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Navigating the new regime with an Outsourced Chief Investment Officer (OCIO)

BlackRock

Seizing opportunities in the current market environment

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Introduction

The demand for an Outsourced Chief Investment Officer (OCIO) investment model is growing. With rising complexity, greater governance and more stringent regulatory demands, investors are turning to an OCIO for their whole portfolio solution. OCIO provider assets under management are expected to surge to US$3 trillion by 2026, according to bfinance, and this opens up a new opportunity within what we see as the new regime.[1]

The BlackRock Investment Institute (BII), recently shared in their 2024 Global Outlook, that we are in a new regime of greater macro and market volatility. We think the era of steady growth and low inflation that fostered a sustained bull market for equities and fixed income, is over. We believe the ending of this era, which we call the “Great Moderation” means a new approach to portfolio construction is required.

In this new environment, we are ***steering portfolio outcomes*** to put money to work and capture the opportunities on offer, through a more dynamic approach to investing. We’re ***managing macro risk*** to build resilient portfolios in a lower growth, higher interest rate environment. We think one way to drive portfolio outcomes is by ***harnessing mega forces***, the big structural drivers at play in the new regime.

1. **Steering portfolio outcomes:** Grabbing the wheel and putting money to work through more dynamic portfolio management, utilising both indexing and active strategies to seek greater alpha whilst staying selective.

2. **Managing macro risk:** The macro-outlook is more uncertain. Exposures to macro risk can be punished as well as rewarded, so we think investors should be deliberate about which exposures they take.

3. **Harnessing mega forces:** Mega forces are key drivers of the new regime, affecting the long-term growth and inflation outlook and creating shifts in profitability. We see them as major opportunities - and risks - for investors.

In this paper, we explore how an OCIO can help guide investors through the new regime, identifying the range of possible opportunities it could open up and will also assess the impact on governance, asset allocation and portfolio construction.

The new regime at play

Financial markets are adjusting to the new regime of greater volatility, uncertainty and divergence in market performance. A more dynamic portfolio approach is needed – and if investors have confidence in their ability to pick good managers, our view is active strategies should play a bigger role in portfolios today. Active strategies include dynamic approaches to indexing.

We believe an OCIO – offering a whole portfolio approach – gives clients the best chance to navigate the new regime. As an OCIO provider, we can be nimbler in the portfolio to quickly take advantage of upside opportunities, and importantly minimise downside risks.

Applying OCIO in the new regime:

1. Steering portfolio outcomes

We believe the approach to portfolio construction needs to be more dynamic and clients will need to revisit their asset allocation decisions more regularly. When choosing to have everything under one roof with an OCIO like BlackRock, investment decisions become more efficient. We can make real-time decisions, not restricted by meeting cycles. In practice this means more regular reviews of the Strategic Asset Allocation (SAA) combined with risk managed Tactical Asset Allocation (TAA) to navigate shorter-term volatility.

The Strategic Asset Allocation ("SAA") of our OCIO clients is reviewed regularly to ensure portfolios are positioned to benefit from longer term trends. Under the new regime, we have seen the strategic preferences in our capital market assumptions shift more regularly. This is why as OCIO, we can review the SAA quickly and efficiently in the context of material market events. Central to our investment process is Aladdin, our portfolio and risk management platform that performs over 5,000+ stress tests and scenario analysis' daily. Our investment philosophy is that by staying invested over the longer term, the SAA aims to deliver the majority of returns our clients seek to achieve.

While proprietary technology platforms may help manage risk, risk cannot be eliminated.

Tactical Asset Allocation ("TAA") has a role to play in helping our clients meet their investment objectives in the new regime, by getting granular with portfolio allocations. Within a volatile market backdrop, TAA can be the difference in capturing opportunities in the short-term, whilst complimenting longer-term trends that we capture when designing the SAA for our OCIO clients. We see alpha, or above-benchmark returns, playing a bigger role in the new regime – and believe a more dynamic portfolio approach is warranted when cash offers attractive returns. Under an OCIO model, TAA is integrated into the investment process and can allow our Portfolio Managers to react, real-time, to market conditions to capture opportunities on the upside and protect portfolios on the downside.

