Under stress

The new macroeconomic reality could test the classic DC balanced portfolio to breaking point

Summary
- The classic 60:40 equity-bond balanced DC portfolio has become shorthand for a mix of growth-seeking assets, and more income-seeking, safer assets in recent years.
- The popularity of the model remains based on the assumption that inflation will soon fall and the negative correlation between equities and fixed income will be restored.
- But inflation data shows that once inflation goes above 5 per cent, it takes a decade to go back below 2 per cent, on average.
- DC funds therefore should be considering a far wider mix of assets and strategies to better protect members – particularly in the pre-retirement phase of their savings journey.

Back when DC funds were still treated as DB's infant cousin and the Pension Protection Fund was a mere twinkle in some civil servant's eye, the 60 per cent equity, 40 per cent bond investment model was thought to be the epitome of a balanced DC default fund.

These days, the 60:40 ratio may not be quite as defined, and the assets may be a little more varied, but the philosophy remains the same. As Nest investment

strategy team economist, Craig Mitchell, says, 60:40 is essentially shorthand for a mix of "growth-seeking assets, and then more income-seeking, safer assets".

This traditional portfolio is underpinned by the premise that bonds and equities are offsetting investments, explains Janus Henderson director of institutional business DC, David Whitehair. This thesis almost turned into doctrine in the pre-Covid world of falling interest rates, low volatility and low inflation.

"The implicit assumption of the balanced portfolio is that stocks and bonds are negatively correlated and will move in opposite directions," says Whitehair. "This assumption is wholly reliant on the economic policy of recent decades, that when stocks go down, central banks cut interest rates in response, in turn, pushing yields down and bond prices up, thereby balancing your portfolio.

"But this relationship only holds since the 1990s. Before that, the correlation was positive, or at best unpredictable. The large majority of us have enjoyed a career in which *[the negative correlation]* is the entirety of our reference point. But in reality it is certainly not the norm when reflecting on financial history."

Nevertheless, prior to 2021, many investment managers and DC trustees got caught up in the belief that inflation would be "transitory" and that economies had entered an almost perpetual "lower-for-longer" interest rate environment, thus dispelling any fears of a durable return to a positive equity-bond correlation.

The return of high inflation in 2022 snapped people out of this trance. "When CPI is above 2.5 per cent, bonds don't effectively offset equities," says Ruffer UK institutional director, James Fouracre. "And so the return of inflation changes everything and calls into question the certainty upon which the entire DC investment system is based – and could continue to spell disaster for balanced portfolios. Bonds are the bedrock of balanced portfolios. The case for owning them is twofold: as an offset to falling equities, and for the income or yield. But in an inflationary environment, neither of these stands to reason.

"Bonds turn from principal offset to principal liability."

Entering a new period

In the view of Newton Investment Management chief investment officer, Mitesh Sheth, we are entering a new market regime characterised by higher and more volatile inflation, higher interest rates for longer, disappointing market returns and greater divergence between company, country and asset class performance.

Given this context, he says, it is not surprising that DC investors are concerned that a passive 60:40 approach could deliver disappointing long-term returns, especially in real terms.

Fouracre stresses that the key to survival for many DC pots will lie in diversifying beyond the traditional balanced portfolio. In a market regime where equities and bonds pull together, investors will need assets with low correlation to these markets, and, importantly, negative correlation at points of stress.

"We believe DC schemes should look more widely than bonds to diversify risk," says LGIM senior DC investment director, Jesal Mistry. "Within our own default options, for example, we invest across a range of different asset classes such as commodities, infrastructure and real estate – all of which help us to avoid concentration risk.

"It's really important that we don't view equities and bonds dimensionally. Instead, we need to consider asset allocation and the range of tools we have available holistically. In practice, this means going beyond more standard bonds and equity portfolios, exploring additional areas such as high-yield, emerging-market debt, supranationals and insurance-linked securities."

For Sheth, this does not mean throwing the 60:40 playbook out of the water, however. He believes that if DC funds can achieve high conviction stock selection within the 60 per cent traditional equity allocation, then they can take a "truly dynamic approach" to global bond management within the 40 per cent bucket. This could involve gaining exposure to low-cost liquid alternatives, with a tactical asset allocation overlay, giving DC savers a "much better chance of achieving positive real returns".

