A NEW FRAMEWORK TO STRATEGIC ASSET ALLOCATION

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Angeles

SUMMARY

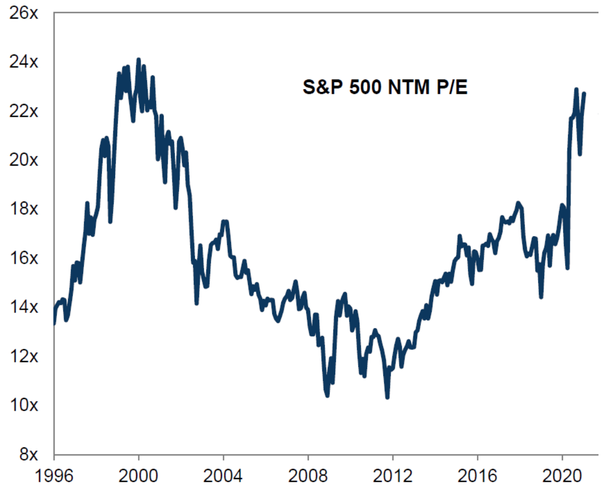
- A traditional asset allocation will likely prove more volatile and will be unlikely in the future to meet investors' return objectives.
- This is primarily due to the shortcomings of high-grade bonds, which offer no real yield and little protection in a downturn.
- We advocate investors hold distinct portfolios customized to their goals:
    - A Liquidity portfolio to meet current spending requirements;
    - A Growth portfolio for optimal long-term returns.

The purpose of an investment portfolio is to support current and future spending. Some spending may be known and near-term: beneficiary payments (in the case of a pension fund), current operational expenses (in the case of an endowment) or committed grants (in the case of a foundation). Other spending plans are indeterminate and longer-term, but investors generally seek to preserve their principal in real (after inflation) terms after spending.

Traditionally, investors have been able to meet both current expenses and future obligations by owning a mix of high-grade bonds, which historically have provided both current income and a moderate real return, and equities, which have historically grown at rates above inflation and spending for most investors.

This traditional mix of high-grade bonds and equities is unlikely to achieve the goal of meeting future obligations while also maintaining the real value of the portfolio. Most banks and advisors, including ourselves, forecast nominal equity returns below 6% and high-grade bond returns below 2% annually. Even with a very low level of inflation (we forecast sub-2%), there is no combination of high-grade bonds and equities that will meet most investors' goals. There are two reasons for this forecast of low future returns: high valuations and low economic growth.

