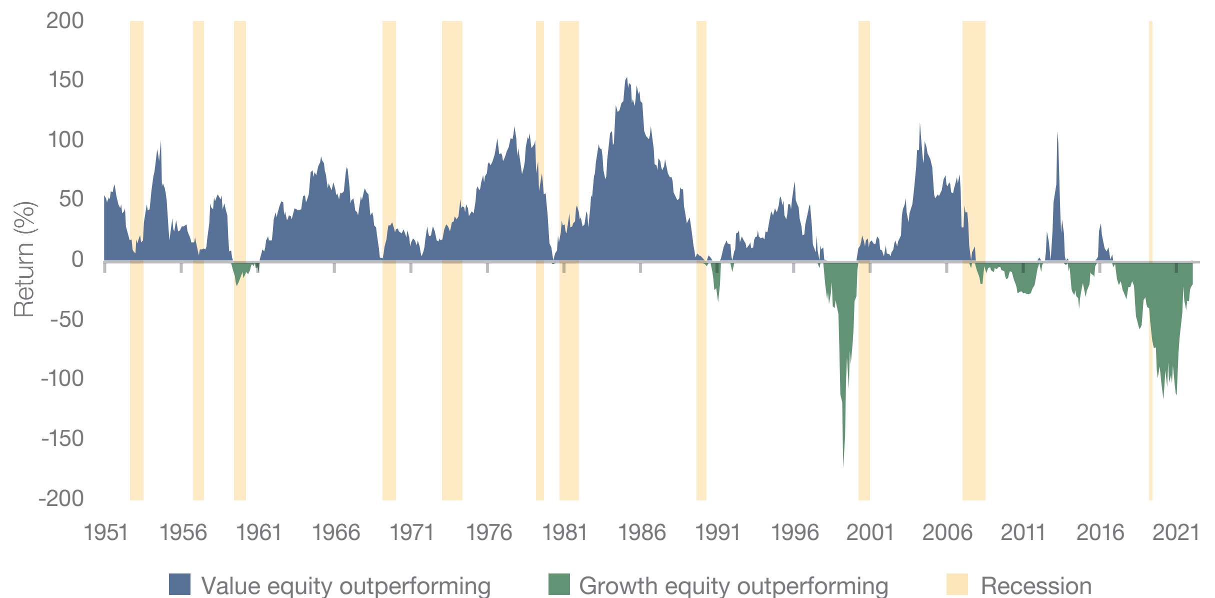
Cycle: A new macro regime requires new investment ideas

The last economic cycle — the post-financial crisis period up to the COVID-19 pandemic — was defined by a particular macroeconomic regime: low and stable economic growth, inflation, and interest rates. Low or declining interest rates support companies' *operations* by reducing their cost of capital and benefit their *valuations* by increasing the value of distant cash flows. Companies with longer-dated expected earnings, namely growth stocks, are more sensitive to changes in interest rates, and therefore benefited disproportionally from this macroeconomic backdrop.

The post-financial crisis environment has been the exception, not the rule. Looking ahead, we believe that interest rates are likely to be higher, inflation is likely to be stickier, and economic growth will be more volatile and uncertain. In such an environment, short duration assets are expected to outperform. Investors should consider reducing their exposure to long duration assets in both stocks and bonds.

Value equity has a long history of outperformance over growth equity

Rolling 5-year returns, expressed as value equity returns less growth equity returns



