PORTFOLIO IMPLICATIONS

Portfolio construction: Moving toward a new architecture

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IN BRIEF

- Expected low returns from a 60/40 portfolio call into question the efficacy of traditional approaches to asset allocation. In particular, the inability of fixed income to provide either compelling returns or diversification suggests that investors need a fresh approach to portfolio construction.
- Instead of a traditional "barbell" strategy built with high volatility equity and low volatility, negatively correlated bonds, we recommend a "full spectrum" approach to uncover alternative sources of return.
- In the full spectrum approach, investors move into a range of nontraditional investment strategies (fixed income-focused, mid risk and equity-focused) and adjust their risk management to address higher levels of complexity and illiquidity.
- In addition to capturing higher beta returns, a full spectrum approach offers higher alpha potential for appropriately skilled and resourced investors.
- While diversification will remain central to asset allocation, the management of liquidity will become an increasingly important tool.

A NEW ARCHITECTURE FOR ASSET ALLOCATION

The basic approach to portfolio construction has changed remarkably little over the past several decades. Equities provide returns and risk; bonds provide protection. This, in a nutshell, is the simplified model that has served investors well for many years.

But it's not working anymore. Market portfolios will likely deliver returns far below both historical levels and investor targets. We expect a 60/40 portfolio[1] to return just 4.3% a year over a 10- to 15-year horizon. Reliance on diversified market exposures to achieve a target level of return with an acceptable level of risk may no longer be possible. Equally critical, though perhaps less widely appreciated, is the impact that the limited downside protection available from fixed income strategies will have on constraining overall equity exposures, absent other types of hedges.

In short, investors need a new architecture for asset allocation – a fresh approach to portfolio construction that moves beyond traditional mean-variance optimization and reliance on backward-looking historical returns, volatilities and correlations. What might that look like? In this paper, we describe a forward-looking model built around the broadest possible investment opportunity set.

This approach also reflects a profound shift in the financial markets that has occurred in recent years: the broadening scope of private markets and alternative asset classes, with increasing granularity and improved accessibility to investment categories that were previously beyond the reach of most investors. An allocation that might have seemed radically tilted away from public markets a decade or two ago is now a better representation of the investment landscape.

Instead of a "barbell" strategy based on market risk and returns, built with high volatility equity and low volatility, negatively correlated bonds, we recommend a "full spectrum" approach to uncover alternative sources of return. This new architecture embraces a range of mid risk assets, such as real assets, mezzanine debt,[2] hedge funds and hedged equity, along with extension from traditional fixed income and equity into alternatives such as private credit and private equity. In the full spectrum approach, the dominant form of risk shifts from correlation to liquidity and complexity. In our view, a reconstituted 60/40 could potentially consist of up to 60% mid risk assets and nontraditional assets and 40% diversified liquid investments across stocks and bonds.

This would not be a simple shift. Investors would need to address the implementation challenges that come with illiquidity and new, sometimes esoteric, asset classes. But we believe a new approach is critical to meet the challenge of low expected returns across a wide range of asset markets.

[1] A 60/40 portfolio consisting of 60% MSCI ACWI, 40% Bloomberg US Aggregate.

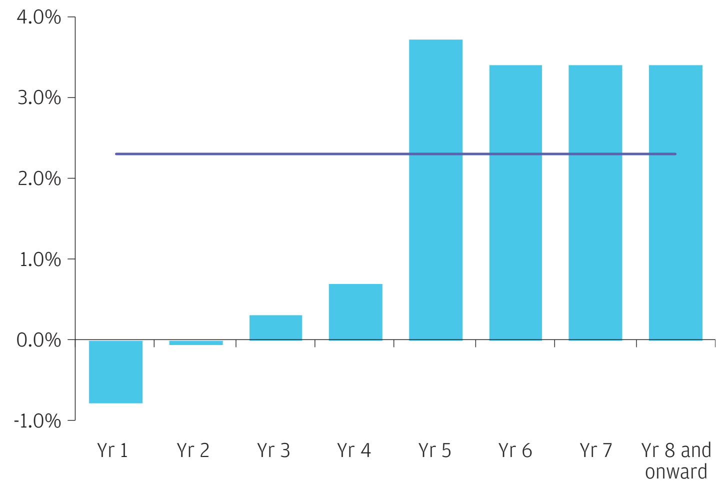
[2] Mezzanine debt is a hybrid of debt and equity financing that gives the lender the right (typically via warrants) to convert to an equity interest in the company in case of default.

