What to do with the 40%?
The first in a new Insight series focused on how investors should consider portfolio positioning to assets other than equities

How should investors approach the allocation within a traditional balanced portfolio to the ‘40%’ not invested in the equity market and why might investors consider an allocation to alternative investments?

The chart below helps explain asset returns since 1980. Each line represents a discrete cumulative 10-year excess return of a traditional 60:40 balanced portfolio consisting of 60% global equities and 40% US government bonds. We use MSCI World and Barclays US Treasury as the two market indices.

The grey dashed line is the 10-year period up to December 2018. You will note that this was the best period for a balanced portfolio for nearly 40 years, a cumulative excess return, over cash, of just under 70% or 5.3% annualised.

That was until end June 2019, when the cumulative return for this ‘traditional’ portfolio of 60% equity and 40% bonds, delivered an impressive 85%, a compound annual return of 6.3%, the best 10 year period since 1980.

Bear in mind, this return is in USD, so for a Sterling based investor, as GBP has depreciated over the period, returns have been even more impressive, adding an approximate 2% pa to this cumulative return.

In short, whether you are looking at traditional asset class returns in USD or GBP, the last 10 years have been an exceptional period.

Turning to what has driven these returns. Unsurprisingly, global equities have been excellent long-term investments delivering 8.4% annualised over the last 35 years. However, this has come with large drawdowns, namely the declines post the Dot-com bubble of late 1990’s and the global financial crisis.
What may be more surprising is the strength in government bonds over this period. Looking at the chart below, we have plotted the return of four developed market, government bond indices, in conjunction with equities, represented by the yellow line.

Source: Bloomberg, Waverton. Data from 31.12.85 to 31.08.19

In Japan, a market where yields were low by global standards in 1985, government bonds yielded 6%. Over time, this has steadily fallen to the current 0%, and the market has delivered a respectable 3.9% compound annual return.

There have been equally impressive returns from German Bunds, 5.7% pa and US treasuries, 6.2% compound.

However, these pale in comparison with the UK gilt market, where investors have been rewarded with an 8% pa total return from lending money to the UK government, a return not dissimilar to equities.

What is also clear from this chart is that this return has been delivered with significantly less volatility. UK gilts over this period have a 6.4% annualised volatility, versus 15% for global equities. In short, government bonds have been fantastic investments, delivering excellent long term risk adjusted returns. In our view, this is unlikely to be repeated and one should consider the role alternative investments can play in both helping diversify risk, but also importantly, deliver returns.

Why do we believe the return profile of UK Gilts is unlikely to be repeated?

The below chart, focusing on just the UK gilt market, shows what has driven these returns and why risks in the bond market have risen significantly.
The green line shows the declining trend in UK gilt yields, falling from 11% in 1985 to the current 0.8%.

This has resulted in duration, the measure of interest rate risk inherent in a bond, represented by the grey line in the chart, steadily moving in the opposite direction, rising from 5 to the current 14. This means for a one percent move higher in interest rates, an investor in the broad UK gilt market may lose 14% of their capital.

Equally, if we take the measly 0.8% yield available on the UK gilt index and compare this with duration, we can deduce that it would take 16 years of income for investors to recover from a 1% move higher in yields. This infers UK gilts appear extremely richly valued versus history.

We are not suggesting investors carry no exposure to governments bonds, indeed the US treasury market continues to look relatively attractive, while we also believe there are opportunities across the credit market. However, we are highlighting the risks inherent within sections of the fixed income market and in forthcoming insight series articles we will detail how an allocation to selective alternative assets across the real asset and absolute return universe can help investors navigate the uncertain outlook and improve portfolio risk adjusted returns.

Luke Hyde-Smith
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Risk Warnings
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