Expert Conversations Series

BlackRock

Getting it right

Tactical asset allocation under the new investment regime

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Setting the scene

Investors are facing a structurally different world. The era of stable growth and inflation is likely behind. We believe higher rates and greater volatility define the new regime. In the decade following the global financial crisis (GFC), investors could rely on static, broad asset class allocations for returns – and gained limited advantage from differentiated insights on the macro outlook. Today, we believe the flipside is true. Policymakers face tough trade-offs between inflation and growth – and can't respond to faltering growth like they used to. This leads to a wider set of outcomes, creating greater uncertainty and new challenges for investors, in our view.

Major economies experienced synchronized growth in the years right after the GFC. That began to change amid the European sovereign debt crisis and trade tensions later. The pandemic hypercharged growth dispersions. Rising inflation and policymakers' diverse actions to tackle specific challenges accelerated the trend. See the chart.

We believe the new, more volatile regime rewards a more dynamic approach to portfolios. We see a static asset allocation becoming less effective. Investment skill is more important today than in the 2010s, when high Sharpe ratios and negative correlations for stocks and bonds made it easier to build a diversified portfolio.

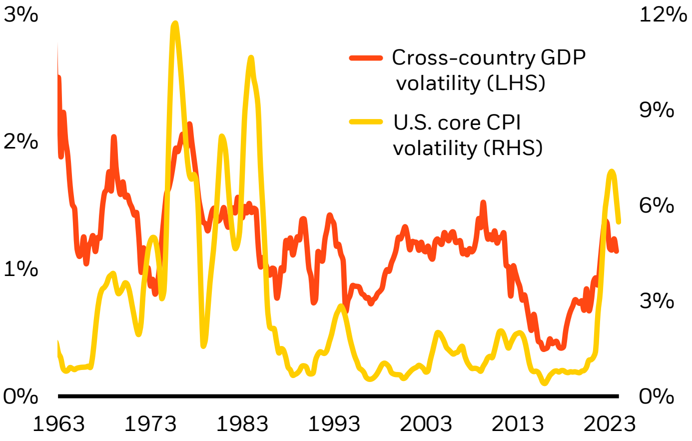
We believe that to get it right under the new regime, investors need to generate reliable, timely and efficient insights and calibrate portfolio exposures beyond broad directional views that worked reasonably well before. This may not be easy, but it is possible! Two veterans in asset allocation delve into the challenges and opportunities the new regime poses and the portfolio strategies they believe can optimize investment performance.

Highlights

- **A new regime of greater macro and market dispersion and volatility has displaced the 'Great Moderation,' a period characterized by stable growth, inflation and expansionary policies.**
- **The new regime leads to a wider set of outcomes, creating greater uncertainty and new challenges for investors. Static investment approaches and overreliance on beta for returns will likely struggle.**
- **Winning in the alpha game demands an active, dynamic approach that efficiently leverages data to generate insights, and sophisticated portfolio design with complementary sources of return.**

Climbing up

Volatility measures, 1963-2023



Source: Refinitiv Datastream, MSCI, and BlackRock calculations, as of 31 Dec. 2023. Global GDP volatility measures how individual developed countries' quarterly GDP changes deviate from the average GDP change of all developed countries, using a 3-Yr rolling average. U.S. core CPI volatility measures the standard deviation of U.S. core CPI using a 3-Yr rolling window. GDP: gross domestic product. CPI: Consumer Price Index. Neither asset allocation nor diversification can guarantee profit or prevent loss.

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What main challenges are multi-asset investors facing today?

There are many challenges, beginning with how to build a diversified portfolio and ensure it rests on a structured process that can be replicated and applied across multiple asset classes and markets.

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Not all investors have deep experience dealing with sustained, elevated macro and market volatility and dispersion. The new regime is more akin to the pre-GFC environment[1] than the suppressed interest rates, inflation and volatility period afterwards. We see this regime persisting as long as fiscal and monetary policy remain drivers of investor sentiment. It is now harder to build a reasonably diversified portfolio, and the rise of traditional asset class correlations and geopolitics, increasingly tied to economic outcomes, do not help either. This challenging macro backdrop sits atop two common challenges we hear from clients. 1. How to build robust portfolios that can meet their specific objectives, and 2. How to set up an efficient investment process that can evolve and adapt to a fast-changing world.