WHAT IS THE FUTURE FOR FIXED INCOME?

In many ways, the challenge begins with the bleak outlook for fixed income – a projected 2.4% return for the 10-year U.S. Treasury (**EXHIBIT 1**) and a 2% return for hedged world government bonds. Factoring in inflation, real returns would be even lower, and quite possibly negative. One might well ask: Why own bonds at all?

We project just a 2.4% expected return for the 10-year U.S. Treasury over a 10- to 15-year investment horizon

EXHIBIT 1: FORECASTED RETURN FOR U.S. 10-YEAR TREASURIES (LINE REPRESENTS LTCMA INFLATION FORECASTS FOR THE U.S.)



Source: J.P. Morgan Asset Management; estimates as of September 30, 2021.

In the past, investors would have justified owning traditional bond strategies in the face of low return expectations because fixed income provided a powerful source of risk diversification in a portfolio heavily weighted to equities.

But if bonds no longer protect portfolios against the volatility of equities as effectively as they once did, what then? Can investors still maintain large allocations to unhedged equity risk? Both strategic asset allocation and approaches to portfolio management need to adjust to this new environment.

RETURNS, RISK AND INSURANCE

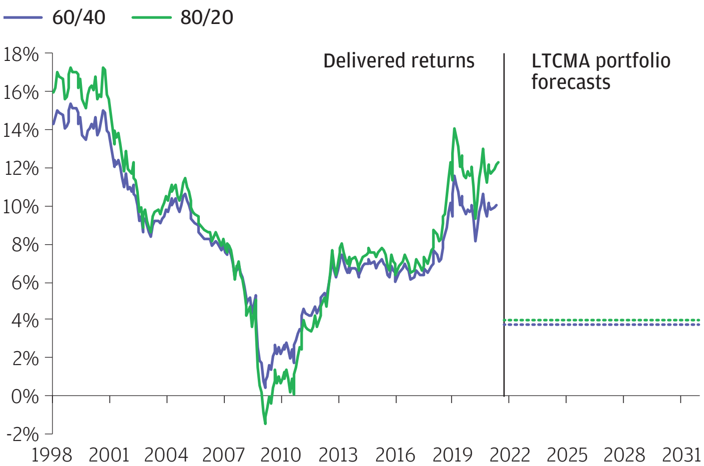
Over the past 40-odd years, investors have certainly been well compensated to take on equity risk (**EXHIBIT 2**). Since the early 1980s, equities have delivered strong and consistently positive returns, despite the occasional sharp drawdown. During those drawdowns, bonds delivered on their promise of risk diversification, dampening portfolio volatility while providing a valuable source of liquidity when it was most needed.

The traditional stock-bond relationship resembles insurance: An uncommon yet costly risk is identified, and protection against that risk is acquired. A homeowner, for instance, does not expect their home to burn down but recognizes that the prospect is so dire that it must be insured against. For investors, the uncommon costly risk is the rare but severe equity market sell-off. The insurance is government bonds, which usually rise in value during periods of market stress.

But unlike a homeowner who expects to pay a premium for insurance, investors have been spoiled by the bond bull market that began in the early 1980s. Since then, bonds have delivered both portfolio protection and strongly positive long-term returns. As a result, the classic 60/40 portfolio strategy has not borne the cost of the insurance provided by bonds even as it has enjoyed remarkably high returns, modest risk and exceptional liquidity.

We see a striking decline in expected return for a 60/40 stock-bond portfolio vs. its history

EXHIBIT 2: 10-YEAR ROLLING RETURN & LTCMA FORECAST, U.S. ASSETS



Source: J.P. Morgan Asset Management; estimates as of September 30, 2021.

Going forward, however, bonds will provide much weaker portfolio protection. Low returns and uncertain correlation characteristics raise the cost and diminish the risk management benefits that bonds provide. In the absence of effective sources of risk diversification, investors looking to achieve their return targets will need alternative sources of return that have lower absolute volatility and do not require large fixed income holdings for protection.

