On the Minds of Investors

February 2021

Why and how to re-think the 60:40 portfolio

IN BRIEF

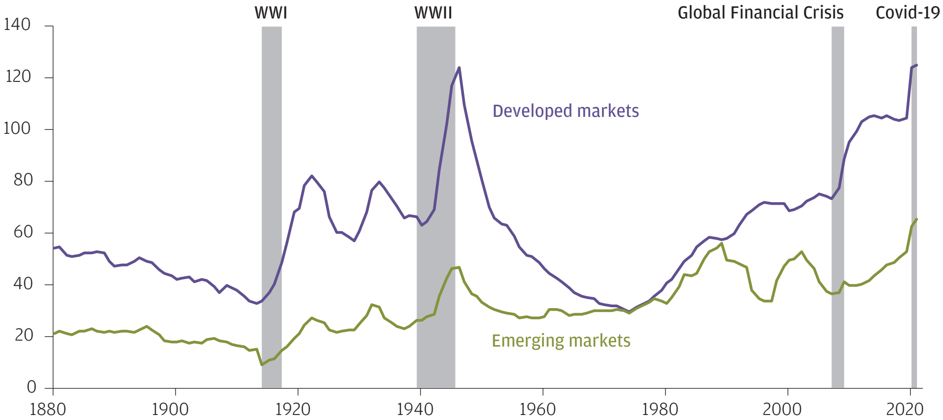
- One of the most immediate challenges facing investors after the pandemic is how they can build resilient portfolios that still offer “decent returns”, given the current low level of government bond yields.
- Government bonds used to provide both income and the prospect of positive returns in recessions and bear markets. For this reason, maintaining a balanced exposure to equities and government bonds has always been the key to building stronger portfolios.
- Today, however, extremely low government bond yields offer little income and upside potential, forcing investors to adopt a more creative approach to diversification, including the use of core infrastructure, real estate and hedge funds to find income and sources of portfolio resilience.

Fixed income markets will bear the scars of Covid-19 for many years

Whether Covid-19 has a lasting impact on our economies and way of life remains to be seen. But one thing is certain. Governments will be left with a mountain of debt, as we can see by soaring debt-to-GDP ratios (**EXHIBIT 1**).

EXHIBIT 1: GLOBAL GOVERNMENT DEBT-TO-GDP RATIOS

% of nominal GDP, forecast after 2019



Source: IMF Fiscal Monitor October 2020, J.P. Morgan Asset Management. *Guide to the Markets - UK*. Data as of 31 January 2021.

AUTHOR

Maria Paola Toschi
Global Market Strategist

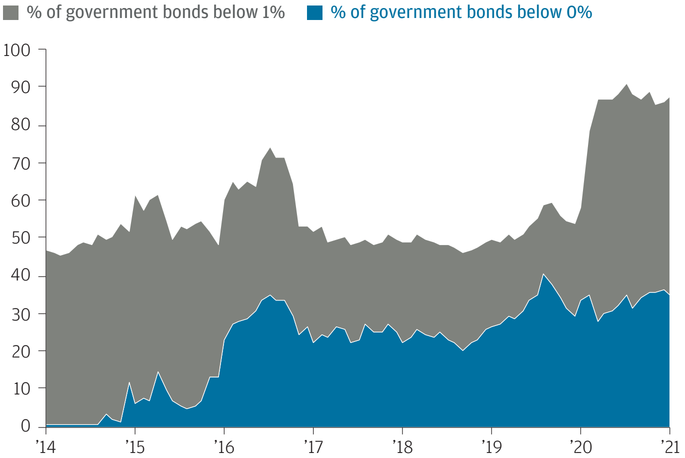
After a decade of austerity it seems unlikely that governments will want to squeeze spending beyond pre-pandemic levels or raise taxes to reduce debt, at least in the short term. The pressure, in our view, will rest on the central banks to keep interest rates low in the hope that governments can instead grow their way out of their debt problems. The US Federal Reserve has already announced its intention to remain tolerant to rising inflation. In short, we expect central banks to keep interest rates at or below zero for an extended period of time.