Challenges on portfolio construction and design

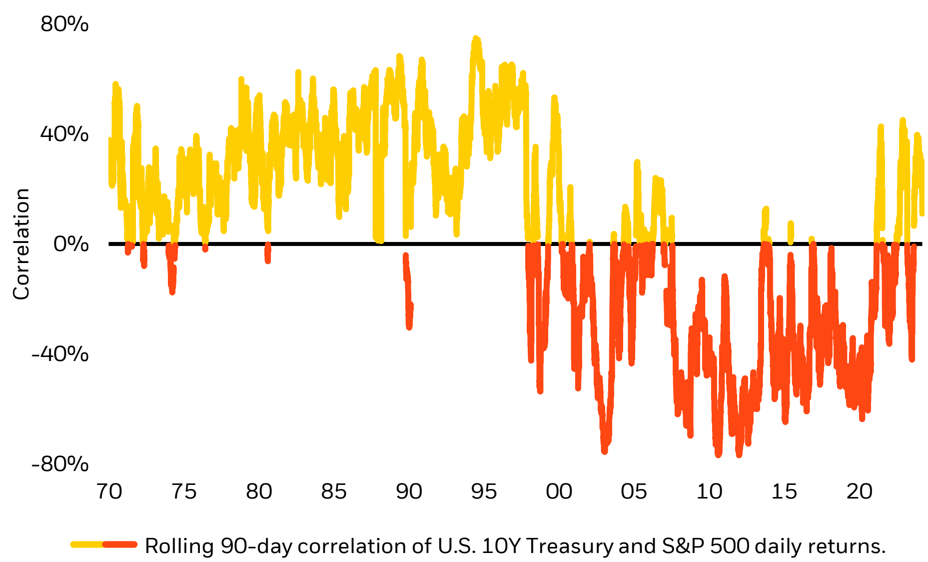
Stock-bond correlation. Higher asset class correlations relative to the past two decades can diminish the power of diversification. Investors must question what is an appropriate stock-bond mix in today's environment and, more generally, how their portfolios may benefit from combining different sources of return.

Cash rates. Cash offered low – in some cases negative – yields until early 2022[2]. However, as central banks pushed short-term rates significantly higher over the past 24 months, holding cash became attractive again. Investors' challenge now is deciding when returning to capital markets becomes worthwhile.

Illiquidity premium. Global investors can't usually hold 80% in assets that would take more than a year to sell. They seek a balance in capitalizing on illiquidity premia, holding a diversified mix of public and private assets - or liquid and semi-liquid assets - and aligning the resulting portfolio with their specific objectives and constraints. The high capital velocity that alters the liquidity risk premia muddles it.

Stepping back

Correlation of bond and equity returns, 1970-2024



Source: LSEG Datastream, chart by BlackRock Investment Institute, as of 19 Mar. 2024.

1. Refers to the period between the dot-com crash and the GFC, characterized by higher interest rates, inflation and volatility compared to the post-GFC to the pandemic period.

2. Bloomberg, short term yields (3M money market) across G20 countries.

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Challenges setting up an efficient investment process

Data quantity versus capacity and resources. Data availability isn't the big challenge anymore; how to process huge amounts of data is. Investors can struggle to transform data into actionable insights, and applying a process globally across countries, sectors and asset classes is often a challenge.

Data complexity versus expertise. Active investors can't rely exclusively on traditional, structured and headline data. Unstructured and alternative data sets often unleash powerful insights that give investors an edge, so long as they possess the required expertise in sourcing, processing and interpreting the data.

Cost efficiency versus opportunity set. It may be desirable to build a large-scale, well-resourced investment team with specialists in every asset class and market segment, but the initial and maintenance costs for an expansive platform turn prohibitive for many investors.

