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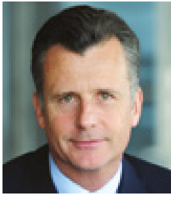
GLOBAL INSIGHTS • FEBRUARY 2017

Positioning for reflation

Asset allocation for U.S. pension funds

BLACKROCK®



Philipp Hildebrand
BlackRock Vice Chairman

Low expected returns pose a challenge to pension funds seeking to meet their liabilities. With this in mind, we present hypothetical model portfolios for U.S. corporate and public defined-benefit (DB) plans. They are the result of a collaborative effort between BlackRock Client Solutions, the BlackRock Investment Institute and BlackRock's investment teams. We plan to update and refine our asset allocation quarterly online to provide interactivity and more granularity within asset classes such as alternatives.

Edwin Conway
Global Head of BlackRock's Institutional Client Business

Richard Turnill
Global Chief Investment Strategist, BlackRock Investment Institute

In this publication, we detail how our model portfolios can help clients navigate today's reflationary environment and challenges such as low returns. We show how they differ from our long-term strategic allocations, and give general criteria for allocating to active and passive investments. Finally, we explain how a factor-based lens can help investors better understand portfolio exposures to macro-economic trends.

Summary

We have upgraded our five-year inflation expectations for the U.S. and UK against a backdrop of reflation taking root globally. We have increased our five-year assumptions for fixed income returns after yields spiked in the fourth quarter. Yet we believe investors are still being compensated for moving up the risk spectrum.

We introduce hypothetical model portfolios for U.S. public and corporate DB plans, and show how these five-year portfolios differ from our long-term strategic asset allocations. Our corporate model portfolio reflects an asset mix weighted toward fixed income due to a focus on its funding status. Our public portfolio allocates about 70% to public equities and alternatives because it concentrates on total return over time. Both portfolios are currently overweighting alternatives, non-U.S. equities, high yield and emerging market (EM) debt, while underweighting government bonds and U.S. equities relative to our strategic allocations.

The new reflationary regime means volatility and dispersion of returns are likely to rise, in our view, creating opportunities for skilled active management. Active strategies can be more effective in asset classes where specialist knowledge is key, managers have a track record of outperformance, the opportunity set is larger than benchmark indexes, and few liquid and low-cost passive alternatives are available. Think alternatives, credit and EM assets. We see a greater role for passive strategies in liquid assets: developed equity markets and plain-vanilla government bonds.

We break down the model portfolios into factors, gaining insights into their exposure to macro-economic trends. Our public portfolio has a large exposure to economic growth, reflecting hefty allocations to public equity markets. The corporate portfolio has more exposure to inflation and real interest rate movements. This is due to its greater allocation to government and corporate bonds. Both portfolios have higher exposure to economic growth, and less to rate and inflation changes, compared with our strategic allocations.

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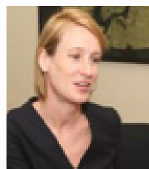
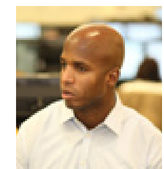




LEFT TO RIGHT

Gabriella Barschdorff – Strategist, BlackRock U.S. Client Solutions

Alain Kerneis – Head of Strategy and Market Views, BlackRock Client Solutions

Isabelle Mateos y Lago – Global Multi-Asset Strategist, BlackRock Investment Institute

Edward Ng – Head of Portfolio Management, BlackRock U.S. Client Solutions

Vivek Paul – Strategy and Market Views, BlackRock Client Solutions

Terry Simpson – Multi-Asset Investment Strategist, BlackRock Investment Institute

Market assumptions

We outline the drivers behind the recent changes in our capital market assumptions, including our raised expectations for global fixed income returns in the next five years. We then show why investors are still being paid to take risk in equities and alternatives.

