INVESTMENT STRATEGY NOTE

60/40: It Is A Good Place To Start

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Poxono has two goals (in no particular order):

1. Make minor changes that enhance portfolios to create meaningful long-term impacts
2. Provide clients transparency and efficiency

We write notes for transparency, and our notes are designed to be educational. We use historical hypotheticals to illustrate concepts and ideas, and we ask that our readers understand that they are not live examples and should not be considered investment advice. Not all of the concepts we talk about will fit your specific needs. Please reach out to discuss potential live examples if you are interested.

In our note today, we will discuss a hypothetical singular minor change during COVID that could have created more than a 6% difference in positive returns over five years, gross of fees, in an educational hypothetical example of a 60/40 portfolio.

BIGPX, 60/40, & 60/40 with a minor change

Let's dive into the 60/40 portfolio we discussed a couple of weeks ago. It's a great place to start, and we want to show you how minor changes can lead to major long-term differences. We'll present a credit example below.

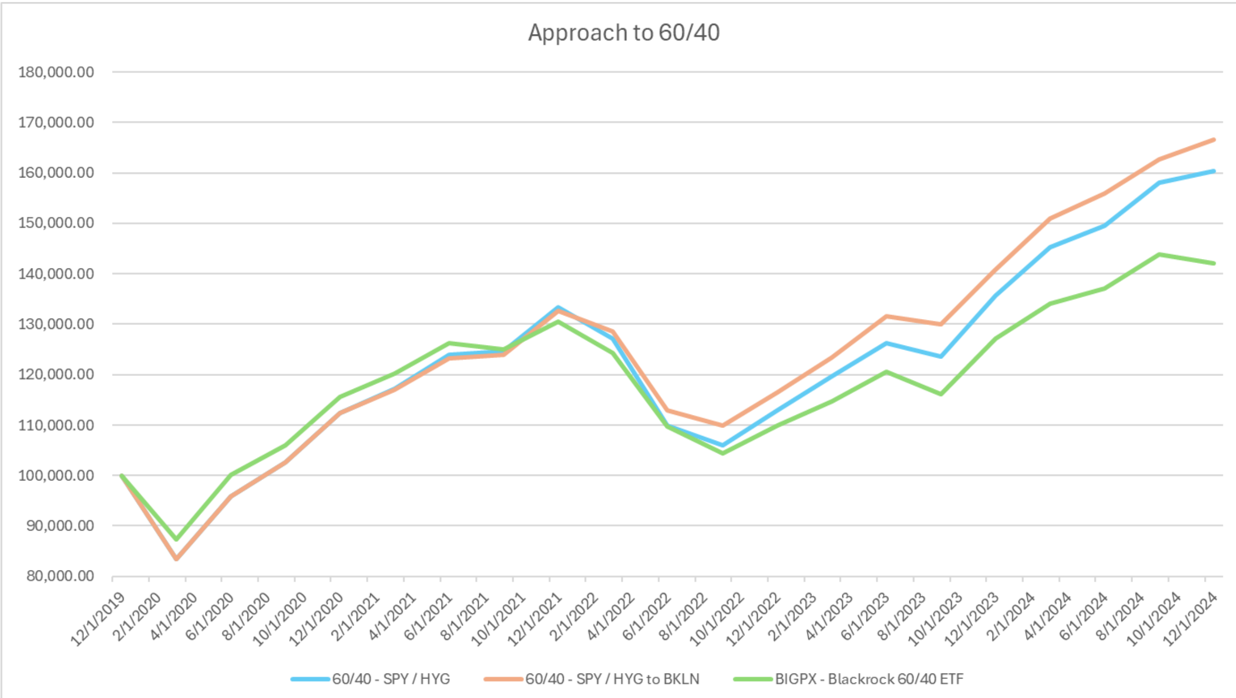
To start, let's look at three products: **BIGPX, 60/40, & 60/40 with a minor change**.

