A TDAM 5 Part Series:

Evolving the Traditional Balanced Portfolio

Advancing the 60/40 approach to keep pace with modern needs

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At a glance

- Traditional balanced portfolios comprised of 60% equity and 40% fixed income were originally designed to provide investors the highest possible return for their acceptable level of risk
- The 60/40 approach served investors well for many years, however, fundamentals have changed, and an evolution in portfolio construction and asset allocation may be warranted
- We believe fixed income returns will be lower for the foreseeable future and present unique risks due to ultra-low interest rates and higher inflation
- Diversification, a primary benefit of a balanced portfolio, may weaken going forward as correlations change

In 1952 two-thirds of families in the U.S. had a telephone and only one-third had a TV[1]. Today, a small digital device in your pocket can communicate or stream content to and from anywhere in the world. Modern Portfolio Theory's "60/40 portfolio" was also developed in 1952[2], however it has yet to materially evolve. Technology is always evolving to serve us better, so why shouldn't our investment portfolios?

With this theme in mind, the Asset Allocation Team has created a 5-part series of papers that addresses the evolution in our approach to asset allocation. In this first paper, we discuss how the 60/40 portfolio has served investors well in the past, why evolution is needed now more than ever and TD Asset Management Inc.'s (TDAM) approach to asset allocation.

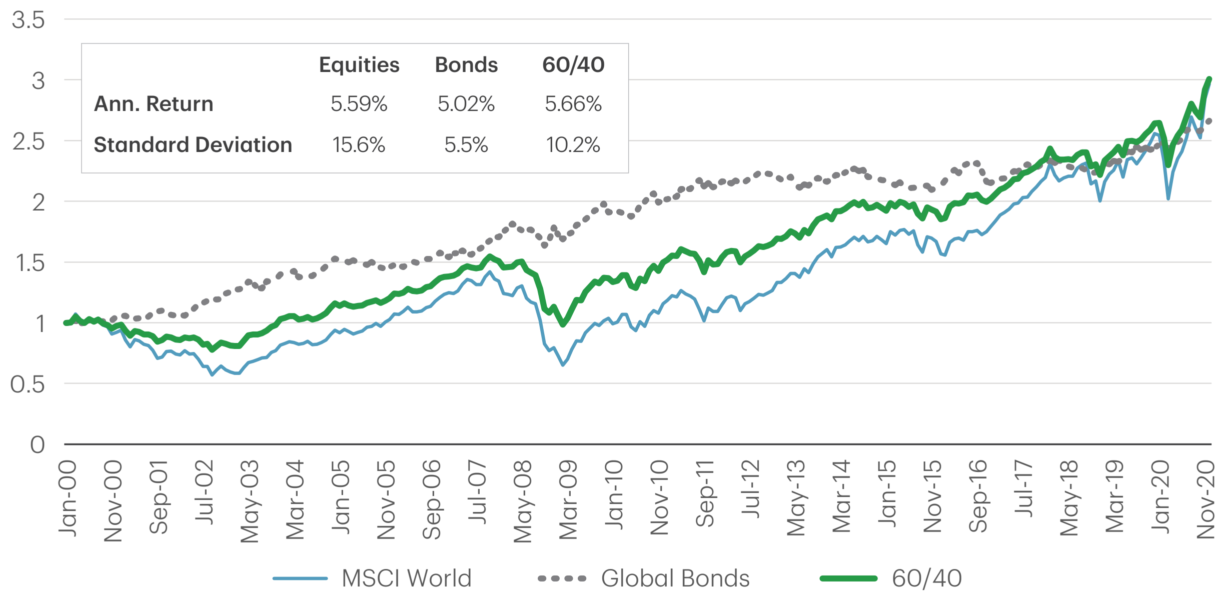
The original thinking behind the 60/40

The original idea behind the Modern Portfolio Theory's 60/40 portfolio was balancing the need for the highest possible return with a client's risk budget[2]. Investors seek higher returns through equities but also want the stability offered by fixed income. This idea is still true today and has been broadly adopted by the investment industry.

The success of this mix was driven by two key structural drivers:

- **Higher returns than expected** – The 60/40 portfolio has done very well with strong returns not only from equities, but also from fixed income, largely due to falling interest rates.
- **Strong diversification** – The 60/40 portfolio has benefited from what many consider the only "free lunch" in investing - the power of diversification. This is created by the negative correlation between equities and fixed income, which typically results in strong risk adjusted returns.