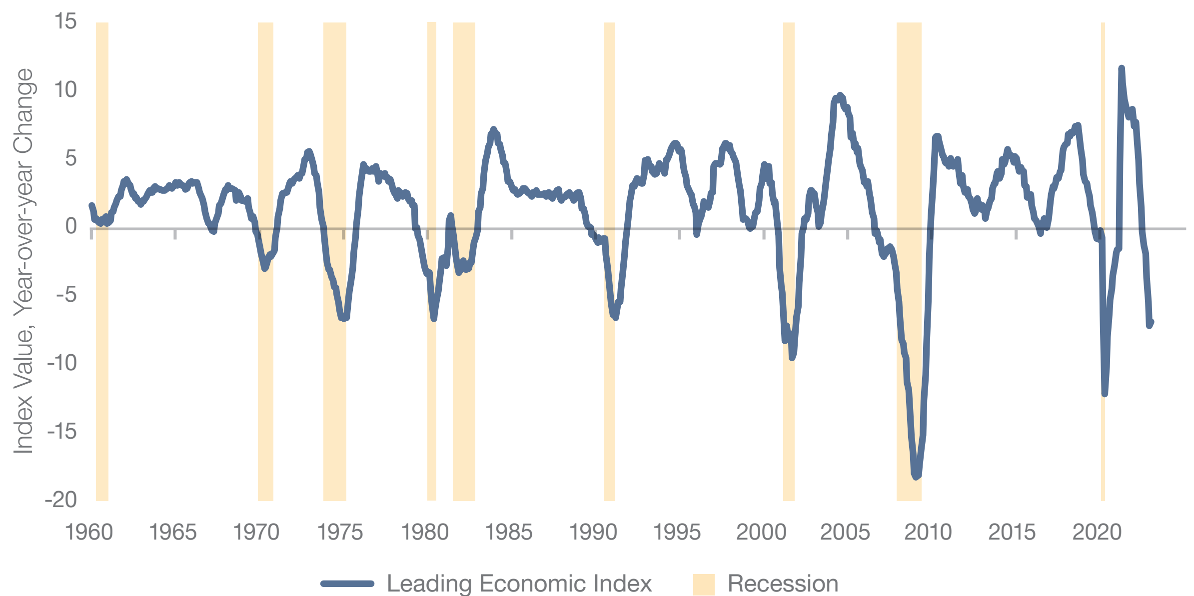
Sources: New York Life Investments' Multi-Asset Solutions, Fama/French Data Library, NBER, Macrobond, October 1951 through December 2022. Value is represented by the average return of the "Big Value" and "Small Value" Fama/French benchmark portfolios. Growth is represented by the average return of the "Big Growth" and "Small Growth" Fama/French benchmark portfolios. Fama/French benchmark portfolios are hypothetical portfolios based on Fama/French equity factors. Past performance is no guarantee of future results. It is not possible to invest directly in a Fama/French benchmark portfolio. Definitions can be found at the end of this piece.

Valuation: Recent price action provides a tactical opportunity

The first quarter of 2023 has provided investors with a favorable rebalancing window. Year-over-year changes in headline inflation have seen a steady decline since summer 2022. And, as investors expected Federal Reserve interest rate hikes to pause soon, market pricing has reflected a pro growth outlook. Given the negative implications that rapidly weakening leading indicators have on the economic outlook, we expect this sentiment to fade. As a result, we believe that now could be an attractive time for investors to lock in gains and rebalance for the future.