Alpha generation versus competitors. The 'smart money' usually has the upper hand in the zero-sum alpha game over smaller and/or non-professional investors. Such investors are more vulnerable to structural impediments and behavioral biases that pervade markets as they have less experience and resources than the professional market participants.

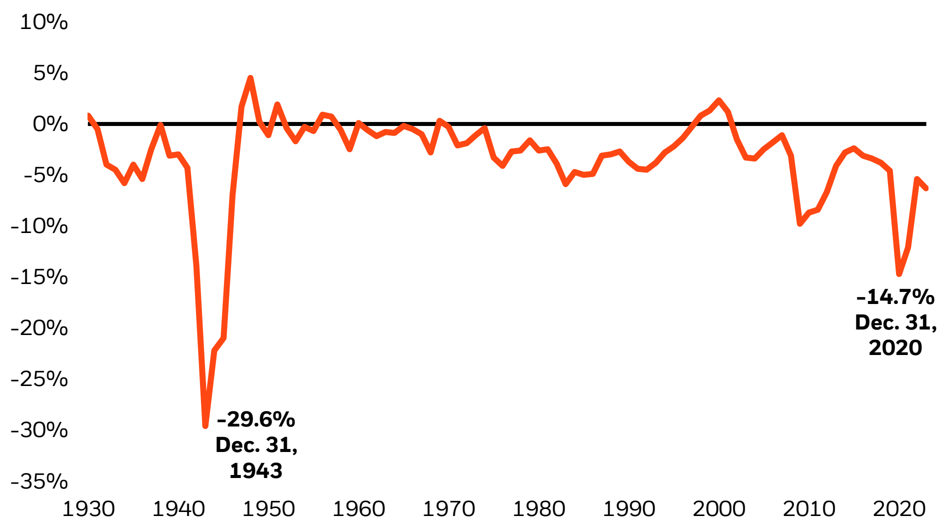
What is different about the macro landscape?

We are at an inflection point, departing from the vastly different macro setup of the past three decades.

Gone is the era of super expansive liquidity that started in 1987 with Alan Greenspan, Chair of the U.S. Federal Reserve Board until 2006. Mr. Greenspan piloted the 'Great Moderation,' a period marked by stable inflation, growth and a massive balance sheet expansion that accelerated dramatically throughout the pandemic. Central banks promoted and provided excess liquidity through various tools and means of monetary policy and added additional stimulus that flooded the financial system with excess liquidity. The Fed started unwinding its balance sheet, but it remains about twice as big as it was a decade ago, and the U.S. fiscal deficit is five times higher than the average between 1960 and the GFC. Deficits haven't reached recent levels outside major wars. See chart.

Deeply indebted

U.S. federal budget as a percent of nominal GDP, 1930-2023



Source: U.S. Treasury, Bloomberg, as of 31 Dec. 2023.

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The U.S. fiscal push aggravated pandemic-induced shortages and bottlenecks, sending inflation to untested levels since the 1970s. The extreme, extraordinary measures appear to be behind, and inflation has decreased after the recent spike and hypersonic-speed rate hikes to bring it down. Uncertainty will likely prevail thanks to sharp policy shifts and structural, longer-term dynamics, such as global fragmentation, artificial intelligence and policy and economic divergences, all of which pull the levers in various directions.

What's the path forward from here ?

