PORTFOLIO INSIGHTS

How investors can reach their 7% return target

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IN BRIEF

- Traditional investment approaches are unlikely to meet investors' long-term goals in the coming years. Simply taking on more market risk will not suffice.
- There's no single silver bullet here. Yet investors can reach a 7% return target by moving beyond pure market beta and drawing on multiple building blocks for generating additional returns. Among them: active currency overlay, global tactical asset allocation, active security/manager selection, real assets and private market assets.
- Investors can benefit from diversification of return sources when these building blocks are used in combination. Further, a more cycle-aware approach to investing can identify those economic environments that will favor particular building blocks across time.
- Finally, investors may want to take a hard look at their guidelines and constraints and identify areas of potential additional flexibility in their asset allocation. In particular, the ability to deploy prudent leverage at the plan level and to increase allocations to private markets may present an additional path to reaching a higher return efficiently.

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FOR INSTITUTIONAL INVESTORS, THE PURPOSE OF SETTING A SPECIFIC NUMERICAL RETURN TARGET CAN BE CURIOUSLY HARD TO PIN DOWN. On the one hand, it can serve as a lodestar for the asset allocation process—a clear goal amid the relative uncertainty of future returns, volatilities and correlations. Yet on the other hand, a numerical target can seem arbitrary and unconnected from current market conditions, possibly leading to excessive (or insufficient) risk-taking. For many investors, however, the target is more than an abstraction. To reach funding targets and make good on obligations as they come due, asset returns are needed along with external contributions. Failing to hit return targets can directly increase the financial burden on the sponsor and other stakeholders.

It is therefore critical that return targets are plausible relative to current market conditions and the available investment opportunity set. The challenge today is clear: Traditional investment strategies are unlikely to deliver returns high enough to meet these goals. Those with an extremely long investment horizon may be tempted to brush aside current low expectations on the grounds that returns will ultimately revert to their longer-term trend. For that reason, they see little benefit in deviating from their strategic benchmark. ***This is risk-taking masquerading as prudence.*** Both history and common sense tell us that current yields and valuation multiples are strong indicators of future performance over the longer term, and an extended period of below-trend asset returns can do a great deal of damage before it concludes.

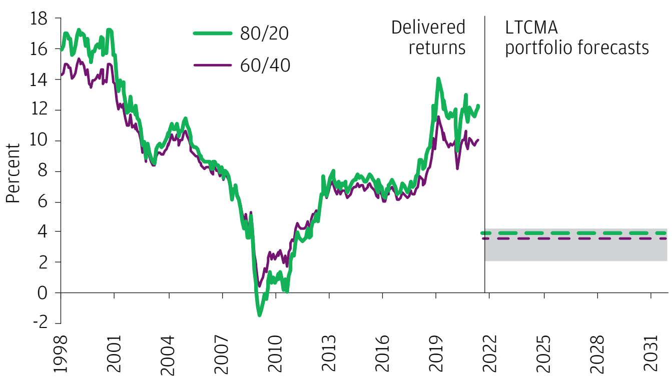
A low return environment does make it challenging to reach return targets using traditional means alone, but investors cannot simply accept this outcome. In this paper, we outline a variety of investment techniques that can improve the prospects of reaching targets and achieving fundamental investment objectives. Our analysis explores different building blocks for generating additional returns across both liquid and illiquid markets, and the trade-offs that must be evaluated when they are used in combination. As we consider which economic environment is more or less favorable for each building block, we identify the potential benefit of taking a more cycle-aware approach to investing. Finally, we suggest that plan sponsors may want to take a hard look at their guidelines and constraints, and identify areas of potential additional flexibility in their asset allocation.

WHAT'S BEHIND THE 7% RETURN TARGET?

We use 7% as a proxy for the targets of total return-focused investors who are looking to achieve the broad objectives of portfolio efficiency and purchasing power protection. It's not an arbitrary target, we believe, but a reasonable goal—albeit one that requires investors to consider new approaches and strategies in what is plainly a more challenging investing environment. The encouraging takeaway from our analysis: Achieving 7% can be done in a number of ways, even if the prevailing interest rate and valuation environment dictates that it will be more difficult in the future than it has been in the past.

Return forecasts for U.S. large cap equities present a binding constraint

EXHIBIT 1: 10-YEAR ROLLING RETURNS FOR 60/40, 80/20 PORTFOLIOS, 1998–2031 (PROJECTED)



Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of June 2021. Forecasts refer to our 2021 LTCMA projections.

EXHIBIT 2: RETURNS FOR U.S. 60/40 AND 80/20 PORTFOLIOS

	Historical (1988-Today)		Forward-Looking (LTCMA, 2021)	
Portfolio	**60/40**	**80/20**	**60/40**	**80/20**
Return	9.4%	10.3%	3.6%	3.9%
Volatility	9.0%	11.7%	9.0%	11.9%
Sharpe Ratio	0.63	0.57	0.27	0.23

Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of June 2021. Forecasts refer to our 2021 LTCMA projections. Portfolio consists of U.S. Large Cap and U.S. Aggregate Bonds.