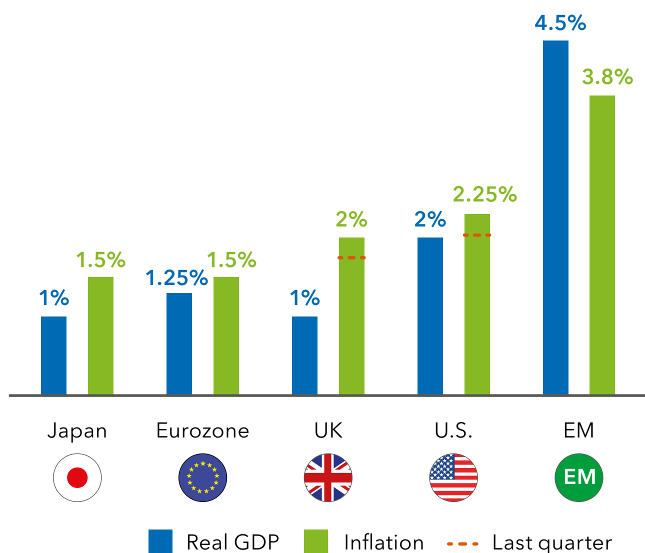
We believe the Federal Reserve will likely meet its inflation target – and may temporarily overshoot it. Reflation is real and has legs, as detailed in our ***Global macro outlook*** of January 2017. We have lifted our five-year assumptions for U.S. inflation to 2.25%, from 2% . We have raised our UK inflation expectations due to a weaker currency driving up the cost of imports, but see Japanese and eurozone inflation stuck at lower levels. See the green bars in the chart below.

We have left our global growth forecasts unchanged. Tax cuts or infrastructure spending could boost U.S. growth, yet much uncertainty clouds the timing and potential impact. President Donald Trump's plans could be watered down by fiscal conservatives or, conversely, lead to a surge in debt levels and interest rates that undermine growth. Rising protectionism also presents near-term risks to growth. Our growth expectations for the rest of the developed world are subdued. See the blue bars in the chart below.

We see structural factors, such as aging populations and weak productivity, weighing down potential economic growth. This should limit how high bond yields can climb, unless reforms push trend growth higher or inflation gets out of control.

Steady as she goes

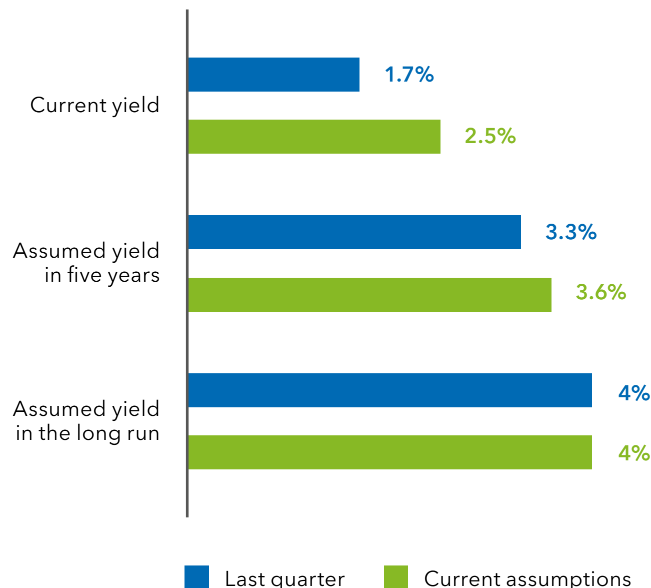
BlackRock's five-year growth and inflation assumptions



Source: BlackRock Investment Institute, February 2017.
Notes: The bars show BlackRock's annualized assumptions for economic growth and inflation (measured by consumer price index) for the next five years. The dotted lines show our inflation assumptions for the UK and U.S. as of September 2016.

A gentler climb

BlackRock's assumptions for 10-year U.S. Treasury yields



Source: BlackRock Investment Institute, February 2017.
Notes: Assumptions are for nominal yields on 10-year U.S. Treasuries. Past performance is no guarantee of future results. This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance.

Indeed, we still see 10-year U.S. Treasury yields settling at a relatively low 4% in the long run, partly as a result of these structural trends weighing on growth. See the bottom bars in the chart above. A rise in yields since our last update in September nudged up our expectations of where Treasury yields will stand in five years to 3.6%. The reflation-led rise in global yields implies that yields have a shorter distance to travel from today's levels. Essentially, market expectations are catching up with our assumptions. We now assume 10-year U.S. Treasury yields will rise by a total of 1.1 percentage points in the next five years, as the chart shows.

The recent decline in bond prices also means we now see moderately higher five-year returns for global fixed income. Our assumptions are based on how much income we expect from yields, and on a more favorable duration effect, or the impact of rising yields on bond prices.

Our bottom line: Yields have a shorter distance to travel to long-run levels – but it may not be a smooth ride.