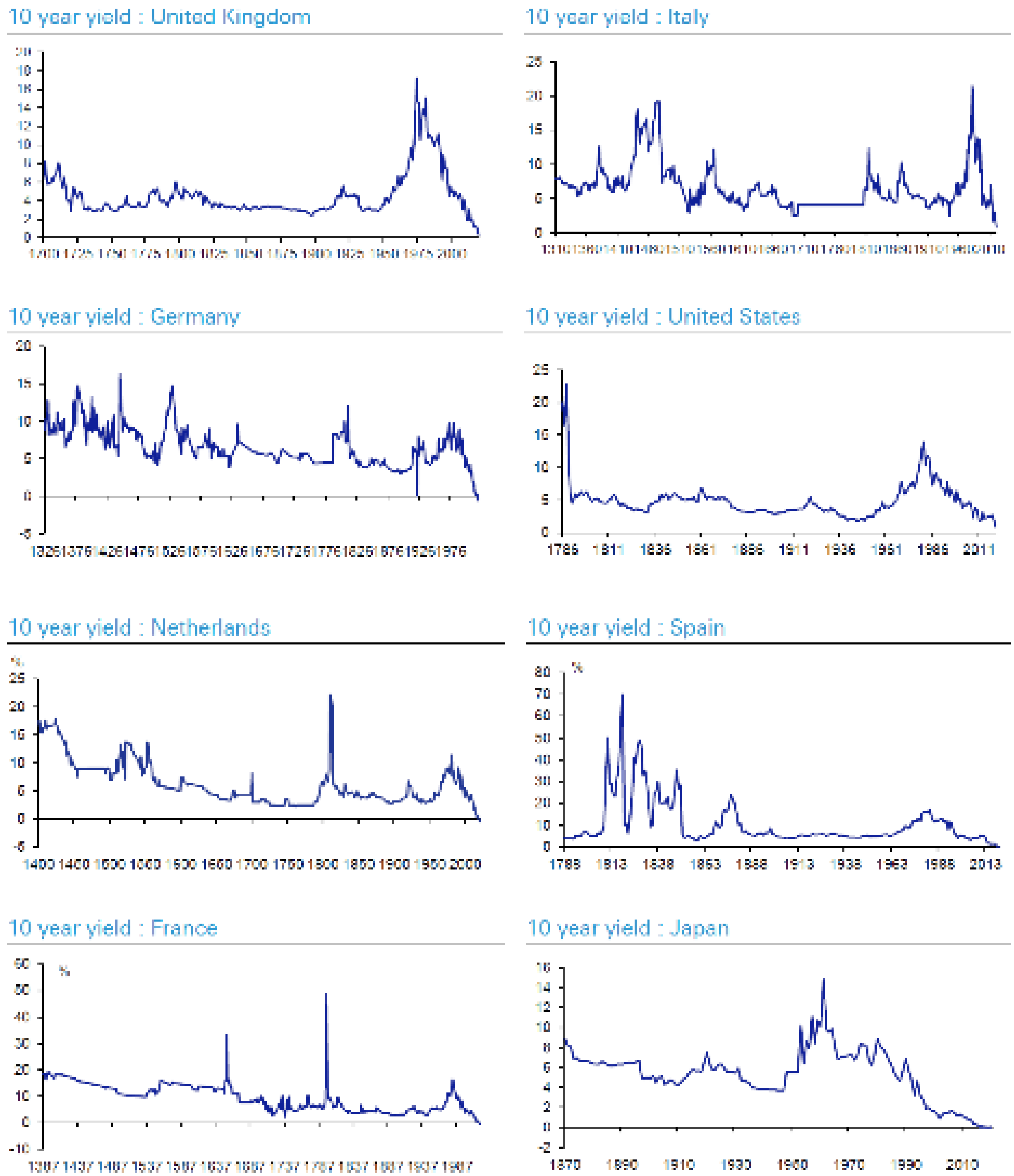
Chart 1: P/E Next Twelve Months, S&P 500 Index, 1996-2021



Source: Goldman Sachs

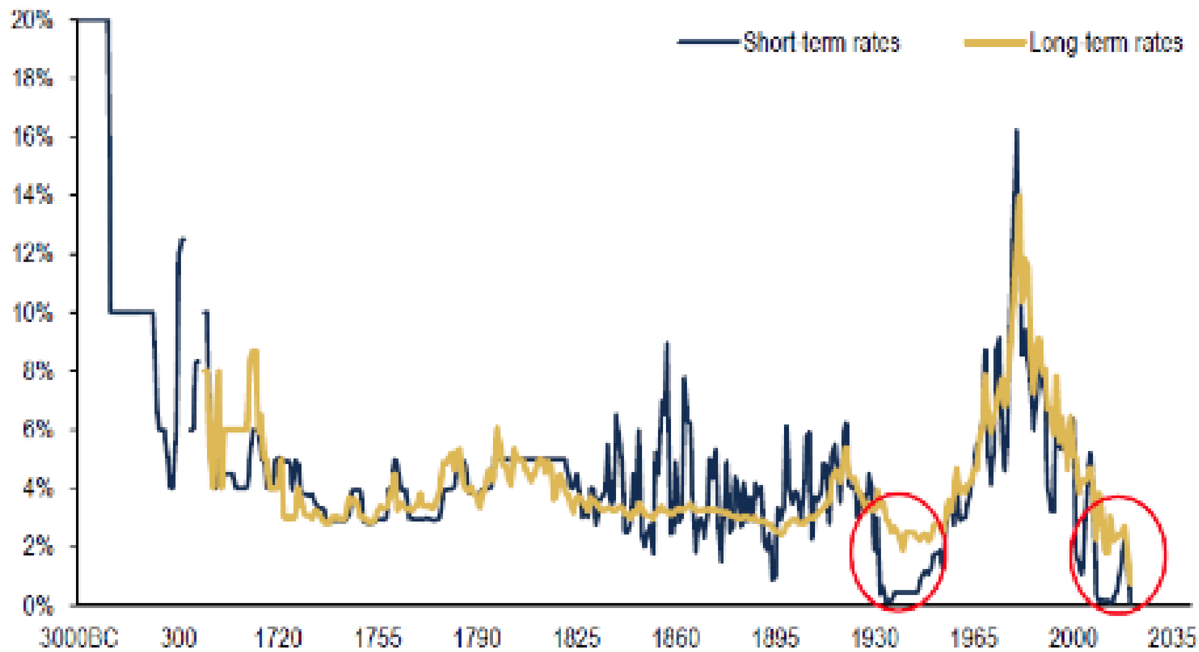
Equity valuations are high (see Chart 1), but bond valuations are even higher. In every major country, interest rates are at their lowest levels in centuries (Chart 2). Piecing together fragments of papyri and shards, we could even say that yields are the lowest in 5,000 years (Chart 3).

