SIMPLIFY

ALTERNATIVES

It's Time to Rethink the "40" in the 60/40 Portfolio

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INTRODUCTION

The classic 60/40 allocation is very intuitive. The 60% equity allocation provides the lion's share of the returns as a simple yet effective exposure to broad economic growth. And no one wants too much risk, so the 40% bond allocation is a simple way to diversify the portfolio and avoid excessive risk. It's a beautifully simple story with historical credibility.

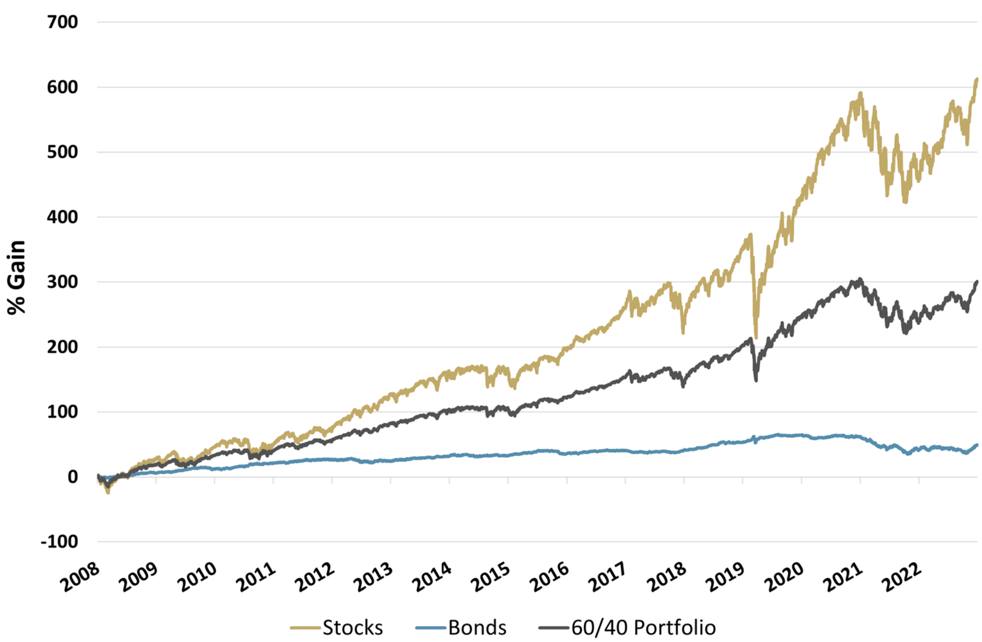
But today's investment landscape is much broader than just stocks and bonds. For the first time ever, alternative investment strategies are now available to the masses through the liquid, transparent, and tax-effective ETF wrapper. And these are the same exact strategies that pensions and endowments have used for decades to build some of the most attractive portfolios out there.

In this article, we review how a simple suite of alternative investments could be used as a replacement for a portion of the 40 to create superior portfolios.

THE 60/40 PORTFOLIO

We begin by reviewing the performance of the 60/40 portfolio over the past 15 years in Figure 1. For the period ending December 2023 the 60/40 portfolio (60% S&P 500 Index / 40% Bloomberg US Aggregate Bond Index) had a total return of 300%, or 9.7% annually.

Figure 1: Stocks, Bonds, and the 60/40 Portfolio
2009 – 2023



Source: YCharts. The 60/40 Portfolio: 60% S&P 500 Index and 40% Bloomberg U.S. Aggregate Bond Index with quarterly rebalancing. Past performance is no guarantee of future results.

Was the 60/40 portfolio a success over the past 15 years? On the one hand, investors with this allocation are probably not unhappy with the results: the portfolio had nearly 10% annual returns while still being able to minimize the steep equity drawdowns during the GFC and COVID-19. On the other hand, portfolio results would have been significantly better if the return contributions from the bond allocation weren't so low (2.7% annually over this period) and if there was more to diversification than just two distinct asset types.

