Chatham Wealth Management

Does the Traditional 60%/40% Asset Allocation Model Work Anymore?

In today's investment environment, portfolio managers are questioning the use of the traditional allocation of 60% in stocks and 40% in bonds. Modern portfolio theory in the 1950's popularized the use of this model as the best way to achieve diversification and maximize risk-adjusted returns for investors. Today, the world has changed as we live in a more global economy coupled with more robust, fast trading equity markets. Information is at our fingertips via the internet and daily financial news streams from MSNBC, Bloomberg or TheStreet.com.

What is different today than in the past is the Federal Reserve's loose and unconventional monetary policy that has artificially kept interest rates at historically low levels over the past four years. While corporations have benefited from the cheap borrowing rates, individuals are no longer paid to keep their money in their checking or savings accounts. As Jim Grant, the editor of Grant's Interest Rate Observer stated recently in a Bloomberg interview – "This truly radical monetary policy is being followed the world over and distorts the meaning of money. Money is now a tool for the manipulation of economies. The current monetary policy has distorted the values in markets and has resulted in many investors committing capital in the wrong places." Mr. Grant believes that the ability of central banks to work out of this mess over time is unlikely given their performance over the preceding ten years.

At Chatham Wealth, we are concerned about what will happen when interest rates do rise. We know that bond prices will fall which will result in losses in many portfolios. Although the Federal Reserve has stated that it will gradually ease off its monetary policy, history tells us that there are always marked events that can move markets quickly and result in plummeting values. We have not forgotten what happened in 1994 when U.S. Treasury bonds suffered significant losses. The 10-Year Treasury bond lost 12% and the 30-Year Treasury bond lost 18% of its principal value that year.

Chatham Wealth's current investment strategy is to adjust the 60/40 model based on the future economic outlook and earnings potential of companies. Our asset allocation model advocates a split among three slices – equities (domestic and international), fixed income and alternatives. We are focusing our investments primarily on domestic, large-cap stocks with dividend yields at 2% or higher.

In fixed income, our investments are primarily in short duration bonds (less than three years maturity) and bank loans (average yield of 4%). Both of these investments will hold their value in a rising interest rate environment. The coupons on bank loans (loans to U.S. corporations) are adjusted to the three month LIBOR rate and as a result, will continually readjust as interest rates rise. For example, a loan that has a coupon of 4% today will have a coupon of 5% tomorrow if LIBOR rates rise 1%. Our current allocation leans toward shorter duration bonds along with a smaller allocation to bank loans. Chatham also uses alternatives and has current investments in MLPs, preferreds and commodities. The use of alternatives provides diversification, income and enhanced returns on a selective basis.

At Chatham Wealth Management, we believe that a static 60/40 model portfolio strategy cannot work in the current investment markets. It is too laissez faire. A dynamic approach is what is needed. Our portfolio management team looks at the opportunities we see in the current macroeconomic environment on a continual basis and makes changes to the asset allocation model when it is prudent to do so.