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Why balanced portfolios may require a revamp

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A 60/40 portfolio has always depended on a clear division of labour. Equities supply long-term growth while bonds generate income and soften the impact during market declines.

That long-held formula became much harder to trust in 2022, when surging inflation and rapidly rising interest rates pushed both asset classes sharply lower.

Persistent correlation risk continues to reshape investment guidance. This year, the Bank of Canada warned that Canadian investors may expect increasingly positive bond-equity price correlations, reducing the protective benefit of diversification.

Whether that's a growing or retreating fixture of markets, experienced money managers say a balanced core remains vital. It's just that the conventional split now demands closer examination.

"I don't think it's dead. It still serves a purpose, providing a more comfortable ride for investors," says Eric Savoie, senior investment strategist on RBC Global Asset Management's (RBC GAM) macro and economic strategy team.

Still, he adds that sudden, sharp changes in inflation expectations create the greatest challenge in today's market regime. Bond yields rise as investors demand more compensation, pulling bond prices lower. Higher discount rates can also reduce equity valuations. Once that adjustment has occurred, though, prospective returns often improve.

Correlation may be a present phenomenon, but hasn't been common historically, Mr. Savoie says. RBC GAM has identified more than two dozen U.S. equity bear markets since the late 1800s. Bonds recorded losses in only three of them.

He notes that bonds' stabilizing potential has improved greatly now that yields have moved well above the exceptionally low levels that prevailed during the COVID-19 pandemic and years preceding it.

"The fixed-income market looks more appealing than it has in a long time," he says.

RBC GAM is slightly underweight in Canadian government bonds and slightly overweight in Canadian investment-grade corporate debt. The tilt is modest because tight credit spreads offer limited compensation for additional risk.

Theresa Shutt, chief investment officer at Harbourfront Wealth Management Inc. in Toronto, takes a different view.

"The traditional 60/40 portfolio allocation is less effective these days," she says.

Her preferred model is closer to 60 per cent equities, 20 per cent bonds and 20 per cent private markets, the latter of which are less prone to volatility and can command an "illiquidity premium."

The debate carries an important message for advisors: 60/40 can remain a reference point to begin the portfolio construction process, but shouldn't be seen as an end point by default.

Other asset classes can fill gaps left by stocks and bonds, although more holdings don't automatically produce greater diversification.

Ms. Shutt uses private investments as a substantial third sleeve, while Mr. Savoie generally treats real assets and other alternatives as smaller satellite positions.

Both Mr. Savoie and Ms. Shutt say the headline ratio is only a starting point. In a post-60/40 world, a durable portfolio depends on whether each holding performs a clear and different function.

For equity allocations, market-cap-weighted indexes can hold hundreds of stocks while deriving much of their performance from a small group of companies.

For example, Mr. Savoie says RBC GAM closely monitors an "effective number of names" metric for concentration risk and holdings that behave similarly. The firm also measures net exposure to dominant themes such as artificial intelligence.

That means RBC GAM holds tactical modest overweights in North America and Asia, while its overall emerging-markets position is neutral. Europe is underweight.

Ms. Shutt sees a stronger case for international diversification, which can offer more attractive valuations. “With equity diversification, you now must look beyond the S&P 500.”

To offset equity risk and address the potential for ongoing correlation risk, Ilana Schonwetter, senior portfolio manager and senior wealth advisor with Sterling Asset Management at Wellington-Altus Private Wealth Inc. in Vancouver, prefers active fixed-income strategies that can adjust duration, weightings and asset mix as conditions change.

“I’m not a fan of a passive fixed-income portfolio that just sits there with a bunch of long-term government bonds,” she says.

Ms. Schonwetter assesses the return clients retain after inflation and taxes, particularly when bonds are held in non-registered accounts.

She also builds an equity core around high-quality companies with strong management and free cash flow. Smaller sector, thematic or factor-based positions can then pursue specific opportunities. Those additions should provide something the core lacks.

“For every unit of risk that you’re taking on, make sure that you’re actually going to have the potential reward,” Ms. Schonwetter says.

For example, buying more of the largest technology companies outside an S&P 500 index holding may just amplify an exposure the investor already holds.

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