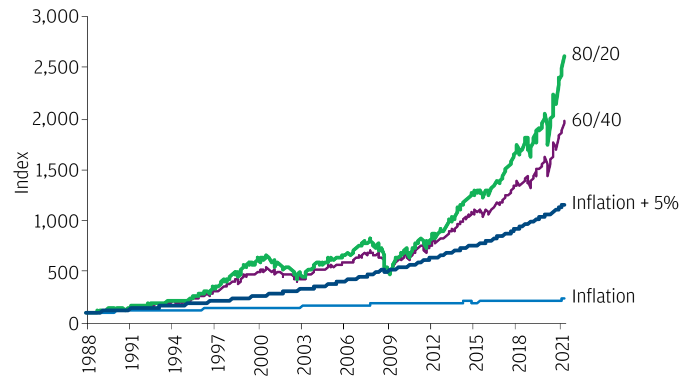
THE BLUNT INSTRUMENT OF MARKET RISK

Having established what our 7% target represents, we turn our attention to the design of our portfolio. For USD-based investors, the 60/40 stock-bond portfolio has come to represent the benchmark for a moderately risk-tolerant balanced portfolio. Historically, the 60/40 portfolio delivered adequate returns, with its bond component providing sufficient protection to manage drawdowns during periods of stock market weakness. However, given low bond yields and high starting valuations for stocks, our forecast returns for a simple domestic 60/40 U.S. equity/U.S. aggregate bond portfolio get us barely halfway to a 7% annualized return target.

One way to boost returns is simply to take on more market risk by increasing the equity weight in the portfolio. For a long-term investor with some tolerance for market volatility, this could be attractive—especially since the real return available from U.S. aggregate bonds is barely above zero. But even allowing for a higher risk tolerance, return forecasts for U.S. large cap equities present a binding constraint. Elevated

In the past, 60/40 returns have comfortably outperformed inflation targets, but the next decade looks very different

EXHIBIT 3: U.S. ASSET PORTFOLIOS VS. INFLATION, 1988–2021



Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of June 2021. Forecasts refer to our 2021 LTCMA projections.

starting valuations limit our 10- to 15-year return forecast to just 4.10%, meaning that moving from a 60/40 allocation to an 80/20 allocation boosts expected returns by just 30 basis points (bps) (**EXHIBIT 1**).

The returns and Sharpe ratios we project over the next decade or so from traditional balanced stock-bond portfolios may appear rather paltry, especially when we consider that the S&P 500 returned 16% in 2020 and 12% so far this year (**EXHIBIT 2**). However, equity returns this year reflect not only a much shorter time horizon—which would require active trading to capture—but ignore the drawdowns that can and will occur over a longer horizon. We concede that there may be upside risks to equity returns. But absenting a wholesale reset of what investors accept as reasonable valuation ranges, we believe that average equity returns over the full cycle will be lower than in the recent past.

The other major driver of today's low returns: 40% of the 60/40 portfolio—the bond component—offers close to a zero real return. There could be a state of the world where "lower for longer" policy holds rates artificially low for some time, in turn subduing volatility and supporting Sharpe ratios but doing nothing to boost returns. In short, the economic and policy environment alone might enhance Sharpe ratios, but we will still have to actively work to generate higher returns.

Some investors may prefer to think about their return targets in real terms. Over history, 60/40 and 80/20 returns have comfortably outperformed a target of CPI+5% (**EXHIBIT 3**). However, our forward-looking portfolio returns do not come close, at 3.6% for a U.S. 60/40 vs. an inflation rate of 2% annualized over the next 10-15 years.

Ultimately, whether we strive for an absolute return target or some CPI+ target, the message remains that market returns in liquid assets alone are unlikely to allow us to clear our return hurdle over the long term. True, we may enjoy years in which above-trend economic growth creates a benign return environment. But over the long haul, we have to balance this with drawdowns and the risk that as rates eventually normalize, returns from the bond part of the portfolio may be a drag on performance. In the next section, we explore how to boost returns over and above those available from a simple U.S. domestic 60/40 portfolio, closer to the target ranges most investors have in mind.

