

BlackRock

The Portfolio of the Future

A spotlight on portfolio trends

An essential series of guides to effective portfolio construction

EDITION
01.

The era of heightened macro and market volatility calls for a new approach to portfolio construction. Since the beginning of this new regime in 2020, markets have continued to evolve and clients' business models have changed markedly leading to one of the most significant investment process transformations seen in a generation.

Against this backdrop, we believe that remaining anchored to the same investment habits of the past might limit an investor's ability to construct efficient multi-asset portfolios.

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The new investment environment calls for a profound rethink of portfolio construction and asset allocation practices.



The bar has been reset, and it is much higher

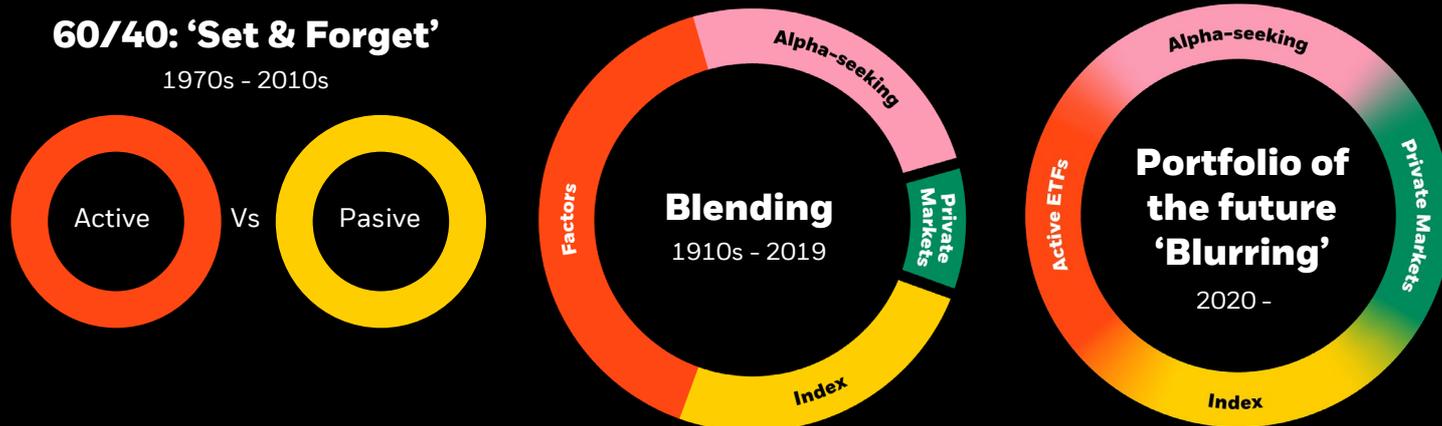
Profound changes are impacting the way institutions are building multi-asset portfolios. Investors are adjusting to a regime of greater volatility, uncertainty and divergence in market returns. While developed market central banks appear to have reached a peak in their tightening cycles, the era of ultra-low interest rates is in the past, and future expected returns look less attractive. There's less conviction about the path ahead: the range of estimates for key macro data, including inflation metrics, has grown wider. We believe excess returns over cash will be much lower for static exposures as a result.

Gone are the days of fixed, set and forget, regionally-constructed portfolio allocations, where product selection was dominated by

building blocks managed in silos – think public vs. private markets, and index vs. active strategies – and where ‘more or less every investment choice worked’ as equities and bonds often rallied together.

We believe we have entered a new phase of portfolios’ alpha being delivered through more dynamic asset allocation choices implemented through granular exposures, characterised by the blurring of lines across strategies and markets, and where investors are measured by end clients against a higher performance bar – which calls for transformative innovation.

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Embracing change: out with the old, in with the new

In the past, portfolio builders placed a great deal of emphasis and resources on selecting investment products. This often resulted in a siloed approach to portfolio construction, as investors adhered to false dichotomies such as ‘public vs. private markets’ and ‘passive vs. active strategies’.

For instance, index funds like ETFs were simply viewed by some as passive exposures and cheap beta building blocks, while the term ‘active’ equated to gaining exposure to alpha-seeking managers who were expected to deliver above-benchmark returns for the entire multi-asset portfolio. This approach led to inefficiencies in fee budget allocations and

shortcomings related to potential unintended tilts between the target and implemented portfolios. However, these inefficiencies were often overlooked due to the decades-long bull market in equities and fixed income, where almost any investment choice was successful.

In Europe, a gradual shift started to occur due to new regulations and changes in client demand. Over the past decade, we have seen greater focus on value for money and increased scrutiny of the products used to meet client objectives.

Traditional fee structures have become more transparent, leading to changes in distributors' revenue models. Technology has enabled new competition in the form of robo advisors and digital offerings that provided simple, cost-efficient portfolio solutions. The adoption of index strategies has increased, as investors have continued to decouple key drivers of portfolio returns and become 'active with their passive', using ETFs to place asset allocation calls. Investors have increasingly recognised the value of viewing the investment universe through a portfolio lens and expressing long-term market and factor choices through index vehicles, while allocating excess fee budget to acquire alpha excellence from managers skilled in timing exposures and security selection.

Since the pandemic, we have entered a new era characterised by heightened uncertainty and performance dispersion, which we believe will accelerate the evolution of portfolio construction practices. We see the fixed allocation public markets model to be significantly challenged right now and going forward. This is due to the increasingly frequent spikes in volatility, as well

as changing correlations between fixed income and equities, resulting in diminished diversification benefits in the whole portfolio. While private markets are not uncorrelated to public markets, or fully immune to the volatility we see, they could offer a differentiated macro risk and return profile and a different market dynamic, which can help to deliver a more resilient portfolio outcome for the future.

To be successful in this new regime, we advocate at a high level for the following shifts in approach:

- Getting more 'active' in portfolios through a more dynamic and granular asset allocation implemented through index and active, public and private market strategies.
- Monitoring risk and stress testing portfolio outcomes.
- Educating end investors focusing on the outcome, not the product.

Follow our series of short papers and videos for our views on how to succeed in the new regime: from implementing a different approach to asset allocation, to product selection, with the aim of building a successful portfolio for the future.

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