INVESTMENT BRIEF

Q4 2022

Strategic Investment Group®

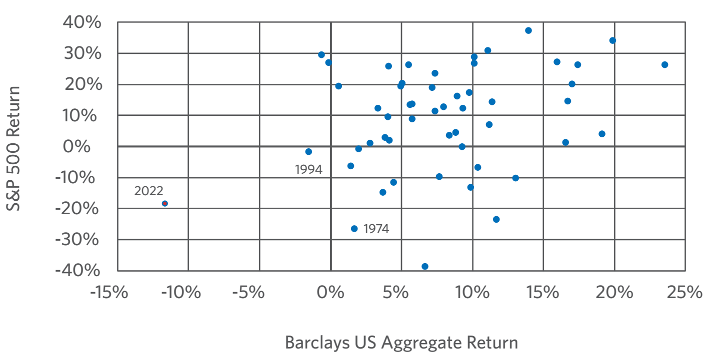
Portfolios Lose Their Balance

Institutional investors seek to strike a balance between real asset growth and capital preservation, and rely on diversification, the only free lunch in finance, to achieve that end. The classic point of departure for such diversified, "balanced" portfolios is the 60:40 split between equities and bonds. This axiomatic approach to portfolio construction badly misfired in 2022, as both stocks and bonds fell by double digits (Exhibit 1). Following two decades of a mostly inverse relationship between stock and bond returns, their correlation spiked to become strongly positive (Exhibit 2). This quarter's special topic considers the factors that led portfolios to lose their balance in 2022, and the lessons that can be drawn from this experience.

EXHIBIT 1:

Balanced Portfolios Lose Their Equilibrium

Source: Bloomberg. U.S. stocks and bonds annual returns, 1970-2022.



Why Balanced Portfolios Stumbled in 2022

Global economies and markets suffered an inflation shock last year triggered by lingering post-pandemic supply chain bottlenecks, abrupt shifts in consumption patterns and employment preferences, highly stimulative fiscal and monetary policies, and Russia's invasion of Ukraine. The uncertainty over the outlook for growth and inflation engendered by this shock was the main driver of the spike in correlation across stock and bond markets seen in 2022. This increase in correlation reached levels reminiscent of the inflation shocks of the 1970s and 1980s and the 1994 global bond market crash.

The high valuations prevailing across global equity and bond markets after years of abundant liquidity made them especially susceptible to the inflation shock, contributing to the magnitude of the market declines. The S&P 500 suffered its sixth largest annual fall since the Great Depression and the aggregate U.S. bond index had its worst year ever. As highlighted in Exhibit 1, last year is the only year in the last 50 in which stock and bond returns were both highly correlated and sharply negative.

Note: Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations.

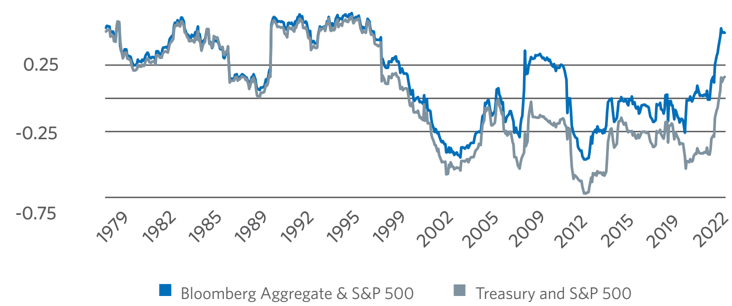
Correlations in Perspective

Since 1900, the average correlation between stocks and bonds has been positive, but low. However, correlations can vary significantly and abruptly change sign (Exhibit 2). Seen from this very long perspective, the two-decade period of mainly negative correlation prior to last year is anomalous. U.S. Treasuries and stocks were negatively correlated throughout this period, while the credit risk embedded in the broader aggregate bond index resulted in a period of positive correlation during the 2007-09 Great Financial Crisis when stocks fell, and credit spreads widened. To investors who had grown accustomed to the negative correlations of the past two decades, the shock of 2022 was especially jarring. However, asset correlations need not be negative for portfolios to benefit from diversification. They just need to be less than one.

EXHIBIT 2:

Inflation Triggers Spike in Stock and Bond Correlations

Source: Bloomberg. Rolling 3-Year correlations.



Regaining Equilibrium

As we have just experienced, correlations across asset classes are unstable and notoriously prone to approach one in times of market turmoil, depriving balanced portfolios of expected diversification benefits at the worst possible time. Testing the impact of fluctuations in cross-asset correlations should therefore be a key part of assessing portfolio risk.

It is also essential to diversify portfolios across a wide range of factors. We rely on two main sources of additional diversification. First, we design our hedge fund portfolio to generate the bulk of its returns from a highly diversified stream of added value, while minimizing its beta. The diversification provided by low-beta hedge funds is invaluable in times of market turmoil similar to last year. Second, across all asset classes, we focus on generating value added from a large number of well-calibrated active positions. Alpha generated in this way is more robust and repeatable than added value derived from a few large active positions. Our approach of embedding multiple diversifiers in client portfolios succeeded in cushioning last year's blow to balanced portfolios. We believe that the 60:40 architype remains a valid point of departure, provided that it is complemented by a broad set of diversifiers.

1001 Nineteenth Street North, 17th Floor
Arlington, VA 22209 USA

+1 703.243.4433 TEL
+1 703.243.2266 FAX

strategicgroup.com