FULL SPECTRUM INVESTING: MOVING BEYOND STOCKS AND BONDS

What might a replacement look like, and what are the implications for portfolio governance and the implementation of strategic asset allocation decisions?

Investors may no longer want to employ a barbell strategy based on market risk and returns with a focus on equity and bonds. Instead, they can turn to a full spectrum approach that makes use of a wider range of mid risk asset classes.[3] At the core of the full spectrum approach are strategies that exhibit more modest risk profiles and are less vulnerable to extreme market movements (put differently, they have less fat-tail risk).

What might qualify as a mid risk asset? These could include real assets, such as core real estate, core infrastructure and core transportation, as well as other assets, such as convertible bonds, hedge funds, mezzanine debt and hedged equity (**EXHIBIT 3**).

[3] Mid risk assets fall outside the traditional equity and fixed income definitions. They may have equity or fixed income features, or combinations of the two. They may offer correlation benefits vs. traditional listed market clusters.

Investors looking to achieve their return targets will need alternative sources of return

EXHIBIT 3: EXAMPLES OF NONTRADITIONAL INVESTMENT STRATEGIES

FIXED INCOME-FOCUSED	MID RISK	EQUITY-FOCUSED
Unconstrained fixed income	Structured credit (CLO/CDO)	Opportunistic real estate
Securitized credit	Hedge funds	SPAC
Multi-sector credit	Convertible bond	Special situations
Bank loans	Core/Core+ real estate	Growth equity
Private mortgages	Core transportation	PE co-investment
Private credit/Direct lending	Core infrastructure	Venture capital
	Timberland	
	Mezzanine debt	
	Preferred/Bank capital	
	Hedged equity	
	Equity income (call writing)	

Source: J.P. Morgan Asset Management. CLO: collateralized loan obligation; CDO: collateralized debt obligation; SPAC: special purpose acquisition company; PE: private equity.

The shift from a portfolio dominated by equities and bonds to one that employs a wider range of mid risk assets will pose a new set of portfolio management challenges and opportunities. Meeting these challenges can be viewed as the price of bridging the gap between returns available from 60/40 portfolios and investors' long-term return targets. In our view, the "new 60/40" portfolio might contain as much as 60% mid risk assets and 40% diversified liquid investments across traditional stocks and bonds. (We note this is just one example of what a full spectrum allocation model might look like; the exact application will be a function of investor-specific requirements and attributes.)

While the move to this "new 60/40" approach may seem an extreme shift, consider that the investment opportunity set is far more diverse today than ever before, with nontraditional categories playing a far larger role.

Using 6%–7% as a generic proxy for the range of investors' target returns, we look to identify a diverse set of nontraditional investment strategies with return expectations close to target. By their nature, most of these investment categories offer less liquidity and higher complexity than public markets. As such, the dominant form of risk management in the new asset allocation framework will migrate from managing correlations across market sectors to managing the total portfolio liquidity and maintaining a diverse mix of underlying return drivers across asset classes.

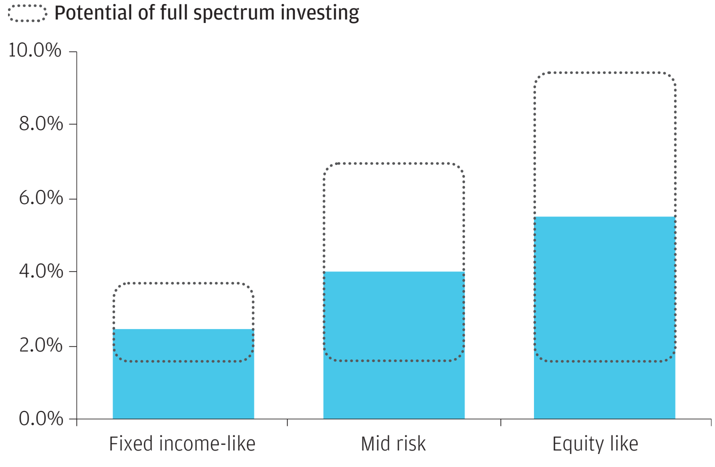
While a shift to full spectrum investing can be supported on the basis of our expectations for market beta, we find that the enhanced scope for alpha typically associated with these assets offers additional upside. Although our Long-Term Capital Market Assumptions (LTCMAs) do not forecast returns for all these assets, we attempt to capture the dispersion of return in these areas (**EXHIBIT 4**).

