Beyond 60/40: Allocating to Private Markets

For decades, individual investment portfolios have been governed by a single ratio: 60/40. Conventional wisdom was that a portfolio of 60% stocks and 40% bonds represented the optimal mix, providing a decent return without assuming too much risk. But that standard allocation model may be due for a rethink.

Most institutional investors — pension funds, endowments and foundations — already have abandoned the 60/40 principle. It may no longer apply to individual portfolios either. The change is timely.

Lower return expectations, particularly for bonds, mean the standard 60/40 portfolio is less likely to produce the returns it has historically. At the same time, alternative asset classes such as private equity and private debt are becoming more accessible to individual investors, expanding the universe of potential investment options within their portfolios.

This investment brief considers what those possibilities mean for individual investors, specifically examining how an allocation to private markets may optimize the risk/return characteristics of their portfolios, much as it has for institutional investors.

The Potential Shortcomings of 60/40

Many financial professionals expect diminished returns from a 60/40 portfolio over the next decade. This perspective is driven by two reasons. First, equity valuations are at or near historical highs, which could potentially limit stocks' return potential going forward. Second, low yields offer a poor starting point for future bond returns.

To be fair, fixed income's primary role in a broad portfolio is to serve as a diversifier to stocks. While the asset class has never been counted on to provide returns as much as equities, bonds still must provide *some* level of return if they are going to comprise a sizeable allocation within a portfolio. Today's yield levels make that increasingly difficult.

Future fixed income returns are highly correlated to current yields. The chart below puts this relationship in perspective, tracking the starting yield and five-year annualized returns for bonds from that point. If history is any guide, this doesn't bode well for bonds' future return potential.

Starting Yield vs. 5-Yr Forward Annualized Return
U.S. Aggregate Bond Index

U.S. Aggregate Bond Index is represented by the Bloomberg Barclays US Aggregate Bond Index.
Source: Bloomberg. Data from 1/31/78-3/31/21

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Institutional Allocations: The Way Forward for Individual Portfolios?

Many institutional investors are anticipating a low return environment and continue to diversify away from stocks and bonds alone. Already, private market allocations for pensions, endowments and foundations generally range from 10% to 20%.[1]

Individual investors may soon follow in institutions' footsteps thanks to improved access to the private markets. Large minimums, complex tax reporting and liquidity constraints have historically been barriers to high-net-worth and mass affluent investment. But new investment structures, called evergreen funds, are democratizing private investments by removing some of those obstacles.

[1] Source: McKinsey Global Private Markets Review 2021.

Evergreen funds typically come with a lower minimum, periodic redemption opportunities and other features associated with ’40 act mutual funds, to which individual investors are more accustomed.

Allocating to Private Markets: Potential for Higher Returns, Lower Volatility

There are a number of reasons individuals may want to consider allocating to private markets. The first – and generally most compelling – is the return potential. Private equity and private credit have outperformed global public equity and credit markets, respectively, in 19 of the last 20 years.

That historical return profile could prove beneficial in an environment where many expect lower returns from public equity and fixed income.

Less appreciated, however, is private investments’ role as a portfolio diversifier that dampens volatility. The table below puts both the historical return and risk benefits into perspective. With each incremental allocation increase toward private markets, the total portfolio return increases, while the volatility of the portfolio (as measured by standard deviation) decreases.

Allocation	Return	Standard Deviation	Sharpe Ratio
60% public equity, 40% bonds	7.47%	6.31%	1.31
57% public equity, 38% bonds, 3% private equity, 2% private credit	7.79%	6.27%	1.37
54% public equity, 36% bonds, 6% private equity, 4% private credit	8.11%	6.23%	1.43
51% public equity, 34% bonds, 9% private equity, 6% private credit	8.44%	6.19%	1.49
48% public equity, 32% bonds, 12% private equity, 8% private credit	8.76%	6.14%	1.55
45% public equity, 30% bonds, 15% private equity, 10% private credit	9.08%	6.10%	1.61
42% public equity, 28% bonds, 18% private equity, 12% private credit	9.40%	6.06%	1.67

Source: Hamilton Lane Data via Cobalt LP and Morningstar. Data based on averaged quarterly returns which were then annualized. Equity date range from 1995 to 2020 and credit date range from 2000 to 2020. Performance shown for illustrative purposes only. Past performance is not an indicator of future results.

A Natural Extension of 60/40?

For investors seeking to expand beyond a 60/40 portfolio for the first time, private markets can potentially be a natural first extension into alternatives. This is because, conceptually, private investments are not that different from public equity and fixed income. A private equity manager is still buying an ownership stake in a company. A private debt manager is still providing capital to a company through a loan. The similarities make private markets easier to grasp than other alternative strategies that may utilize exotic financial instruments or employ more complex strategies such as shorting.

That said, there are some real distinctions between private and public markets. One major difference between the asset classes is that the private markets are much more expansive. There are more than 17,000 U.S. private companies with annual revenues above $100 million, compared with just 2,600 public companies with the same revenue levels.[2]

This depth has a few implications. First, it means there is a wider hunting ground for portfolio managers to find innovative companies. That hunting ground is also less efficient than public markets, where a larger universe of buyers researches and follows the same, small subset of companies. That size and inefficiency can potentially translate into more opportunity for investors.

[2] Source: Capital IQ (February 2021).

Private markets' breadth also provides diversification benefits. Public markets have become increasingly concentrated in the last two decades, with the number of publicly listed companies dropping by a third since 2000.[3] Venturing into private markets means owning a wider, and potentially more diverse, swath of the corporate universe.

Another key difference between private and public markets is that private investments are less liquid. As we explore in the next section, an investor's ability to withstand illiquidity is a major factor in determining how much they can allocate to private markets.

How Much to Allocate to Private Markets?

When allocating to private assets, investors must decide how much of their portfolio they can dedicate to an illiquid investment. This is an important consideration, even for evergreen funds that offer periodic redemptions. While such funds may improve the liquidity profile of private investments on the margins, it still takes considerable time for private investments to realize their value. As such, an investor's time horizon is a major factor determining the appropriate allocation to private markets. An investor with a longer time horizon who is comfortable not accessing a portion of their portfolio for several years may be best suited for a larger allocation.

Another important consideration when allocating to private markets is where that allocation should come from. Given similarities between the two, investors often allocate to private equity by proportionally trimming their public equity exposure. Similarly, private debt is often viewed a substitute for a portion of the traditional fixed income allocation. While the precise amount to allocate is a case-by-case decision, institutional investors – many of which have perpetual investment horizons – often carve out substantial allocations to private markets. The average university endowment, for example, allocates 23% of its portfolio to private equity and venture capital.[4] Leading university endowments invest upwards of 30%.

Conclusion: Beyond 60/40

Given low return assumptions for both public equities and fixed income, investors may want to consider expanding beyond the traditional 60/40 portfolio to meet long-term return goals. Private markets could play an important role. Private equity and private debt have each outperformed their public market counterparts for 19 of the last 20 years. Adding private investments has also historically reduced the volatility of a broader portfolio.

Sophisticated institutional investors have realized these benefits for decades and abandoned the 60/40 structure in favor of an allocation that includes private markets. As new fund structures make these markets more accessible to high net worth and mass affluent investors, individuals may want to learn more about the opportunity, and decide whether an allocation makes sense for their own investment objectives.

[3] Source: Research by Professor Jay R. Ritter, University of Florida.
[4] 2020 NACUBO-TIAA Study of Endowments®

Definitions

Bloomberg Barclays Aggregate Bond Index is a broad bond index covering most U.S. traded bonds and some foreign bonds traded in the U.S.

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