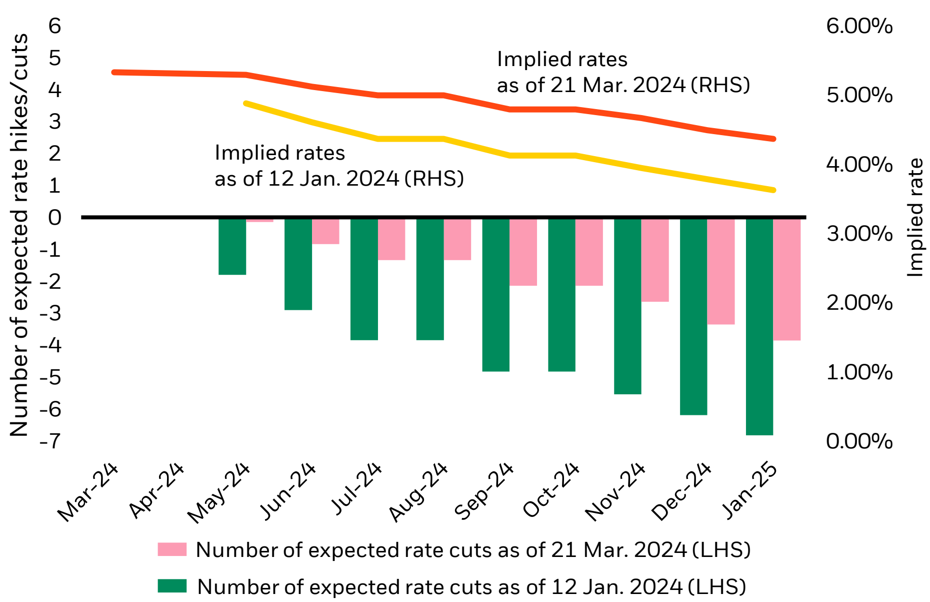
We see a policy driven environment continue to stoke dispersion and volatility across markets and asset classes. This creates challenges and opportunities for investors.

We see the path forward as highly policy-dependent. Policymakers' balancing act of taming inflation while preventing a recession manifests through hawkish monetary policy and very loose fiscal policy that has stoked volatility and investor angst. We believe interest rates will remain above average for as long as inflation remains a concern for central bankers, and the U.S. budget deficit will likely remain sky-high.

Debt monetization, the permanent rise of the monetary base to fund government spending, keeps the music going. No one believes this is sustainable in the long term, but for now, it is broadly supported by politicians from left to right. Debt monetization inevitably leads to inflation, eroding consumers' purchasing power and pressuring fixed income-bearing instruments. It can also lead to currency depreciation, reducing the value of investments denominated in that currency. Finally, it creates doubt about the future direction of monetary policy, leading to heightened volatility in financial markets. Investors notoriously overhype perceived pivots in policy direction. Earlier this year, U.S. stocks priced in about seven Fed rate cuts in 2024. Not anymore! Markets quickly adjusted expectations based on data flow. See chart. We believe that lack of global policy coordination as global monetary and fiscal authorities face different priorities may add further instability. These dynamics pose challenges for investors but also create opportunities for active asset allocators.

Shifting expectations

Fed funds futures implied rates, 12 Jan. 2024 and 21 Mar. 2024



Source: Chicago Board of Trade, Bloomberg as of 21 Mar. 2024. There is no guarantee that any forecasts made will come to pass.

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What opportunities does the current environment present for macro investors?

We believe the current market environment presents a benign backdrop for an active macro approach, as a result opportunities abound.

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We believe this is an exciting time for a global macro approach. As active macro investors, we seek to generate returns from diversified alpha sources without leaning much into market beta. Our conviction in macro investing as a suitable investment style in today's environment has empirical support. In nearly three decades, whenever interest rates have exceeded 2%, as they do now, macro investing has performed significantly better than cash and any other investment style in liquid alternatives, BlackRock research shows[1]. We don't see this rate environment changing drastically anytime soon.

We seek to add risk complementarily and are leery of approaches that source all or most of their portfolio returns from directional exposures. To benefit from the heightened dispersion, we like relative value – or as we call them 'cross-sectional' strategies that can add return and risk complementarily to what is often already in an investor aggregate portfolio i.e., exposure to traditional stocks and bonds.

Take the 85% return difference between the best-performing equity market in 2023 (Egypt) and the worst-performing (Thailand) within the MSCI All-Country World Index. Since 2017, the quarterly return gap between the best- and worst-performing markets was 37%, on average. See the chart below. Such dispersion alludes to the opportunities for trading equity allocations at a more granular level. The same is true across industries and sectors – for example, the return gap between technology and commercial real estate in 2023[2] – and other market segments. Large return dispersions also occur across asset classes, as the table on risk-adjusted returns illustrates. In short, we believe relative value trades can add a deeper, often complementary, dimension to asset allocation decisions.

