TMX THE FUTURE IS YOURS TO SEE.®

MACROHIVE

MONTRÉAL EXCHANGE

October 2022

# How to Manage the 60/40 Portfolio in Canadian Markets

## Summary


- The 60% equity/40% bond portfolio has long been an asset allocation strategy that allows investors to benefit from the upside of equities and income of bonds.
- Over time it has largely performed as advertised. But in 2022 both bonds and equities have posted highly correlated and severe negative returns.
- At this juncture, bonds should find a floor once inflation slows and central bankers stop raising rates. But equities still face considerable downside risk from a slowing economy and a potential economic or geopolitical crisis.
- But none of this is written in stone either. Investors can maintain equity positions and limit downside exposure using equity derivatives.


## The 60/40 Portfolio is Performing Poorly

The standard diversified portfolio is a 60%/40% asset allocation between equities and bonds, respectively. The idea is to combine the steady income of bonds with the upside of equities, while reducing the volatility of equities. A key assumption of this strategy is that the correlation between bond and equity returns is relatively low or negative. That means that when equity markets underperform, bonds outperform, thus providing diversification benefits.

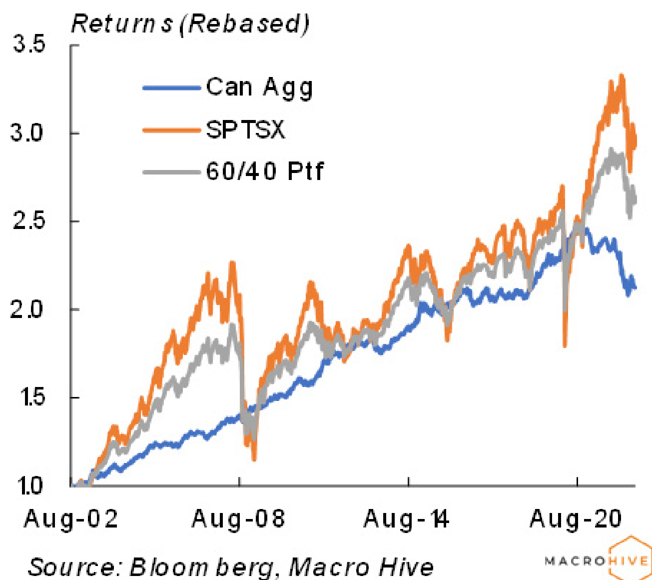
However, 2022 has been highly unusual in that equities and bonds have been highly correlated and posted significant negative returns at the same time. In this note we review the experience of the Canadian S&P/TSX 60 Index* and the S&P Aggregate Bond Index, which combines Canadian government and investment grade corporate debt, in a 60%/40% allocation. We implicitly assume an investor holds a diversified mix of stocks and bonds or funds/ETFs that are similar to these indices. We suggest strategies to maintain this allocation and reduce downside risk.

## The 60/40 Portfolio Since 2002

Over time the 60/40 strategy has largely performed as advertised. The combined portfolio has tracked equities while avoiding much of the noisy aspects of equities (Figure 1). That said, it did not avoid significant losses in the major selloffs of 2008 and 2020.

**FIGURE 1**

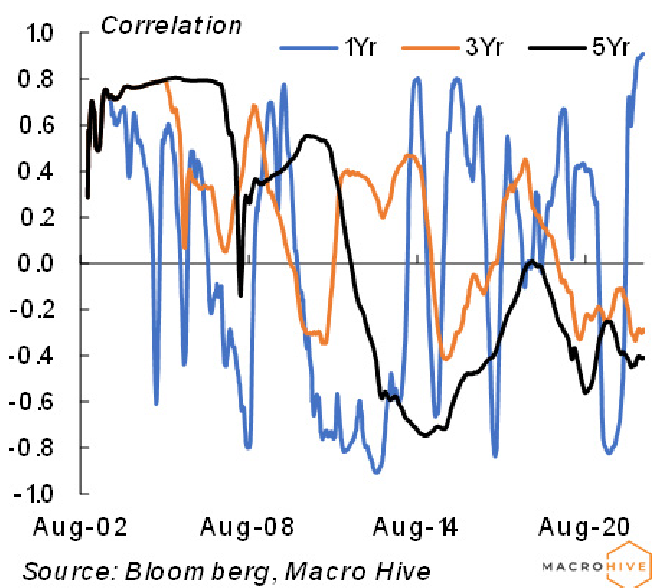
### 60/40 Mix Dampens Volatility



Source: Bloomberg, Macro Hive

**FIGURE 2**

### Equity/Bond Correlation Often Low



Source: Bloomberg, Macro Hive

Statisticians consider correlations higher than 0.75 or less than -0.75 to be high; correlations in the 0.5 to -0.5 range are weak or meaningless.

Correlations between equity and bond returns have mostly been in the latter range over rolling 3-year and 5-year periods (Figure 2), which should be a source of comfort for buy-and-hold investors.

