INVESTOR NEWSLETTER

STICK TO THE PLAN

HELPING YOU MAKE INFORMED INVESTING DECISIONS

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EMBRACE THE POSS/BLE™

Ever since Harry Markowitz, American economist and Nobel Memorial prize winner wrote his ground-breaking dissertation on Model Portfolio Theory in 1952, the balanced portfolio has been the linchpin of most investor portfolios. The theory posits that diversification helps reduce risk while still providing a desired return. Most balanced portfolios are generally made up of 60% stocks and 40% bonds (60/40 portfolios), widely considered the optimal risk-to-reward mix for a typical investor.

The appeal of the balanced portfolio has always been that equities provided growth potential and bonds provided income and stability. Those two asset classes generally move in different directions, so overall performance is usually smoothed out to help the investor sleep better at night. That was the theory, anyway.

It all came crashing down in 2022, when bonds and stocks fell together (a very rare instance). Markets were battered by the spectre of high inflation, tight monetary policy, and a looming recession, among other issues. The balanced portfolio had one of the worst years in its history.

The problem was that the correlation between stocks and bonds became positive, in a major diversion from their usual relationship. A positive correlation means the two asset classes move in the same direction – in this case, down. Stock/bond correlations generally become positive when there is an unexpected surge in inflation as we saw in 2021, without an increase in earnings expectations. Given the ongoing problems with the supply chain in 2022 amid continued inflationary pressures, correlations rose accordingly.

Indeed, many market watchers predicted the end of the 60/40 portfolio, especially when it came to bonds, as many of the issues that had affected fixed income assets appeared to be persisting for the long term.

But Henry Markowitz's theory remains true today. As inflation receded and the supply chain recovered, the correlation between stocks and bonds began to revert to its usual relationship - and that's a good thing. This has allowed bonds to once again act as effective diversifiers, resuming their role as a portfolio's ballast.

And this, in turn, helped the balanced portfolio to have a remarkable comeback in 2023, once again demonstrating its resilience.

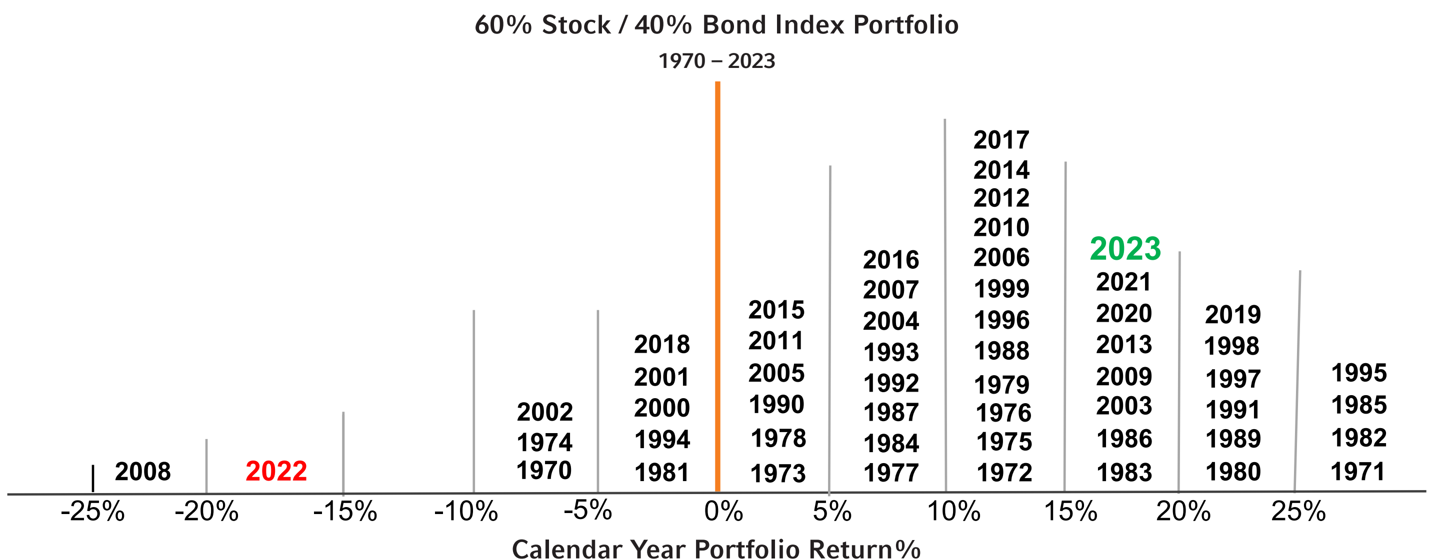
Which brings us to the primary tenet of successful investing: **stick to the plan!**

The two charts, below and on the next page, help tell the story.