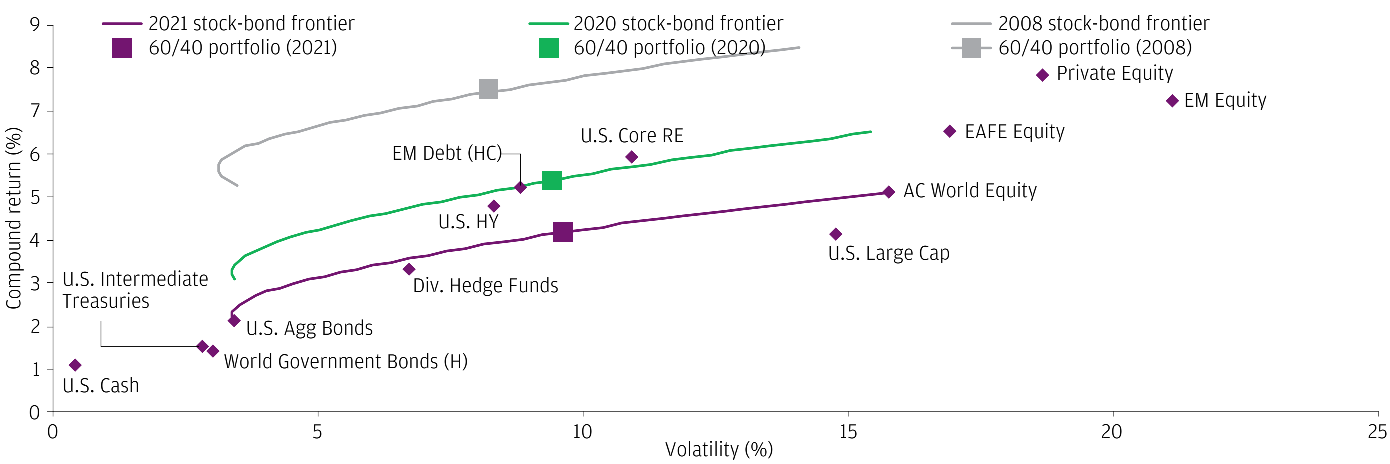
BUILDING BLOCKS TO REACH A 7% RETURN

While the returns available to investors from a simple U.S. domestic 60/40 portfolio get barely halfway to our 7% target, it is important to recognize what the 60/40 represents. Our 3.6% return forecast for a U.S. domestic 60/40 portfolio assumes pure market beta returns from a buy, hold and rebalance portfolio. Such a portfolio assumes no international exposure, no currency risk, no exposure to illiquid assets, no use of active asset or security selection and no leverage. In other words, it represents the baseline return that forms a solid—if unexciting—foundation for constructing a portfolio that might access a range of incremental return streams (**EXHIBIT 4**).

Here we examine the building blocks for generating additional returns and provide estimates of what additional returns may be achievable, based on investing experience and our own Long-Term Capital Market Assumptions (LTCMAs). We view the

Moving beyond pure market beta can add meaningful incremental return

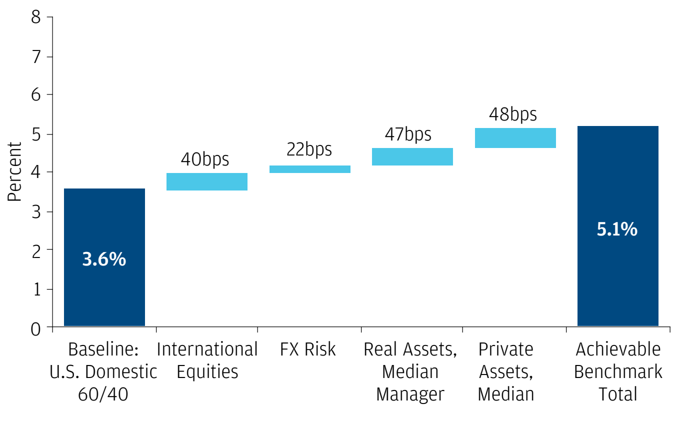
EXHIBIT 4: LONG-TERM CAPITAL MARKET ASSUMPTIONS FORECASTS AND PROJECTED RETURNS



Source: J.P. Morgan Asset Management; estimates as of September 2020. U.S. portfolios consist of U.S. Large Cap and U.S. Aggregate Bonds. Diversified portfolios consists of international equities, real estate, infrastructure, private equity, direct lending and U.S. aggregate bonds. Performance as of December 31, 2020.

Adding passive return building blocks expands the opportunity set, but it does not clear the 7% hurdle

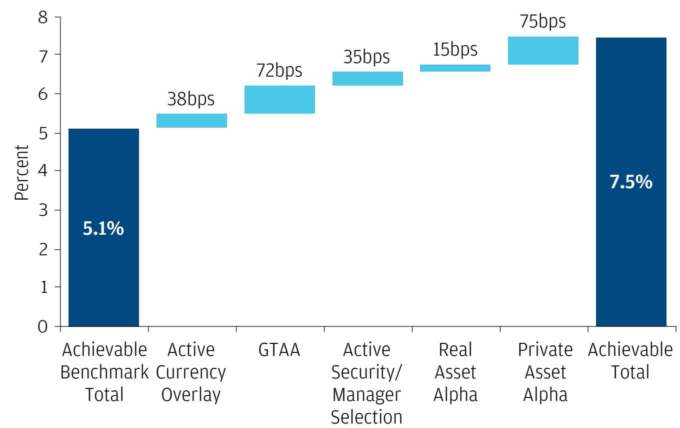
EXHIBIT 5: PASSIVE RETURN PORTFOLIO BUILDING BLOCKS



Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of June 2021. Forecasts refer to our 2021 LTCMA projections. Real Assets include Real Estate and Infrastructure. Private Assets include Private Equity and Direct Lending.