Chart 2: Government Bond Yields in Selected Countries, 1310-2020



Source: GFD, Bloomberg Finance LP, Deutsche Bank

Chart 3: Interest Rates Past 5,000 Years



Source: Bank of England, Global Financial Data, Homer and Sylla 'A History of Interest Rates' (2005), BofA Global Investment Strategy
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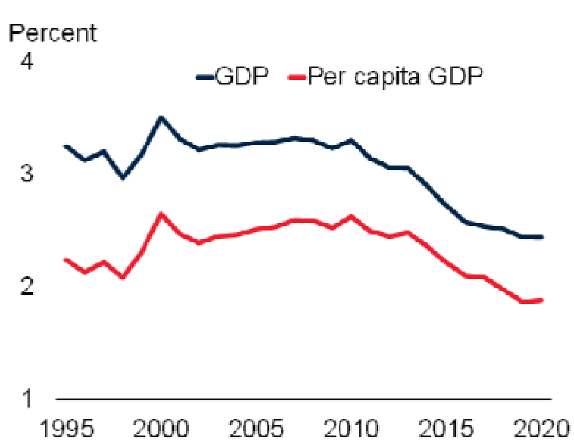
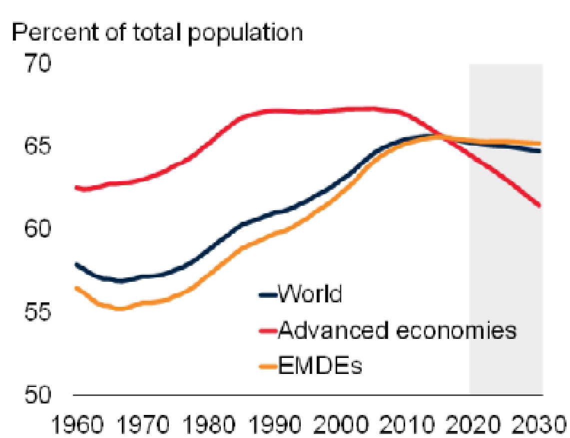
The second driver of our forecast is slower economic growth. This is not a new phenomenon, as forecasts for economic growth have been falling for the past two decades (Chart 4). We previously identified a number of trends and factors that point to weak economic growth in the coming years [(https://www.angelesinvestments.com/institutional-insights/sunrise-or-sunset-thoughts-on-a-post-pandemic-world-part-1).](https://www.angelesinvestments.com/institutional-insights/sunrise-or-sunset-thoughts-on-a-post-pandemic-world-part-1) These include rising levels of debt, risk aversion that favors savings over consumption, declining productivity and investment, and a reduction in trade, or deglobalization more generally. To this list we could add weak demographic growth (Chart 5), exacerbated by restrictions on immigration, and rising taxes and regulations as governments take a bigger share of the economy.