WHY WE OWN BONDS

Bonds are a large component of portfolios because they have the potential to act as a useful hedge during large equity drawdowns. Figure 2 shows the total returns of the Bloomberg U.S. Aggregate Bond Index versus the S&P 500 Index during our four most recent stock market drawdowns. In each of these periods we can see that diversification into bonds worked with varying degrees of effectiveness.

Figure 2: Bond Returns During Equity Drawdowns

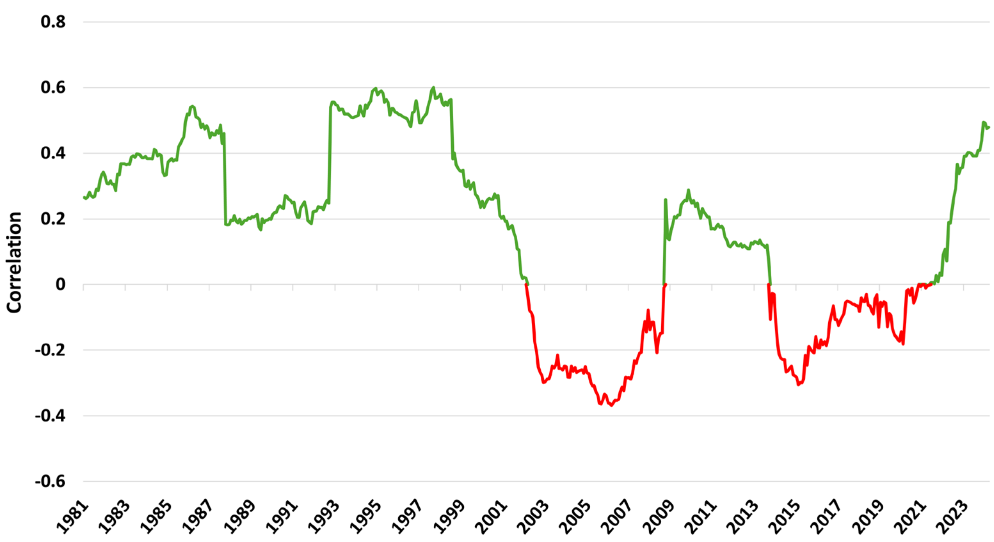
Period	Dates	S&P 500 Index	Bloomberg U.S. Aggregate Bond Index
Dot.com Bust	03/24/00 - 10/09/02	-47.4%	+29.1%
Global Financial Crisis	10/09/07 - 03/09/09	-55.3%	+7.2%
Covid Meltdown	02/19/20 - 03/23/20	-33.8%	-0.9%
Inflationary Rate Hikes	01/04/22 – 10/12/22	-24.5%	-14.3%

Source: Ycharts. Past performance is no guarantee of future results.

While bonds sometimes work as a diversifying hedge, we must keep in mind that they are a proxy hedge against equity risk, not an explicit hedge. There have in fact been many periods where negative stock returns have been accompanied by negative bond returns. A great example of this was the recent equity drawdown experience of 2022, which saw significant losses in both equities and bonds simultaneously (see last row of Figure 2).

The effectiveness of bonds as an equity hedge is fundamentally dynamic. For instance, bond behavior relative to equities is very sensitive to both the interest rate and inflation environment at any given time. This dynamic can be quantified by looking at bonds' correlation with equities (see Figure 3). We can see that bonds can go through long periods of time where their correlation with stocks is positive rather than negative.

Figure 3: Rolling 60-month Correlation Between Stocks and Bonds



Source: Bloomberg. Correlation is calculated between the S&P 500 Index and the Bloomberg U.S. Aggregate Bond Index. Past performance is no guarantee of future results.

If bonds have a tenuous benefit as a portfolio diversifier, and have significantly lower returns than equities on top of it, is there anywhere else investors should look to balance their equity allocations?