Changing order

Risk-adjusted returns, 2020-2023

2020	2021	2022	2023
World Gov Bonds 1.5	US Equities 2.19	European Equities -0.58	Global HY Bonds 2.63
Global Corp Bonds 1.39	All Country Equities 1.78	US Equities -0.75	All Country Equities 2.11
AxJ Equities 1.13	European Equities 1.27	Japanese Equities -0.78	US Equities 2.00
Japanese Equities 0.95	Global HY Bonds 0.4	AxJ Equities -0.89	Global Corp Bonds 1.40
UST Ultra Long Bonds 0.87	EM Equities -0.16	All Country Equities -0.93	European Equities 1.35
Global HY Bonds 0.65	Japanese Equities -0.23	EM Equities -0.99	Japanese Equities 1.26
All Country Equities 0.62	AxJ Equities -0.29	UST Ultra Long Bonds -1.54	EM Equities 0.78
EM Equities 0.56	UST Ultra Long Bonds -0.32	Global HY Bonds -1.62	World Gov Bonds 0.70
US Equities 0.53	Global Corp Bonds -0.77	Global Corp Bonds -2.01	AxJ Equities 0.44
European Equities 0.2	World Gov Bonds -1.59	World Gov Bonds -2.09	UST Ultra Long Bonds 0.15

Source: Bloomberg, as of 31 Dec. 2023. The colors represent different asset classes, as represented by widely followed indices. Risk-adjusted return shown as total return over standard deviation. Columns display the highest to lowest risk-adjusted returns for the various asset classes.

Mind the gap

Dispersion of country equity returns, 2017-2023.

Source: BlackRock, data as of 31 Dec. 2023. **Past performance is not indicative of future results**. The chart above represent the best and worst performing equity return among countries represented in the MSCI All Country World Index (ACWI) for the respective quarter. Index returns do not deduct fees and expenses. Indices are unmanaged and it is not possible to invest directly in an index. Neither asset allocation nor diversification can guarantee profit or prevent loss.

1. Data from Bloomberg and Morningstar for the period 1994-2023, as of 31 Dec. 2023.

2. Bloomberg, S&P 500 information technology + 56.4%, real estate +8.27%, as of 31 Dec. 2023.

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What is required to generate alpha through asset allocation?

It isn't just one thing, but a combination of factors that must come together, starting with a philosophy to establish the places to look for potential alpha.

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Active investing is a zero-sum game. Positive alpha is funded from someone else's negative alpha. That means one's insights need to be better than someone else's. We believe that a clearly defined investment philosophy and approach to establishing where alpha sources live is a critical first step.

We consider financial-market inefficiency as the bedrock for alpha generation. Investors are notoriously ineffective at incorporating the macro backdrop into asset-class prices or asset returns. Market distortions can come from behavioral biases (e.g., recency bias and under-overreaction to events and/or news flow) and structural barriers (e.g., regulatory rules that keep investors off-limits or information asymmetries that hide valuable insights). These biases impede price discovery and market equilibrium. The resulting dislocations, discrepancies and divergences represent fertile grounds for harvesting alpha. Two challenges emerge. The first is to identify those potential sources; the second is to decide what to trade and how to do it efficiently and effectively. We believe a few factors underpin success in the alpha game.

Factors that can help investors get better at the alpha game	
People	You need to have sufficient expertise and experience in researching and developing original intellectual property. You need the knowledge to trade markets globally and across a variety of asset classes. Lastly, you need an efficient investment-decision framework across the group of investors – within a smaller or larger investment team.
Technology	You need to collect data systematically, cross reference and corroborate or challenge your insights. You also need to innovate and evolve constantly and incorporate new methods and technologies into the mix. The fast-spreading adoption of artificial intelligence and other technological advances signals how technology is increasingly a core part of investing.
Process	You need to have a scalable and effective process to move from idea generation to idea framing, and from critical and constructive discussion and debate to implementation. Investment processes and investment decisions should be fact-based and data-driven, built for consistency, and robust and nimble to enable tweaks and support enhancements.
Transparency	An effective investment framework enables and promotes transparency, allowing outside investors to easily understand the basics and nuances of the investment philosophy, process and strategy. Communicating investment decisions in a well-articulated and effective way is at the forefront of successfully managing capital for others.

