No, the 60/40 Portfolio Is Not Dead – Transcript

Jenna Dagenhart:

There's been nowhere to hide in 2022 with stocks and bonds both declining. It's an environment that has some pundits declaring the traditional 60/40 portfolio obsolete, suggesting investors who have long relied on this strategy look for returns elsewhere.

Joining us today are Weitz Investment Management co-CIO and portfolio manager Brad Hinton and fixed income research analyst and portfolio manager Nolan Anderson. Thank you both for joining us.

Brad Hinton:

Thanks for having us, Jenna.

Nolan Anderson:

Great to see you, Jenna.

Jenna:

I'll start with you, Brad. What's your take on the headlines? Has the 60/40 portfolio run its course?

Brad:

Yeah. So we'd say you know the 60/40 portfolio may well be in hibernation, but it's far from dead. There's nothing really fundamentally flawed about the concept or the portfolio construction. And with a long enough investing horizon, the approach has really stood the test of time, and that's over decades. The primary challenge lately has been high asset valuations. That's been true for the 60% that's traditionally in stocks and it's certainly been true for the 40% in bonds. But importantly we'd also argue that's been true for most other private and public assets. The more asset prices rose over the past few years, the lower the probability that they could keep generating strong returns. So that's where we sat coming into 2022, pretty much across the board. But in our view, that's a snapshot at a moment in time, not a structural flaw. And as we've seen the past few months, asset prices change, often quickly, as do opportunities. In short, death seems like a premature diagnosis to us.

Jenna:

Of course, it's not the first time we've heard the proverbial funeral bells ringing for the 60/40. We saw similar headlines as we came out of the Global Financial Crisis back in 2009. Yet the 60/40 and other allocation portfolios live on. How do you think the environment today compares with that of the post-GFC period?

Brad:

Right, good question. So after the global financial crisis, a lot of the hand-wringing about 60/40 was very backward looking. The approach hadn't done especially well in the early 2000s, but that's primarily because it was what's been called a lost decade for stocks. You know, investors projected those poor returns going forward when in fact asset valuations at the time were pretty low and set up pretty strong future gains. Of course, the Fed gets an assist as both stock and bond returns in the 2010s were turbocharged by what was then very easy monetary policy. The concerns today we think are more well-founded as risk assets face more headwinds than tailwinds. Not the least of which is the Fed reversing course and tightening monetary policy in response to inflation. Still, asset prices are critical and those have changed materially in the past five months. Popular stock indexes are down mid-teens to mid-twenties, with many speculative corners of the market down even more. And the Bloomberg Agg Bond Index is down nearly ten. As you said, Jenna, there have been very few places for investors to hide.

So it's certainly been a hibernation period with markdowns in both stocks and bonds. And while valuations are not super compelling, a lot of the froth has been taken out of the market. Higher bond yields provide investors with more options, and they increase competition for capital. We do think investors need to look beyond the indexes to create allocation strategies that can protect and grow capital. But the outlook is already more constructive, or at least less dour than it was just a few months ago.

Jenna:

Turning now to some specifics, in your view, Brad, what should investors be looking for today on the equity side of their allocation portfolio?

Brad:

Yeah, so we love ownership positions and productive, durable, and growing companies. We think these should be the centerpiece of really any allocation strategy. We'd encourage investors to focus on total returns rather than current income and specifically look for companies that can be worth a lot more five years from now than they are today. Examples would include Danaher in life sciences, Analog Devices in semiconductors, Martin Marietta Material in rocks and gravel, MasterCard in payments, and companies like Aon and Schwab in financial services. These companies all pay modest dividends, but the real appeal is their ability to efficiently grow business value over long stretches of time.

It's a good time to talk about what we wouldn't be looking for. I mean, I think first we wouldn't chase dividend yield on the equity side. There's nothing wrong with dividends as a component of return, but we'd rather not have them be the component of return. You really need the equity component to be the growth engine of an allocation strategy. So we'd focus on companies that generate lots of free cash flow, but ones that also have very attractive reinvestment options. So with the heavy dividend payers, one risk is that you get a little payout along the way, but you end up with a business that's worth less down the road. We'd also be less interested in plumbing the new low lists of highly speculative companies. Sort of think meme stocks, profitless disruptors and the like. We try to keep in mind that percentage off highs does not mean cheap. You know, stocks that are down 75% can and often do go down another 50%. Our focus instead would be on buying what we call Quality at a Discount. You know, especially in uncertain times, we want our own very strong businesses purchased at sensible prices. And after the recent correction, we don't think investors have to sacrifice one or the other. Now, we're not saying that the average stock is cheap or that the selling pressure is behind us. A lot of unknowns with no shortage of things that can go wrong. But for long term investors with reasonable expectations, we certainly see more options that may deliver acceptable returns.

