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# Goals-Based Investing: Moving Beyond the 60/40 Portfolio

By Anthony B. Davidow, CIMA®

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# Goals-Based Investing

## MOVING BEYOND THE 60/40 PORTFOLIO

*By Anthony B. Davidow, CIMA®*

*Market participants willing to accept illiquidity achieve a significant edge in seeking high risk-adjusted returns. Because market players routinely overpay for liquidity, serious investors benefit by avoiding overpriced liquid securities and by embracing less liquid alternatives.*
—David F. Swensen (2009)

Over the past decade, many pundits have predicted the death of the 60/40 portfolio, when in fact it has worked well during a rising U.S. equity market. The naive 60/40 portfolio came into prominence as advisors looked to institutional allocations as a guide for individual investors. Advisors could increase the equity allocation for investors seeking higher returns or lower equity allocations for more conservative clients.

The 60-percent allocation to equities provided growth and the 40-percent allocation to fixed income provided income and stability. This worked well when investors achieved the long-term historical average of the S&P 500 (10.2 percent), the roughly 4-percent yield of traditional bonds, and a modest degree of diversification benefit, because stocks and bonds historically had exhibited low correlation to one another.

The 60-percent equity allocation evolved to include value and growth, and large and small cap; and as the merits of diversifying outside our borders became more accepted, advisors began dividing allocations to include international and emerging markets. Fixed income allocations also expanded beyond Treasuries and corporate bonds to include high yield and sovereign debt among other sub-asset classes.

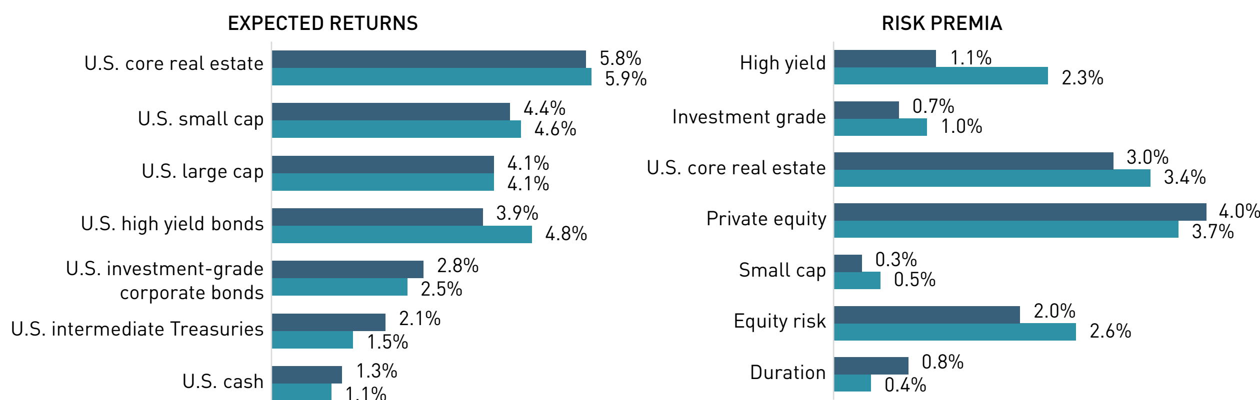
The composition of the 60/40 portfolio has evolved, but given current market conditions, the question for advisors is whether the future will be like the past. Will the 60/40 portfolio provide sufficient growth, income, and diversification to meet clients' goals and objectives?

### WHAT IF THE FUTURE ISN'T LIKE THE PAST?

Critics will point to the current market environment and expectations for dramatically lower returns in the future. U.S. markets have risen dramatically since 2009, with a few pauses, but a generally upward trajectory. U.S. equity markets have been propped up by accommodative fiscal and monetary policy, generationally low bond yields, and a belief that there is no alternative.

Most firms' capital market assumptions (CMAs) are projecting substantially lower returns over the next 10 to 20 years. If U.S. equity returns were projected to be slightly lower, advisors may be fine sticking with the old 60/40 portfolio. But if the projected returns are less than half the historical average (4.10 percent versus 10.2 percent), then advisors will need to expand their menu

Figure 1 RETURN AND RISK PREMIA FOR KEY ASSET CLASSES




*Source: J.P. Morgan Asset Management: data as of September 30, 2021. Note: Return pickup (premium) for asset as follows: HY vs. IG; IG vs. UST; Core RE vs. IG; PE vs. U.S. large cap; small cap vs. U.S. large cap; large cap vs. UST; UST vs. cash.*