Why investors need to rethink the traditional 60:40 portfolio

The impact on government bond yields of ultra-low interest rates is clear: over 85% of developed market government bonds are yielding below 1% and around 35% deliver negative yields (**EXHIBIT 2**).

EXHIBIT 2: DEVELOPED MARKET GOVERNMENT BOND YIELDS

% of ICE BofA Global Government Bond Index



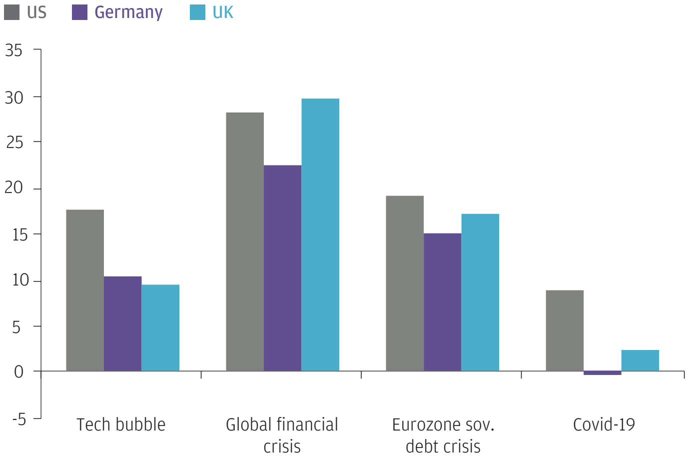
Source: Bloomberg, ICE BofA, J.P. Morgan Asset Management. Index shown is the ICE BofA Global Government Bond index. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - UK*. Data as of 31 January 2021.

Low or negative bond yields create extraordinary challenges for investors, who have generally relied on fixed income assets to serve two purposes in a portfolio: first, as a source of steady income; and second, as a source of protection in periods of volatility. In past recessions, central banks cut rates to support the economy, which supported bond prices. The negative correlation between stocks and bonds was an investor's best friend.

With such low interest rates today, the upside for government bonds during recessions has decreased. **EXHIBIT 3** shows that government bonds have provided positive returns during past bear markets, but during the Covid-19 market collapse, when rates were already at record lows, the returns on government bonds were limited—or in the case of Europe—non existent.

EXHIBIT 3: 10-YEAR GOVERNMENT BOND RETURNS DURING EQUITY MARKET SHOCKS

%, total return over the period



Source: Refinitiv Datastream, J.P. Morgan Asset Management. Returns are shown over the period when MSCI World was falling in local currency terms. Tech bubble: 24 Mar '00 to 21 Sep '01; Global financial crisis: 13 Jul '07 to 9 Mar '09; Eurozone sovereign debt crisis: 18 Feb '11 to 3 Oct '11; Covid-19: 19 Feb '20 to 23 Mar '20. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - UK*. Data as of 31 January 2021.

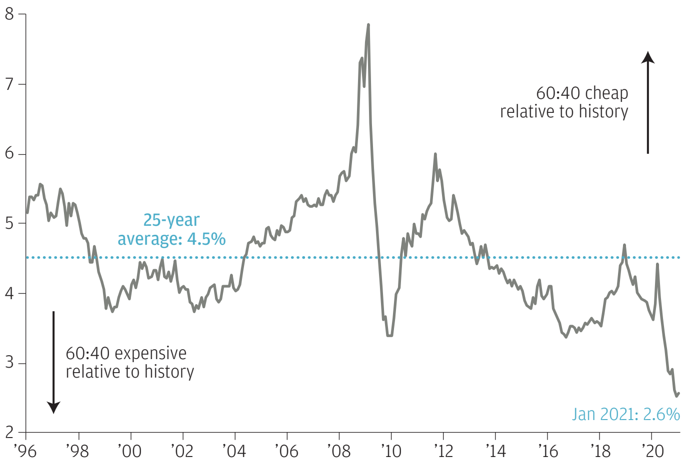
The income and diversification challenge

According to our **2021 Long-Term Capital Market Assumptions**, over the next decade, a traditional 60:40 sterling stock:bond allocation is expected to earn a return of only around 4.2% per year.

