Time to rethink your 60/40: The case for adding commodities

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Key Takeaways

- The 60/40 stock-bond portfolio has been challenged over time, with some arguing for all-equity portfolios, but it has remained popular due to its strong risk-return balance.
- Substituting treasuries with commodities in the traditional 60/40 portfolio can significantly enhance returns, particularly during periods of inflation and market volatility.
- While a 60/40 split with commodities shows strong performance, research indicates that even a small allocation to commodities instead of treasuries can improve a balanced portfolio's risk-return profile.

A long-lived rule of thumb

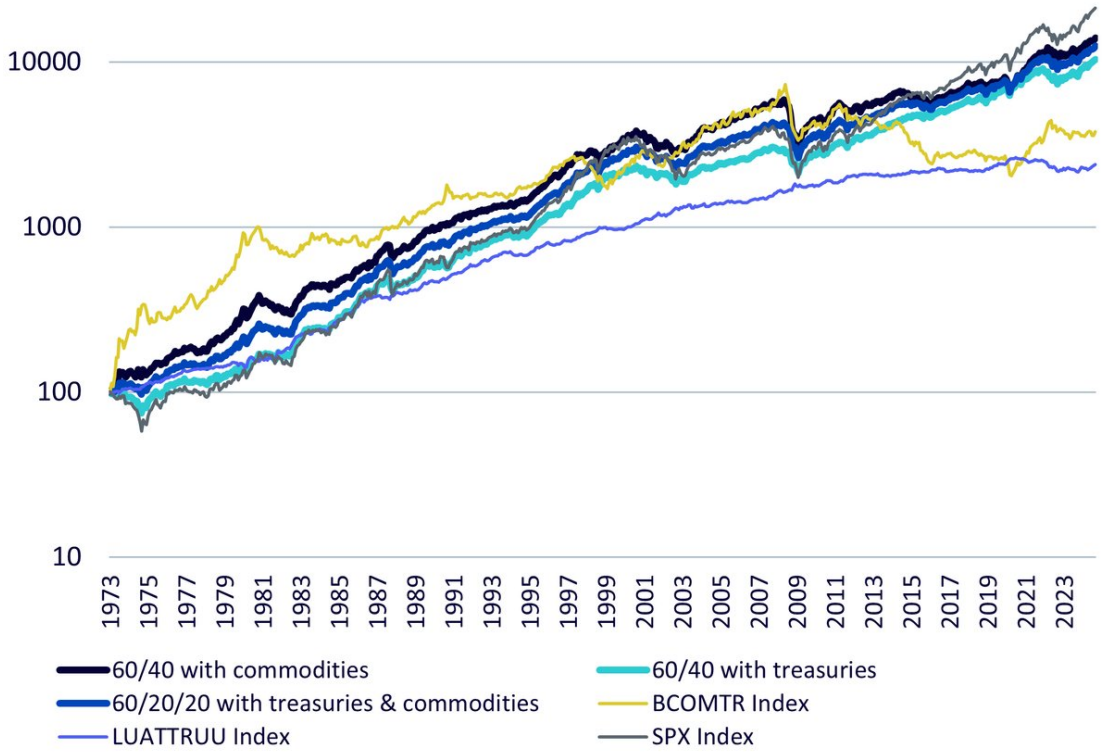
The 60/40 portfolio is probably one of finance's most long-lived rules of thumb. It postulates that the best (or good enough) way to allocate your portfolio is 60% in stocks and 40% in fixed income. Stocks are for the long run, and fixed income protects you when equities take a breather.

Over the years, the 60/40 portfolio has been challenged many times by academics and practitioners. Still, the concept has survived and remains the default when discussing asset allocation.

A notable challenge arose when *College and University Endowment Funds: Why not 100% Equities?* was published[1]. The authors' idea was simple: investing solely in equities promises much higher long-term returns. So, if you are a long-term investor, you should forget about bonds and put everything into equities.

Ironically, a quant came to the rescue and reaffirmed the validity of the 60/40 heuristic. Cliff Asness, co-founder of AQR Capital Management, published a paper in 1996[2] arguing that to compare a 60/40 portfolio with an all-equity portfolio fairly, you need to adjust for the difference in risk, specifically by matching their volatility. The comparison becomes fair by using a leveraged 60/40 portfolio that aligns with the risk level of equities. Asness found that, when adjusted this way, the leveraged 60/40 portfolio outperforms the equity portfolio (this is equivalent to saying that the balanced portfolio has a better risk-adjusted profile than the equity portfolio). It is time to question the 60/40 portfolio again, not in its proportions but in its components.