Chart 4: Ten-year Ahead Forecast for GDP Growth, 1995-2020



Source: IMF World Economic Outlook, January 2021

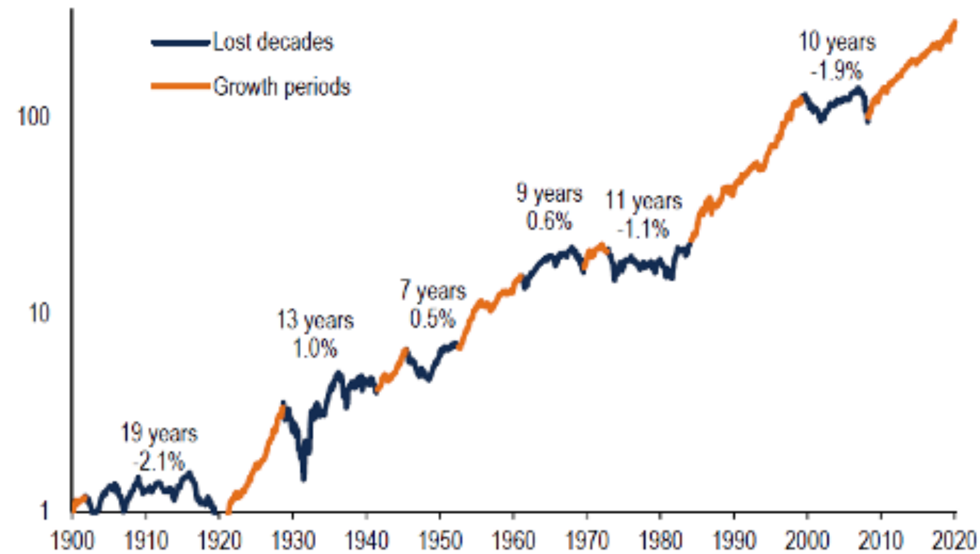
Chart 5: Global Working-Age Population as Percentage of Total Population, 1960-2030



Source: IMF World Economic Outlook, January 2021

A period of negative real returns is not unusual. In the decade from 2000 to 2009, investors with a traditional asset allocation saw -1.9% annual returns. In the 11 years from 1973-1983, investors lost 1.1% annually (Chart 6).

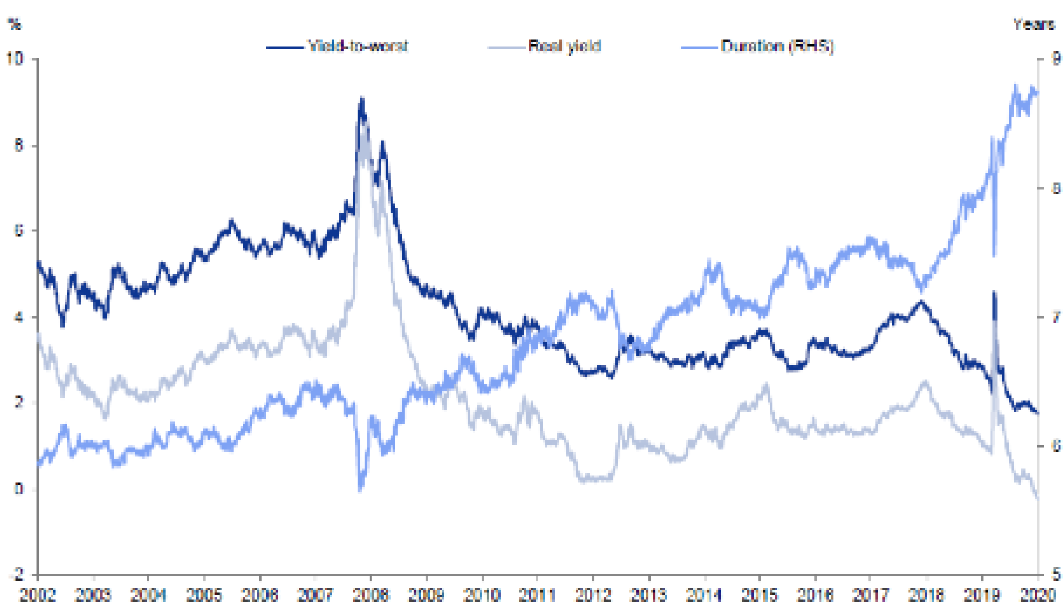
Chart 6: Real Annualized Returns for 60% US Stocks / 40% US Treasury Bonds, Log-Scale, 1900-2020