EXHIBIT 4 shows how, at today's prices, a global 60:40 portfolio currently has the lowest yield for multiple decades.

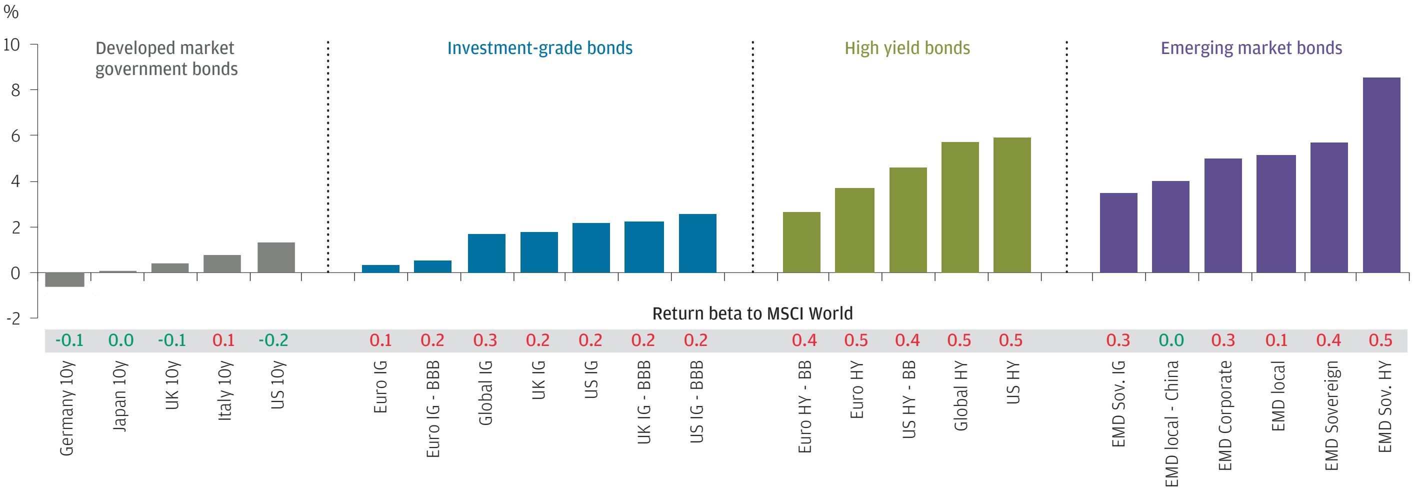
EXHIBIT 4: EARNINGS/COUPON YIELD ON A 60:40 PORTFOLIO

%, blended MSCI ACWI earnings yield and Barclays Global Aggregate yield-to-worst



Source: Bloomberg Barclays, MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 31 January 2021.

EXHIBIT 5: FIXED INCOME YIELDS



Source: Bloomberg, Bloomberg Barclays, ICE BofA, J.P. Morgan Economic Research, Refinitiv Datastream, J.P. Morgan Asset Management. Beta to MSCI World is calculated using monthly total returns since 2008. Indices used are as follows: Euro IG: Bloomberg Barclays Euro-Aggregate - Corporate; Global IG: Bloomberg Barclays Global Aggregate - Corporate; UK IG: Bloomberg Barclays Sterling Aggregate - Corporate; US IG: Bloomberg Barclays US Aggregate - Corporate; Euro HY: ICE BofA Euro Developed Markets Non-Financial High Yield Constrained Index; Global HY: ICE BofA Global High Yield Index; US HY: ICE BofA US High Yield Constrained Index; EMD corporate: CEMBI Broad Diversified; EMD local: GBI-EM Global Diversified: EMD local - China: GBI-EM China: EMD sovereign: EMBI Global Diversified; EMD sov. IG: EMBI Global Diversified IG; EMD sov. HY: EMBI Global Diversified HY. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - UK*. Data as of 31 January 2021.

