

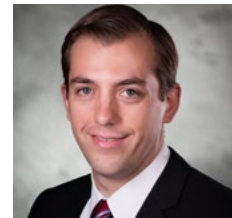
MULTI-ASSET PORTFOLIOS

Asset Allocation: The Big Decisions

By Brian Kmetz

When it comes to portfolio construction, you need to get the big decisions right, and there is no bigger decision than asset allocation. Asset allocation acts as a portfolio’s foundation, and without a sound foundation the entire structure collapses. So where to begin when constructing an asset allocation? And if the foundation is already built, how can you determine whether it is sound?

The most intuitive place to start is with the desired risk profile. This is determined by risk tolerance and time horizon. Based on the selected risk profile, an investor or advisor can select the appropriate benchmark. A common benchmark for a moderate risk tolerance, US-based investor is a global 60% MSCI All Country World Index / 40% Barclays Aggregate Bond Index. While an argument can be made this benchmark is outdated given subdued outlooks for equity and fixed income, the global 60/40 has stood the test of time and is universally accepted.



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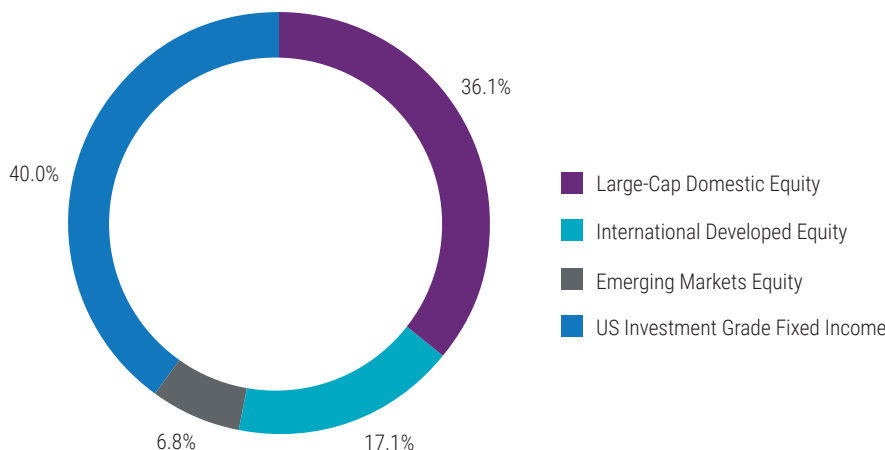
Competing objectives?

For a benchmark-relative strategy there are two investment objectives providing tension in the asset allocation process: outperforming the benchmark and keeping tracking error within an acceptable range. While higher tracking error can raise the odds of outperformance, it also raises the odds of diverging significantly from the benchmark.

There are two distinct levers driving excess return and tracking error in an asset allocation: relative asset class weights and out-of-benchmark asset class bets. To operate the two levers effectively, the benchmark must be broken out into asset class components with appropriate weights.

Figure 1 shows the current asset class breakout for our global 60/40 benchmark:

FIGURE 1: Global 60/40 Portfolio Benchmark Weights



Source: Natixis Investment Managers Solutions. For illustrative purposes only.

Weighty decisions

Not only must investors decide on relative weights, they also need to decide whether to include any asset classes not represented in the benchmark. Here it helps to define the asset class investment universe. What may be a viable and investible asset class for some may be too esoteric or risky for others.

Figure 2 lines up the benchmark asset classes and weights with a hypothetical asset class universe. Note the out-of-benchmark bets, especially in fixed income. Here the investor should have good reason

to include each asset class in the investible universe, including differentiation from existing asset classes in terms of risk drivers and return expectations.

Once the benchmark and investible universe are defined, the hard decisions begin. Namely, what asset classes to overweight, underweight or remain neutral? What out-of-benchmark asset classes should be funded and how large a position? While there are many variables that go into this decision, the two most important are the investment selection framework and time horizon.

Institutions typically use forward-looking capital market assumptions that project over a full market cycle of around seven to ten years. For individual investors with shorter timeframes, the investment outlook could be three to five years while blending forward assumptions with asset class fundamentals such as valuations and current yields. A tactical component could also be employed to capitalize on short-term dislocations.

Figure 3 shows a strategic allocation for an individual investor with a three-to-five-year investment outlook.

FIGURE 2: Asset Class Universe Comparison

	Portfolio Asset Classes	Representative Index	7-Year Annualized Return	7-Year Annualized Standard Deviation
EQUITY	Large-Cap Domestic Equity	S&P 500 Index	11.14%	15.33
	Small-Cap Domestic Equity	Russell 2000 Index	5.91%	20.25
	International Developed Equity	MSCI World Index	2.70%	13.04
	Emerging Markets Equity	MSCI Emerging Markets Index	2.79%	13.39
FIXED INCOME	US Investment Grade Fixed Income	Barclays US Aggregate Index	1.42%	3.69
	International Developed Fixed Income	Barclays Global Aggregate Index	0.50%	5.26
	US High Yield Debt	Barclays Corporate High Yield Index	3.48%	7.82
	Emerging Markets USD Debt	J.P. Morgan Emerging Markets Bond Global Diversified Index	1.33%	9.11

Source: Natixis Investment Managers Solutions. For illustrative purposes only.