Additional levels of active decision-making can help reach the 7% return target

EXHIBIT 6: PORTFOLIO BUILDING BLOCKS WITH ACTIVE ALPHA



Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of June 2021. Forecasts refer to our 2021 LTCMA projections. Real Assets include Real Estate and Infrastructure. Private Assets include Private Equity and Direct Lending.

building blocks not simply by asset type but from the perspective of investment approaches and the nature of the risk premium that they aim to monetize.

This framework considers a range of independent sources of incremental return, including: international exposure, active currency overlay, global tactical asset allocation (GTAA), active security/manager selection, real assets and private market assets. Later, we also touch briefly on leverage as a means of further enhancing portfolio returns. We begin with a passive perspective (**EXHIBIT 5**) and then expand the analysis to include value add from security selection (e.g. from factor exposures or manager alpha) where it is available (**EXHIBIT 6**). Adding passive return building blocks expands the opportunity set and monetizes a number of additional risk premia beyond the market risk implicitly captured in the 60/40. Importantly, though, widening the opportunity set alone does not reach the 7% hurdle when operating within reasonable asset allocation constraints.

To clear the 7% hurdle, additional levels of active decision-making need to be applied across the widened opportunity set. This does not require a wholesale leap into bottom-up active stock-picking but, rather, looks to a plan's investment staff to consider where they have demonstrable or achievable skill in manager or strategy selection. The ability to consistently select upper-quartile managers in private assets, real assets, GTAA and so forth can boost returns meaningfully, which in turn suggests that developing such expertise within an investment team is a central consideration in hitting a 7% target.

NO SINGLE SILVER BULLET

There is no single silver bullet that will allow investors to get all the way to 7% quickly. Some high returning alternative assets offer a lot of promise for boosting returns through monetizing the illiquidity risk premium, but capturing their full potential would require skilled manager selection and a patient approach to funding new strategies. In public markets, where active alpha is available from a range of sources, manager selection skill, factors exposures, and fee impact require careful consideration.

In our view, there are two distinct components to reaching the 7% target, and they need to be used in combination: widening the opportunity set to monetize the fullest possible range of market risk premia, and identifying and deploying deep investing skill to capture active alpha in specific parts of the opportunity set. **EXHIBIT 7** summarizes each of the building blocks, the potential return uplift (including reasonable ranges) and some of the trade-offs that investors should consider when incorporating these assets into their portfolios.

The numbers in the table represent a reasonably conservative view of potential return uplift based on our LTCMAs and our experience in designing and running multi-asset portfolios. Estimates for elements of active investing in particular do have an upside skew, and the numbers captured in the table represent a median long-term experience in a multi-asset portfolio context. Of course, in some markets the potential gains from active security

