



Asset Allocation

Ideas for a Low-Expected-Return World

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The No. 1 challenge for investors is: How can we achieve 4%–5% medium-term real return targets (or 7%–8% nominal) if the expected return of a 60/40 equities/bonds portfolio is below 3%?

Investors' responses vary. Wishful thinking has been one approach (witness nominal return assumptions still near 8% for many pension funds), and increasing allocations to equities another. However, poor results and growing awareness of forward-looking valuations — their relevance in predicting returns and their still-uninspiring message about prospective returns — have led investors to look elsewhere.

Over the past decade, many investors adopted the "endowment model" and diversified into various alternative asset classes, combining reliance on the equity premium with faith in an illiquidity premium and in hedge fund alpha. The experience has been mixed. There were some successes but many investors were disappointed in both their return and diversification realizations, as alternative investments moved in synch with the 60/40 portfolio and the true costs of private equity investments were revealed as commitments paralyzed many investors and forced them to sell liquid holdings.

We think that risk-balanced diversification across well-chosen return sources is the most reliable strategic approach to achieving ambitious real return targets.

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