ALTERNATIVE ETFS FROM SIMPLIFY

Simplify has launched a suite of alternative investment strategies that are designed to have low correlations to both stocks and bonds and can thus be used as portfolio diversifiers in lieu of bonds. For an in-depth review of the history of liquid alts and how Simplify is bringing institutional alternatives to the ETF wrapper check out our previous case study on the subject found on the Simplify home page:

That report goes into greater detail on the workings and rationale behind Simplify's suite of alternative ETFs which include:

- Simplify Managed Futures Strategy ETF (CTA)
- Simplify Market Neutral Equity Long/Short ETF (EQLS)
- Simplify Multi-QIS Alternative ETF (QIS)

Each of these three alternative ETFs exhibit low – or even negative – correlations with both stocks and bonds, making them effective portfolio diversifiers (see Figure 4). Note that the starting date of historical analysis for these funds is constrained by the inception date of the youngest of the funds, EQLS, launched on 07/10/23.

Figure 4: Simplify Alternative ETF Correlations with Stocks and Bonds
07/10/2023 - 04/16/2024

Ticker	With Stocks	With Bonds
CTA	-0.16	-0.61
EQLS	-0.18	-0.34
QIS	-0.18	-0.09

Source: Portfolio Designer. Data as of 04/16/2024.

Not only do these three alternative ETFs display negative correlations with both stocks and bonds, but they also display low or negative correlations with each other, which further improves their diversification benefits (see Figure 5).

Figure 5: Simplify Alternative ETF Correlations with Each Other
07/10/2023 - 04/16/2024

Ticker	CTA	EQLS	QIS
CTA	1.00	0.21	-0.02
EQLS	0.21	1.00	0.02
QIS	-0.02	0.02	1.00

Source: Portfolio Designer. Data as of 04/16/2024.

Another way to think about correlation benefits is to ask what happens to these alternatives on those days that stocks are down. Since the EQLS inception date of 07/10/23 there have been 83 days with negative stock market returns. An equal-weighted mix of the above three Simplify ETFs had positive returns on 55 of those 83 days *(Source: Portfolio Designer).*

INTRODUCING THE 60/20/20 PORTFOLIO

The 60/20/20 takes half of the 40% that was originally dedicated to bonds and allocates it to an equal weighted mix of CTA, EQLS and QIS. The resulting portfolio is comprised of:

- 60% Stocks
- 20% Bonds
- 6.67% CTA
- 6.67% EQLS
- 6.67% QIS

As you can see in Figure 6, the 60/20/20 has displayed superior return and risk metrics, including higher returns, lower volatility, smaller maximum drawdown, and higher Sharpe Ratio since the inception of EQLS. And to be clear, these alternative strategies were indeed designed to be both diversifying and provide strong returns, so that diversifying your core equity exposure doesn't require sacrificing returns, as has been the case when using bonds as your sole ballast to equities.

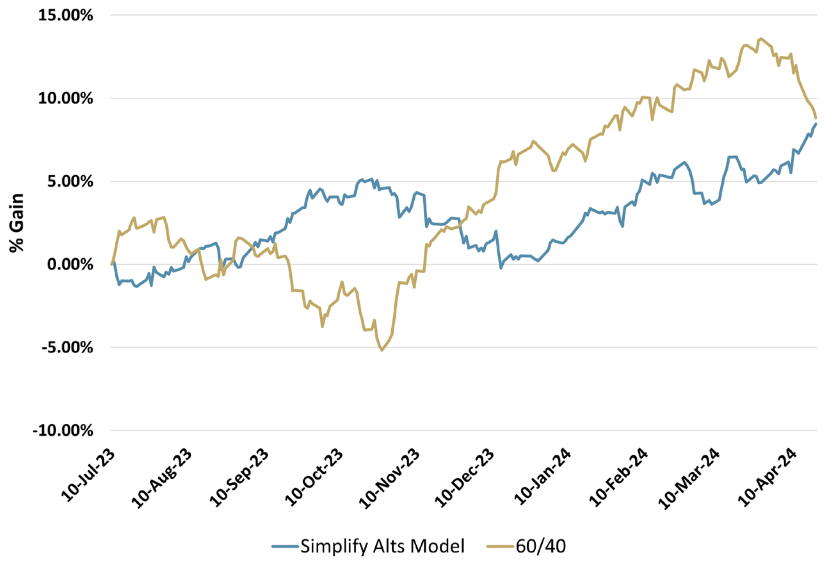
Figure 6: 60/40 vs. 60/20/20
07/10/2023 - 04/16/2024

	60/40	60/20/20
Cumulative Total Return	11.90%	13.22%
Annualized Total Return	15.64%	17.41%
Annualized Volatility	8.27%	7.05%
Maximum Drawdown	7.80%	5.96%
Sharpe Ratio	1.19	1.64

Source: Portfolio Designer.