EXHIBIT 7: RETURN DRIVERS, POTENTIAL RETURN UPLIFT AND PORTFOLIO CONSTRUCTION TRADE-OFFS

Return driver		Description	Calculation	Baseline uplift	Tradeoffs and considerations
Baseline: U.S. Domestic 60/40		Domestic liquid public market returns	Return derived from our LTCMAs, for a 60-40 portfolio of U.S. Large Cap and U.S. Aggregate Bonds	356bps	• Baseline domestic U.S. portfolio of U.S. Large Cap and U.S. Aggregate Bonds
International Equities	**International Premium**	Hedged international assets	Replacing U.S. stocks with MSCI ACWI (Hedged).	40bps	• Global equities are cheaper than those in the U.S. and so have a valuation tailwind • Some restrictions on country-specific allocations may exist • Moving away from a domestic bias may require some messaging to plan participants • International equities have tailwinds from ESG
	FX Risk	Unhedged international assets	Replacing U.S. stocks with MSCI ACWI (Unhedged).	22bps	• We forecast the U.S. dollar to depreciate, supporting unhedged international equity returns • Unhedged FX introduces porfolio-level volatility, which may be related to geopolitical risk
Active Currency Overlay		Active FX as an alpha source	Based on long-term average of 5yr rolling IR from an unconstrained FX overlay, assuming 1% risk allocation	38bps	• Active FX management can be thought of as an uncorrelated source of return • This diversified return stream is scalable, given the depth of the FX market, but risk factors must be managed • This strategy requires in-house macro skill or selecting an effective manager
GTAA		Liquid market asset allocation	Based on long-term GTAA estimate from a 100 bps tracking error representative account.	72bps	• This is implemented through an overlay framework or funded allocation • The CIO function may focus on tactical macro investing • Ongoing scrutiny of strategic and tactical positioning is necessary
Active Security/ Manager Selection		Active security/manager selection in stocks and bonds	Based on long-term active manager selection estimate from a representative account.	35bps	• Moving from passive to active funds or factor strategies means that manager selection skills are important • Fee differentials have narrowed, and the environment for active managers has become more favorable • Upside to active management estimates in some markets, especially international equities and non-core real assets
Real Assets (15% allocation)	**Allocation**	Return uplift from median manager	Incorporating a 15% weight spread equally across Global Core Real Estate and Global Infrastructure. Our LTCMAs forecast median manager returns.	47bps	• Begins to monetize the illiquidity risk premium, adding a return stream with low correlation to core assets • The pandemic has raised questions about real estate, but we see an attractive environment for real assets • Illiquidity is the real concern, and may be a constraint for some funds • The income return stream may offset the loss of income from bonds
	Alpha	Return uplift from top-quartile manager	Incorporates a higher return for real assets accounting for a top-quartile manager's performance.	15bps	• Manager selection is perhaps the most important skill required for successful investments in real and private assets • Outsourcing is possible, with the appropriate governance processes developed • Estimate based on core real asset markets only
Private Assets (15% allocation)	**Allocation**	Return uplift from median manager	Incorporating a 15% weight spread equallty across Private Equity and Direct Lending. Our LTCMAs forecast median manager returns.	48bps	• Investing in private assets offers the largest potential return uplift per unit of risk • Illiquidity is the key risk to manage • The perception, possible among plan members and trustees, that private assets are extremely risky, is a concern • Outsourcing is possible, with the appropriate governance processes developed
	Alpha	Return uplift from top-quartile manager	Incorporates a higher return for private assets accounting for a top-quartile manager's performance.	75bps	• Manager selection is perhaps the most important skill for successful investments in real and private assets • Outsourcing is possible, with the appropriate governance processes developed

Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of June 2021. Forecasts refer to our 2021 LTCMA projections. Real Assets include Real Estate and Infrastructure. Private Assets include Private Equity and Direct Lending. Note that GTAA and FX overlay assume a 100% of portfolio overlay; international equities assumes a market-cap weight optimized allocation; and real assets/PE are capped at a 15% allocation – hence the numbers are not directly comparable one lever to another, but instead build up from the baseline return following these parameters.

or manager selection can be higher: In real assets, the gap between a top-quartile and a median manager in extended real estate is 10 times larger than it is for core real estate; and within some international equities markets, a top-quartile manager can add as much as 300bps above a median manager. Our estimates in the table therefore represent only a modest assessment of the potential impact of active manager and security selection.

APPLYING LEVERAGE, WEIGHING TRADE-OFFS

A final consideration that can be applied either at the overall portfolio level or within individual components is leverage. This can be achieved directly or via various derivative and overlay strategies. In our view, applying leverage to address the shortfall from negative real yielding assets in the fixed income allocation could be prudent, especially earlier in the cycle, when liquidity is abundant. The potential uplift from leverage, of course, depends not only on the degree of leverage adopted but also on the extent it is deployed across the portfolio and the implied cost of funding—all of which will vary greatly from one plan to another. Nevertheless, leverage potentially offers another angle to boost returns toward the 7% threshold for some portfolios.

Overall, investors would need to consider several of these building blocks to realistically approach a 7% return target. Common trade-offs include the need to build deep manager selection capabilities, a re-evaluation of the benefits of active management across a range of overlays, and monetizing illiquidity premia. Building manager selection skills is essentially a decision about staffing and organizational design that may well be within a manager's broad remit. The decisions to consider active investing styles and to monetize illiquidity premia—as well as decisions around currency and international exposures—may be subject to the views of plan sponsors, plan members, trustees and regulators. Nevertheless, we believe that the merits of these building blocks for achieving a 7% return target provide a valid premise for exploring and questioning prevailing investment constraints.

THE ROLE OF BUILDING BLOCKS IN DIFFERENT PHASES OF THE ECONOMIC CYCLE

As with different asset classes, the different investment approaches that we have described likely lend themselves to some economic environments more than to others. Today, we think of the economic cycle in four phases: early cycle, mid cycle, late cycle and recession. Our framework defines these phases by the level of output gap in the economy and uses a range of indicators to identify which phase the economy is in.

Early cycle often delivers the strongest equity returns as confidence and activity rebound from a trough amid easy financial conditions. An economy in mid cycle is roughly in equilibrium, showing few signs of supply constraint or exuberance. Late cycle is typically characterized by tightening financial conditions, some investor exuberance and, in some instances, corporate overreach (excessive capex, unrealistic leverage or deal making, etc.). Imbalances that grew over the cycle are forced to correct—often violently—during recession. The recession phase often starts with a slump in equity markets, but it is worth noting that markets generally start to rebound up to two quarters before an economy exits recession.