Assumptions: All portfolios are hypotheticals. The portfolios are presented gross of fees and are meant to be educational examples – not live examples. Additionally, we are happy to provide the spreadsheet used to create the charts, and we are happy to walk through the mechanics of the spreadsheet on a call. Do not hesitate to reach out to clientservices@poxono.com for more information. The hypothetical portfolios in the excel do not include potential leakage from bid/ask spread and transaction costs. Both products are quite liquid at $100k so transactions are likely minor, but something to note.

BIGPX—BIGPX is a listed target allocation fund designed to deliver a 60/40 equity/fixed income allocation. The allocation has a global focus. Bloomberg Professional's description is provided at the conclusion of the note.

60/40—60/40 is an allocation on a client's balance sheet using the ETFs SPY (equity) and HYG (credit). In this case, the portfolio is rebalanced quarterly, and only rebalanced when the equity weight of the portfolio is out of balance by more than 3%. Cash from dividend payments are deployed at the conclusion of each quarter. This portfolio is also designed to be US-focused (vs. BIGPX, which has a global focus).

60/40 with a minor change—this portfolio includes the assumptions above and one minor change: switching from a fixed-rate to a floating-rate credit allocation at the 12/31/2020 rebalancing (shown in orange).



Source: Bloomberg Professional, Poxono Capital – Excel Available Upon Request

Gross Annualized from 12/31/19 to 12/31/24	7.27%	9.91%	10.74%
Date	**BIGPX - Blackrock 60/40 ETF**	**60/40 - SPY / HYG**	**60/40 - SPY / HYG to BKLN**
12/31/2019	100,000.00	100,000.00	100,000.00
3/31/2020	87,345.68	83,479.16	83,479.16
6/30/2020	100,132.28	95,811.73	95,811.73
9/30/2020	105,996.47	102,570.66	102,570.66
12/31/2020	115,564.37	112,426.17	112,426.17
3/31/2021	120,282.19	117,186.24	117,017.57
6/30/2021	126,190.48	123,986.47	123,283.21
9/30/2021	125,044.09	124,585.94	123,981.98
12/31/2021	130,599.65	133,361.46	132,734.85
3/31/2022	124,338.62	127,195.20	128,624.86
6/30/2022	109,656.08	109,952.29	112,945.63
9/30/2022	104,320.99	106,013.08	109,942.44
12/30/2022	109,964.73	112,884.67	116,566.82
3/31/2023	114,770.72	119,659.94	123,374.16
6/30/2023	120,502.65	126,295.11	131,538.34
9/29/2023	116,181.66	123,623.70	129,985.55
12/29/2023	127,204.59	135,745.52	140,738.11
3/28/2024	134,038.80	145,353.04	150,943.67
6/28/2024	137,169.31	149,590.25	155,888.28
9/30/2024	143,871.25	158,126.64	162,699.35
12/31/2024	142,019.40	160,417.10	166,573.28