The challenge for investors is how to rethink the 60:40 portfolio, and specifically how to recreate the income *and* diversification that traditional fixed income exposure used to provide. After all, there appear to be options for income outside of government bonds, such as high yielding corporate debt and emerging market bonds. However, as the numbers on the bottom axis in **EXHIBIT 5** show, in many cases these asset classes have a historically high correlation with global equities.

Investors may feel these correlations have changed given the interventions of central banks in this crisis. In our view we can only be confident of that backstop in the highest-quality segments, and would avoid excessive dependence on the support of central banks given the volatility that can occur when policy support recedes (such as seen in the 2013 taper tantrum).

Potential solutions

We believe bonds still have a critical role to play in portfolios, but strategies require a global reach, and must be sufficiently flexible and attempt to pre-empt macro and policy risks. Chinese government bonds are one example, with a 2%-3% yield depending on duration, limited or no correlation with global equities and the potential for long-term currency appreciation.

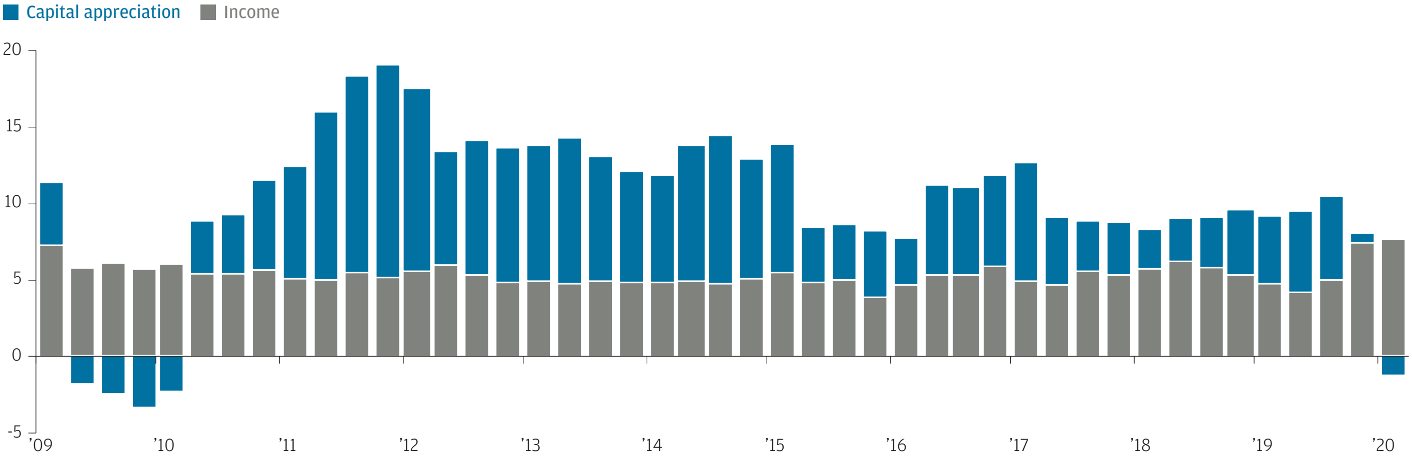
In terms of income, high dividend stocks will also play an increasing role in portfolios. Dividends were cut in 2020 but analysts have started revising up their expectations for next year. Of course, while solving the income challenge, dividend paying stocks do not help to reduce portfolio volatility. In the past, some high dividend paying sectors have also been some of the most volatile parts of the markets.