Leading indicators point to slowing growth ahead

Evolution of leading economic indicators ahead of historical recessions

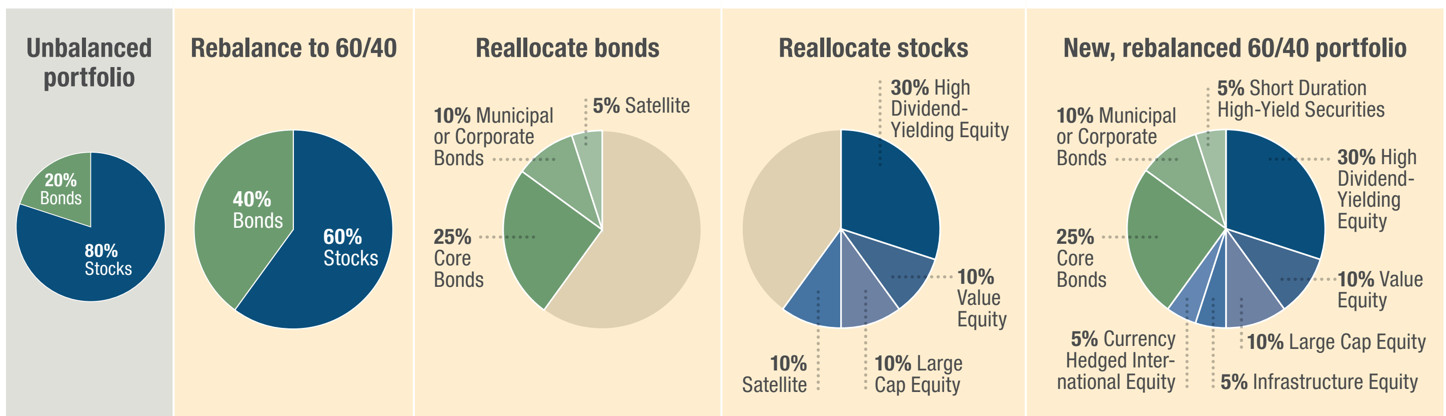


Sources: New York Life Investments' Multi-Asset Solutions, The Conference Board, NBER, Macrobond, 1/31/23. Past performance is no guarantee of future results. An investment cannot be made directly into an index. Index definitions can be found at the end of this piece.

It's time to consider rebalancing and reallocating

The table below summarizes the challenges facing a 60/40 portfolio investor and our view on how to build a 60/40 portfolio positioned for the new macro regime. Please keep in mind that these strategies are not recommendations and do not take into account the investment objectives or financial needs of particular investors.

	Portfolio drift	Correlation	New macro regime	New 60/40 starting point
Challenge	In the last economic cycle, low interest rates would have resulted in a 60/40 portfolio becoming unbalanced (closer to an 80/20 portfolio).	In 2022, both stocks and bonds valuations were driven downwards by the same factor: an inflation surprise.	In the last 10 years, the macro environment has been driven by low and stable rates and inflation.	Investors should consider the sample portfolio below as a **new 60/40 starting point**. The allocation is backed by quantitative portfolio modeling and lets investors tailor allocations through satellite holdings. (See note on methodology below.)
Our view	Over a 100-year historical period, the 60/40 portfolio has tended to be appropriate for long-term risk-adjusted returns.	We expect economic growth (or lack thereof) to command the narrative in 2023 and this has tended to reduce stock/bond correlation.	We believe that the next few years will see higher inflation and interest rates. In historical periods like this, value and high dividend stocks have tended to perform better.	
Response	Consider reallocating to a more balanced portfolio (e.g., sell 20% stocks for 20% bonds).	We believe diversification is very important and suggest diversifying bond exposure. Consider **municipal and corporate bonds**, which have tended to outperform on a risk-adjusted basis during periods of high but falling inflation.	Some investors may need to rebalance from growth-heavy allocations towards shorter duration equity. Consider an overweight allocation to **high dividend**-producing stocks in addition to value and large cap stocks.	



SATELLITES:

BONDS: In the current environment, we expect interest rates to continue to rise or maintain their current levels. In this case, we think investors should consider maintaining a short duration in their bond allocation and consider **short duration high yield bonds** as a 5% satellite. However, for investors looking to add satellite exposure to long duration bonds in case yields fall, we think **taxable municipal bonds** may provide quality, long-dated duration with an attractive yield potential.

STOCKS: **Infrastructure equity**: Offers a potential inflation hedge and exposure to a structural and global investment theme. **Currency hedged international developed markets' equity**: Diversify business cycle exposure as a potential hedge against a strengthening USD.

Note on methodology: Sample portfolios, excluding satellites, were modeled and ranked on risk-adjusted monthly return (Sharpe ratio). Portfolios were analyzed from 1973 through 2022 and assumed annual rebalancing. Satellites could not be modeled into the historical analysis due to shortened time frames in the existence of reliable data. Excluding the satellites, or allocating them to core bonds in the bond sleeve and high-dividend stocks in the stock sleeve, the portfolio presented represents the portfolio with the highest risk-adjusted return over the analysis period. However, a 5% bond satellite and 10% stock satellite can be carved from core bonds and high-dividend stocks, respectively, without significantly altering historical risk-adjusted returns. The satellites can then be used to tailor investor preferences to the current macroeconomic regime.

INDEX DEFINITIONS

Big growth tracks the performance of a benchmark portfolio composed of large U.S. companies with low book-to-market ratios as compiled by the Fama/French database.

