LoCorr FUNDS

Is the 60/40 Allocation Still Optimal?
Not in this Rate Environment

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In the history of modern finance, perhaps no ratio has been as well known or widely accepted as 60/40. An asset allocation of 60% stocks and 40% bonds has been the portfolio standard for decades, providing sufficient returns with reduced risk.

But the "40" component of that model has recently come under attack, as persistently low interest rates raise a fundamental question: Should investors dedicate so much of their portfolio to an asset class likely to provide meager returns going forward? The math suggests not.

Key Takeaways

- Low interest rates portend meager fixed income returns in the future and may undermine the effectiveness of the conventional 60/40 portfolio.
- With rates still historically low, equities would need to deliver exceptional performance for a 60/40 allocation to achieve its historical returns. With valuations currently high, that is asking a lot.
- The market paradigm may make it essential for individuals to borrow from the institutional investment playbook, and add low-correlating alternatives to the portfolio mix.

While fixed income is rightly thought of as a diversifier that protects against equity market downturns, its historical contribution to portfolio returns is less appreciated. Bonds have done some heavy lifting over the past 20 years, with fixed income (as measured by the Bloomberg U.S. Credit Corp 5-10 Year Index) returning almost as much as equities (5.6% vs. 5.9% annually, respectively).

Bonds are now struggling to be **heavy lifters** for portfolios.

Going forward, that type of contribution seems unlikely. Yields on the long and short end of the curve have fallen steadily since 1981, and today's low rates provide a poor starting point for future fixed income returns. The tables below illustrate how the low-rate environment affects returns for the standard 60/40 portfolio.

Let's Do the Math

To set the stage, the table below shows how a gradual change in interest rates – up or down – could impact different types of fixed income. The hypothetical example ignores the impact of other factors that affect bonds and focuses purely on bonds' sensitivity to interest rates, known as duration. The example follows the principle that, generally, for every 1% increase or decrease in interest rates, a bond's price will move 1% in the opposite direction.

As the table shows, a 0.5% rise in interest rates would translate into a -0.8% decline for a portfolio tracking the Bloomberg U.S. Aggregate Bond Index the following year. If rates rose 1.0%, the same bond portfolio would decline -3.6%.

The Impact of Interest Rate Fluctuations on Fixed Income

Hypothetical Illustration of Interest Rate Movement	**Interest Rate Movement** (bps)				
	-100	**-50**	**0**	**+50**	**+100**
Bond Index	**Price impact after 1-year** (based on duration as of 12/31/21)				
Treasury 5-10 Year	7.7%	4.7%	1.8%	-1.1%	-3.8%
Corporate Credit 5-10 Year	8.3%	5.4%	2.6%	-0.1%	-2.8%
Treasury 1-3 Year	1.9%	1.5%	1.0%	0.6%	0.1%
Corporate Credit 1-3 Year	2.2%	1.8%	1.4%	1.0%	0.6%
Mortgage-Backed Securities	4.2%	3.4%	1.9%	0.0%	-2.2%
Asset Backed Securities	2.7%	2.0%	1.4%	0.7%	0.1%
BBg US Agg Bond Index	7.7%	4.8%	2.0%	-0.8%	-3.6%

Source: FactSet. As of 12/31/21

This hypothetical example ignores the impact of convexity and illustrates the approximate sensitivity to interest rates, otherwise known as duration. The scale of possible interest rate changes was chosen to represent a symmetrical scale in rate movements. Rates can change more or less than in these examples.

The data tables on the next page are related to the above table. If a portfolio consists of 60% stocks and 40% bonds, how much return is needed from stocks when bonds are down or up x%? These tables show the returns needed from stocks to generate an overall portfolio return of 5% or 7%. No equity returns being assumed. No fees or taxes are being included.

Drawing from those returns in different interest rate scenarios, the next table shows what this means for a 60/40 portfolio. It demonstrates the returns the equity portion of a portfolio must achieve for a 60/40 portfolio to meet a 5% return objective.