Correlations over shorter periods, on the other hand, are highly variable. The 1-year rolling correlation has veered from negative to positive, sometimes hitting the high threshold. What is particularly notable is that it does not spend much time in the weak middle zone. Fortunately, most of these fluctuations are fairly short-lived, and wash out over time as shown by the longer-term correlation series. There was one period of extended negative correlation during 2010-2013 when equities and bonds traded in a narrow range but offsetting range.

# What About Today?

Today we face a situation quite different from the experience of the past 20 years. The 1-year correlation is over 0.90 – higher than any time over our study period. Both equities and bonds are falling. Year to date, the Canadian S&P Aggregate Bond Index and S&P/TSX 60 Index are down 11.7% and 8.7%, respectively. In previous large equity selloffs, bonds were relatively stable, or up.

In our view, risks continue to be tilted to the downside, especially for equities.

Bonds should find a floor once inflation slows and central banks stop raising rates. If the economy moves toward or into recession, bonds could even gain when central banks start cutting policy rates.

Equities are vulnerable as long as central banks are raising rates (as a higher discount rate is applied to future earnings and dividends). If higher rates cause the economy to slow or go into recession, earnings will be squeezed, putting more pressure on equity valuations. There is also elevated risk of a major crisis and selloff. Possible catalysts include the Russian/Ukraine war, the energy crunch in Europe, or upheavals following elections. Bonds could benefit from a flight to quality in a crisis scenario.

The simple answer would seem to be to reduce equity exposure. But there are reasons for optimism too. Inflation pressures may ease as supply chains gradually return to normal. Central bankers may prove to be nimble and adjust policy to changing circumstances before a recession becomes inevitable. Unemployment is low in the US and Canada, so the economy may be able to keep growing, despite higher rates.

# Trade Idea: How to Manage 60/40 in This New Regime

Rather than sell equities, investors can maintain the 60/40 allocation, but reduce exposure to equity downside by using equity derivatives that trade on the Montréal Exchange.

One approach is to sell futures on the Montréal Exchange's S&P/TSX 60 Index Standard Futures (SXF™). This strategy essentially locks the equity valuation at the level of the contract. It limits downside risk, but at the cost of losing out on any upside until the position expires or is unwound.

A second approach is to buy puts on SXF. That sets a floor on downside equity exposure at the strike price of the put.

Buying outright puts can be expensive, especially for at or near the money strikes. Investors can create a collar position to pay for the put. This entails writing out-of-the-money calls to generate income to pay for the puts. This strategy limits downside risk, but also limits the upside if the index rises above the call strike price.

The commentary contained in the above article does not constitute an offer or a solicitation, or a recommendation to implement or liquidate an investment or to carry out any other transaction. It should not be used as a basis for any investment decision or other decision. Any investment decision should be based on appropriate professional advice specific to your needs.

Bilal Hafeez is the Founder and CEO of Macro Hive – a leading independent research firm. Prior to Macro Hive, Bilal was Global Head of International Fixed Income Strategy at Nomura between 2016 and 2019. Before that Bilal held various senior roles at Deutsche Bank between 2002 and 2015 including Head of Multi-Asset Research, Advisor to the CEO, Head of Asia Research in Singapore and Global Head of Foreign Exchange Research. Bilal started his career at J.P. Morgan in 1998. During his sell-side career, Bilal was rated #1 market strategist by Euromoney and Institutional Investor for most years between 2004 and 2013. He also pioneered FX investment and smart beta benchmarks. Academically, Bilal was an Honorary Visiting Professor of Finance at Cass Business School. He studied Economics at St Johns College, Cambridge.

# For more information

irderivatives@tmx.com

**m-x.ca**

Copyright © 2022 Bourse de Montréal Inc. All rights reserved. Do not copy, distribute, sell or modify this document without Bourse de Montréal Inc.'s prior written consent. This information is provided for information purposes only. The views, opinions and advice provided in this article reflect those of the individual author. Neither TMX Group Limited nor any of its affiliated companies guarantees the completeness of the information contained in this publication, and we are not responsible for any errors or omissions in or your use of, or reliance on, the information. This publication is not intended to provide legal, accounting, tax, investment, financial or other advice and should not be relied upon for such advice. The information provided is not an invitation to purchase securities listed on Montréal Exchange, Toronto Stock Exchange and/or TSX Venture Exchange. TMX Group and its affiliated companies do not endorse or recommend any securities referenced in this publication. Montréal Exchange, MX and SXF are the trademarks of Bourse de Montréal Inc. TMX, the TMX design, The Future is Yours to See., Toronto Stock Exchange, TSX, TSX Venture Exchange, TSXV, and Voir le futur. Réaliser l'avenir. are the trademarks of TSX Inc. and are used under license.

*The S&P/TSX 60 Index (the "Index") is the product of S&P Dow Jones Indices LLC or its affiliates ("SPDJI") and TSX Inc. ("TSX"). Standard & Poor's® and S&P® are registered trademarks of Standard & Poor's Financial Services LLC ("S&P"); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"); and TSX® is a registered trademark of TSX. SPDJI, Dow Jones, S&P, their respective affiliates and TSX do not sponsor, endorse, sell or promote any products based on the Index and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability for any errors, omissions or interruptions of the Index or any data related thereto.