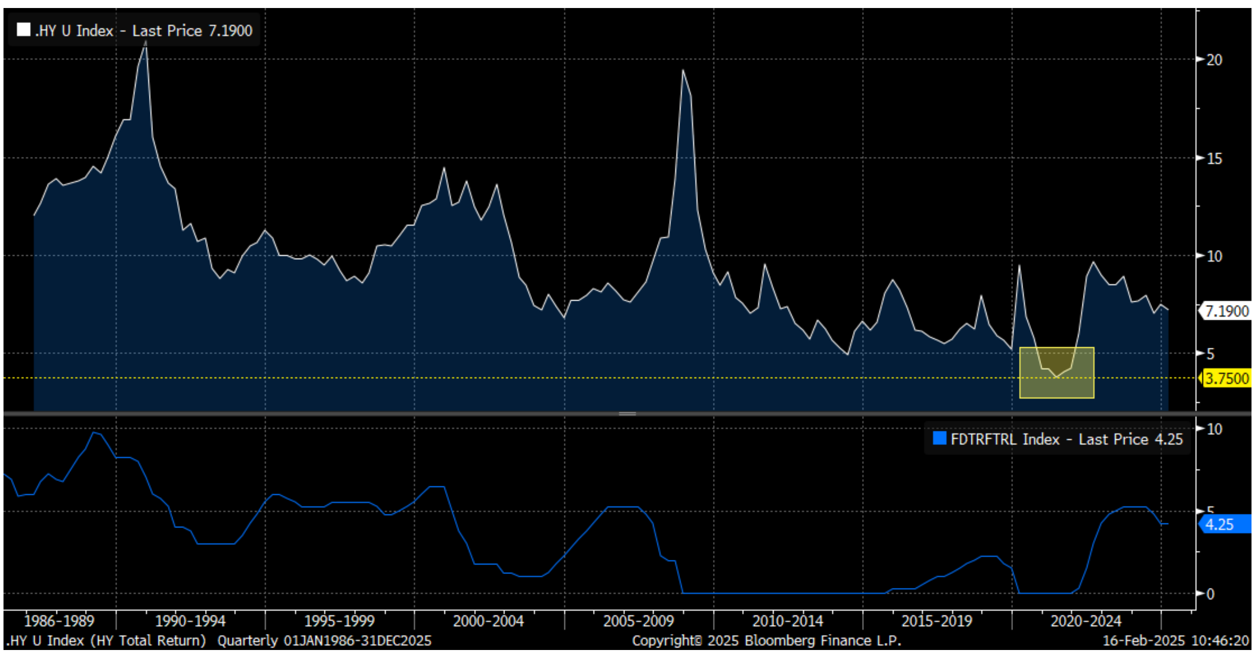
Source: Bloomberg Professional, Poxono Capital – Excel Available Upon Requestion

A couple of observations in our hypotheticals:

1. Bringing 60/40 onto your balance sheet (switching from green to blue) using relatively inexpensive ETFs SPY and HYG instead of an off-the-shelf product such as BIGPX added 20+% to gross hypothetical returns over the 5-year period
2. A minor change of Fixed to Floating coupons in the credit allocation at year-end 2020 added roughly 6% gross of fees to hypothetical returns over the 5 year period
    a. The change allowed individuals to buy more equity during the 2022 downturn during quarterly rebalancing
    b. The change protected principial by decreasing bond duration

How did you know to switch from Fixed to Floating? What were the tax implications of the change? Did the change have a material impact on my returns prior to Federal Reserve pivot?

Why Switch?



.HY U Index is made using the formula: CSI BARC Index + USGG10YR Index
Source: Bloomberg Professional, Poxono Capital

The Federal Reserve cut lower-bound rates during COVID to zero and flooded the market with liquidity. High Yield total return eventually traded to yield returns not seen in the history of the indices (late 1980s). I won't spend too much time on the concept of duration. I recommend you use this rule of thumb when thinking about duration: *the lower the yield given the same time to maturity, the more interest rate changes affect an investor's principal*. If the index we track's total yields are at the lowest point in history and the Federal Reserve has already cut lower-bound rates to 0, fixed-rate coupon bonds carry a large amount of duration risk (in theory, the most since the late 1980s). In this case, the move to floating rate appears to be very advantageous because the bond's coupons move with interest rates and therefore decrease the bond's sensitivity to interest rate changes.

Tax Implications?

We would be changing securities to achieve the fixed to floating rate credit allocation, so taxes would be something we would consider in applicable accounts. Generally, we are more likely to make minor trades in credit than equities because the tax implications can be smaller in the credit space. The main reason for the smaller tax implications is that most gains in credit come from interest payments that are already subject to yearly taxes in taxable accounts, rather than capital gains.

Did it have material impacts on the hypothetical return prior to the Federal Reserve Pivot?

In our hypothetical scenario, the minor change occurred at year-end 2020. The Federal Reserve didn't begin hiking rates (the catalyst for why we changed from fixed to floating) until roughly 1 year later. From 12/31/2020 to 12/31/2021, the hypothetical floating-rate-based credit portfolio underperformed by ~$625 gross due to slightly lower yields. We think that potential small leakage was well worth the eventual ~$6,000 greater performance in the 5-year hypothetical.

Conclusion

Overall, this minor change is just one of many that we believe we would have considered during COVID. We believe in our process, which focuses on markets, and helps us uncover opportunities like the one described – a minor change that can have a meaningful impact.

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