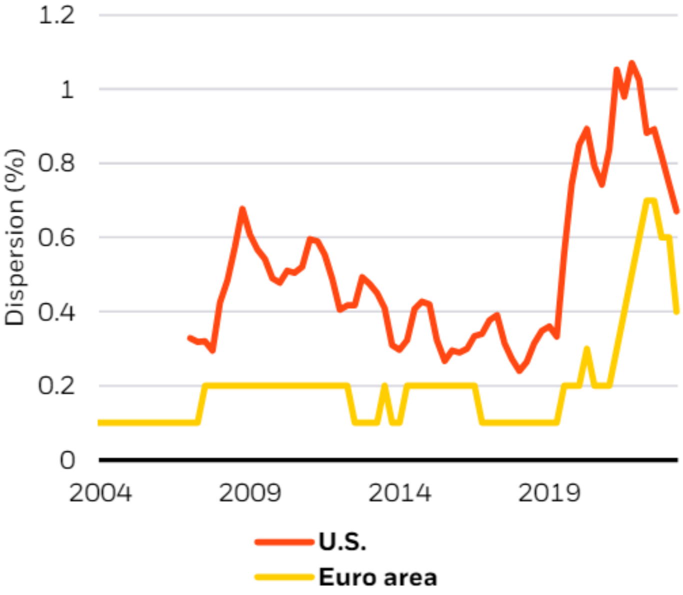
Manager selection is the third lever that we pull as OCIO. We leverage BlackRock's team of Manager Research experts to select and monitor best-in-class managers that we believe will deliver outperformance over the long-term. In our opinion, static allocations to broad asset classes will not serve investors as favourably in the new regime.

However, research from the BlackRock Investment Institute (BII) finds that dispersion in some markets has increased, offering more opportunities for skilled managers. Professional managers as a group have not become more skilled at delivering active returns overall – but BII believe today's environment is more conducive for skilled managers to deliver more active returns. This is shown by top performing developed market (DM) equity and hedge fund managers delivering more active returns by exploiting the new regime's uncertainty and dispersion. Of course, to take advantage of this, one needs to be able to pick skilled managers – which is where deep resources in manager selection can play a pivotal role.

Ultimately, differentiated investment insights combined with a dynamic portfolio approach could be better rewarded now because of today's greater uncertainty.

Heightened uncertainty

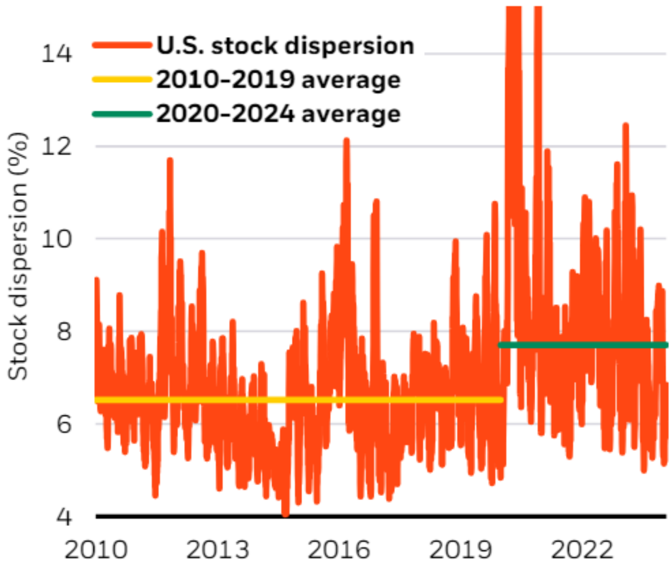
Dispersion of inflation forecasts, 2004-2024



Source: BlackRock Investment Institute, European Central Bank, Philadelphia Federal Reserve, with data from Haver Analytics, February 2024. Notes: The chart shows the dispersion in near-term inflation forecasts in the U.S. and euro area from central bank surveys of professional forecasters.