Let's look at the annual performance chart first. The most obvious takeaway is that the 60/40 portfolio has far more good years than bad ones. Since 1970, the balanced portfolio has posted positive performance 83% of the time. That's a pretty good track record.

The next lesson in the chart is that the year following a bad year is generally a very strong year. We see that in the 2022-2023 period. And again, in the 2008-2009 period when markets fell due to the credit crisis and recovered shortly afterward. And yet again in the 2018-2019 period amid a trade war and rising interest rates. But the worst year of all for a balanced portfolio, 2008 – the height of the Great Financial Crisis sparked by the collapse in subprime mortgages – was followed by a decade of strong returns.

What a difference a year makes for diversified portfolios / Stocks and bonds both bouncing back from difficult 2022



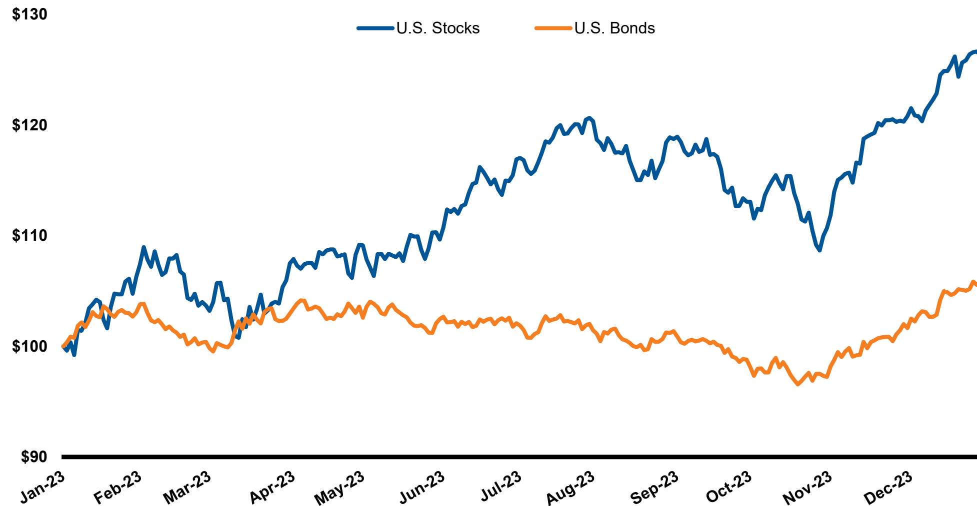
- Both stocks and bonds posted positive results following a historically difficult 2022
- Portfolios have recently demonstrated a pattern of resiliency following tough stretches
  - 2008 ➡ 2009
  - 2018 ➡ 2019
  - 2022 ➡ 2023
- Those moving out of the markets tend to miss the rebound, hurting long-term portfolio results.

Index portfolio of 60% S&P 500 Index* and 40% Bloomberg U.S. Aggregate Bond Index*.

Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. Indexes are unmanaged and cannot be invested in directly.

However, many investors run for the exits when markets are as challenging as they were in 2022. In fact, the flight to "cash" was significant that year. Cash means easily accessible short-term investments such as savings ac counts, Certificates of Deposit (CDs), short-term bonds, money market funds and so on – the proverbial sack of money under the mattress. At the end of 2023, there was $6.0 trillion held in cash or cash equivalents, up from $4.8 trillion at the end of 2021[1]. Theoretically that money is available for reinvesting in the markets. But that means an investor holding cash has to "time" the market to re-enter at the most optimal time.

2023 year in review / Growth of $100 in 2023 – U.S. stocks & bonds



- Cooling inflation and resilient economic growth saw stocks deliver positive returns (+26.3%)
- Stabilizing interest rates helped bonds produce positive returns as well (+5.5%)

Source: Morningstar Direct: U.S. Stocks = S&P 500 Index* TR USD; U.S. Bonds = Bloomberg U.S. Aggregate Bond Index* TR USD. Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. Indexes are unmanaged and cannot be invested in directly.

How would anyone choose the optimal time given the amount of volatility? That's the point: no one can. Markets can move for all sorts of reasons – political or economic events, data, stock-specific news or even technical triggers. They can be unpredictable and that's why the best strategy is usually to remain diversified and stick to the plan through thick and thin. In other words, hold a balanced portfolio over the long term.