Source: BofA Research Investment Committee, Global Financial Data

The traditional asset allocation is not only unlikely to achieve investors' return objectives, it is also likely to be a more volatile portfolio than in the past. The interest-rate sensitivity of high-grade bonds has climbed to record levels, nearly nine-years duration, as yields have fallen to record lows (Chart 7).

Chart 7: US Investment-Grade Bond Yields, Nominal and Real, and Duration, 2002-2021



Note: The real yield is calculated as the index yield to worst minus the 10 yr traded breakeven inflation rate

Source: Bloomberg-Barclays, Federal Reserve, Haver Analytics, Goldman Sachs Global Investment Research

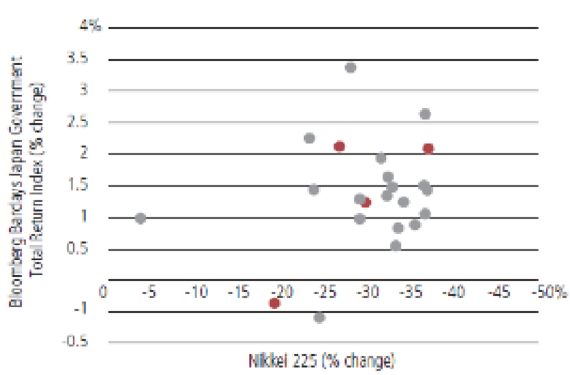
Record low yields means there is less ability of bonds to rally during equity market selloffs. The performance of high-grade bonds has degraded in each of the previous stock market selloffs we have seen. In the most recent drop a year ago, the broad investment-grade index fell 3% as equities declined 34%, offering no buffer in the portfolio (Table 1).

Table 1: Equity and Bond Market Performance in Select Equity Selloffs, 2000-2020

BEAR MARKET START	BEAR MARKET END	S&P 500	AGGREGATE	US TREASURIES	BEG. TR. YIELD	END TR. YIELD
24 Mar. 2000	9 Oct. 2002	-49%	+18%	+31%	6.4%	3.3%
9 oct. 2007	9 Mar. 2009	-55%	+2.4%	+15%	4.3%	2.0%
19 Feb. 2020	23 Mar. 2020	-34%	-3%	+5.4%	1.5%	0.7%

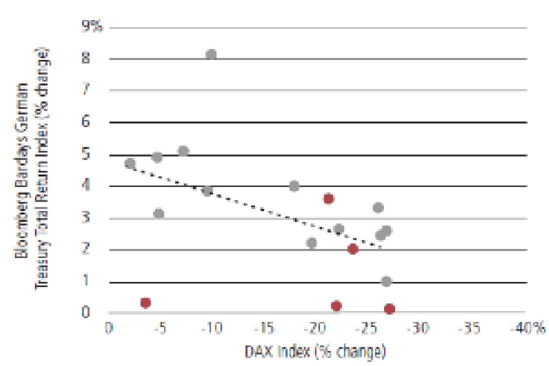
The experience of Japan and Germany confirm the inability of government bonds to offer protection in an equity downturn. At no time in the past twenty years in Japan did bonds rally more than 3 ½% during equity drops of 20% and more (Charts 8, 9).

Chart 8: Performance of Stocks and Bonds During Worst Three-Month Equity Draw-downs, Japan, 2000-2020



Source: UBS Asset Management, Bloomberg, Data as of November, 2020.