Low returns ahead

Historically low rates and slow economic growth take a toll on prospective asset returns. Our ***capital market assumptions*** (CMAs) point to subdued returns for bonds – particularly government debt – albeit improved from a quarter ago. See the blue bars in the chart below. We still see rewards for owning riskier equities (green bars) and alternatives (orange), as detailed in ***A new paradigm for portfolios*** of October 2016. Note that our CMAs reflect assumed returns from market exposure (beta); they do not take into account returns we expect from security selection.

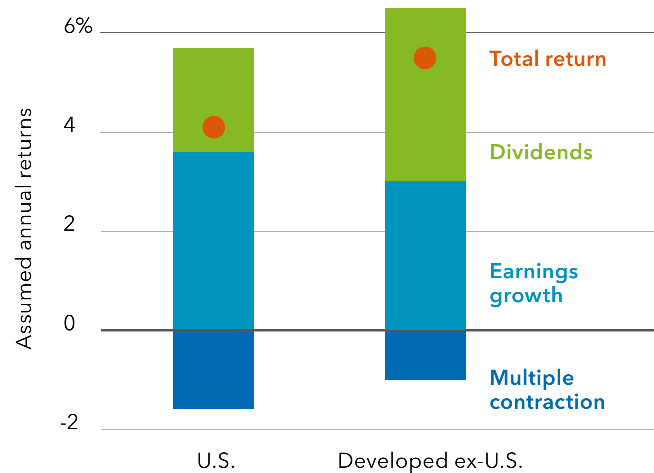
Our equity return assumptions are largely unchanged since our last quarterly update. Despite stretched valuations, we see higher inflation supporting stock returns via improved nominal earnings growth. Our preference for international equities over the U.S. market is driven by relatively lower valuations and higher assumed dividend payouts of 3.4% a year. See the chart on the right. We see corporate earnings growth outside the U.S. slightly lagging that of the U.S. market on a five-year horizon, but see scope for non-U.S. profits to rebound from depressed levels in the short run.

We see a larger valuation drag on U.S. equity returns, reflected in the expected contraction in price-to-earnings multiples. This is a result of strong performance and elevated valuation multiples today. U.S. earnings growth has downside risks in the case of further strength in the U.S. dollar.

Selected alternatives can diversify portfolio risk, in our view, and have the potential to provide additional returns from active management in an otherwise low-return landscape.

