Creating Value through Innovative Financial Solutions

LC Monthly Investment Memo : June 2020

Is the 60/40 Allocation Over?

Combining bonds with equities used to be the alpha and the omega of portfolio diversification and risk mitigation. The ideology was simple: bonds, whose prices fluctuate inversely with interest rates, serve as a good diversifier to the equities exposure in a recessionary environment where both interest rates and earnings are expected to decrease. Therefore, adding bonds along with equities in a portfolio would potentially reduce both volatility and drawdowns in a portfolio without giving up too much of the upside. The relationship was all the more relevant when interest rates were high and the opportunity cost of having to choose between bonds and equities was limited.

In a world where interest rates are quickly falling close to 0%, good quality issuers are also now yielding close to nothing. The initial appeal of combining bonds and equities in a portfolio, regardless of the allocation, must now be revisited as the downside buffer that bonds once presented seems to have vanished. More worryingly, the recent sell-off exhibited an increasingly positive correlation between bonds and equities, especially during market stress as shown on the graph below.

Chart 1 – iShares iBoxx IG Corporate and S&P 500 index prices over the last 12 months

Source: Bloomberg

Investors who still observe this traditional portfolio allocation are left with little choice but to either extend the duration, reduce the average credit rating, increase leverage or exercise all of the three to their bond holdings in order to achieve a “decent” yield. The caveat is that the aforementioned options will also concurrently increase the risk of a portfolio (sometimes significantly) without significantly adding much value from a returns perspective. In our view, this approach is not only counterproductive, but also detrimental. It is imperative for investors to be prudent in their bond selection going forward due to the asymmetric risk-reward, particularly for the high yielding ones as discussed earlier in the memo. Considering the mountain (and rising!) of debt at both corporate and government levels, the Central Banks are left with little choice but to keep interest rates close to 0% (or for some even negative) for the foreseeable future to postpone an economic collapse.

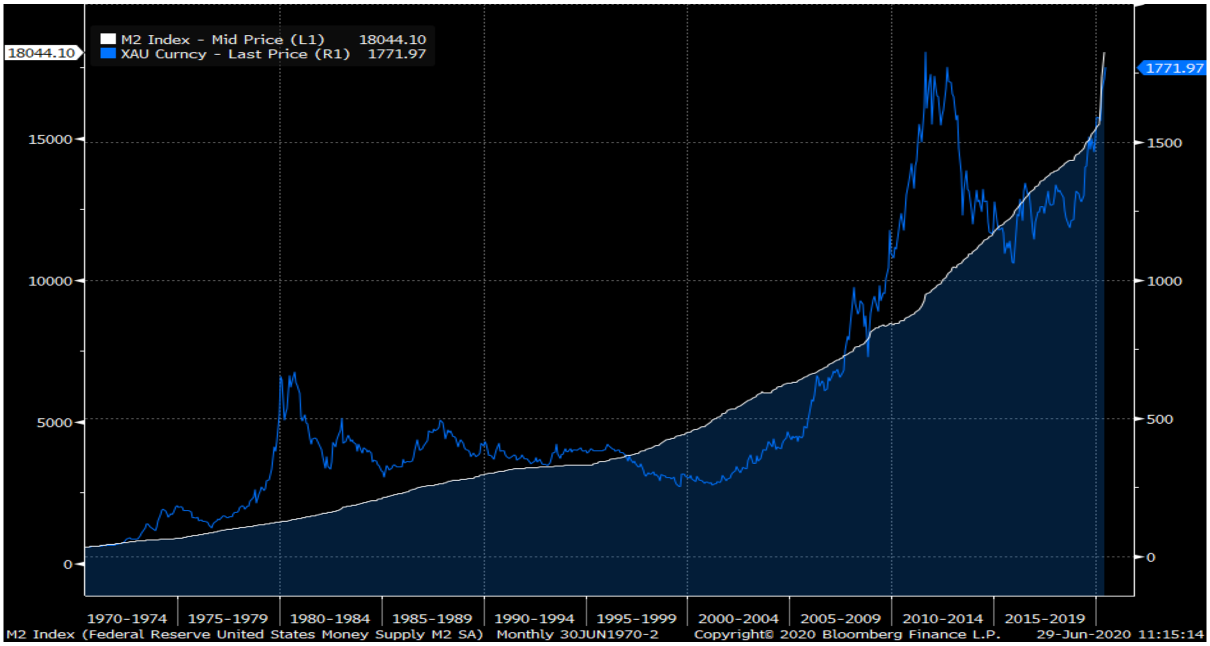
The End of Diversification?