Greater dispersion

Dispersion of S&P 500 performance, 2010-2024



Past performance is not a reliable indicator of current or future results, and index returns do not account for fees. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, with data from LSEG Datastream, February 2024. Notes: The chart shows the dispersion in S&P 500 monthly stock returns on a daily basis and the median level of dispersion from July 2010 after the global financial crisis through 2019, and from 2020 through Jan. 31, 2024.

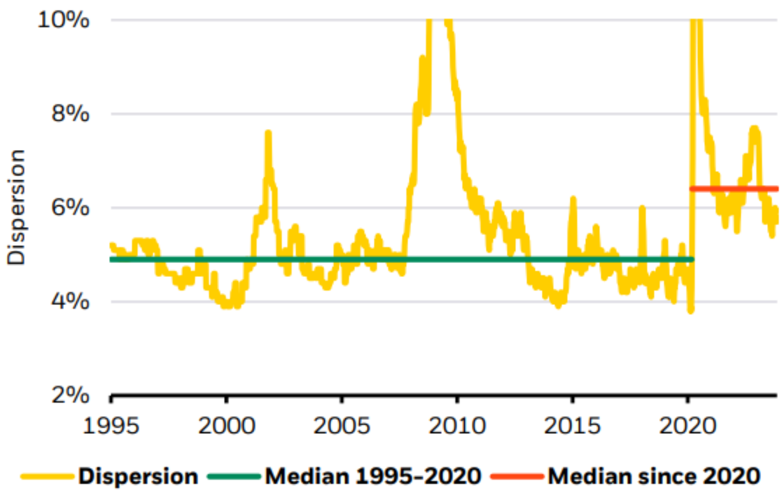
There is no guarantee that any forecasts made will come to pass.

2. Managing macro risk

We believe macro exposures can be seen as both risks and opportunities, where we are able to be deliberate about which exposures we take. We potentially see more scope to outperform the market now than in the less volatile Great Moderation. This is where an OCIO manager can help, by taking a whole portfolio view and the ability to act quickly in the market. Through an OCIO framework, our clients can benefit from the speed of decision making and reduced governance burden by not having to wait for the regular meeting cycles to ratify changes in the portfolio and lock in potential portfolio gains.

Adjusting to new regime

Dispersion of U.S. equity analyst earnings estimates, 1995-2023



Source: BlackRock Investment Institute, LSEG Datastream, December 2023. Notes: The chart shows the aggregate standard deviation of analyst earnings estimates for S&P companies. The green line shows the median from 1995 to end January 2020, and the orange line shows the median since February 2020.

Chart takeaway: During the Great Moderation, analyst views of expected company earnings were much more grouped together outside of major shocks. Now they are more dispersed, showing that an environment of higher inflation and interest rates makes the outlook harder to read. This highlights the importance of being selective when trying to steer portfolio outcomes.

The macro-outlook is more uncertain. Exposures to macro risk can be punished as well as rewarded, so we think investors should be deliberate about which exposures they take.

Still, we think investors need to be alert to risks around macro exposures in the new regime, and this is where an OCIO can help.

Firstly, markets are slowly adjusting to structurally higher inflation and policy rates set by Central Banks, but it is uneven. For example, U.S. 10-year Treasury yields surged to 16-year highs around 5%, but most developed market equity earnings yields haven't risen much.[2]

Second, structurally lower growth and higher rates pose a problem for ballooning U.S. government debt. If borrowing costs from higher yields stay near 5%, the government could spend more on interest payments than Medicare in a few years. We are watching this closely as this increases the long-run risk of higher inflation as central banks become less aggressive on inflation. We also see a rise in term premium, or the compensation investors demand for the risk of holding long-term bonds.