In a full spectrum approach, the breadth of the opportunity set is a key appeal. It provides an attractive level of internal diversification across the various strategies, as well as lower absolute volatility when compared with traditional equity-focused portfolios. This diminishes the need for negatively correlated assets to manage risk, not only volatility but also drawdown risk.

But even a well-diversified strategy built from a full spectrum approach will bear a key risk: illiquidity and, by extension, a new set of investment challenges.

Return potential increases as investors expand to full spectrum investing

EXHIBIT 4: EXPECTED RETURN RANGE FROM SIMPLE STOCK-BOND TO FULL SPECTRUM



Source: J.P. Morgan Asset Management; data as of September 30, 2021. For illustrative purposes only. Blue bars reflect the LTCMA forecasts for government bonds, a 60/40 stock-bond portfolio and U.S. equity, respectively. Dotted areas reflect the range of likely outcome of Fixed income-like, Mid risk and Equity-like assets shown in Exhibit 3.

LIQUIDITY RISK AS AN ALTERNATIVE RETURN LEVER

Think of liquidity and illiquidity on a spectrum rather than as a binary factor. Some assets, such as Treasury bills, are completely liquid, while others, such as private equity funds with a long lock-up, offer little to no liquidity. But many strategies exist somewhere in between. They might provide short-term liquidity at the cost of a high bid/offer spread (e.g., high yield bonds). Or they might require a longer time period, perhaps a few months or quarters, to redeem the investments (e.g., open-end core real estate funds).

Liquidity risk is nothing new, of course. But a full spectrum approach implies a deliberate and marked shift toward illiquidity in order to secure returns in excess of those available from a 60/40 portfolio. That is, liquidity risk becomes an alternative lever to help achieve investment goals. To be sure, a full spectrum portfolio has a markedly lower level of overall portfolio liquidity than its traditional counterpart. Thus, investors need to consider a portfolio's capacity to provide access to capital when needed. Institutions will need to assess their ongoing and contingent obligations to their sponsors and scale their liquid asset portfolios to best meet those obligations. We should highlight that obligations are both to sponsors (i.e., pension holders) and the providers of some investment products (e.g., private equity funds). The challenge is for investors to successfully balance these two obligations. Individual investors can follow a similar path, determining potential needs for access to capital and investing accordingly.

Investors can deploy the full range of public market assets for liquidity management – not just bonds. Equities, while volatile, are highly liquid and can certainly play a role in managing this risk. Actively managed fixed income and equity strategies can allow public market exposures to generate alpha while remaining liquid. Going a step further, multi-asset allocation strategies also remain highly liquid, while offering the potential to generate additional returns through the tactical movement of risk across market sectors. Vehicle choices may play a role as well, with ETFs (including active strategies and some mid risk categories, such as hedged equity) offering intraday liquidity.

Finally, we recognize that the ability of a portfolio to generate stable income across time is a powerful antidote to lower asset liquidity. Many of the strategies presented in Exhibit 3, and particularly the private mid risk approaches in the middle column, derive the majority of their total return from income (e.g., core real estate and infrastructure). Income and redemptions can also help to meet cash flow and operational needs, thereby reducing the need to liquidate assets to meet obligations.

THE NEW PORTFOLIO IN PRACTICE

But how could this work in practice? To illustrate a potential application, we use the LTCMAs as a starting point. Our example is based on a hypothetical investor shifting from a 60/40 stock-bond portfolio. The remainder of the portfolio is made up of a range of fixed income-focused, mid risk and equity-focused assets, taken from both private and public markets (**EXHIBIT 5**).