Considering the lack of visibility on the long-term impact of Covid-19 on the real economy, diversification has become growingly important. With bonds no longer attractive as an asset class and equities trading at overly optimistic levels, investors need to start looking in other directions.

In our recent memos, we continue to emphasize the importance of investors increasing their exposure to non-correlated strategies, especially in this current environment. A diversified portfolio of funds with strategies spanning across relative value, long-short equities and trade finance can still offer an attractive risk-adjusted return but with lower volatility or drawdown.

Gold has also become an interesting play as it seems to provide an upside potential as well as a layer of diversification within a portfolio that neither bonds nor equities can achieve on their own or combined. The reason is that the quantity of gold is relatively fixed whereas quantity of money increases. Therefore, as the supply of money increases, the price of gold will be expected to follow suit in order to prevent the dilution of gold’s purchasing power. In other words, gold’s price is somewhat directly correlated to the money supply in the economy over the long run, as shown on the graph below.

Chart 2 – United States M2 Money Supply and Gold price since 1970



Source: Bloomberg

The strong market rally which we witnessed since April has left many experienced investors and economists puzzled as they struggle to make sense of the drivers behind this rally. The factors mentioned below logically point to a bear market scenario:

i) Companies are filling for bankruptcy protection at a pace rarely seen before
ii) Interest rates have collapsed globally as a response from Central Banks to support economies
iii) Wider credit spreads indicate that more pain is yet to come
iv) Gold is back to $1800, a level last seen in 2012

However, equities are displaying otherwise. For instance, the S&P index rebounded 35% since its March lows and is now back above its pre-crisis level of 3000 pts. Witnessing retail investors actively piling into bankrupted companies (Hertz) or IPOs (Nikola) are clear signs of a bubble, driven by liquidity and the sentiment that Central Banks will rescue markets at all cost (Fed Put). Assessing whether investors should stay invested, hedge their positions or wait on the side creates a lot of frustration.

What Can an Investor Do?

Since 90% of a portfolio performance can be attributed to asset allocation (i.e. proportion of bonds, equities, others), we have recommended our clients to diversify their portfolios with the following considerations:

- Alternative managers that offer strategies with low correlation to traditional asset classes as well as against its peers, should be favored. However, manager selection is crucial in identifying such talents. Track records and risk management (especially over multiple market cycles) are paramount when calibrating long-term allocation to these managers.

- Companies with solid balance sheets (Investment grade issuers) will manage to raise capital at very attractive prices (i.e. unattractive yields for investors) while High Yield issuers (weaker credit rating) are likely to face challenges to rollover their debt. This is illustrated by High Yield spreads settling well above 500 bps. Investors will have to be highly selective to avoid a drag on performance (Investment Grade bonds) or losses/volatility (High Yield bonds).

- Structured credit, as an asset class is likely to offer a strong risk/reward ratio in the coming quarters on the back of low interest rates environment. Due to the illiquid nature of this strategy, investors should be compensated with strong risk-adjusted returns. Once again, the quality of the due diligence is key.

- Equities are expensive and likely to remain volatile at least in the medium term. Therefore, investors should only invest and hold companies which present a long-term upside i.e. those whose earnings showing a potential to increase in the coming years. The current volatility level offers interesting zero cost structures on options where investors can benefit from the next 10-15% upside, while being delivered the stock at 15% discount.

Yours Faithfully,

The Lighthouse Canton Team