Upgrade your asset allocation

Executive summary

The time is now for investors to adapt to the lower expected returns across asset classes and drive towards sustainable investing that are fundamentally altering the investment landscape. To this end, UBS Asset Management is releasing a series of papers designed to outline approaches you can take to upgrade your asset allocation and address these urgent challenges.

Our updated five-year capital market assumptions crystalize the difficult environment facing investors. The robust rebound in risk assets from their March lows has come at a cost: expected forward returns across equities and credit have compressed materially. With central banks across advanced economies approaching their effective lower bounds, the diversification benefits of bonds in providing substantial appreciation during risk-off periods is also challenged. Meanwhile, regulations and client demands increasingly necessitate that portfolio managers incorporate non-financial environmental, social, and governance factors into the asset allocation process.

Meeting return objectives in an environment where expected returns across publicly-traded risk assets are lower bolsters the appeal of expanding the investment horizon through the use of alternatives. Alternative investments: Improving portfolio performance provides a comprehensive overview of the different asset classes investors can integrate into their portfolios more broadly – private equity, hedge funds, real estate, infrastructure, and commodities – and how to do so. We believe investors that add exposure to alternatives under the guidance of sophisticated managers will be able to improve the risk/reward profile of their portfolios through superior returns and diversification benefits.

Enhancing Diversification in a Low-Yield World, outlines a set of solutions given the likelihood that developed market debt will fail to provide the same degree of ballast to portfolios during equity market drawdowns. While there is no perfect substitute for the safest sovereign debt, Chinese sovereign bonds are among the best solutions to serve as a structural replacement in portfolios. Within foreign exchange and commodities, we have also identified tactical liquid diversifiers that behave similarly to bonds during risk-off episodes with a minimal drag during risk-on periods. Dynamic risk strategies may also allow investors to increase exposure to asset classes with higher expected returns while directly managing drawdown risks.

An additional forthcoming paper, Asset Allocation with ESG: Challenges and opportunities for the efficient frontier, aims to examine the benefits and obstacles involved in adopting a sustainable investment approach at the portfolio level, and whether this has implications for the efficient frontier. This is accomplished through an extensive overview of the academic literature surrounding ESG investing and an original empirical analysis of the available data.

We believe the key to delivering strong performance in the years to come will be driven by how investors navigate lower expected returns, increased diversification in a low yield world and incorporating ESG into investment process. We hope you will find this series a formative guide on the opportunities available to overcome these challenges.

Ryan Primmer, Head of Investment Solutions, Louis D. Finney, Co-Head of Strategic Asset Allocation Modeling, Michele Gambera, Co-Head of Strategic Asset Allocation Modeling, Evan Brown, Head of Multi-Asset Strategy, Luke Kawa, Director
Americas
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