Big value tracks the performance of a benchmark portfolio composed of large U.S. companies with high book-to-market ratios as compiled by the Fama/French database.

The **Bloomberg U.S. Aggregate Bond Index** (core bonds) is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities (agency and non-agency).

The **Conference Board Leading Economic Index** is an American economic leading indicator intended to forecast future economic activity.

Corporate bonds are represented by the ICE BofA U.S. Corporate Index which tracks the performance of U.S. dollar-denominated investment grade corporate debt publicly issued in the U.S. domestic market.

Currency hedged international developed markets' equity is represented by the MSCI EAFE Index, which is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia, and the Far East, excluding the U.S. and Canada.

High dividend tracks the performance of a benchmark portfolio composed of high-dividend paying companies as compiled by the Fama/French database.

Infrastructure is represented by the MSCI USA Infrastructure Index which is a free float-adjusted market cap weighted index that includes companies in the telecom, utilities, energy, transportation, and social infrastructure sectors.

Large cap is represented by the S&P 500 Index, an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance.

Municipal bonds are represented by the ICE BofA US Municipal Securities Index which tracks the performance of U.S. investment grade, tax-exempt municipal bonds.

The S&P 500 Index is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance.

Small value tracks the performance of a benchmark portfolio composed of small U.S. companies with high book-to-market ratios as compiled by the Fama/French database.

Small growth tracks the performance of a benchmark portfolio composed of small U.S. companies with low book-to-market ratios as compiled by the Fama/French database.

Taxable municipal bonds are represented by the ICE BofA Broad U.S. Taxable Municipal Securities Index which tracks the performance of U.S. dollar-denominated debt publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market.

Value equity is represented by the S&P 500 Value Index which measures the performance of companies from the S&P 500 Index that fit Value style characteristics of valuation and earnings.

DEFINITIONS

Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Correlation is a statistical measure that calculates the strength of the relationship between the relative movements of two variables. A correlation of -1.0 shows a perfect negative correlation, in which two variables move in exactly opposite directions. A correlation of 1.0 shows a perfect positive correlation, in which two variables move in the same direction.

The **Fama/French three-factor model** is a statistical model designed in 1992 by Eugene Fama and Kenneth French to describe stock returns.

The **National Bureau of Economic Research (NBER)** traditionally defines **recession** as a significant decline in economic activity that is spread across the economy and that lasts more than a few months.

Satellite exposure represents an actively managed portion of a portfolio in which a portfolio manager's skill provides an opportunity to earn greater returns than the broad market benchmark, as opposed to the "core" portion of a portfolio which may be passively managed.

Sharpe Ratio is a measure that compares the return of an investment to its risk. The ratio is calculated by taking the average return minus the risk-free return, divided by the standard deviation of return on an investment.

1. Correlation describes the degree to which two variables move in coordination with one another. A perfect correlation of 1.0 describes a situation in which two variables move to the same degree, and in the same direction and degree over time. Two variables may have a larger correlation if they are driven by similar factors. The lower the two variables' correlation, the more distinct their drivers are.

2. Investors might consider the 60/40 allocation as the starting point for portfolio construction because, on average over time, the 60/40 has been the optimal allocation for long-term risk-adjusted returns. From there, investors can tailor their allocation towards different themes and regimes. Adjusting a portfolio with a perspective towards current holdings may leave investors vulnerable to anchoring bias, i.e., "this allocation worked so I'll adjust from here." When reallocating towards a new regime, start with 60/40 regardless of what may have worked in the recent past. Past performance is no guarantee of future returns, which will vary.

3. According to research by AQR Capital Management, growth risk and inflation risk surprises have a significant impact on the stock/bond correlation. If economic growth dominates the news, the correlation is expected to be negative, whereas a positive correlation is more likely if inflation is driving the narrative. MacKay Shields' Macro and Quantitative Solutions team has also conducted research on this topic, positing that surprises in inflation and economic growth drive differences in asset class performance. MacKay Shields is an affiliate of New York Life Investments.

IMPORTANT DISCLOSURES

All investments are subject to market risk, including possible loss of principal. Diversification cannot assure a profit or protect against loss in a declining market.

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