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How do you maintain a competitive edge in this space?

Reliable data is the baseline, but insights, trading knowhow and market access bring ideas to implementation.

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Data is at the core and heart of investment decision-making. An investor wants the best, most relevant, most reliable data in the timeliest possible way. The challenge is quality control and effective data manipulation to draw accurate and meaningful insights and conclusions. It demands curating thousands of data sets and ten thousand data series into reliable, easily digestible indicators. This is crucial because much of your decision-making efficacy rests on the quality and reliability of your data sets.

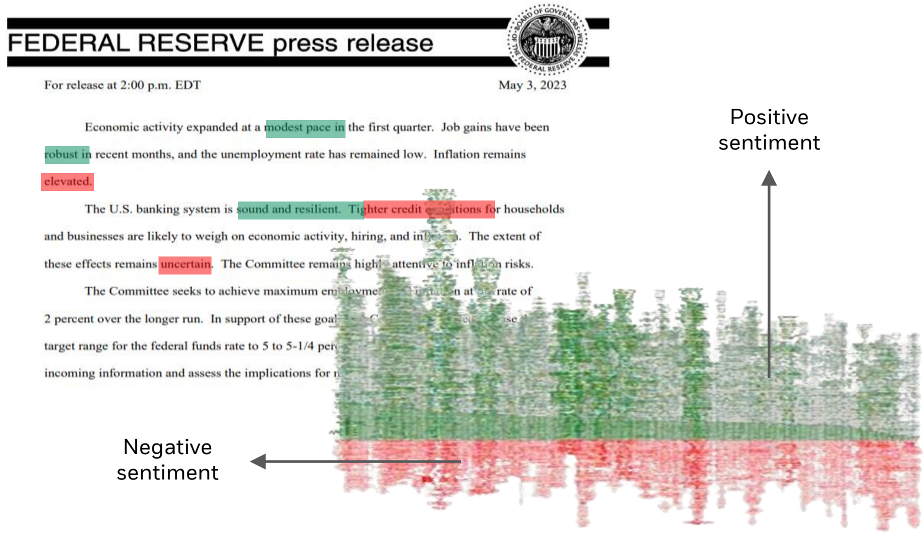
Our conversations with other investors often touch on sourcing, processing and interpreting data. Data access these days isn't just following economic releases that are widely available. Harnessing information from a wide range of traditional and non-traditional sources is key and applied technology plays a big role. We for example use text-based analysis to quantify central bank policy or measure market sentiment and market attention across many topics. See the illustration.

We corroborate – or contrast – insights from macro data across growth, inflation and policy with alternative sources, such as mobility data, satellite imagery and temperature or geospatial data. More recently, we've added machine learning and other artificial intelligence methods to our non-traditional data processing toolkit. One example among many is our use of large language models to process unstructured data sources. Each of our insights comprise qualitative and quantitative aspects, which we view as critical in generating alpha.

Beyond data, you need tools to cover markets holistically and comprehensively to create breadth in your insights. How else could you produce ideas on trading inflation in Poland or fiscal policy in Brazil? You need to know how to trade an idea – what instruments to use, and how to access the markets. How could you express negative views if you can only go long on trades? How could you express a positive view of the Indonesian economy effectively in your portfolio? We believe there are multiple ways to get a competitive edge in the alpha game and the current environment is optimal to apply them.

Policy insights

Keyword aggregation using large language models.



Source: BlackRock. For Illustrative purposes only, as of 31 Dec. 2023. The model offers another lens into sentiment analysis that is less subjective and less prone to biases.