EXHIBIT 8 lays out the phases that may favor particular building blocks. We're not suggesting that plan sponsors become macro soothsayers, attempting to predict the direction of the economy. Instead, we think that understanding the alignment between economic environments and alpha engines may allow for some tactical flexibility to emphasize and deemphasize strategies across time and business cycles.

On balance, we believe that the adoption of active investing—GTAA or active security selection—and sound manager selection skills are generally evergreen. Similarly, active FX overlay is less governed by the cycle phase. It can be useful throughout the economic cycle as investors move from defensive to high carry currencies and back. By contrast, leverage is probably best deployed in early and mid cycle phases, when capital is cheap and plentiful, and the opportunity to boost both cyclical and secular returns is higher.

For private market investments, the early and mid cycles may offer the strongest returns upside, while tightening liquidity in late cycle could present a headwind. However, during recessions private market assets can have a dampening effect on portfolio volatility due to the lower frequency of price reporting. Provided the liquidity needs of the overall portfolio do not force the liquidation of private assets, during stock market sell-offs such exposures may be less troubling to portfolio-level information ratios than public equities would be.

EXHIBIT 8: PORTFOLIO BUILDING BLOCKS AND ECONOMIC CYCLE CONSIDERATIONS

Building block	Early cycle	Mid cycle	Late cycle	Recession
International equities	Extends opportunity set beyond domestic U.S. equity; economic rebounds can favor more cyclical markets outside U.S.	Extends opportunity set beyond U.S.	Extends opportunity set beyond U.S.	Bid for USD in times of weakness may weigh on unhedged international exposures
Active FX overlay	Scope to capture exposure to cyclical and higher carry currencies	Potentially uncorrelated return source, though returns will likely be lower if volatility is muted		FX valuation strategies tend to perform in recession, as imbalances correct; Scope to capture safe haven bid for USD, CHF, JPY
GTAA	Relevant in all cycle phases			
Active security selection	Active equity alpha may be strongest in early and middle phases of cycle, where emphasis on earnings recovery is strongest; later-phase active management can be used well to play rates cycle			Higher correlations associated with recessions a possible headwind for active alpha
Real assets	Relevant in all cycle phases – note that income stream from real assets can remain strong in recessions and the drawdowns (ex-global financial crisis) are manageable within the income streams to keep returns broadly positive			
Private assets	Relevant in all cycle phases provided illiquidity is planned for; in recession phase, lower "accounting vol" can have dampening effect on portfolio volatility compared with public market equivalents			
Leverage	Credit spread may be costly but rates low, becoming favorable for leverage – especially as real yields in bonds may be very poor	Rates typically low, high liquidity/low volatility environment, favorable for leverage	Rates may be rising, and financial conditions starting to tighten; reduces benefit of leverage	Avoid leverage, as recessions/ bear markets often start with a liquidity crunch

Source: Bloomberg, J.P. Morgan Asset Management Multi-Asset Solutions; data as of June 2021. Forecasts refer to our 2021 LTCMA projections. Real Assets include Real Estate and Infrastructure. Private Assets include Private Equity and Direct Lending. Note that GTAA and FX Overlay assume a 100% of portfolio overlay; international equities assumes a market-cap weight optimized allocation; and real assets/PE are capped at a 15% allocation. As a result, the accompanying return uplift is not directly comparable from one discrete return driver to another. In this analysis we have focused on returns. Each return driver has a different risk profile which may have a positive or negative impact on portfolio level risk, and as such should be managed prudently. Each return driver aims to monetize a type of risk (e.g. liquidity) other than simple market risk.

ADDING VALUE BY THOUGHTFULLY RELAXING INVESTMENT CONSTRAINTS

As our analysis has shown, investors seeking to reach their return objectives will benefit from a global opportunity set, active management, tactical flexibility and the use of illiquid investments. In many cases, however, there are operational limitations on the extent to which these tools can be deployed. This raises an important question: Are these constraints the result of sound risk management or some less justifiable rationale, such as habit? In some cases, it seems clear that habit is the critical factor. Thoughtfully reconsidering these investment constraints may allow further gains in portfolio performance and efficiency.

In the following section, we examine how investors can use the building blocks we have discussed—international equities, FX overlay, GTAA and so on—to realize those further gains.