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Table 1

## CORRELATION BETWEEN U.S. STOCKS AND COMMODITIES (JANUARY 2000–DECEMBER 2009)

| | U.S. Equity | Global Equity | Global High-Yield | Commodities | Global Bonds |
|---|---|---|---|---|---|
| U.S. Equity | 1.00 | | | | |
| Global Equity | 0.97 | 1.00 | | | |
| Global High Yield | 0.66 | 0.72 | 1.00 | | |
| Commodities | **0.20** | **0.29** | **0.29** | **1.00** | |
| Global Bonds | **0.14** | **0.24** | **0.34** | **0.19** | 1.00 |

Table 2

## CORRELATION BETWEEN U.S. STOCKS AND COMMODITIES (JANUARY 2010–DECEMBER 2020)

| | U.S. Equity | Global Equity | Global High-Yield | Commodities | Global Bonds |
|---|---|---|---|---|---|
| U.S. Equity | 1.00 | | | | |
| Global Equity | 0.97 | 1.00 | | | |
| Global High Yield | 0.75 | 0.83 | 1.00 | | |
| Commodities | **0.57** | **0.61** | **0.69** | **1.00** | |
| Global Bonds | **0.25** | **0.34** | **0.52** | **0.23** | 1.00 |

of options. JP Morgan's CMAs are projecting substantially lower returns across most major asset classes; however, from a risk premia perspective, they note the relative attractiveness of equity and private equity (see figure 1).

In addition to coping with forecasts for lower equity returns, advisors are struggling to find yield without taking on substantial risk. Brusuelas (2021) reported there was more than $15 trillion in negative yielding assets globally, and bond yields are near record low levels in the United States and other markets. Given the low-yield environment, advisors and investors have been tempted to seek alternative sources of income including high yield bonds, real estate investment trusts (REITs), and master limited partnerships (MLPs). But these investments introduce additional portfolio risk.

Increasing correlations across most traditional asset classes pose another challenge for advisors. This is due to increased global connectivity and rapid flow of information. As tables 1 and 2 show, correlations between U.S. stocks and commodities rose from 0.20 during 2000–2009 to 0.57 during 2010–2020. Global equities and commodities show similar correlations.

In fact, in periods of extreme shock such as Q4 of 2019 and March and April of 2020, correlations across most major asset classes increased dramatically. When we need the benefits of diversification most, diversification often fails to deliver. Therefore, we need to identify a broader set of tools to help in building more durable portfolios.

The final market dynamic that advisors need to solve for is inflation. Over the past couple decades, the Federal Reserve has struggled to meet its 2-percent inflation target. However, with the flood of easy money pumped into the system to keep the economy alive during the COVID-19 pandemic, and the Fed getting ready to end its bond purchases, we have begun to see inflation rear its ugly head for the first time in decades. Inflation is currently at levels not seen since the early 1980s. Advisors need to identify investments that can help in hedging the impact of inflation.

### THE NEED FOR A BETTER TOOLBOX

In today's market environment, wealth advisors need to expand their toolboxes to identify alternative sources of growth and income; they also must identify investments that historically have delivered lower correlations and can hedge against the corrosive impact of inflation. Alternative investments are flexible multi-purpose tools that should be carefully considered.

Alternative investments include hedge funds and private markets. Hedge funds can be divided into equity-hedge, event-driven, relative value, macro, and multi-strategy. Private markets include private equity, private credit, and real assets (real estate, infrastructure, and natural resources).

It may be instructive to examine how some of the biggest and brightest allocators of capital are dividing assets (see figure 2). Institutional investors historically have used these valuable tools in meaningful ways to meet their constituents' needs. Often the larger the size of the institution, the larger the percentage allocation to alternative investments. Bary (2021) reported that the Yale Endowment, as of June 30, 2020, had a target alternative allocation of more than 78 percent and an allocation to U.S. equities of around 2 percent. I'm not suggesting that advisors follow the Yale allocation with high-net-worth (HNW) investors; rather I'm using the example to illustrate how one of the most successful endowments allocates capital.