Jenna:

And Nolan, same question to you but on the bond side, where are you seeing opportunities in terms of fixed income today?

Nolan:

Yeah, thanks Jenna. As Brad alluded to, interest rates have risen a lot. So the opportunity set, although far from perfect, rates have risen a lot, so the opportunity set has increased. When investors think about their core of their fixed income allocation, most think about balancing preservation of capital with generating income. And coming out of COVID, the Federal Reserve's QE programs pushed yields on Treasuries, agency mortgages, and investment grade corporate bonds to all-time lows. So as a result, traditional core portfolios like the Bloomberg Barclays Agg or other passive core strategies haven't provided much protection or income. We have long believed that fixed income investors can achieve more balanced diversification and better long-term returns in their core portfolios by allocating to active strategies. One of the fundamental reasons for this is that active managers have a much larger menu of investments to choose from.

The slide you see on your screen represents the large opportunity set outside of the traditional Agg-like portfolios. Over on the right, you can see the asset backed securities market, which today is a greater than $1.5 trillion market and is largely not accessible to investors in Agg-like or core passive strategies. Asset backed securities represent a large swath of the U.S. economy, including commercial real estate, single family homes, automobiles, small and large ticket equipment, fleet lease vehicles, credit card and consumer loans, and middle market and large corporate loans. Asset backed securities provide investors the opportunity to invest in a large variety of high quality assets with varying maturity profiles, including floating rate securities, which are all the rage today. We believe this market provides investors the opportunity to increase diversification and generate more attractive risk-adjusted returns as part of a balanced portfolio.

Jenna:

Finally, the two of you co-manage a strategic allocation product. Have you felt challenged to find investment opportunities for this fund over the years and maybe specifically more recently? And if so, how have you managed through it?

Brad:

Well, Jenna, that's certainly been tough. I think our primary allocation strategy, it's a conservative allocation fund, which generally invests 40 to 50% in equities and then 50 to 60% in a collection of shorter maturity, higher-rated bonds. Our investors are interested in protecting and growing capital over time and hopefully with a less bumpy ride than an all equity portfolio would provide. And while it's never easy when you're balancing competing objectives, the past few years have certainly been more challenging than most. And I think on the equity side, after a long bull market, it was tougher to find quality companies trading at discounts to what we think they're worth. And at the same time, bonds were offering very little return, coupled with fairly high price risk. But throughout, our strategy has been consistent. We don't change our approach as trends come and go. Our tactics, on the other hand, are adaptable and flexible with an ever-expanding toolkit. What we own evolves over time, but how we analyze it does not. It's really been most notable on the bond side, which you heard a little bit about from Nolan today.

So in equities, we manage a relatively concentrated portfolio of 30 to 35 stocks. And one silver lining of that, combined with our long term investment approach, is that we really only need one or two good ideas a year. We've typically been able to find those in almost any valuation environment, and since we own very solid companies, we don't need to sell to try to sidestep temporary drawdowns.

And in fixed income, discipline and patience have really been key. Bonds that have provided important ballast to the portfolio even when the yields were not inspiring. And our short duration portfolio allows us to redeploy maturing proceeds at higher yields as interest rates rise. So in our view, allocation strategies make sense for certain investors, whether it's 60/40 or a more conservative version like ours. The strategy has been called obsolete many times in the past, but it's never really proven out. It might seem a little stodgy or out of step, but I think we'd argue that a flexible, concentrated, common sense approach to allocation should be a timeless strategy.

Jenna:

Well, Brad, Nolan, thank you both for joining us.

Brad:

Thanks for having us.

Nolan:

Thank you, Jenna.

Jenna:

And thank you for watching. I'm Jenna Dagenhart with Asset TV.

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- Analog Devices, Inc. (ADI): 1.6%, 0.0%, 0.0%, 0.0%, 3.6%.
- Aon PLC (AON): 2.2%, h.f%, 0.0%, 3.3%, 0.0%.
- Danaher Corporation (DHR): 2.1%, 0.0%, 0.0%, 0.0%, 4.3%.
- Martin Marietta Materials, Inc. (MLM): 1.5%, 3.3%, 0.0%, 3.1%, 0.0%.
- Mastercard, Inc. (MA): 1.8%, 0.0%, 5.0%, 3.6%, 4.3%.
- The Charles Schwab Corporation (SCHW): 1.4%, 0.0%, 2.8%, 2.9%, 2.9%.

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