In our view, some of the most attractive solutions for providing income and diversification can be found in alternatives. Real assets, such as real estate and infrastructure, offer more attractive yields than government bonds. Some categories of real estate have come under pressure from Covid-19, such as office buildings. Despite anticipating more flexible working, we believe office space will still be desirable when corporate life returns to normal.

Online shopping will be an ongoing threat to retail properties, but this trend is presenting new opportunities in other categories of property, such as warehousing. So, while property continues to offer attractive yields, selectivity is critical.

EXHIBIT 6: GLOBAL CORE INFRASTRUCTURE RETURNS

%, rolling 4-quarter returns from income and capital appreciation



Source: MSCI, J.P. Morgan Asset Management. Infrastructure returns represented by the "low risk" category of the MSCI Global Quarterly Infrastructure Asset Index. Data show rolling one-year returns from income and capital appreciation. The chart shows the full index history, beginning in the first quarter of 2009. Past performance and forecasts are not reliable indicators of current and future results. *Guide to the Markets - UK*. Data as of 31 January 2021.

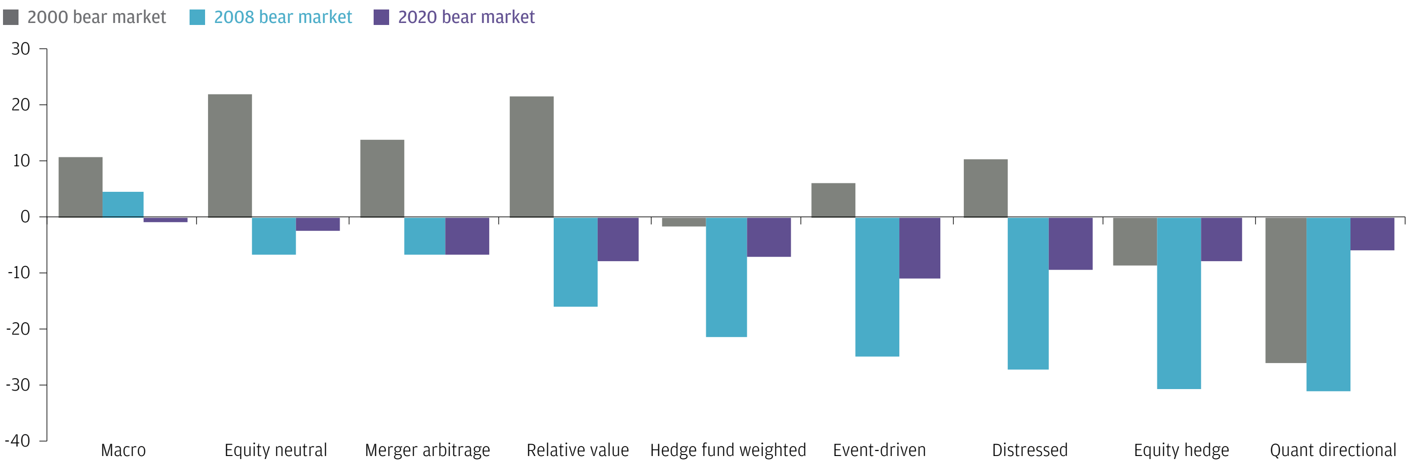
EXHIBIT 6 shows how global core infrastructure has produced remarkably consistent and defensive income streams in different periods, including the last two recessions, thanks to often contracted or regulated cash flows. Yields around 7% are clearly attractive for investors seeking a relatively defensive source of income.

The downside with some of these alternative strategies is their relative illiquidity, or their higher correlation to equities if owned in a listed form (for example, real estate securities).

Some of the more liquid alternative strategies that can provide some downside protection include hedge funds. However, **EXHIBIT 7** shows that not all the different types of hedge fund strategy perform the same during bear markets. Macro funds have done the best job of consistently protecting portfolios. While return expectations for macro funds as a whole have been relatively low, good manager selection may help to boost returns in bull markets while at the same time providing downside protection during bear markets.