FIGURE 3: Strategic Allocation vs. Benchmark

	Asset Class	Benchmark Weight	Strategic Portfolio Weight	Difference
EQUITY	Large-Cap Domestic Equity	36.1%	34.1%	-2.0%
	Small-Cap Domestic Equity	0.0%	4.0%	4.0%
	International Developed Equity	17.1%	16.1%	-1.0%
	Emerging Markets Equity	6.8%	5.8%	-1.0%
	Total Equity	60.0%	60.0%	-
FIXED INCOME	US Investment Grade Fixed Income	40.0%	33.0%	-7.0%
	International Developed Fixed Income	0.0%	2.0%	2.0%
	US High Yield Debt	0.0%	3.0%	3.0%
	Emerging Markets USD Debt	0.0%	2.0%	2.0%
	Total Fixed Income	40.0%	40.0%	-

Source: Natixis Investment Managers Solutions. For illustrative purposes only.

Tactical considerations

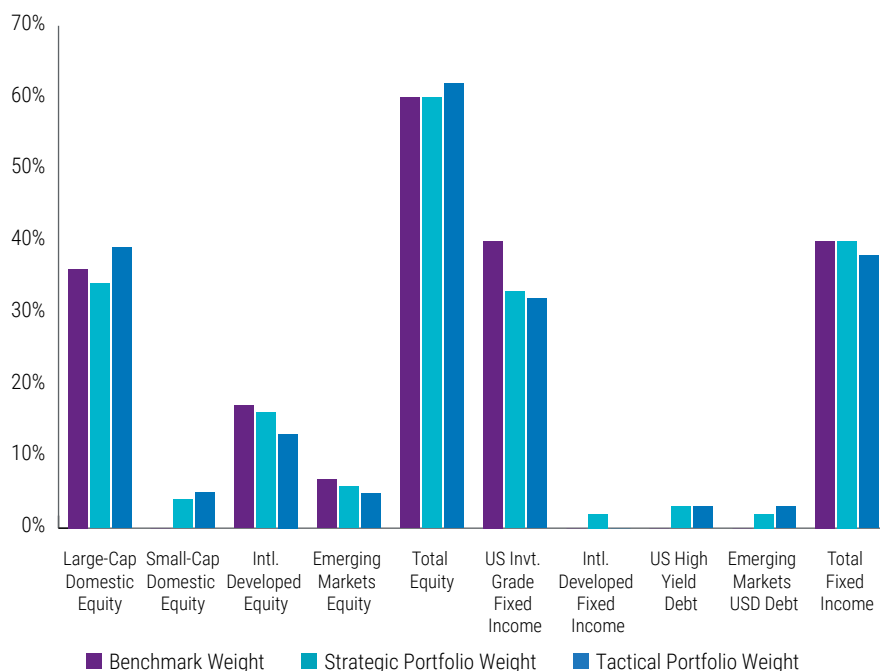
This hypothetical investor may also want to incorporate shorter-term views to capitalize on market dislocations. The timeframe for tactical views can range anywhere from three to six months or six months to a year – as long as the rationale remains valid. The sample tactical allocations shown in **Figure 4** are based on the following analysis:

- **Large-Cap Domestic Equity** Overweight 3%, based on strong growth prospects in the US vs. the rest of the world; valuations have partially reset.
- **Small-Cap Domestic Equity** Overweight 5%, due to attractive relative valuations vs. large-caps and the rest of the world.
- **International Developed Equity** Underweight 4%, due to recession risk, slowing growth and vulnerability to energy shock.
- **Emerging Markets Equity** Underweight 2%, based on zero Covid policy and slowing growth in China plus property market slowdown.
- **US Investment Grade Fixed Income** Underweight 8%, as aggressive Federal Reserve hiking is hurting duration.
- **International Developed Fixed Income** Neutral, as yield differential favors US, plus currency risk.
- **US High Yield Debt** Overweight 3%, as the US should avoid recession in the foreseeable future.
- **Emerging Markets USD Debt** Overweight 3%, due to yield pickup vs. competing asset classes.

The end result is a portfolio that incorporates both longer-term and shorter-term views in an effort to outperform the benchmark with reasonable tracking error. **Figure 5** shows various risk and return statistics for the benchmark, strategic allocation and final allocation. While the allocations will shift over time, these static allocations show how each allocation layer changes risk and return.

Once the allocation is determined, the next step in the portfolio construction process is implementation, which can add additional tracking error but is also a source of potential excess return. The challenge is how to structure the portfolio with strategies that reflect the spirit of the asset allocation, but also offer the latitude to add value – another balancing act. Part 2 of this series reviews the selection and structuring of appropriate strategies.

FIGURE 4: Tactical Allocation vs. Benchmark



Source: Natixis Investment Managers Solutions. For illustrative purposes only.

FIGURE 5: Trailing 5-Year Annualized Statistics

Factset Data	Benchmark	Strategic	Strategic + Tactical
Return	4.83%	5.43%	5.96%
Standard Deviation	10.12	10.37	10.80
Sharpe Ratio	0.37	0.42	0.45
Beta	1.00	1.02	1.06
Tracking Error	–	0.53	0.99

Source: Natixis Investment Managers Solutions. For illustrative purposes only.



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