The interest in hedge funds from HNW investors has waned in recent years, due in part to the longest bull market in



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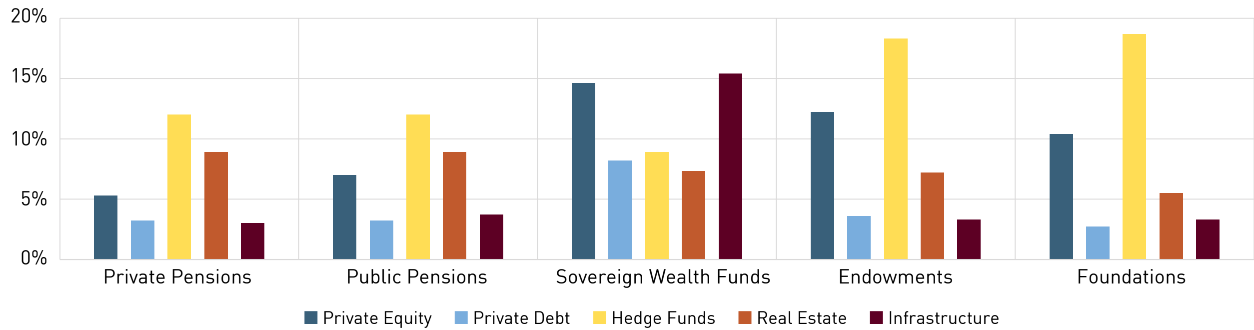
Figure 2

## ASSET ALLOCATION BY INSTITUTIONAL SEGMENT




*Source: Prequin and CAIA Associates, 2021.*

history (2009–2019) and a mismatch in expectations regarding the role of hedge funds in portfolios. Hedge funds can provide several benefits in a portfolio, including potentially stronger returns, particularly in environments with high volatility and low correlation. They can protect capital through active risk management and hedging, and they can diversify traditional exposures through access to different markets.

Investors often think of hedge funds as being homogeneous, but there is a great deal of diversity from one strategy to the next. Hedge fund strategies represent a broad set of solutions, including equity-hedge, event-driven, relative value, macro, and multi-strategy. These can be further broken down into sub-strategies such as market-neutral, activist, merger arbitrage, managed futures, and distressed, etc. All hedge fund strategies are not created equal, and not all strategies are solving for the same thing (Davidow 2021, 114–115).

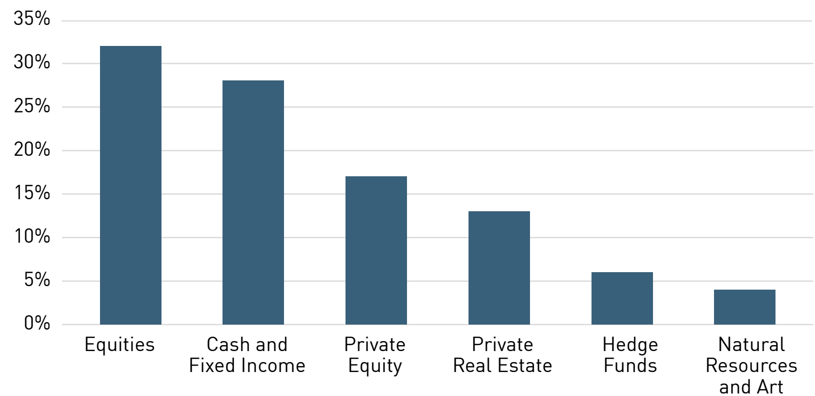
If we examine the asset allocations of family offices, we see that private equity and private real estate represent significant allocations (see figure 3). Private equity and private real estate together historically have been a big differentiator for family offices, which have been provided unique access and have been handsomely rewarded for locking up their capital for several years.

Private markets have gained interest from HNW investors lately as these once-elusive investments have become more readily available (Davidow 2019). Family offices and institutions have allocated significant portions of their portfolios to private equity, private credit, and real assets. Private equity and private credit historically have delivered an illiquidity premium compared to their traditional equivalents (see figure 4). The illiquidity premium is the amount of excess return generated for locking up capital for an extended period of time.

Private equity's appeal is the opportunity to invest in early-stage companies and reap benefits as companies go public.

Figure 3

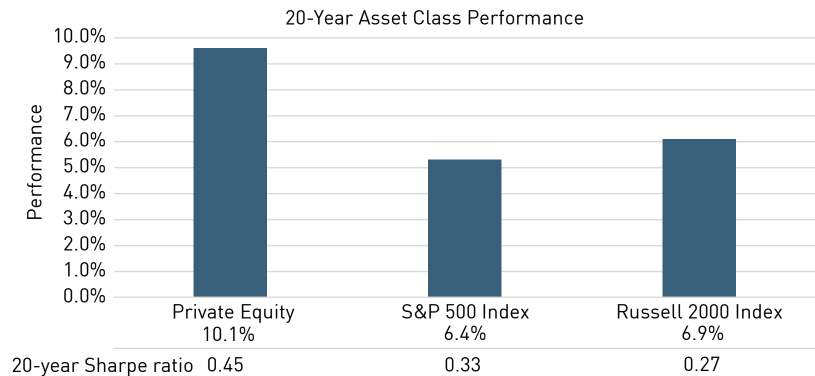
## ASSET ALLOCATION OF U.S. FAMILY OFFICES