And cost should not be a barrier either. "Global equities, global bonds, global currencies and global commodities are large and liquid markets," he says. "Active investment strategies that invest in and across these markets should not be expensive, especially where they can utilise more quantitative approaches."

No need to panic?

Despite the new inflationary reality, few portfolios have – to date – changed their composition to reflect the new investment environment, choosing instead to stick with the status quo, says Fouracre.

Mitchell provides an insight into why this may be. "We don't necessarily think that the 60:40, idea is completely dead or redundant," he says. "It would be a big reaction to shift away from a *[long-term]* pattern of portfolio construction after just one year of poor returns."

Nevertheless, Nest itself has taken the opportunity of tweaking some of its portfolio, searching, as Mitchell reveals, for asset classes that can give the fund growth and income characteristics, while providing diversification in different environments. "In higher inflation environments, you might want to be more exposed to the sort of real asset space, so you have infrastructure assets that are maybe less sensitive to the economic cycle that have contractually-linked revenues to inflation."

To this end, Nest is planning on working towards allocating over a fifth of its portfolio to investments such as private equity, private credit and infrastructure. With the size of the scheme, it is able to leverage current fund manager relationships to embark on further diversification without busting the budget in additional performance fees.

"The return of inflation changes everything and calls into question the certainty upon which the entire DC investment system is based – and could continue to spell disaster for balanced portfolios"

Forging final flightpaths

In another sense, the whole rationale for running a 60:40 portfolio for a DC member's entire savings lifecycle has also been undermined by low contribution rates and, in some cases, late-starting membership under auto-enrolment.

"If you think about what the what the investment needs are for a member in the growth phase, it isn't really diversification," says Whitehair. "It's about focus on return."

Later on, then, in the middle and pre-retirement phases, a gradual phasing in of more defensive allocations can aid portfolio resilience. In the past decade or so, DC funds have attempted to carry this lifecycle plan out with a more holistic multi-asset proposition rather than a supposedly balanced 60:40 mix. This has seen the rise of diversified growth funds (DGFs), which in recent times, have not lived up to their name. As a result, these vehicles have also had to search elsewhere for alpha and beta. "Even within their own portfolios, it's important to note that they're not just buying investment-grade corporate credit and gilts, they will hold high yielding assets, they also hold shorter-dated credit, maybe some commodities and listed real estate," says Whitehair.

"The key question when it comes to your equities and bonds portfolio, and whether or not it is out of date is at that final, pre-retirement phase. What has happened in the last couple of years should make decision-makers think about what exact assets they have got in the mix there. Are the fixed income assets doing what I need them to do?

"Broadly speaking, DC funds have been invested in investment-grade corporate credit and gilts – predominantly higher duration assets that are more sensitive to changes in interest rates."

Last year's mini-Budget crisis, highlighted the importance of better asset diversity at the final stage of DC saving in the starkest possible manner, calling into question the attitude that, in the main, a 60:40 mindset will best serve members over the long term. After all, smoothing out average returns to paint a positive picture over a 30-year horizon would be scant consolation for a pre-retiree in 2022.

"In theory, it's a very safe thing to de-risk into bonds towards the end of a savings flightpath," says PLSA deputy director of policy, Joe Dabrowski, "But what we saw in the gilts crisis last year was that, as the bond market blew up, people did see large drops in savings pots at that point, depending on what was happening with their provider, as they had de-risked and there wasn't much further room for upside."

In it for the long term?

Those holding fast to the historically conventional 60:40 system may continue to have their assumptions stress-tested in reality over the coming years, suggest Fouracre.

"Does a short- to medium-term change to the correlation really matter?" he asks rhetorically. "This question makes an assumption of a speedy return to central banks sub-2 per cent inflationary target. But when one considers inflation data from 1980 to 2020, in advanced economies, it shows us that once inflation goes above 5 per cent, it takes on average of a decade to go back below 2 per cent."

Sheth is similarly pessimistic. "We believe we are moving into a period of structurally higher and more volatile inflation, with the deflationary benefits of globalisation behind us," he says.

"Ultimately, in the face of a changing market regime change, it is important to look forward rather than backward, and this is an important opportunity for DC investors to chart a different course."

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