In our illustrative portfolio, for fixed income we shift from U.S. aggregate bonds to unconstrained bonds; publicly traded credit such as high yield bonds, loans and emerging market sovereign debt; and direct lending. We also enhance the bond-like features of the portfolio through exposures to mid risk assets such as convertible bonds and core real estate. Within equity, we shift from developed world equities to All-Country World equity, private equity and hedged equity. We use mezzanine debt and value-added real estate to provide both equity and debt characteristics.

A move toward real assets and mid risk strategies can achieve a better return outlook

EXHIBIT 5: AN ILLUSTRATIVE EXAMPLE OF A "FULL SPECTRUM" PORTFOLIO

	WEIGHT		LOADING		
	60/40	FULL SPECTRUM	BOND	EQUITY	REAL ECONOMY
U.S. aggregate bond	40%		Y		
Unconstrained fixed income		10.0%	Y		
Credit		10.0%	Y		
Convertible bonds		7.5%	Y	Y	
Direct lending		10.0%	Y		Y
Core real estate*		5.0%	Y		Y
Core transport*		7.5%	Y		Y
Core infrastructure*		7.5%	Y		Y
Mezzanine debt		7.5%	Y	Y	
Equity income (call writing)		5.0%	Y	Y	
Hedged equity		5.0%		Y	
Opportunistic real estate		5.0%		Y	
MSCI AC World*	60%	10%		Y	
Private equity		10%		Y	
Total	100%	100%			
Expected return (est)	4.3%	5.6%			
Potential added return		1%–2%			
Vol	9.7%	9.5%			

Source: J.P. Morgan Asset Management; estimates as of September 30, 2021. Expected return captures LTCMA asset classes' beta return expectation. Additional return potential captures elements such as added nonbeta return from unconstrained fixed income, asset allocation and strategy-specific return drivers beyond the beta loading. *Core real estate, core transport and core infrastructure are all global asset classes.

The majority of the traditional 60/40 portfolio shifts to the full spectrum portfolio. Of course, none of these asset classes provides daily liquidity. By including more mid risk assets as part of a core diversified real asset basket, this new portfolio is well balanced among bond, equity and real economy risk exposure.

The full spectrum portfolio increases the 4.3% per annum (p.a.) return provided by the 60/40 portfolio to approximately 6% p.a. We estimate that, based on current market conditions, enhanced potential for alpha associated with some of the asset classes and strategies included in the full spectrum approach could add 1%–2% p.a. for appropriately skilled and resourced investors. Of course, given that some of the asset classes and strategies are small relative to liquid markets, it is reasonable to expect alpha potential to fall as investor interest increases.

Risk as defined by volatility is similar between the two portfolios, based on our LTCMA forecasts (9.7% vs. 9.5%). Of course, additional risk comes with the shift to illiquid assets. As a result, the incremental returns associated with the new model have a "price." Nevertheless, as the portfolio is fairly well balanced among equity, fixed income, rates and exposures to real assets, portfolio implementation could offer further diversification benefits driven by the idiosyncrasies that arise when implementing the target strategies, as well as enhanced scope for alpha.

As suggested above, the precise application of the full spectrum approach to asset allocation will depend on investor-specific requirements for return, risk, income and so forth, as well as each investor's ability to navigate the implementation challenges of the new asset allocation model. But as this simplified example shows, the full spectrum approach has the potential to offset the limitations associated with traditional 60/40 investing. Despite the disappointing outlook for most liquid assets, flexible investors can still achieve their goals. Of course, given the marked differences between traditional 60/40 anchored approaches to portfolio construction and the full spectrum approach, as well as the implications for governance, the changes suggested will likely be a journey rather than a single leap.

CONCLUSION

Investors face a clear choice. Traditional approaches to portfolio construction focused on liquid assets and mean-variance optimization will not satisfy their return requirements and may leave them exposed to higher levels of risk. From such a starting point, they can embrace change, or they can accept either higher risk or lower returns – possibly both. Embracing a full spectrum approach to asset allocation, and accepting the challenges associated with enhanced illiquidity, a more extended range of asset classes and enhanced nonnormality, can allow investors to bridge the gap between 60/40 returns and their own return targets and risk limits. While this shift will certainly present challenges, it also offers opportunities for flexible and thoughtful investors to deliver returns in excess of current targets while remaining within the boundaries of appropriate risk management.

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