For example, if interest rates rose by 50 basis points, an investor with a 60/40 portfolio (bonds represented by the Bloomberg U.S. Aggregate Bond Index) would need a 8.9% return from their equity allocation just to meet a 5% return target. Should rates rise further, the math gets more challenging. If rates rose 1%, the same 60/40 allocation would require a 10.7% return from stocks just to get the portfolio to a 5% return.

Under Pressure: Rising Rates and a 5% Return Target

	Interest Rate Movement (bps)				
	-100	**-50**	**0**	**+50**	**+100**
Bond Index	**Equity contribution**				
Treasury 5-10 Year	3.2%	5.2%	7.2%	9.0%	10.9%
Corporate Credit 5-10 Year	2.8%	4.7%	6.6%	8.4%	10.2%
Treasury 1-3 Year	7.0%	7.4%	7.7%	8.0%	8.3%
Corporate Credit 1-3 Year	6.9%	7.1%	7.4%	7.7%	7.9%
Mortgage-Backed Securities	5.5%	6.1%	7.0%	8.3%	9.8%
Asset Backed Securities	6.5%	7.0%	7.4%	7.8%	8.2%
BBg US Agg Bond Index	3.2%	5.1%	7.0%	8.9%	10.7%

Source: FactSet, LoCorr Fund Management. As of 12/31/21. Stocks are represented by S&P 500. This is a hypothetical example intended for illustrative purposes only. Index performance is not illustrative of Fund performance. One cannot invest directly in an index.

Looking to achieve a 7% total portfolio return? The math gets more daunting. Using the Bloomberg U.S. Aggregate Bond Index as a proxy for the fixed income allocation, the investor's equity allocation would need to achieve a 12.2% return if rates increase just 0.5%.

The Performance Stocks Must Achieve for a 60/40 Portfolio to Return 7%

	Interest Rate Movement (bps)				
	-100	**-50**	**0**	**+50**	**+100**
Bond Index	**Equity contribution**				
Treasury 5-10 Year	6.5%	8.5%	10.5%	12.4%	14.2%
Corporate Credit 5-10 Year	6.1%	8.1%	9.9%	11.8%	13.5%
Treasury 1-3 Year	10.4%	10.7%	11.0%	11.3%	11.6%
Corporate Credit 1-3 Year	10.2%	10.5%	10.7%	11.0%	11.3%
Mortgage-Backed Securities	8.9%	9.4%	10.4%	11.7%	13.1%
Asset Backed Securities	9.9%	10.3%	10.7%	11.2%	11.6%
BBg US Agg Bond Index	6.5%	8.4%	10.4%	12.2%	14.0%

Source: FactSet, LoCorr Fund Management. As of 12/31/21. Stocks are represented by S&P 500. This is a hypothetical example intended for illustrative purposes only. Index performance is not illustrative of Fund performance. One cannot invest directly in an index.

Each of the preceding tables lay bare the concerns about a 60/40 portfolio. With rates tethered near historic lows, there is, at best, minimum upside potential left for bonds. Just as likely (perhaps more so), rates could rise and create negative returns for the asset class.

In either scenario, investors would have to rely on exceptional stock market performance for the 60/40 portfolio to reach a 5% or 7% return target. With stocks already at record highs and valuations stretched, those expectations seem optimistic.

Now What? What Investors Can Do.

