Is the traditional 60/40 dead? Redefining diversification with Efficient Core solutions

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Pierre Debru
Head of Research, Europe

Key Takeaways

- WisdomTree's Efficient Core strategy provides a solution to the increasingly important issue of finding space in portfolios for diversifiers.
- Efficient Core strategies deliver $90 exposure to stocks for growth and $60 exposure to bonds for balance for every $100 invested.
- By integrating Efficient Core strategies in their portfolios, investors can incorporate alternative investments without compromising core holdings, leading to improved diversification and potential for enhanced returns.

Private market assets are projected to grow at more than twice the rate of public assets, reaching $60 to $65 trillion by 2032[1]. This anticipated expansion underscores investors' search for portfolio diversification, across all diversifiers like private equity, private credit, broad commodities, real estate, infrastructure, gold, and crypto assets. Academic research consistently demonstrates that such diversification enhances a portfolio's risk return profile. And such diversification is particularly pertinent given the rising concentration in market-cap-weighted indices, where a handful of large tech companies dominate, thereby reducing diversification within these core portfolio components. However, achieving this additional diversification presents a significant challenge: how to incorporate these assets while maintaining exposure to core holdings like public equities and fixed income.

The diversification dilemma: finding the space for more and more diversifiers

In recent years, WisdomTree has conducted extensive research on enhancing portfolios through alternative assets and diversifiers to improve overall long-term efficiency. Our analyses, both retrospective and prospective, indicate that:

- Broad commodities could warrant up to a 15% allocation in a multi-asset allocation (Shah & Debru, The Case for Investing in Broad Commodities), (Shah & Berlanda, The Role of Broad Commodities in a Portfolio, September 2023).

- Most portfolios would benefit from a gold allocation of up to 10% or 15% (Shah & Berlanda, The role of gold in a portfolio, October 2023).
- A crypto and carbon allocation of a few percent would improve diversification and could improve long-term returns (Shah & Berlanda, The role of Carbon in a portfolio, November 2023) (DEBRU, et al., A New Asset Class: Investing in the Digital Asset Ecosystem, July 2022).

Collectively, these assets could constitute 30% of a portfolio. Employing a delta-one approach would necessitate a substantial reduction in allocations to bonds and, predominantly, equities to accommodate these diversifiers. Clearly, investors require innovative tools to address this issue and unlock new opportunities for their portfolios.

Introducing Efficient Core: a new era of smart investing

To tackle this challenge, WisdomTree has developed a range of Efficient Core strategies designed to enhance capital efficiency by 'stacking' multiple assets within a single solution. These strategies provide a 90% exposure to large-cap equities and a 60% exposure to government bond futures in the corresponding currency for every $100 invested. Effectively, this approach delivers a capital-efficient 60/40 allocation, freeing up capital that can be allocated to diversifying assets without sacrificing core equity and bond exposures.

The strategies are comprised of three key exposures:

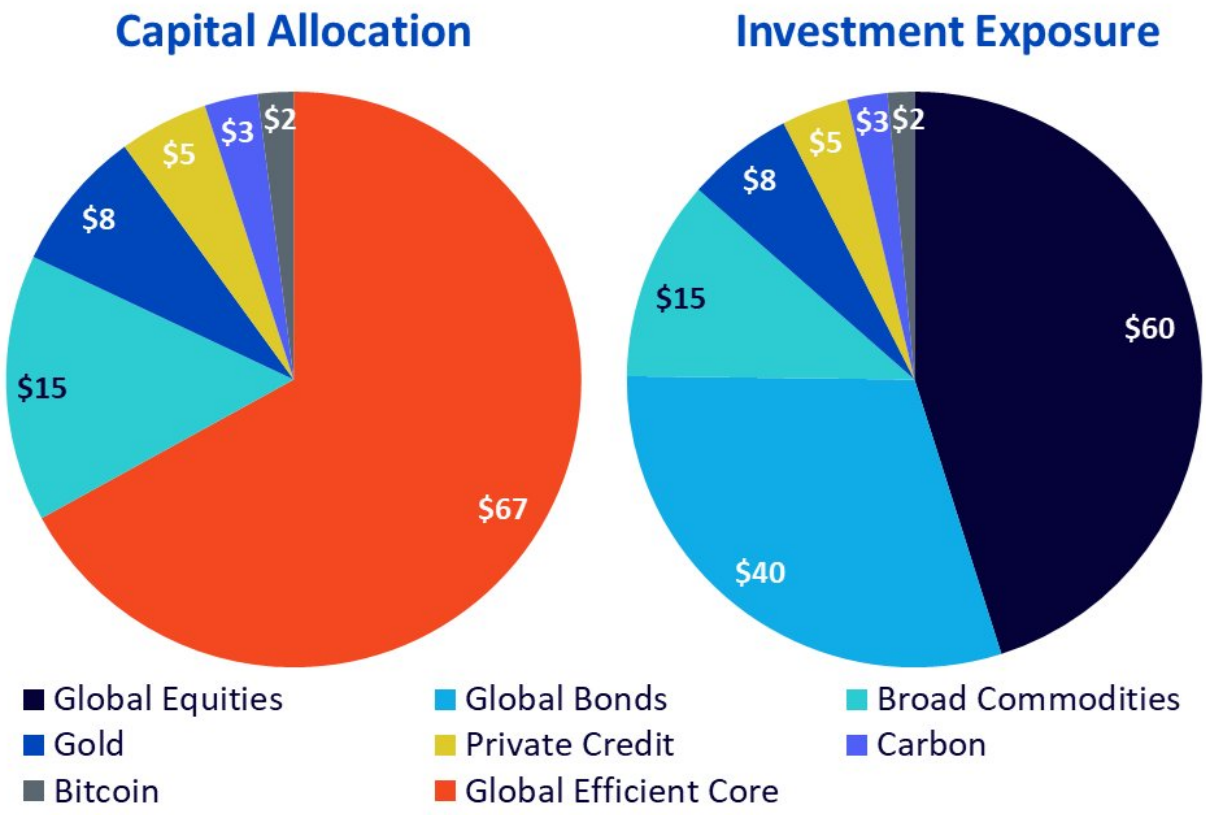
- **Equity Exposure:** 90% invested in a diversified ESG-screened basket of large-cap stocks.
- **Bond Exposure:** 60% in a diversified basket of government bond future contracts, ranging from 2- to 30-year maturities.
- **Cash Collateral:** 10% cash, serving as collateral for futures contracts.

Capital efficiency in portfolios: making room for alts/diversifiers

By implementing the Efficient Core strategy, investors can maintain their desired exposure to traditional assets while freeing up capital to invest in diversifiers such as private assets, commodities, or cryptocurrencies. This methodology facilitates the integration of alternative investments aimed at enhancing diversification and potential returns without compromising the foundational holdings of the portfolio. Additionally, it allows for the introduction of uncorrelated return streams, improved diversification, reduced portfolio volatility, and more consistent performance across various market conditions.

Consider a practical example: starting with a 60/40 portfolio investing in global equities and global bonds. Traditionally, incorporating commodities, crypto, gold, or real estate would require reducing the equity allocation, as these diversifiers tend to exhibit volatility. However, by allocating 66.7% of the capital to the Global Efficient Core strategy, an investor would achieve a 60% exposure to global equities and a 40% exposure to fixed income (via government bond futures contracts). This allocation leaves 33.3% of the capital available for investment in alternative assets and diversifiers of the investor's choice.

Figure 1: Using Efficient Core strategy creates space for both the 60/40 exposure and multiple diversifiers



For Illustration Only.

Conclusion

Diversification is increasingly becoming a key driver of portfolio construction. With correlations rising within and across asset classes, it is imperative for investors to explore beyond core assets and consider new asset classes that are becoming more accessible. Conversely, creating space in the portfolio for these diversifiers must not come at the expense of the portfolio's long-term return potential. The Efficient Core strategies provide a viable pathway to achieve this balance, enabling portfolios to be both diversified and positioned for long-term growth.

[1] Bains & Company. August 2024. https://www.bain.com/about/media-center/press-releases/2024/private-market-assets-to-grow-at-more-than-twice-the-rate-of-public-assets-reaching-up-to-%2465-trillion-by-2032-bain--company-finds/?utm_source=chatgpt.com

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