EXHIBIT 7: HEDGE FUND STYLE RETURNS DURING BEAR MARKETS

% total return



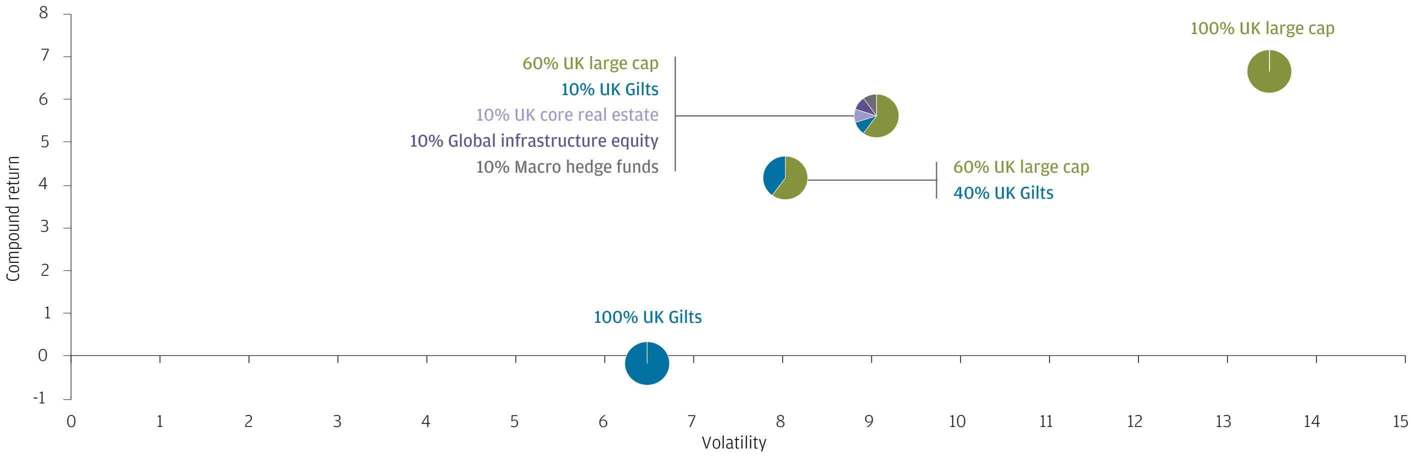
Source: Hedge Fund Research Indices (HFRI), Refinitiv Datastream, J.P. Morgan Asset Management. 2000 bear market is from 31 March 2000 to 31 October 2002, 2008 bear market is from 31 October 2007 to 28 February 2009, 2020 bear market is from 31 January 2020 to 30 April 2020. Hedge fund strategies are defined in the HFRI hedge fund strategy classification system. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - UK*. Data as of 31 January 2021.

CONCLUSION

Shifting to a much higher equity allocation to boost returns, such as an 80:20 portfolio, would require the acceptance of considerably higher volatility, which may be particularly uncomfortable for investors with shorter-term savings objectives. In our view, **EXHIBIT 8** shows that investors would be wise to instead maintain a flexible fixed income exposure but supplement this proportion of the portfolio with real estate, infrastructure and macro strategies.

EXHIBIT 8: EXPECTED RETURNS AND VOLATILITY FOR A GBP INVESTOR IN COMING 10-15 YEARS

% annual compound return



Source: 2021 Long-Term Capital Market Assumptions, J.P. Morgan Multi-Asset Solutions, J.P. Morgan Asset Management. The resulting projections include only the benchmark return associated with the portfolio and do not include alpha from the underlying product strategies within each asset class. Macro hedge fund return expectations are currency hedged. The assumptions are presented for illustrative purposes only. Forecasts are not reliable indicators of current and future results. *Guide to the Markets - UK*. Data as of 31 December 2020.

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J.P.Morgan
Asset Management