*Source: Global Family Office Report, UBS (2021)*

Figure 4

## PRIVATE EQUITY HAS GENERATED LONG-TERM OUTPERFORMANCES




| 20-year Sharpe ratio | 0.45 | 0.33 | 0.27 |
|---|---|---|---|

*Source: Hamilton Lane Data via Cobalt and eVestment. Data is from Q3 2000–Q3 2020.*



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Investors get in on the ground floor of the next Google, Facebook, Tesla, or Airbnb. Private equity represents a range of opportunities across various stages of development. On one end of the spectrum, we find venture capital: early-stage companies that still are developing a product or service. At the other end of the spectrum, we find buyout: companies that have positive cash flow that may benefit from reorganizing or selling certain assets.

Private equity historically has delivered a 3- to 4-percent illiquidity premium relative to traditional investments. Based on forward-looking capital market assumptions, private equity is projected to deliver returns of approximately 9–10 percent over the next 10 years, a roughly 3-percent illiquidity premium over traditional equity returns. This is due to multiple factors, including the growing number of private companies and the falling number of public companies and the ability of private companies to execute long-term strategies without having to meet short-term shareholder demands (Davidow 2021, 135–136).

It is worth noting that the private equity illiquidity premium varies a great deal between the top and bottom quartiles of funds. Figure 5 shows there is a significant premium in selecting the best-performing private equity funds as well as a great deal of dispersion between the best and worst funds. The spread between the best and worst global equity funds is relatively small compared to the large dispersion of returns for global private equity and for U.S. venture capital (390 basis points [bps], versus 1,900 bps and 2,400 bps, respectively). Therefore, because results can vary significantly, the wealth advisor's value is in selecting the right fund and in the right private equity investment structure.

With global yields at historically low levels, investors increasingly are seeking alternative yield sources, and private credit has become an attractive source of return. Private credit historically has offered attractive risk-adjusted results. Direct lending has been the fastest-growing segment of this market. Investing in the debt of private companies is another way investors can gain exposure to private companies, potentially with less risk involved than a private equity company. Like public company debt, private credit may offer investors an attractive income stream.

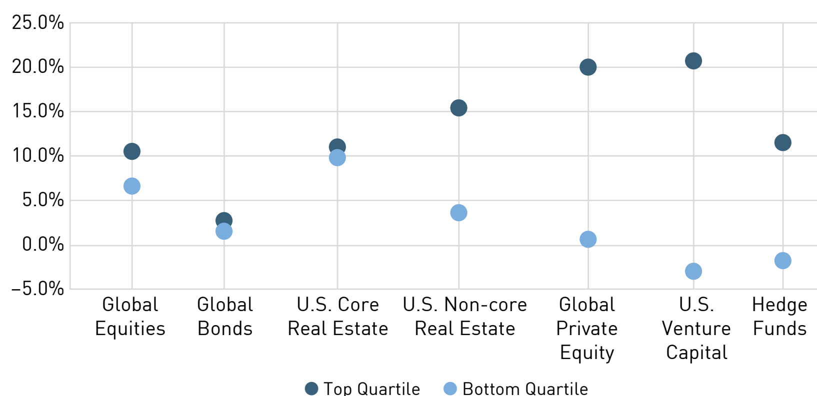
Typically, private credit has low correlation to other more traditional fixed income because the debt is not traded and subject to the volatility of the public markets. The debt is often at floating interest rates, so investor income rises with overall interest rates—an attractive feature in a rising-rate environment.

Wealth advisors should help investors evaluate the type of debt in which a fund is investing and the fund's risk level relative to the underlying securities. They should consider the capital structure hierarchy to determine which type of investment has preference and priority. Senior secured debt has priority over second lien, mezzanine, and equity holders. In other words, senior secured debt holders have a preferential claim on assets if a company becomes financially distressed. Wealth advisors also should evaluate structural considerations such as fees, use of leverage, and credit quality, etc.