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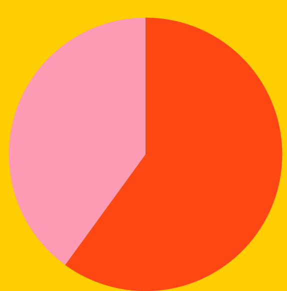
What last thoughts do you have for someone trying to win in the alpha game?

Adopt a more active, dynamic approach, that relies on forward-looking views and seeks to add risk complementarily across multiple alpha sources.

Typical allocation
The 60/40 portfolio



Portfolio returns

2017	15.4
2018	-5.5
2019	19.4
2020	16.0
2021	5.9
2022	-16.0
2023	15.4

Source: Please see source field for the chart on the right.

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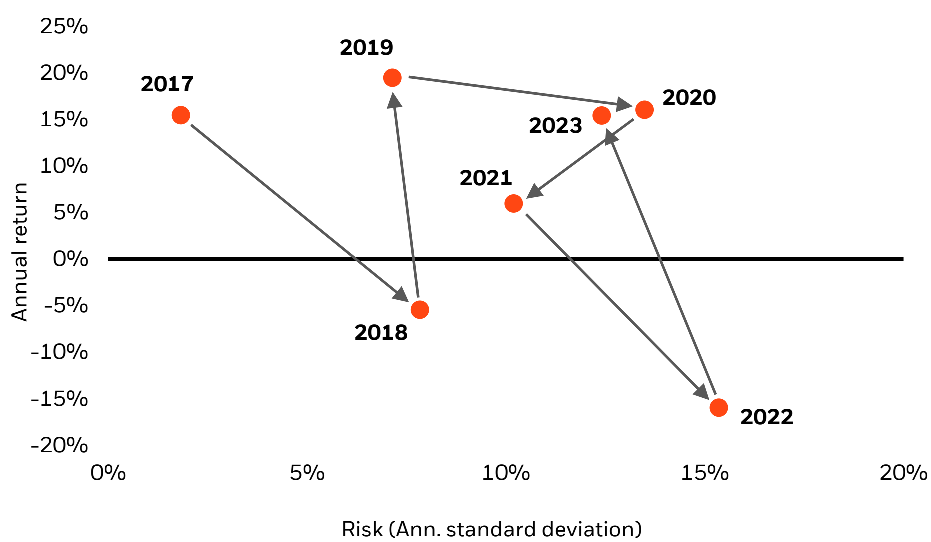
We believe the new regime calls for more active, more nimble and more granular investment strategies that seek to add risk in a diversifying and complementary way across multiple sources of alpha. We believe that a rear-view mirror approach won't work under the new regime. A supposedly well-diversified portfolio, such as a 60% stock and 40% bond portfolio, isn't insulated from macro risk. Reactively adjusting portfolios to changes in global macro won't go too far this time. Winning the alpha game will require more.

First. We suggest adjusting allocations dynamically based on forward-looking views i.e., proactively anticipating changes in the macro landscape, rather than reacting to the new data flow of yesterday.

Second. We propose avoiding over-dependence on beta for returns. It's brave to bet the success of a portfolio mainly on allocating 20% versus 80% to equities or on running a one-year versus six-year of duration. One-dimensional, often very binary bets increase the odds of delivering subpar performance. See all charts.

Third. We caution that cash investors, especially those with outsized allocation to cash, potentially face a lot of reinvestment risk during the easing cycle. We believe the money set on the sidelines because of a sell-off in bonds or a general risk consideration should come back tactically to optimize portfolio shifts.

Bouncing around
Annual return of a 60/40 portfolio, 2017-2023



Source: Bloomberg as of 31 Dec. 2023. Reflects returns and risk for a hypothetical balanced portfolio consisting of 60% MSCI All Country World Index and 40% BBG Barclays Global Aggregate Index. For illustrative purposes only. The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. The performance shown is hypothetical, does not represent any existing portfolio, and as such, is not an investible product. There are frequently sharp differences between a hypothetical performance record and the actual record subsequently achieved.

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