Figure 1: A different 60/40



Source: Bloomberg, WisdomTree. Start date: January 1973; end date: September 2024. **Historical performance is not an indication of future results and any investments may go down in value.**

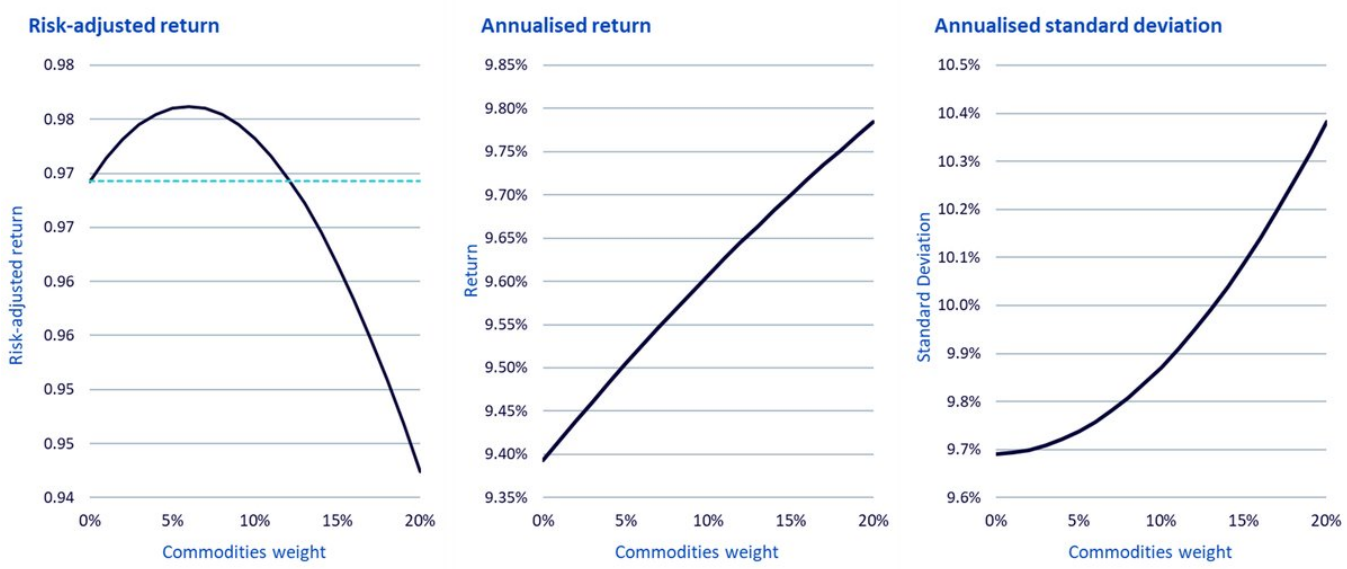
Figure 1 shows, in light blue, a traditional 60/40 portfolio, made up of 60% by the S&P 500 and the remaining 40% by 10-year treasuries. On the other hand, the dark blue line substitutes the treasuries portion with an allocation to the Bloomberg Commodity Index (BCOM)[3].

This shows clear performance improvement in this “twisted” version of the traditional 60/40 portfolio. This may surprise some investors, as commodities have often been an overlooked asset class, but they play a critical role in portfolio diversification. Commodities offer a durable positive risk premium, effectively hedge against inflation, and have a low correlation with traditional assets like equities. They tend to perform well during inflationary periods and geopolitical tensions, making them valuable assets during economic uncertainty. With their positive return skew, commodities provide both downside protection and the potential for significant gains, enhancing overall portfolio resilience. More on the role of commodities in a portfolio here.

But what’s the right proportion of commodities? The chart also shows a third option: a portfolio that equally splits the non-equity portion between treasuries and commodities. The annualised return for the three balanced portfolios is 9.4%, 10.0% and 9.8% for the traditional 60/40, the commodities 60/40, and the 60/40 with both commodities and treasuries, respectively. So, what’s a reasonable allocation?

To avoid repeating the same mistake by not scaling for risk, Figure 2 shows the risk-adjusted return[4] of a balanced portfolio that invests 60% in equities and the remainder in a varying combination of treasuries and commodities (so for example, in the chart below, the 10% on the x-axis represents an investment in 60% equities, 30% in treasuries and 10% in commodities), together with the respective annualised return and annualised standard deviation. We can see that an allocation of approximately 6% in commodities maximises the risk-adjusted return, while an allocation of around 12% in commodities achieves the same risk-adjusted return as a traditional balanced portfolio (dashed light blue line on the left subplot) but with better performance[5]. So, even for a risk-conscious investor, adding some commodities seems to benefit the portfolio performance.