60/40 Returns Over the Past 20 Years



Source: Bloomberg L.P. Data as of December 31, 2020. Equities are represented by the MSCI World Index TR and Bonds are represented by Bloomberg Barclays Global Aggregate Index TR. Standard deviation is the statistical measure of market volatility, measuring how widely prices are dispersed from the average price. If prices trade in a narrow trading range, the standard deviation will return a low value that indicates low volatility.

Investor portfolios should ideally provide competitive returns within a pre-defined risk budget, helping to achieve their investment goals in the smoothest way possible. However, markets and economies have evolved since the theory's origins, particularly over the last decade, resulting in changed return expectations and a different relationship between assets-classes. This inherently requires new thought and approaches.

Markets and economies have evolved since the theory's origins, particularly over the last decade

Return expectations have changed

A quick glance at financial news and headlines over the past several years would give the impression that fixed income and equity returns seem highly unpredictable. While this may be true in the short term, as explained in our Are Equity Returns Predictable thought leadership paper, they are driven by steady economic forces over the long-term (long-term yields drive fixed income returns & earnings/dividends drive equity returns).

From a historical standpoint, fixed income return expectations are broadly much lower than ever before. Bond yields have been steadily falling over the years and have dropped to all-time lows which can be attributed in part to the recent COVID-19 pandemic induced recession.

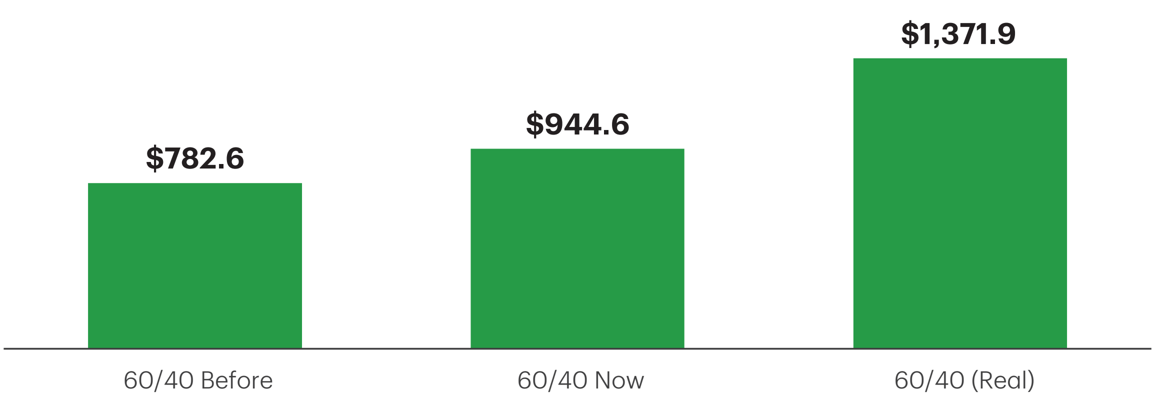
Central banks from around the world have also fundamentally changed their inflation management approach and are expected to keep Interest rates low for many years. The large increase in money supply created by large fiscal and monetary support during the COVID-19 pandemic, has resulted in high government debt levels. In turn, keeping yields and interest rates low not only helps the economic recovery, but also helps over-indebted economies to grow out of their excess debt without having to raise taxes or default (financial repression). This central bank stimulus also raises the prospect of materially higher inflation going forward and surprise inflation (inflation not otherwise expected) is bad news for fixed income returns.

From an equity return standpoint, high capital inflow to the economy, with a combination of low yields, support economic growth which leads to improving corporate profits. This continues to drive strong equity return expectations.

As a result, lower fixed income return expectations fundamentally alter what one can expect from a 60/40 portfolio. Moving forward, investors may need a new approach to safely meet their goals.

> **Lower fixed income return expectations combined** with strong equity return expectations fundamentally alters what one can expect from a 60/40 portfolio.

Monthy contribution required to save $1,000,000 over 30 years in a 60/40 portfolio



Source: Bloomberg L.P. Data as of December 31, 2020. For illustration purposes only. Does not take into consideration any tax impact on various saving strategies. Bonds are represented by the FTSE Canada Universe Bond Index Total Return and equities are represented by MSCI World Total Return in CAD. 60/40 Before – monthly payment needed to reach $1,000,000 in 30 years using the average return of bonds and equities over the past 30 years ending Dec. 31, 2020. 60/40 Now – monthly payment needed to reach $1,000,000 in 30 years using the average return of equities over the past 30 years ending Dec. 31, 2020 and using an expected average bond return of a 2% over the same 30-year period. 60/40 Real – Same assumptions as the “Now” example except it is also is adjusted for inflation. We use the Federal target of 2% for the inflation figure of the 30-year time-period.