Value beyond U.S. equity shores

BlackRock's five-year equity beta return assumptions

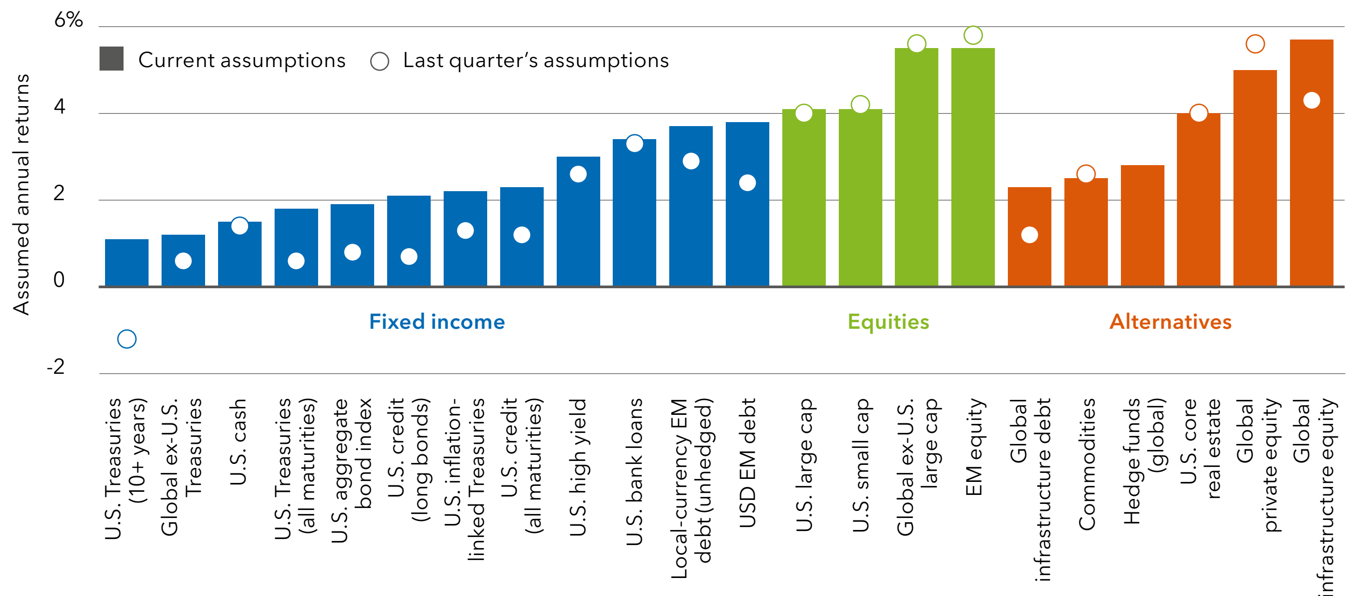


Source: BlackRock Investment Institute, February 2017.
Notes: This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even an estimate - of future performance. The U.S. is represented by the MSCI USA Index; developed ex-U.S. by the MSCI World ex-USA Index. Returns are unhedged and in geometric terms from the perspective of a U.S. investor. Indexes are unmanaged and used for illustrative purposes only. They are not intended to be indicative of any fund or strategy's performance. It is not possible to invest directly in an index.

Our bottom line: Our expectations for fixed income returns have improved, but we believe investors are still better compensated for taking risk in equities and alternatives. International equities and selected alternatives look attractive relative to U.S. stocks and most global fixed income .

Paid to take risk

BlackRock's five-year beta return assumptions for selected asset classes



Source: BlackRock Investment Institute, February 2017. Notes: The bars show annualized nominal return assumptions for the next five years from a U.S. dollar perspective in geometric terms. For representative indexes used, see our ***Capital Market Assumptions website*** at www.blackrock.com/institutions/en-us/insights/portfolio-design/capital-market-assumptions. Indexes are unmanaged and used for illustrative purposes only. They are not intended to be indicative of any fund or strategy's performance. It is not possible to invest directly in an index. This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise of future performance.

Asset allocation

We introduce hypothetical model portfolios for corporate and public U.S. DB pension plans that are informed by our five-year return assumptions. We show how these U.S. portfolios differ from our long-term strategic allocations; discuss whether to take a passive or active approach; and evaluate the portfolios' exposures to macro factors.

The prospect of compressed returns is somewhat depressing. Consider that a standard 60/40 equity/government bond portfolio will generate an average annual return of just 3.6% in the next five years, according to our CMAs. This means it could take a U.S. corporate pension fund 15 years or more to reach a 100% funding rate relative to its current liabilities, from an average funding rate of 80% now.

What to do? We introduce a hypothetical asset allocation for U.S. DB plans that we believe can generate higher returns at only slightly higher volatility over a five-year horizon.

Our hypothetical corporate portfolio aims to control volatility in its funding status through allocations to long-dated bonds while also seeking to shrink its funding deficit versus liabilities. It has a beta return assumption of 4.2% a year. Our hypothetical public portfolio focuses on a high risk-adjusted total return, and assumes 4.7% annualized returns. As a result, it allocates less to bonds than our corporate portfolio.

Our starting points are our long-term strategic allocations for both types of plans. These are based on our equilibrium assumptions for asset returns, volatility levels and correlations, as detailed in our ***CMA methodology*** paper of February 2016.

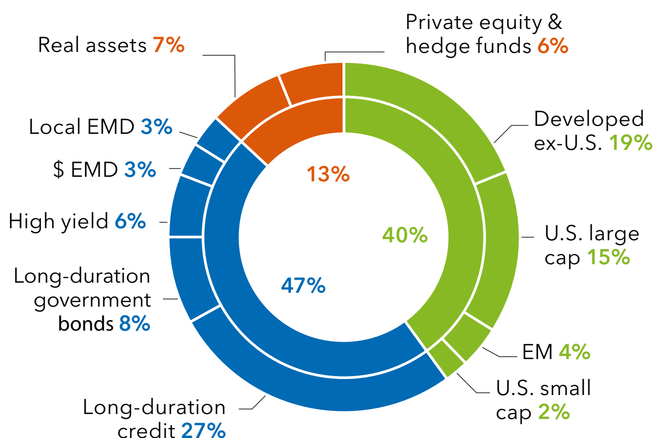
We then adjust these strategic allocations to give greater weight to our five-year CMAs, while staying at comparable volatility levels to our long-term allocations. In other words, we are overweighting asset classes that offer, in our view, higher risk-adjusted returns and underweighting markets that we believe have weaker prospects over the next five years.