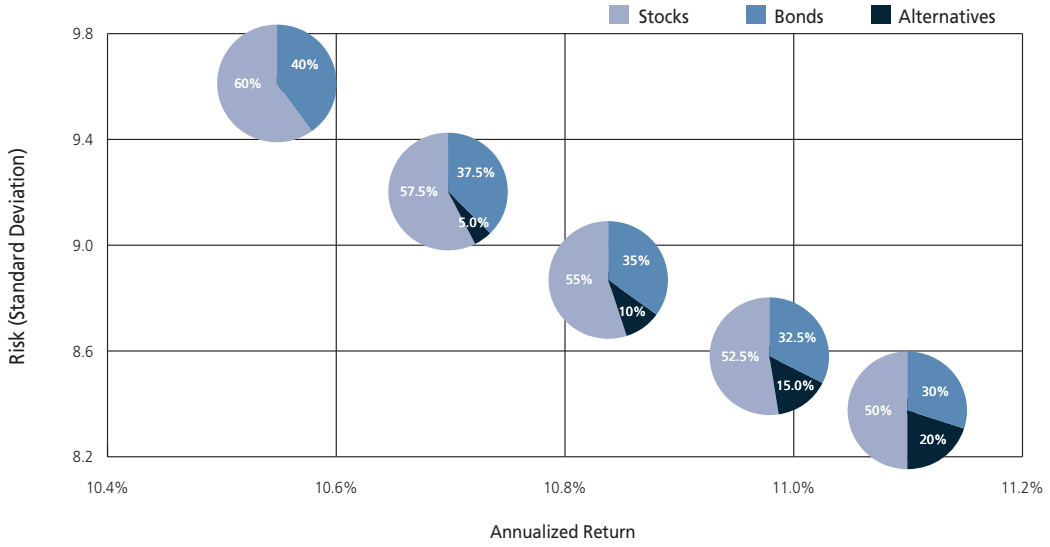
With stocks near all-time highs and bond yields near historic lows, it is imperative to find new sources of return that can move independently from both stocks and bonds. That means constructing a portfolio that includes equities and a broader set of diversifiers, not just fixed income.

For individual investors, we believe the new 60/40 should look more like 60/30/10 or even 60/20/20 by shifting assets to a sleeve of low-correlating strategies which seeks to create a smoother ride and a more consistent outcome for client portfolios.

Low-correlating strategies seek to create a smoother ride and a more consistent outcome for investors.

With such an approach, historically the results have been favorable. The next chart shows how the performance and volatility (as measured by standard deviation) of a portfolio changed when low-correlating alternatives were added to the mix. As the allocation shifts away from a 60/40 portfolio by adding more alternatives, both performance and risk characteristics improved.

The Impact of Adding Alternatives to a Portfolio



Source: Morningstar. Data from 1/1/80-12/31/21. Stocks are represented by the S&P 500 Index. Bonds are represented by the Bloomberg U.S. Aggregate Bond Index. Alternatives are represented by the CISDM CTA Equal Weighted Index.

Institutional investors – including universities and endowments – have already moved away from 60/40, with the average endowment or foundation portfolio steadily decreasing its reliance on stocks and bonds, in favor of low-correlating asset classes.

While uncorrelated strategies have been a hallmark of institutional portfolios for decades, adoption has been slower among individual investors. As the math in this article shows, the current market paradigm makes it crucial to embrace them.

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About LoCorr

LoCorr is a leading provider of low-correlating investment strategies founded on the belief that non-traditional investment strategies with low correlation to stocks and bonds can reduce risk and help increase portfolio returns. LoCorr offers investment solutions that provide the potential for positive returns in rising or falling markets and help to achieve diversification in investment portfolios.

To learn more about how LoCorr can help you reach your investment goals, contact us at **888-628-2887** or visit us at **www.LoCorrFunds.com**.

The interest rate tables in the presentation are utilizing a modified duration calculation. Modified duration is a formula that expresses the measurable change in the value of a security in response to a change in interest rates. Modified duration follows the concept that interest rates and bond prices move in opposite directions. This formula is used to determine the effect that a 100-basis-point (1 percent) change in interest rates will have on the price of a bond. Modified duration measures the average cash-weighted term to maturity of a bond. Modified duration is an extension of something called the Macaulay duration, which allows investors to measure the sensitivity of a bond to changes in interest rates. In order to calculate modified duration, the Macaulay duration must first be calculated.

Treasury 5-10 Year represented by BBg US Treasury 5-10 Year Index, Corporate Credit 5-10 Year represented by BBg US Credit Corp 5-10 Year Index, Treasury 1-3 Year represented by BBg US Treasury 1-3 Year Index, Corporate Credit 1-3 Year represented by BBg US Corporate 1-3 Year Value Index, Mortgage Backed Securities represented by BBg US Mortgage Backed Index, Asset Backed Securities represented by Barclays Asset Backed Index, Bloomberg Aggregate Bond represented by Bloomberg US Aggregate Value Index. One cannot invest directly in an index. The data reflects the duration of each index. This is the interest rate sensitivity. Therefore, if there is a +100 basis point move in rates, how will performance change? Assumptions used: 1) rates moves are in a parallel fashion; 2) rate moves are in a gradual fashion over the horizon (as opposed to immediate at time zero); c) bonds that mature are reinvested at the 2-year swap rate. Data as of 12/31/21.