Diversification dynamics have changed

A negative correlation between bonds and equities is a basic requirement for diversification, but this relationship has not always been consistent over time. We believe the primary risk to the traditional 60/40 approach and the "free lunch" afforded by diversification is that this negative correlation may weaken going forward.

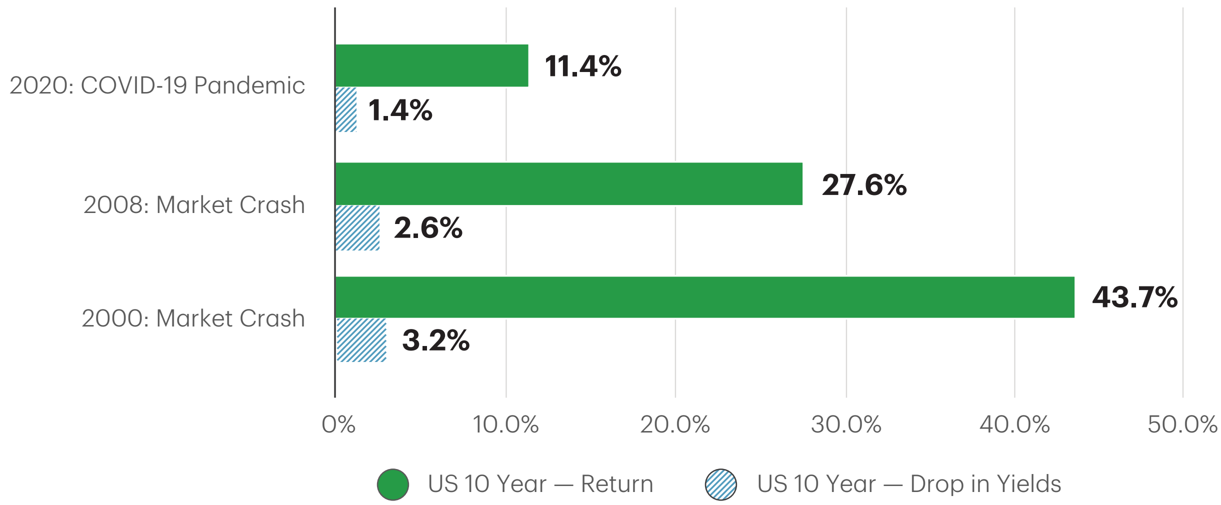
> **The diversification benefits** between a mix of stocks and bonds has been weakening.

Another factor that reduces the diversification benefit from a fixed income perspective is lower interest rates and yields. Over the last two decades, yields have steadily fallen and now with the effects of the COVID-19 pandemic, they sit at about 0%. This potentially changes the downside protection from bonds, reducing the diversification benefit as shown in the chart below.

Both equities and fixed income markets have benefited from monetary policy through quantitative easing (QE). Changes to these economic tools/monetary policy support may impact both asset classes simultaneously, hence creating a positive correlation and reducing the benefit of diversification.

For example, rising yields due to reduced QE means lower fixed income returns and potentially lower equity returns due to higher corporate debt cost and lower relative excess return (equity risk premium).