Going global the right way

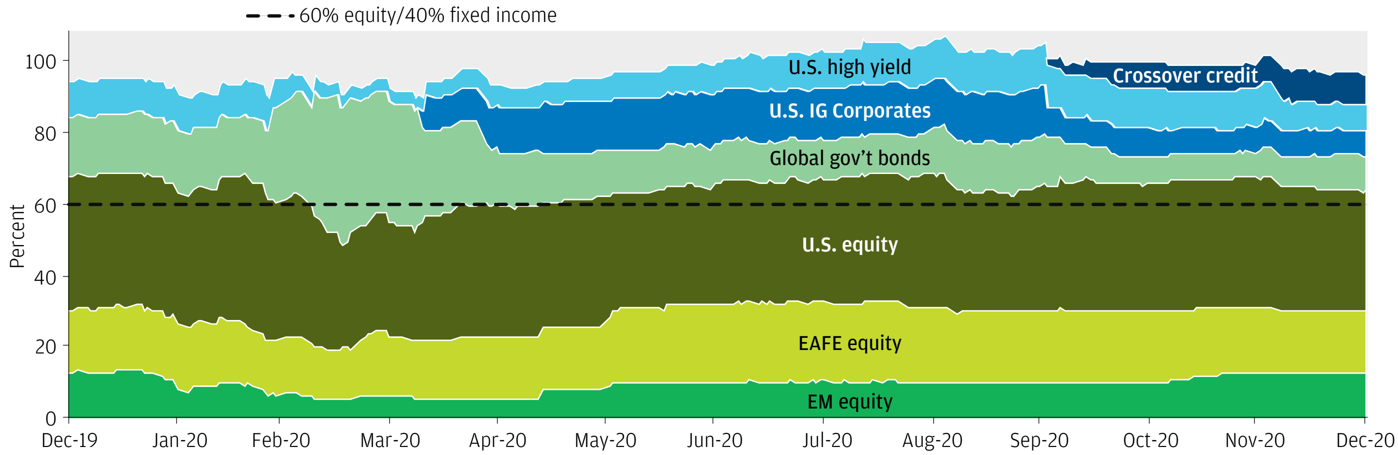
Home country bias is a widely observed phenomenon in asset allocation. For many U.S.-based investors, this seems like a benign phenomenon insofar as U.S. markets offer a breadth of investment opportunities sufficient to meet return and diversification needs. While portfolios often include certain non-U.S. sectors, such as global equity and emerging market (EM) equity and fixed income, these allocations tend to be small and frequently tactical in nature. This approach limits the benefits that a more "full-spectrum" global allocation can provide. We highlight three key areas for improving non-U.S. investment allocations:

- **Don't let currency risk be a barrier to global investing.** Currency volatility is manageable at the manager level or via a strategic overlay across the full allocation. Non-U.S. investors have been using the latter model for many years, and it can have powerful benefits with respect to separating bottom-up investment opportunities from top-down macro volatility. We explore passive hedging of international assets further in "To hedge or not to hedge, that is the question".

- **Cap-weighted fixed income benchmarks are a bad idea.** Cap-weighted passive indices have an obvious flaw, overweighting the most indebted countries/issuers. Active management, with its flexibility to move across global markets, is a superior approach and can be combined with

Investors can preserve a portfolio's overall risk posture while allowing more flexible exposures

EXHIBIT 9: DYNAMIC ASSET ALLOCATION VS. 60/40 BENCHMARK



Source: J.P. Morgan Asset Management. Allocation data ranges from 12/31/2019 to 12/31/20; Total Equity Includes Alternatives. The Fund is an actively managed portfolio, holdings, sector weights, allocations and leverage, as applicable are subject to change at the discretion of the Investment Manager without notice. Past performance is not an indication of current and future performance.

currency hedging to ensure that FX volatility does not overwhelm the fixed income returns themselves.

- **A structural underweight to China is probably not a good idea.** Common global and EM benchmarks underweight China's domestic equity and fixed income market shares relative to both economic activity and market capitalization. An unconstrained global or emerging market strategy that has the capacity to scale up China exposure closer to its true economic weight (or beyond) offers one practical means of fixing this problem. Alternatively, a dedicated exposure to onshore assets (such as the China A-share market) offers a more targeted approach.

Active management and tactical flexibility are not the same thing

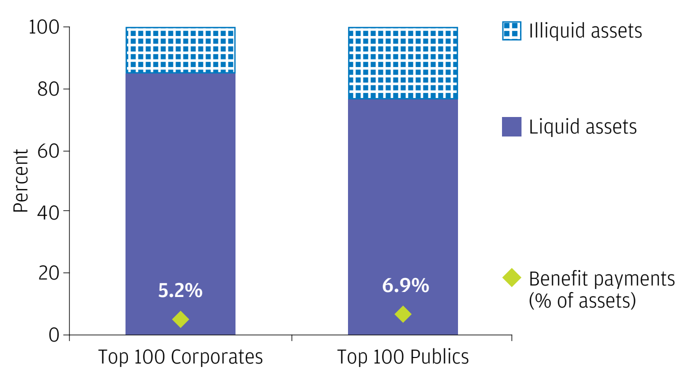
The benefits of active management are widely understood, although investors hold varying views about how durable manager-level alpha can be within different market sectors. Regardless, the scope for realizing the benefits of an active manager's investment skill is typically limited to a single market sector and a single market benchmark.