Finally, the broad opportunity set within private markets can offer investors with an illiquid appetite the prospect to generate higher returns when compared to liquid assets. In today's current market environment, we prefer to allocate private capital to strong and resilient sectors such as Technology and Healthcare to reduce default risk. Further, private market assets are often less correlated with public markets, so there can be greater portfolio diversification as the asset class may not rise or fall at the same time, because of the long term and illiquid nature of the asset class.

3. Harnessing mega forces

We think mega forces are another way to steer portfolios – and think about portfolio building blocks that transcend traditional asset classes. At the centre of BlackRock's Thematic investing philosophy lies five mega forces: digital disruption and AI, a fragmenting world, low-carbon transition, demographic divergence and the future of finance. These mega forces harness a compelling way for investors to align portfolios with the trends shaping the future. A spectrum of long-term and short-term themes are increasingly influencing which companies lead the way as economies grow and markets evolve.

These mega forces are already reshaping markets. Take digital disruption and artificial intelligence (AI). The chart to the below illustrates the outperformance of U.S. tech relative to the broader market this year. We think this reflects how quickly markets embrace such fundamental shifts in the market outlook.

Mega force at work

S&P tech sector vs. S&P 500 performance, 2023 year-to-date

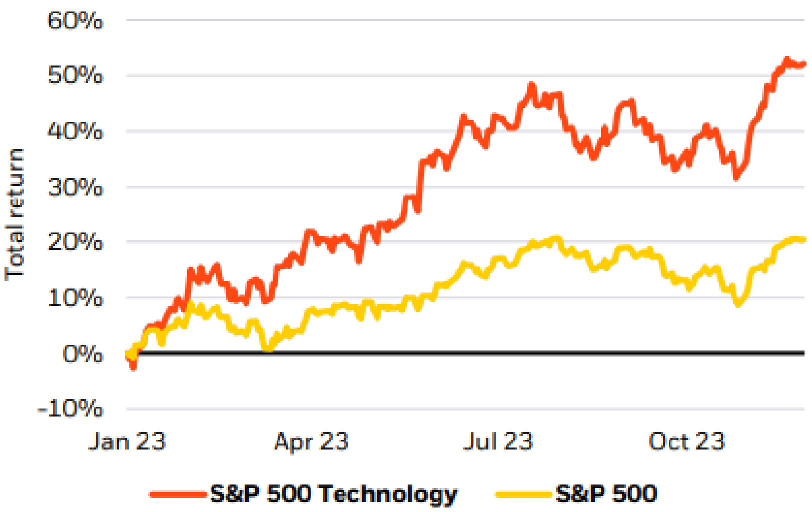


Chart takeaway: Investor enthusiasm for AI and digital tech has offset the drag of rising yields. That has pushed U.S. tech stocks to easily outshine the broader market in 2023.

Past performance is not a reliable indicator of future results. Index returns do not account for fees. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, with data from LSEG Datastream, December 2023. Notes: The chart shows ttarget – the dotted green line – would require the Fed to deal a significant blow to the economy.

This is where asset owners can benefit from an OCIO framework, by the ability to act quickly and shift the portfolio to capture upside opportunities, or conversely, protect the assets against the downside risk.

An example of this is the **Thematic Private Markets Fund**, a multi-alternatives private markets solution that we launched exclusively for our OCIO clients in 2023. The fund invests in thematic areas across a broad range of alternative assets, including Private Debt, Private Equity and Real Assets. Thematic alignment of the fund is achieved by investing into companies that align to the UN Sustainable Development Goals, such as Climate Focus, and Good Health and Wellbeing.

Below we detail how, we believe, each mega force can impact investment portfolios and how we are harnessing these forces for our OCIO clients:

Digital distribution and artificial intelligence

Introducing data innovation tools such as text scraping to monitor and assess central bank policy statements and other fast moving data points such as job postings. These feed through into our TAA views in OCIO portfolios.