How does this work out for our model corporate portfolio? The left chart below shows we are allocating a total of 47% to fixed income (blue), 40% to equities (green) and the rest to alternatives (orange). The bottom right chart shows how these allocations differ from our strategic allocation: We overweight alternatives, non-U.S. equities, high yield and EM debt, and underweight government bonds and U.S. equities.

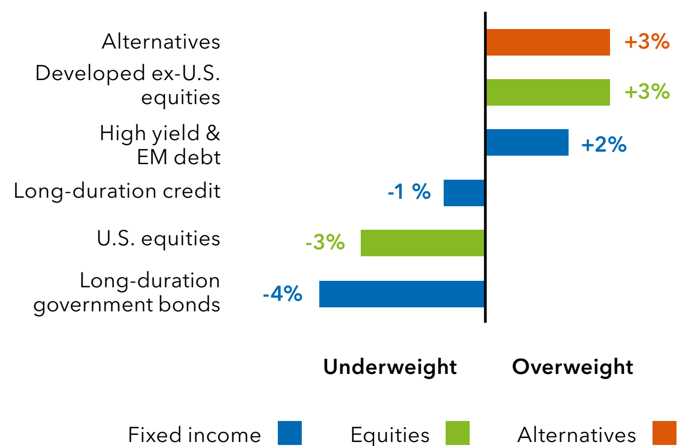
Tweaking the corporate mix

Hypothetical model five-year portfolio for corporate U.S. defined-benefit plans

Five-year corporate plan allocation



Difference with long-term strategic allocation

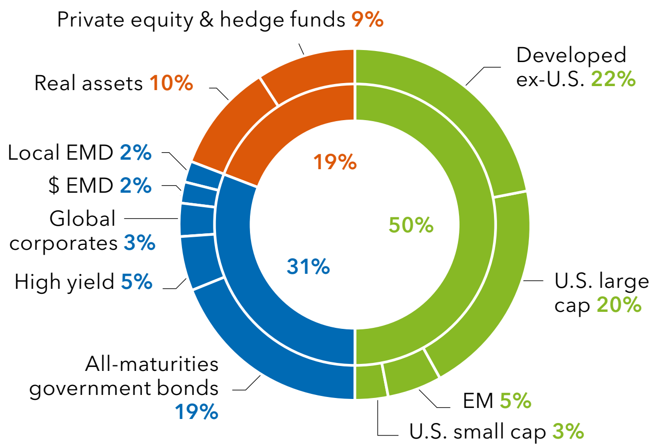


Sources: BlackRock Investment Institute, February 2017. Notes: The chart shows a hypothetical model asset allocation for a corporate U.S. defined-benefit plan. It assumes a funding ratio of approximately 80% and a mature liability duration of around 12 years. The left chart shows the detailed breakdown of our current model portfolio for a five-year horizon. The right chart shows how this portfolio deviates from our assumed long-term asset allocation for corporate plans in percentage points. Our U.S. model portfolios may differ from those for non-U.S. investors, are intended for information purposes only and do not constitute investment advice.

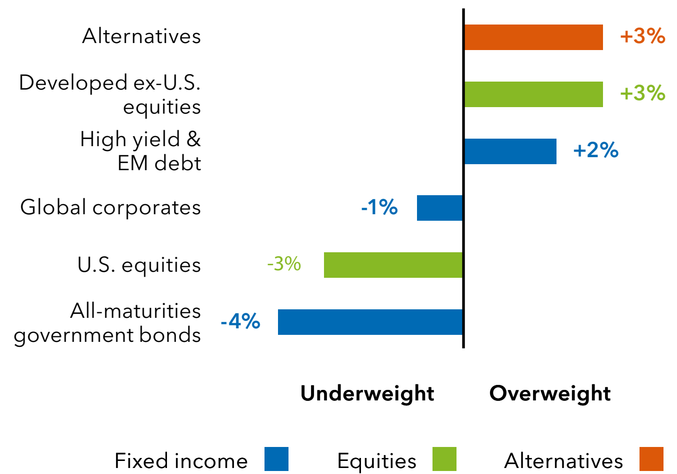
Tweaking the public mix

Hypothetical model five-year portfolio for public U.S. defined-benefit plans

Five-year public plan allocation



Difference with long-term strategic allocation



Sources: BlackRock Investment Institute, February 2017. Notes: The chart shows a hypothetical model asset allocation of a public U.S. defined-benefit plan. The left chart shows the detailed breakdown of our five-year model portfolio. The right chart shows how this portfolio deviates from our assumed long-term asset allocation for public plans in percentage points. Our U.S. model portfolios may differ from those for non-U.S. investors. They are intended for information purposes only and do not constitute investment advice.