However, investors often overlook the value of real-time investment flexibility across market sectors. This may well be a legacy of a strategic asset allocation process built around long-term capital market assumptions, as well as operational and skill constraints that prevent short-term responses to asset price volatility. On this point, we are clear: Failing to take advantage of tactical flexibility is absolutely a missed opportunity.

- Multi-asset strategies can be managed against a strategic benchmark, preserving the overall risk posture of the asset allocation while allowing more flexible exposures across markets.
- A tactical asset allocation strategy can deliver higher potential returns and preserve portfolio-level liquidity.

Most institutions can take on larger allocations of illiquid assets

EXHIBIT 10 : BENEFIT PAYMENTS RELATIVE TO LIQUID ASSETS FOR THE TOP 100 CORPORATE AND PUBLIC PENSION PLANS



Source: J.P. Morgan Asset Management. Data reflects 100 largest publicly sponsored corporate pension plans and 100 largest public pension plans by assets. Corporate plan data is sourced from 10-K filings and public plan data is sourced from the Public Plans Database (PPD). All data as of 12/31/2000.

- Using liquid market exposures and avoiding portfolio-level leverage allow tactical/dynamic asset allocation strategies to scale up far beyond the level that would be prudent for a global macro hedge fund or similarly dynamic strategy elsewhere in the allocation.

In **EXHIBIT 9**, we illustrate the benefits of dynamic asset allocation relative to a 60/40 benchmark.

Right-sizing the illiquid asset pool

Illiquid alternatives—such as private equity, private credit, real estate and infrastructure—offer some clear benefits: the potential for higher returns than public markets, along with diversification from a broader mix of underlying investments. Their risks are more difficult to characterize. Historical volatilities are muted by the stickiness of asset prices, which can make these investments appear less risky than they truly are. Tail risks and manager dispersion are both idiosyncratic and hard to generalize. Nonetheless, investors have gotten comfortable with the broad risk and return characteristics of illiquid alternatives, which over many years have increased as a component of portfolios.

The attractiveness of the sector and its growing use in institutional portfolios make the sizing of the allocation a key concern for investors. Illiquid investments pose a risk to operational flexibility and specifically present the risk that an investor might be unable to raise liquidity when needed, or be forced to do so at a high cost. Fear of this outcome has constrained illiquid allocations to a relatively modest size, though there is good reason to think that investors have far more flexibility to move in this direction—particularly if they embrace the full spectrum of less liquid alternatives (**EXHIBIT 10**). Consider:

- Most institutions pay out 5%–7% of their assets annually, though this number can be smaller when netted against contributions and portfolio income. Illiquid allocations are rarely larger than 20%–25% of assets. Simple math suggests that there is room for larger allocations to these categories.
- Legacy exposures to private equity and real estate represent some of the least liquid sectors within alternatives. Private credit and core real assets frequently offer shorter average lives, better liquidity terms and greater income generation.

Capital efficiency and the role of leverage

The ability to replicate market exposures synthetically using futures contracts or total return swaps allows investors to become more capital efficient. By replacing passive exposures to equity or Treasuries with functionally equivalent derivatives, investors can free up capital to be redeployed elsewhere to increase returns. Among the potential approaches:

- An investor can redeploy the capital across the strategic asset allocation and thus increase the level of market exposure at the plan level. This is effectively leveraging the strategic allocation, allowing for higher long-term returns with essentially similar risk profiles.
- Further, if an attractive alpha engine with low correlations to the market beta can be identified, the combination of alpha and market beta can provide a return tailwind to what was formerly passive exposure.

We recognize the possibility that some investors might be unable to make use of the full toolkit we have described and therefore could still face a structural shortfall to the long-term 7% return target. The ability to deploy leverage at the plan level, or to add alpha to what was previously passive beta exposure, presents additional avenues to reaching a higher return.

CONCLUSION

In this paper, we have had two goals: first, to offer a justification for investors sticking with long-term return targets despite challenging markets; and second, to demonstrate that a variety of investment techniques can be added to a traditional market risk portfolio to increase the likelihood of success. On the first point, recall that while a market portfolio has comfortably met return targets in recent decades, a significant decline in bond yields has been a key cause—and a scenario that is unlikely to be repeated. The stark reality of low forward returns necessitates a more diversified approach to return generation. To that end, we have isolated specific, actionable steps that can be taken to incrementally diversify and increase investment performance. As investors consider which approaches may be best suited to their particular circumstances, it will be critical to evaluate the constraints—on global investments, currency risk, liquidity and leverage—that prevent the adoption of a more efficient and effective allocation.

FOR MORE INFORMATION

If you're interested in any of these services or other discussions and analysis, please contact your J.P. Morgan Asset Management Client Advisor directly or you can reach the authors of the paper by email at john.bilton@jpmorgan.com, jared.b.gross@jpmorgan.com, zachary.page@jpmorgan.com or timothy.lintern@jpmorgan.com.

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