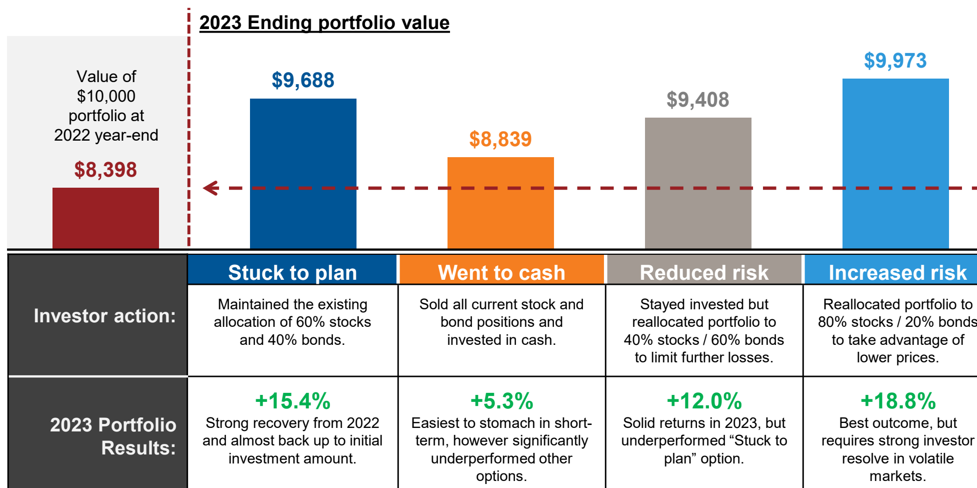
See the next page for a chart that demonstrates why the balanced portfolio has stood the test of time. We can see that $10,000 invested at the beginning of 2022 had fallen to $8,398 by the end of that year.

Looking at the different scenarios, the investor who held on to their balanced portfolio recouped their initial monies and even ended up slightly ahead by the end of 2023. The investor who fled to cash did see some gains, but the ending value is still well below the original investment.

There are other options besides just sticking it out or running for the exits. The final two scenarios show what happens when a portfolio's risk is adjusted. A portfolio that lowered risk by reducing the allocation to equity and raising the allocation to bonds also did well but underperformed the original portfolio. And the portfolio that increased risk by raising the equity allocation outperformed all the other options – but there may have been some nail-biting moments for the investor. We've already seen how volatile the U.S. equity market was in 2023.

Stick to the plan / Staying invested was rewarded in 2023

- In 2022, a $10,000 portfolio of 60% global stocks / 40% bonds shrank to $8,398 by year-end
- In 2023, investors had several options for that portfolio:



	Stuck to plan	Went to cash	Reduced risk	Increased risk
Investor action:	Maintained the existing allocation of 60% stocks and 40% bonds.	Sold all current stock and bond positions and invested in cash.	Stayed invested but reallocated portfolio to 40% stocks / 60% bonds to limit further losses.	Reallocated portfolio to 80% stocks / 20% bonds to take advantage of lower prices.
2023 Portfolio Results:	+15.4% Strong recovery from 2022 and almost back up to initial investment amount.	+5.3% Easiest to stomach in short-term, however significantly underperformed other options.	+12.0% Solid returns in 2023, but underperformed "Stuck to plan" option.	+18.8% Best outcome, but requires strong investor resolve in volatile markets.

The balanced portfolio has stood the test of time. If there is any lesson to be taken from the gyrations in the financial markets over 2022 and 2023, it is that anything can happen at any time. Patterns can be upended and risk is unavoidable. The most prudent strategy has been and remains: develop an investment plan based on the investor's goals and circumstances, and then stick with it. As always, partnering with a financial advisor has value in helping you stay the course over the long term.

Source: Morningstar. Stocks represented by MSCI ACWI Index*, bonds represented by Bloomberg U.S. Aggregate Bond Index* and cash represented by FTSE 3 Month T-Bill Index*. Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

[1] Source: Morningstar Direct. Total Net Assets – U.S. Money Market Funds (including obsolete funds)

Russell Investments

INDEX DEFINITIONS

*S&P 500 Index: a free-float capitalization-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the U.S. The stocks included in the S&P 500 are those of large publicly held companies that trade on either of the two largest American stock market exchanges: The New York Stock Exchange and NASDAQ. Bloomberg U.S. Aggregate Bond Index: An index, with income reinvested, generally representative of intermediate-term government bonds, investment grade corporate debt securities, and mortgage-backed securities. MSCI ACWI Index: A market capitalization index, with net or with gross dividends reinvested, that is designed to measure large and mid cap global developed and emerging market equity performance. FTSE 3 Month T-Bill Index: An unmanaged index that tracks short-term U.S. government debt instruments.

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