Future of finance

Capital pressures on banks are opening a path for private credit and non-traditional sources of credit to fill the lending void – part of the future of finance. For OCIO clients that have appetite for illiquidity, private credit presents a compelling investment case.

Demographic divergence

Aging populations in major economies are poised to limit how much countries can produce and grow. We see potential for technology and medical breakthroughs to help offset these risks – and present opportunities. By contrast, selected emerging market economies are poised to benefit from younger populations and growing middle classes.

Low-carbon transition

The transition to a low-carbon economy is set to spur a massive reallocation of capital as energy systems are rewired. All of our OCIO portfolios are optimised by using BlackRock’s Climate Aware Capital Market Assumptions, meaning our asset allocation process accounts for transitioning to a low-carbon economy.

Geopolitical fragmentation

We see geopolitical fragmentation and economic competition driving a surge of investment in strategic sectors like tech, energy and defense. With almost 49% of the world heading to the polls in 2024, OCIO can help asset owners react quickly to fast moving developments and hedge risks such as currency.[3]

About the authors

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Lara leads the development of our Defined Benefit OCIO client relationships. She is part of a broader team who deliver our OCIO capabilities to Defined Contribution, Family Offices, Endowments, Foundations and Insurance clients.

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How BlackRock partner with institutions for OCIO

Our OCIO business sits at the heart of our firm's purpose, *to help more people experience financial well-being*. As of 31st December 2023, we managed over £31bn of OCIO assets in the United Kingdom.[4] Through our deep experiencing in partnering with our OCIO clients, we understand the unique needs of our clients and the challenges they face, particularly in the new market regime.

To learn more about our OCIO offering, please contact our dedicated relationship team or visit our website:

https://www.blackrock.com/uk/professionals/solutions/outsourced-chief-investment-officer

Sources

1 bfinance, 21 September 2023

2 BlackRock Investment Institute, 31 December 2023

3 Time, 28 December 2023

4 BlackRock, 31 December 2023

Risk Warnings

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.

Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.

Changes in the rates of exchange between currencies may cause the value of investments to diminish or increase. Fluctuation may be particularly marked in the case of a higher volatility fund and the value of an investment may fall suddenly and substantially. Levels and basis of taxation may change from time to time and depend on personal individual circumstances.

There is no guarantee that a positive investment outcome will be achieved.

Liquidity Risk: The Fund's investments may have low liquidity which often causes the value of these investments to be less predictable. In extreme cases, the Fund may not be able to realise the investment at the latest market price or at a price considered fair.

Valuation risk: Given the uncertainty inherent in the valuation of assets that lack a readily ascertainable market value, the value of such assets as reflected in the Fund's net asset value may differ materially from the prices at which the Fund would be able to liquidate such assets.

Concentration Risk: Investment risk is concentrated in specific sectors, countries, currencies or companies. This means the Fund is more sensitive to any localised economic, market, political or regulatory events.

Lack of available investments: There can be no assurance that the Fund will be able to locate, attain and exit investments that satisfy its investment objectives, or that the Fund will be able to fully invest its committed capital.

Redemption risk: The Fund's investments are generally illiquid and therefore an investment in the Fund is intended for long-term investors able to accept the risks associated with an illiquid investment and who are able to commit their funds for the duration of the Fund Redemptions, to the extent they are permitted, may be limited, postponed or altogether suspended in certain circumstances.

Risks associated with the Fund include, but are not limited to, the following:

The Fund's investments may suffer defaults losses in value; the Fund's investments are illiquid which may be subject to limitations on transfers or other restrictions that would interfere with the subsequent sale of such investments or adversely affect the terms of any disposition thereof; transferability of the Fund's interests is restricted and subject to approval of the BlackRock; the fees and expenses of the Fund may offset any profits of the Fund; uncontrollable factors including adverse economic, market, regulatory and governmental conditions may impact the Fund's investments; the Fund is not subject to the same regulatory requirements as mutual funds; increased competition from other investors; and lack of diversification of investments outside of real estate.

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