Real assets are tangible, physical assets with values derived from their physical use. This is a distinct feature that differentiates real assets from financial assets such as stocks and bonds, which derive benefits from ownership claims to underlying assets, the prices of which reflect the forces of supply and demand. By contrast, real assets are often key inputs for economic activities with intrinsic value. Buildings, bridges, and farmland have utility even if they are not being traded, and a large portion of a nation's wealth and economic capacity is tied to its stock of real assets.

Real assets are versatile tools that serve multiple roles in portfolios including generating attractive returns, diversification relative to traditional investments, an alternative source of income, and hedging inflation. Real estate historically has been a source of income, often generating larger yields than traditional fixed income options. Note that there are big differences between private and public real estate, and institutions and family offices typically are allocating to private real estate.

**Figure 5** PUBLIC AND PRIVATE MANAGER DISPERSION OF RETURNS




*Sources: Lipper, NCREIF, Cambridge Associates, HFRI, J.P. Morgan Asset Management*

*Global equities (large cap) and global bonds dispersion are based on the world large stock and world bond categories, respectively. Manager dispersion is based on: Q3 2010–Q3 2020 annual returns for global equities, global bonds, U.S. core real estate, and hedge funds. U.S. non-core real estate, global private equity, and U.S. venture capital are represented by the 10-year rate of return (IRR) ending Q2 2020. Data is based on availability as of November 30, 2020.*



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Table 3

### THE ROLE OF VARIOUS ASSET CLASSES

| Growth | Income | Diversification | Inflation hedging |
|---|---|---|---|
| • Equities (large, small, value and growth, international and emerging market)<br>• Hedge funds (equity-hedge and event-driven)<br>• Private equity (venture capital, growth, and buyout)<br>• Infrastructure | • Fixed income (Treasuries, corporate, high yield, international, etc.)<br>• Private credit (direct lending, mezzanine, distressed, etc.)<br>• Real estate (public and private)<br>• Other (MLPs, royalties, etc.) | • Cash and cash equivalents<br>• Treasuries<br>• Commodities (gold and precious metals, energy, agriculture)<br>• Natural resources<br>• Hedge funds (relative value, macro, and multi-strategy) | • Treasury Inflation-Protected Securities (TIPS)<br>• Currencies<br>• Real estate<br>• Gold<br>• Natural resources (agriculture, timber, minerals, and mining) |

Infrastructure has several distinct features that makes it a differentiated asset class. Infrastructure projects generally are large, fixed, long-term assets providing essential services to a society or business sector. Consequently, they are less sensitive to the business cycle than public equities and fixed income. Infrastructure assets generate cash flows that often are linked directly or indirectly to inflation, providing a potential hedge. Infrastructure can provide incremental returns given the need to build and modernize airports, bridges, highways, and broadband.

Natural resources include energy, agriculture, timber, and mining and minerals. Natural resources provide the opportunity for higher returns, serve as a hedge for rising inflation, and provide valuable diversification benefits. They benefit from limitations in their availability and their valuations fluctuate based on supply and demand. Natural resources can be accessed through a diversified fund or by accessing the discreet sub-asset classes.

## PUTTING THE PIECES TOGETHER

Wealth advisors need to evolve their toolboxes to ensure they have the right investments to meet client goals and objectives. The traditional 60/40 portfolio helped us introduce the benefits of diversification to investors. As time went on, we expanded the equity and fixed income allocations to capture additional asset classes. Given the challenges facing investors today, we need to continue to expand the asset classes and focus on how to achieve growth, income, diversification, and inflation hedging.

The asset allocation approaches of many institutions and family offices offer some guidance. Institutions and family offices have moved well beyond the 60/40 portfolio and embraced different kinds of alternative investments to solve for the challenging environment. Product innovation has helped bring many of these difficult-to-access asset classes to a broader group of investors.

Wealth advisors should embrace this expanded toolbox as well and explore how to use these tools effectively to meet client goals and objectives. The flaw with the 60/40 portfolio is bad math. If equity returns are projected to deliver half the historical average, and bond yields globally are well below historic levels, then wealth advisors need a different playbook. Wealth advisors should carefully consider the role of various asset classes and what they are trying to solve for—growth, income, diversification, and inflation hedging.

## THE ROLE OF VARIOUS ASSET CLASSES

As table 3 illustrates, there are ample tools for addressing the challenges that investors face, including both traditional and alternative investments. Certain investments such as real estate, natural resources, and gold serve multiple purposes in a client portfolio.

How these tools are used will vary based on the prevailing market environment, the goals that you are solving for, the account type, tax considerations, and the client's wealth and sophistication, among other issues. Investors who don't meet the accreditation standards may have limited investment options, but there are other blunt instruments to help address the challenges.