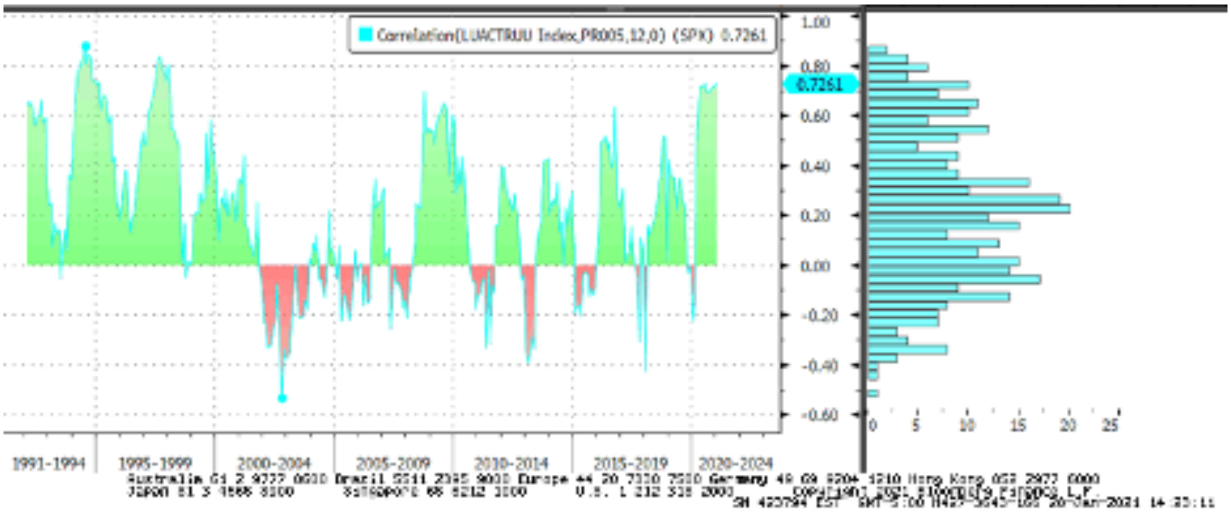
Chart 9: Performance of Stocks and Bonds During Worst Three-Month Equity Drawdowns, Germany, 1998-2020



Source: UBS Asset Management, Bloomberg, Data as of November, 2020.

Additionally, the correlation between high-grade bonds and equities is not stable. For much of 15 years between 2002-2017, the correlation was mostly negative, offering portfolio diversification. But in the 1990s, and in recent years, that correlation has become positive (Chart 10).

Chart 10: Correlation Bloomberg Barclays US Corporate Bond Index and S&P 500 Index, 1991-2021



The combination of high interest-rate sensitivity, low yields and positive correlation challenge the traditional role of high-grade bonds in investment portfolios. An all-equity portfolio may (possibly) achieve long-term returns in excess of inflation and spending, but the very high volatility of equities makes them a poor choice for funding near-term expenses and liabilities.

Investors are better served by bifurcating their portfolios by investment horizon. In our framework, rather than having to choose among risk/return points along a capital market line, as they must do in traditional asset allocation modeling, investors are simply asked to specify a desired amount of liquidity, freeing the rest of the portfolio from the constraints of liquidity and volatility.

Near-term expenditures can be covered by high-grade short-term bonds. We call this a liquidity portfolio. Yields are low, but the operations of the institution cannot be jeopardized. As funds are spent, this portfolio is replenished by the second, long-term growth portfolio, a portfolio comprised of equities and credit, public and private. The existence of a liquidity portfolio that meets the near-term spending requirements enables investors to create a second portfolio with a principal focus on long-term growth, less restricted by liquidity needs and volatility constraints. Such a portfolio has a higher probability of achieving investors' long-term return objectives.

Investors are challenged to meet current and future obligations while also maintaining the real value of the portfolio over time. The traditional asset allocation will likely be unable to protect from losses and will fail to achieve investors' required returns. Creating distinct portfolios to address each of these objectives will raise the probability of meeting both current spending and achieving long-term growth that protects the value of the portfolio. A liquidity portfolio of high-grade, short-term bonds will meet current spending needs, and a long-term growth portfolio less constrained by liquidity and volatility constraints will be better positioned to maintain portfolio value in excess of inflation and spending.

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