It is also helpful to compare the performance of the 60/40 to this Simplify alts sleeve by itself, to build intuition on how it works as a new chess piece in your portfolio. Figure 7 shows us that the alts sleeve can really zig when the 60/40 zags, as evidenced during Q4 of 2023 and Q2 of 2024, while simultaneously providing absolute returns in other more "normal" periods.

Figure 7: 60/40 vs. Simplify Alts Portfolio
07/10/2023 - 04/16/2024



Source: Portfolio Designer.

The performance data quoted represents past performance and is no guarantee of future results. Current performance may be lower or higher than the performance data quoted. Investment returns and the principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. For performance data current to the most recent month-end please call (855) 772-8488 or go to https://www.simplify.us/etfs. For CTA standardized performance, click here. For EQLS standardized performance, click here. For QIS standardized performance, click here.

CONCLUSION

The 60/40 portfolio was born during an era in which there were few alternatives, and those that were available were both inconvenient and expensive. Today there are many alternative choices in the highly accessible ETF format.

Given rising correlations to stocks, higher volatility, and uninspiring returns, it's tempting to dismiss bonds entirely and consider replacing an entire bond allocation with alternatives. But just like bonds, alternative strategies are indirect hedges as well, and investors should diversify their diversifiers.

A reasonable starting point then would be to replace half of a bond allocation with a mix of alternative investments. An equal-weighted mix of CTA, EQLS and QIS shows great promise since inception as a diversifying complement to bonds.

Important Information

Investors should carefully consider the investment objectives, risks, charges, and expenses of Exchange Traded Funds (ETFs) before investing. To obtain an ETF's prospectus containing this and other important information, please call (855) 772-8488, or visit SimplifyETFs.com. Please read the prospectus carefully before you invest.

An investment in the fund involves risk, including possible loss of principal.

The fund is actively-managed is subject to the risk that the strategy may not produce the intended results. The fund is new and has a limited operating history to evaluate. The Fund invests in ETFs (Exchange-Traded Funds) and entails higher expenses than if invested into the underlying ETF directly. The lower the credit quality, the more volatile performance will be. When junk bonds sell off, the lowest-rated bonds are typically hit hardest known as blow up risk. Likewise, the riskiest bonds typically rise fastest in a bull market however these investments that don't have a credit rating are typically the most volatile, hard to price and the least liquid.

The use of derivative instruments involves risks different from, or possibly greater than, the risks associated with investing directly in securities and other traditional investments. These risks include (i) the risk that the counterparty to a derivative transaction may not fulfill its contractual obligations; (ii) risk of mispricing or improper valuation; and (iii) the risk that changes in the value of the derivative may not correlate perfectly with the underlying asset, rate, or index. Derivative prices are highly volatile and may fluctuate substantially during a short period of time. The use of leverage by the Fund, such as borrowing money to purchase securities or the use of options, will cause the Fund to incur additional expenses and magnify the Fund's gains or losses. The Fund's investment in fixed income securities is subject to credit risk (the debtor may default) and prepayment risk (an obligation paid early) which could cause its share price and total return to be reduced. Typically, as interest rates rise the value of bond prices will decline and the fund could lose value.

While the option overlay is intended to improve the Fund's performance, there is no guarantee that it will do so. Utilizing an option overlay strategy involves the risk that as the buyer of a put or call option, the Fund risks losing the entire premium invested in the option if the Fund does not exercise the option. Also, securities and options traded in over-the-counter markets may trade less frequently and in limited volumes and thus exhibit more volatility and liquidity risk.

Diversification does not ensure a profit or guarantee against a loss.

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