## GOALS-BASED INVESTING

Like most things in wealth management, we need to constantly evolve to remain relevant. We need to learn the lessons of history and leverage the insights of the best and brightest. We shouldn't blindly follow the allocations of institutions and family offices, but we shouldn't ignore them either. We need to tailor these insights for HNW investors who may be solving for multiple needs simultaneously including intergenerational wealth transfers, college funding, saving for a retirement home, charitable giving, etc.

Because HNW investors often are solving for multiple goals across multiple accounts, the 60/40 portfolio seems like an imperfect cookie-cutter solution that ignores the family's specific goals. The 60/40 portfolio may suffice for retail investors in a robo offering—but it would seem inadequate for HNW investors with complex needs.

If we need to evolve beyond the naive 60/40 portfolio, the question becomes, "What is the preferred approach to allocating capital?" I have long argued that goals-based investing combines attributes of modern portfolio theory (MPT) and behavioral finance. Institutions often refer to this approach as outcome-oriented investing.



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MPT is mathematically driven, with the inputs determining the outputs. Behavioral finance is emotional, focusing on how investors respond to stimuli. Goals-based investing recognizes that investors often are solving for multiple goals simultaneously and maximizing returns may not be one of those goals. Goals-based investing moves the wealth advisor's discussion from outperforming the market to achieving client goals. Goals-based investing aligns the portfolio allocation to specific goals.

Goals-based investing is designed to increase the likelihood of achieving life goals: accumulating wealth, generating income in retirement, saving for college, giving to charities, or some other specific outcome. HNW families pass on wealth from generation to generation through trusts, and they often fund numerous charitable activities. They may have multiple account types with different goals and objectives for each. Goals-based investing provides the flexibility of solving for multiple goals, across multiple account types, simultaneously.

## CASE STUDY

John and Mary Jones are both 65 years old, with two adult children, Sara, 22, and Susan, 24. John is a retired investment banker and Mary is a part-time special education teacher. John has set up a business primarily to invest in clean energy companies. They have a small income ($200,000) from John's board involvement and Mary's teaching salary plus $10 million in investments divided among several accounts. Their home is fully paid off and their two daughters are employed and independent. John and Mary are actively involved in several charities and would like to continue contributing time and money. The following are a few of the family's goals:

**Personal accounts ($6 million)—focused on wealth preservation so the family can travel and enjoy life.** John and Mary are contemplating buying a second home and a boat, and would like to contribute to several charities. Allocation: diverse equity and fixed income, private equity, private credit, private real estate, and multiple hedge fund strategies (70 percent equity, 10 percent fixed income, and 20 percent alternatives).

**Business account ($2.5 million)—focused on accumulating wealth, willing to take on considerable risks.** Allocation: primarily private equity, private real estate, natural resources, equity, and some cash as opportunities are sourced (45 percent equity, 50 percent alternatives, and 5 percent cash).

**Retirement accounts ($1 million)—focused on generating income through retirement.** John and Mary will be drawing down their retirement accounts (pension plans and individual retirement accounts). Allocation: diverse equity and fixed income, private equity, and private real estate (30 percent equity, 50 percent fixed income, and 20 percent alternatives).

**Trust accounts ($500,000)—focused on accumulating wealth.** John and Mary have set up trust accounts for Sara and Susan that can be accessed when they reach age 25. Allocation: diverse equity and fixed income, and diversified hedge fund exposure (50 percent equity, 30 percent fixed income, and 20 percent alternatives).

The case study serves as an illustration of the various goals and allocations of a HNW family. Clearly, this family has the wherewithal to allocate to alternative investments and can afford to lock up capital for an extended period of time. Each account has its own goal and consequently separate asset allocations. Note that defaulting to a cookie-cutter 60/40 portfolio for each account would not be appropriate.

A client's portfolio is the means to an end. It's how wealth grows over time and how a family achieves desired outcomes. Adopting a goals-based approach does not mean that wealth advisors should ignore performance; rather, it changes the utility function to solve for a family's individual objectives. HNW families obviously want and expect access to the best investment strategies. However, if the top-performing strategies come with high volatility and high turnover, then their value may be negated on an after-tax basis.

Wealth advisors should use goals-based investing to solve the needs of HNW families by adjusting their relationships and value proposition to better align with client goals. HNW families have complex needs, and goals-based investing is designed to deal with them individually. Goals-based investing is preferable to the naive 60/40 portfolio for both wealth advisors and HNW families.

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