Stocks are represented by S&P 500. This is a hypothetical example intended for illustrative purposes only. It does not represent the returns of any actual investment or take into account the effects of taxes, fees, or other expenses that would reduce returns. It should not be considered investment advice or a forecast or guarantee or future results. Illustrations of hypothetical principles have inherent limitations and cannot account for future economic conditions. Results may vary. Past performance does not guarantee future results. Index performance is not illustrative of Fund performance. One cannot invest directly in and index. Fund performance may be obtained by calling 1.855.LCFUNDS, or visiting www.LoCorrFunds.com. Data as of 12/31/21.

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Past Performance does not guarantee future results. Index performance is not indicative of fund performance. For current standardized fund performance, please call 1.855.LCFunds or visit www.LoCorrFunds.com. The performance of various indices is shown for comparison purposes only. The performance of those indices was obtained from published sources believed to be reliable, but which are not warranted as to accuracy or completeness. Unless noted otherwise, index returns do not reflect fees or transaction costs and reflect reinvestment of net dividends. One cannot invest directly in an index.

The Fund's investment objectives, risks, charges, and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling 1.855.LCFUNDS, or visiting www.LoCorrFunds.com. Read it carefully before investing.

Mutual fund investing involves risk. Principal loss is possible. The Funds are non-diversified, meaning it may concentrate its assets in fewer individual holdings than a diversified fund. Therefore, the Funds are more exposed to individual stock volatility than a diversified fund. The Funds invest in foreign investments and foreign currencies which involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks are greater for emerging markets. The Funds may make short sales of securities, which involves the risk that losses may exceed the original amount invested. Investing in commodities may subject the Funds to greater risks and volatility as commodity prices may be influenced by a variety of factors including unfavorable weather, environmental factors, and changes in government regulations. Investing in derivative securities derive their performance from the performance of an underlying asset, index, interest rate or currency exchange rate. Derivatives can be volatile and involve various types and degrees of risks, and, depending upon the characteristics of a particular derivative, suddenly can become illiquid. Derivative contracts ordinarily have leverage inherent in their terms which can magnify the Fund's potential for gains or losses through increased long and short position exposure. The Fund may access derivatives via a swap agreement. A risk of a swap agreement is the risk that the counterparty to the agreement will default on its obligation to pay the Fund. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in Asset Backed, Mortgage Backed, and Collateralized Mortgage-Backed Securities include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. The LoCorr Long/Short Equity Fund may invest in small- and medium-capitalization companies which involve additional risks such as limited liquidity and greater volatility. The Fund may also invest in lower-rated and non-rated securities which present a greater risk of loss to principal and interest than higher-rated securities. ETF investments are subject to investment advisory and other expenses, which will be indirectly paid by the Fund. As a result, the cost of investing in the Fund will be higher than the cost of investing directly in ETFs and may be higher than other mutual funds that invest directly in stocks and bonds. ETFs are subject to specific risks, depending on the nature of the ETF. The Spectrum Income Fund's portfolio will be significantly impacted by the performance of the real estate market generally, and the Fund may be exposed to greater risk and experience higher volatility than would a more economically diversified portfolio. Property values may fall due to increasing vacancies or declining rents resulting from economic, legal, cultural, or technological developments. Investments in Limited Partnerships (including master limited partnerships) involve risks different from those of investing in common stock including risks related to limited control and limited rights to vote on matters affecting the Limited Partnership, risks related to potential conflicts of interest between the Limited Partnership and the Limited Partnership's general partner, cash flow risks, dilution risks and risks related to the general partner's limited call right. Underlying Funds are subject to management and other expenses, which will be indirectly paid by the Fund.

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