WHEN 60/40 IS NOT ENOUGH

What investors can do in negative yield fixed income environments.

For many years, traditional 60/40 portfolios worked well (i.e. 60% stocks, 40% bonds). The idea was to capture equity returns, while also tapping into the stabilizing benefits of fixed income to reduce volatility, add diversification, and offer a layer of downside protection. While investors traditionally considered bonds a safe haven, our current fixed income environment has challenged that theory.

CORRELATION

The correlation between stocks and bonds has generally been negative since 2000. Before that, the last time the correlation was negative was from 1950 to 1965. However, in the wake of the COVID-19 pandemic, this trend has started to reverse itself. Globally, central banks rolled out easy monetary policies with prolonged low interest rates, which have heightened inflation concerns. Historically, stocks and bonds generally move in the same direction during periods of elevated inflation.

YIELD

Over the past several decades, investors have traditionally been able to count on some meaningful amount of yield from their fixed income portfolio. However, bond yields have also been compressed due to low interest rates. Investment grade and sovereign bond yields are negative on a real basis, and even lower-rated "junk bonds," in which investors sacrifice credit quality for increased yield, are negative-yielding for the first time in history.

HOW TO APPROACH THE 40% STABILIZER

These market conditions present a challenge for investors – how do you seek yield when interest rates are low, and diversification when markets are highly correlated? In order to achieve attractive relative yields along with diversification away from historically high equity prices, investors must get creative and be willing to sacrifice some liquidity where appropriate. To that end, we believe a "basket approach" containing low or uncorrelated return streams is best for yielding oriented returns and providing the critical diversification to soften market volatility.

EXAMPLES

- **Business Development Companies ("BDCs")** could provide attractive yield in the current environment. Non-traded BDCs are not traded on an exchange, avoiding the daily volatility experienced by their listed peers, while still providing corporate credit exposure via senior secured loans. With a modest amount of leverage applied, investors can potentially receive attractive yields with low correlation to traditional credit markets.
- **Private Asset-Backed Lending ("ABL")**, also referred to as private Asset-Based Finance ("ABF"), are strategies that could offer an attractive option. These structures are short-duration loans backed by some form of collateral/asset such as accounts receivables, inventory, property, etc. The asset itself is often held in bankruptcy remote vehicles containing a ring-fenced pool of assets, meaning only the lender has access to the collateral. ABL offers short-duration credit exposure to an asset, as opposed to traditional corporate credit. Asset-backed strategies finance millions of businesses and consumers globally through mortgages, credit cards, consumer installment loans, auto financing and equipment leasing.

Another interesting yielding strategy that comes in the form of equity (as opposed to debt) are **non-traded Real Estate Investment Trusts (REITs)**. These vehicles invest in real estate with the underlying property types comprised of multifamily, industrial, office, hospitality and others. The REIT acquires the properties with a combination of equity and debt, makes minor improvements to the properties or repositions them, with the goal of leasing up to quality tenants and collecting rent. The rent is passed through in the form of a distribution yield to investors. In addition to attractive yields, real estate offers a hedge to inflation through periodic rent increases.

The aforementioned strategies are just a few examples of tools that investors can use to add diversification and yield to their portfolios. With traditional passive fixed income offering low to negative real yields, an active management approach is warranted. The goal of every investor should be to construct a portfolio of individually attractive strategies, but when combined into a broader portfolio, offer differentiated return streams from each other. In order to execute true diversification at the portfolio level, one must expand their thinking beyond traditional fixed income into alternative, perhaps less liquid, esoteric, yielding strategies.

IMPLEMENTATION

The step up in yield often comes at a cost through somewhat higher fees and perhaps less tax efficiency, and in some cases, investors must also sacrifice a level of liquidity. Some yielding and diversifying strategies come in fully private vehicles with five- to seven-year lives, but many are offered in semi-liquid options with monthly or quarterly liquidity to investors.

The market environment is constantly evolving, and therefore, investor portfolios must be dynamic as well to reflect those changes. COVID accelerated many challenges that were already presenting themselves, along with creating a few new ones. Seeking yield, investors should be thoughtful and careful, and always consult an experienced fee-only wealth advisor.