Our model portfolio for public plans allocates nearly 70% to equities and alternatives, as the left chart above shows, due to its focus on total return. We are essentially over- and underweighting the same asset classes as in our corporate portfolio, as the right chart shows.

What are the key views underlying our model portfolios? Our ***Weekly Commentary*** outlines our short-term views, while our quarterly ***Global investment outlook*** spans a slightly longer period. These views feed into our five-year CMAs but can also differ due to the shorter time horizon. Highlights include:

Equities: We prefer non-U.S. stocks within our overall equity preference. These stocks have historically outperformed in periods of global reflation, we find. Investors also still appear lukewarm toward overseas markets, which we take as a contrarian signal. They also currently overstate European political risks, in our view. We advocate hedging the currency risk of these exposures as higher U.S. growth and inflation could translate into a stronger dollar.

Credit: We like credit with a yield buffer against capital losses in a rising-rate environment, so are overweight EM debt and high yield on a five-year basis. Yet we acknowledge the credit cycle is maturing and valuations have run up, so we currently want to avoid excessive credit risk. This is why we prefer investment grade and higher-quality, short-duration high yield in the short term. Similarly, we are neutral on EM debt in the short run, and prefer to gradually increase allocations to selected EM credits over time.

Alternatives: We believe active management has potential to harvest illiquidity premia and generate additional returns.

Active or passive?

Many active managers underperformed their benchmarks net of fees in recent years as a global flood of central bank liquidity suppressed volatility. At the same time, cost-effective and sophisticated passive strategies mushroomed. The new reflationary market regime means volatility and dispersion of returns are likely to rise, in our view, creating opportunities for skilled managers. When considering active strategies, we suggest asset owners start by asking three key questions:

1. Does investing in this asset class require specialist knowledge, or are there other barriers to entry that would enable active managers to have an edge?
2. How has the average active manager performed historically in this asset class?
3. Are there liquid, cost-effective passive vehicles with minimal tracking error in this asset class?

Within equities, we advocate greater allocations to passive strategies in liquid developed markets that offer a wide range of cheap beta exposures. We emphasize active in small caps or EM where in-depth research is needed, the opportunity set is greater than benchmark indexes, and passive vehicles are scarce or expensive. Similarly, we see a greater role for passive in most government bonds, but prefer a larger active allocation to credit and EM debt. In alternatives, asset owners for now have little choice but to go active.

Active investing creates winners and losers, so manager selection is key. Yet it is important to evaluate active strategies on how they affect the *total* portfolio. Diversification benefits typically dissipate and monitoring costs rise once asset owners hire many managers per asset class, we find.

Factoring in factors

We break down the exposures of our model portfolios into factors, which we define as broad and persistent drivers of investment risk and return. We track seven factors that represent inflation, real rates, economic growth, credit, EM, currency and commodity risks. These factors explained more than 95% of the variability in returns across 13 global asset classes over the period from 1997 to 2015, our research shows.

Certain investments represent specific views on underlying factors. One example: An investment in a corporate bond is essentially a bet on real interest rates, inflation and credit risk. Viewing investing through a factor lens offers several benefits, we believe:

- Factors provide a common language to understand risk exposures within and across asset classes in public and private markets, including illiquid alternatives.
- Diversifying portfolios across factors can help reduce risk, in our view. Individual return drivers have historically had relatively low correlations with each other – and have performed well in different parts of the economic cycle, our analysis suggests.
- Delving into factor exposures helps us better understand how portfolios might perform under different economic scenarios.

Bottom line: A factor-based approach to investing can help investors recognize their portfolio's underlying return drivers, balance out risks and stress-test scenarios.

Inflation and movements in real rates are the greatest factor exposures of our corporate portfolio, as the left chart below shows. Nominal government bonds and corporate bonds are sensitive to inflation, and our large allocation to these assets contributes to inflation being the dominant factor exposure. Inflation underweights in both model portfolios relative to our strategic allocations reflect our belief that fixed income valuations will modestly cheapen in the medium term, rather than a desire to reduce inflation exposure.