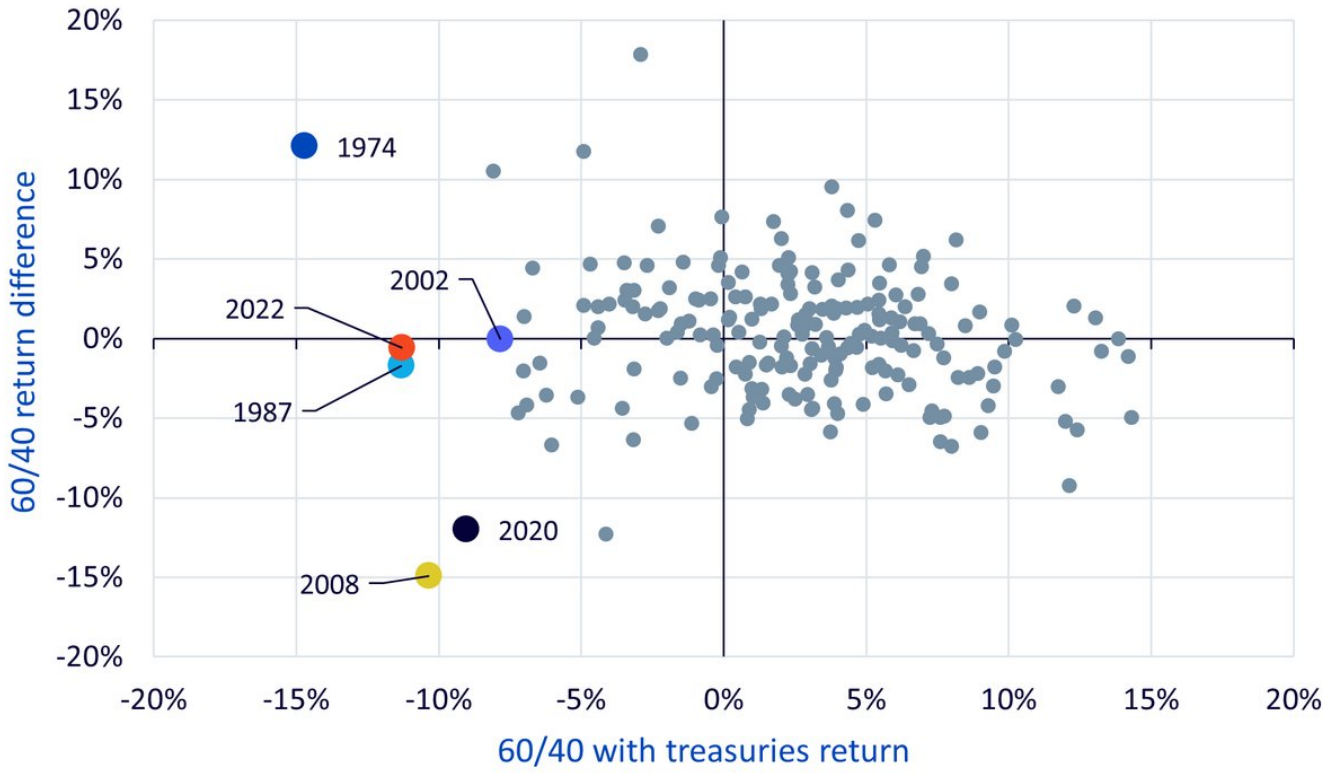
Figure 2: Risk-adjusted return, annualised return and annualised standard deviation



Source: Bloomberg, WisdomTree. **Historical performance is not an indication of future results and any investments may go down in value.**

Worst Quarters

Figure 3: Traditional 60/40 vs Commodities 60/40



Source: Bloomberg, WisdomTree. Start date: January 1973; end date: September 2024. Quarterly returns. The colored dots represent those quarters where the S&P500 had a return lower than 15%. The label for the colored dots represents the year in which the quarterly performance has accrued. **Historical performance is not an indication of future results and any investments may go down in value.**

Figure 3 plots the quarterly returns for traditional balanced portfolio on the x-axis and the quarterly return difference between the Commodity 60/40 portfolio and the Traditional 60/40 portfolio on the y-axis. The quarters for which the S&P 500 lost more than 15% are highlighted.

As the chart shows, commodities and treasuries sometimes behave similarly, such as during the deflation of tech stock bubbles (2002 and 2022) and in 1987. However, during major economic crises like the Oil Crisis (1974, blue dot), the Global Financial Crisis (2008-2009, yellow dot), and the COVID-19 pandemic (2020, dark blue dot), they responded differently, reflecting their broader fundamental characteristics. Commodities tend to outperform treasuries during inflationary periods or supply-side shocks, while treasuries typically fare better in deflationary environments or when investors seek safety during demand-side economic contractions. Incorporating commodities into a balanced portfolio can thus enhance diversification and resilience during periods of high inflation and geopolitical tension.

[1] Thaler, Richard H., and J Peter Williamson. “College and University Endowment Funds: Why not 100% Equities” Journal of Portfolio Management, Fall 1994

[2] Cliff Asness. “Why not 100% Equities”

[3] All the three indices are total return indices.

[4] Simply defined as the ratio between the annualized return and the annualized volatility.

[5] Please note that the set-up is slightly different here compared to the Broad Commodities Portfolio Insight paper, where we estimate a higher optimal commodities allocation. In the Portfolio Insight paper, both the equity portion and the fixed-income portions decline with a higher commodity allocation. On the other hand, in this set-up, the equity portion is always fixed at 60%.

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