U.S. 10 Year Treasury Yield / Returns During Various Periods of Volatile Markets

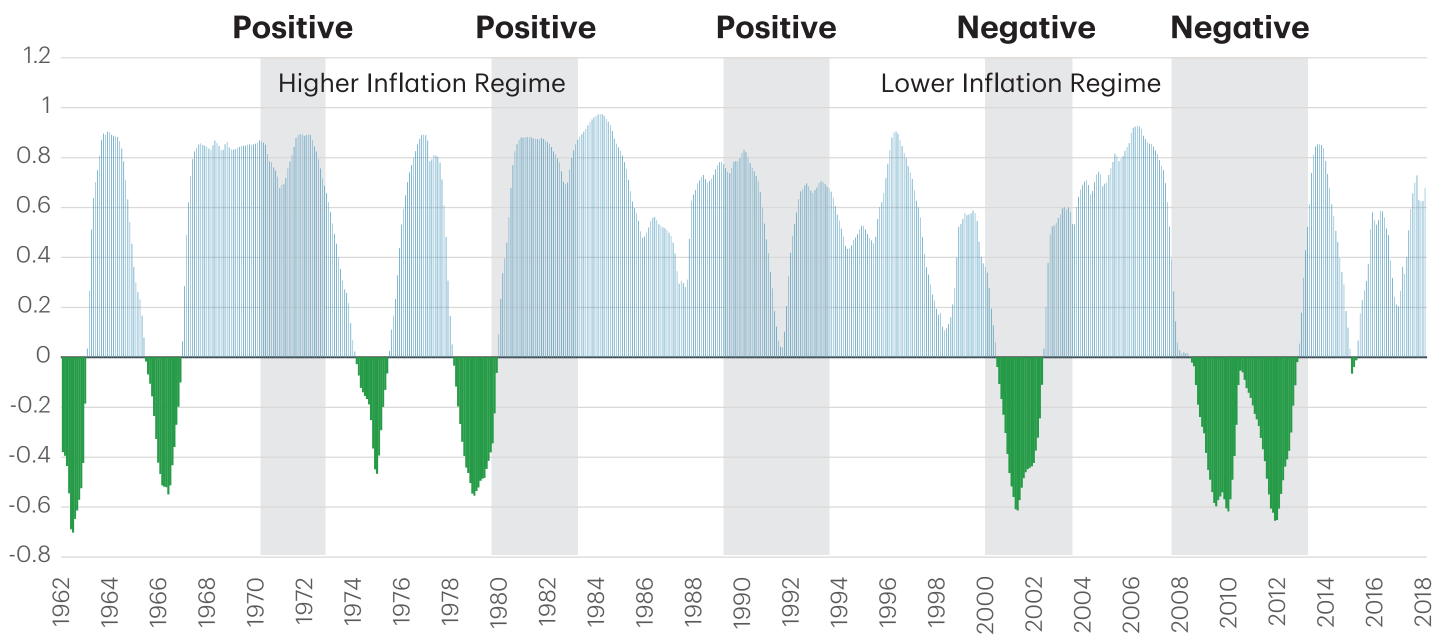


Source: Bloomberg. 2020 Covid19 pandemic timeline is Dec. 31, 2019 to March 31, 2020. 2008/09 Global Financial Crisis timeline is Sep. 30, 2007 to March 31, 2009. Dot-com Bubble crash timeline from Jan. 1, 2000 to Sep. 30, 2002.

Dynamics

Historically, correlations between equities and fixed income have not always been negative. During periods of higher inflation (from 1950-1980s), correlation has been positive, and the benefit of diversification has been limited, sometimes even detrimental, to the overall client experience since higher inflation negatively impacts both equities and fixed income. This dynamic also increases future risk around the reduced diversification benefit between fixed income and equities.

Fixed Income and Equity Correlations in Past Recessions
"Are Not Always Negative"



Source: Shiller, S&P 500 Earnings Yield vs U.S. 10 Year Treasury Note Yield. Data from Jan. 1, 1962 to April 30, 2017. Data is forward looking as correlation is defined as what we observe 3 years after the event. Equity yield is used as it shows the correlation without accounting for duration/convexity.

The search for yield has altered the risk relationship

The other assumption within the traditional portfolio construction approach is that all stocks and bonds are alike. However, asset classes are not homogenous. A blue-chip stock doesn't have the same risk level as a small cap tech stock. The same can be said for bonds.

Within fixed income, because of low interest rates, investors have searched for yield in riskier areas of the market, such as high-yield or emerging market bonds. While these assets can play a role in a portfolio, compared to less risky bonds they are much more positively correlated with equities which reduces diversification benefits and offers less protection from volatility.

> **Search for yield within fixed income has reduced the** diversification benefit from the asset class and made it riskier in some cases.

The future of the 60/40 portfolio

Investors continue to have the same needs as they did in 1952; to achieve the necessary returns to help meet their goals, with the smoothest journey possible. However, the modern world has changed and so has the return outlook for major asset classes and the relationship between them. Just as technology has evolved, new innovative techniques and asset classes have enabled an evolution in portfolio construction. Innovative solutions can better align with client goals and provide higher returns, with improved risk mitigation.

Be sure to look for our upcoming articles that include the new ways in which TDAM views and explores a more modern portfolio. Some of the upcoming topics include:

- **The new role of fixed income**
- **How to benefit from higher equity returns**
- **Alternative investments**
- **Combining our ideas to build better portfolios for balanced investors**

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[1] Pearson, Stephen. "The Year 1952." The People History. Web. 20 Dec. 2016. http://www.thepeoplehistory.com/1952.html
[2]The Journal of Finance, Vol. 7, No. 1. (March, 1952) Portfolio Selection, Harry Markowitz
https://www.math.ust.hk/~maykwok/courses/ma362/07F/markowitz_JF.pdf