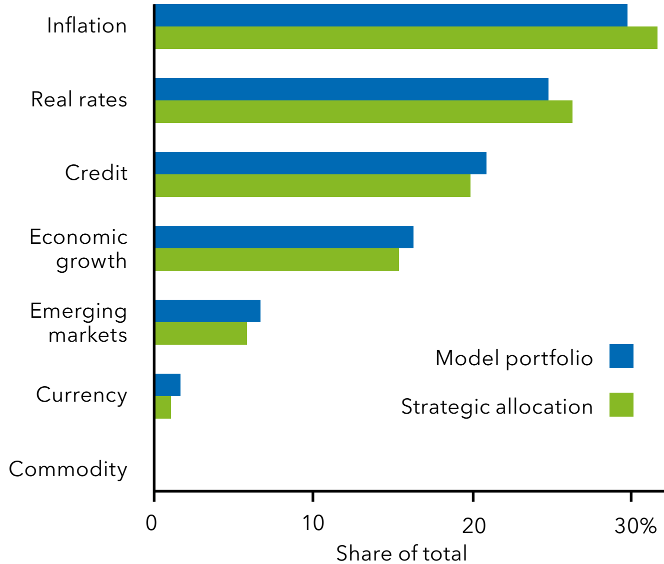
Our public model portfolio's largest factor exposure is to economic growth, as the right chart below shows. This reflects its relatively large allocation to public equities. Yet it also is the result of investments in alternatives. Higher weightings of these assets relative to our long-term strategic allocations have raised the portfolio's sensitivity to economic growth.

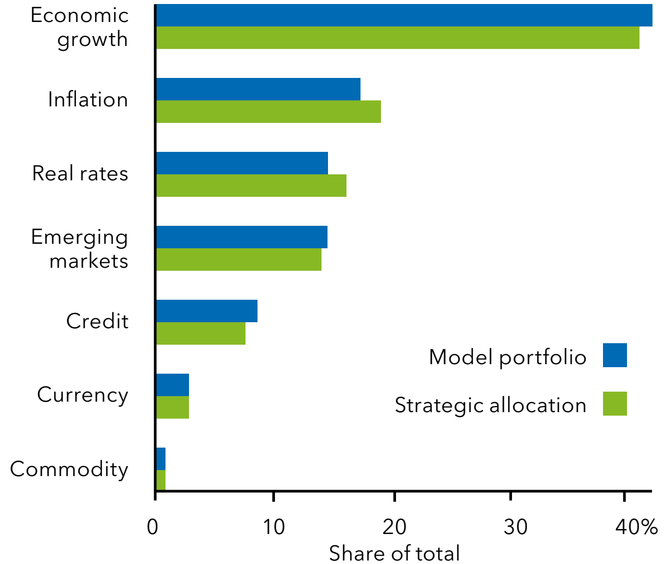
Factors enable us to stress-test the performance of our model portfolios under two macro scenarios: "growth surprises on the upside" and "growth disappoints." The former involves double-digit gains in equities, a global bond sell-off and a weaker dollar. The latter is a classic risk-off scenario, with double-digit declines in equities, falling bond yields and a rising U.S. dollar. How do our portfolios perform?

The public portfolio shows most variability due to its greater exposure to economic growth. A positive growth surprise results in a rough doubling of its assumed five-year performance, whereas a growth disappointment exerts a significant drag. The corporate portfolio shows a muted response due to its relatively conservative allocations. It slightly underperforms (versus the base case) in the positive scenario and takes a modest hit in the negative one.

Finding factors

Breakdown of factor exposures of BlackRock's hypothetical model portfolios vs. their strategic allocations





Sources: BlackRock Investment Institute, February 2017. Notes: The chart shows the breakdown of factor exposures of our hypothetical asset allocation for corporate (left chart) and public (right) DB plans. The factors are based on BlackRock's analysis of broad and persistent drivers of returns. For more information on factors, see BlackRock's ***factor investing website*** at www.blackrock.com/investing/investment-ideas/what-is-factor-investing.

BlackRock Investment Institute

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References to future returns are not promises or even estimates of actual returns a client portfolio may achieve. Assumptions, opinions and estimates are provided for illustrative purposes only. They should not be relied upon as recommendations to buy or sell securities. Forecasts of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. We believe the information provided here is reliable, but do not warrant its accuracy or completeness.

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