RBC Global Asset Management
PH&N Institutional

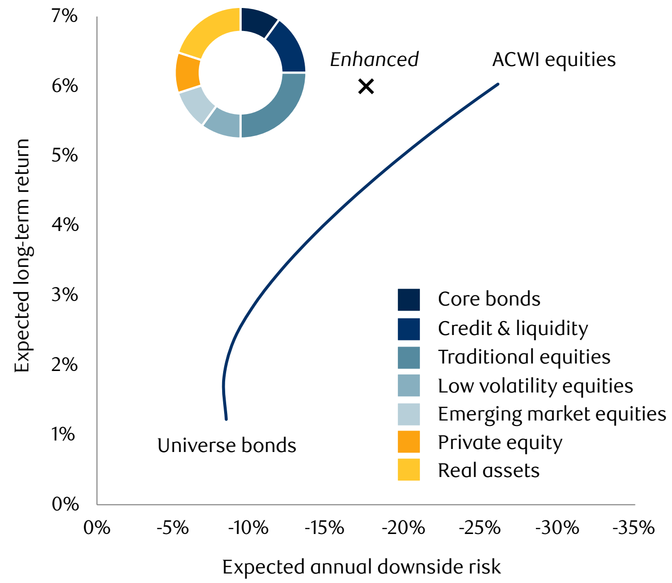
Strategic asset mix decisions in a new return regime

Introduction

For more than a decade leading up to 2022, institutional investors faced a significant challenge: building an investment policy asset mix that would support long-term risk/return objectives while future return expectations steadily declined across most asset classes. This situation led many investors to venture into a variety of new asset classes and strategies, in many cases increasing the complexity, cost, and illiquidity of their investment programs.

However, a major shift in capital markets started at the beginning of 2022. As interest rates climbed to persistently higher levels and equity valuations declined sharply from their peak, the long-term return outlook for most asset classes improved significantly. A strong rally in both fixed income and equity markets at the end of 2023 had a tempering effect, but forward-looking returns remain higher than what investors had grown accustomed to over the previous decade. For example, bond yields remain considerably above their depressed levels from the past environment, offering both better return prospects and an improved downside risk profile. Given where we find ourselves today, it is worthwhile examining whether traditional asset classes once again have a prominent role to play in investor portfolios and contribute meaningfully towards risk/return objectives.

Figure 1: Risk/return trade-off in the old environment



Source: PH&N Institutional. Refer to the end of this article for modelling assumptions and disclosures. Hypothetical performance analyses are for illustrative purposes only and there is no guarantee that hypothetical returns or projections will be realized. Expected annual downside risk = CVaR95, denoting the expected loss in the worst 5% of return outcomes. “Traditional equities” represented by Canadian and global equities. “Low volatility equities” represented by global low volatility equities.

Portfolio construction in the old environment (pre-2022)

The main problems underlying asset mix design in the old environment were twofold: (1) core fixed income as a fundamental source of liquidity and risk mitigation had insufficient yield to fulfill that purpose while contributing towards return objectives, and (2) equities as a fundamental source of long-term growth had increasingly lower forward-looking returns relative to their inherent volatility.

Figure 1 depicts the efficient frontier of portfolios running from 100% fixed income (represented by the FTSE Canada Universe Bond Index) to 100% equities (represented by the MSCI ACWI Index) during one of the most challenging moments from the old environment (2021). When looking at the extremes of this spectrum, the aforementioned challenges are clearly illustrated: bonds had the lowest risk but lacked sufficient returns, while equities had only moderate returns at the cost of significant risk. In this environment, investors would have required an extremely risky all-equity portfolio to achieve even a 6% expected return, and any attempt to reduce that risk would have required a compromise on return potential, highlighting the challenge of balancing risk and return objectives within the traditional opportunity set.

Due to the extremely low return expectations of traditional bond and equity portfolios, most institutional investors turned their attention towards specialty strategies to generate higher returns while managing risk more effectively.

As a result, a variety of changes were implemented, either in terms of strategy selection or broader shifts in investment policy. These generally fell into three categories:

- **Increasing fixed income yield** (e.g., adding exposure to credit and liquidity premia).
- **Improving risk-adjusted equity returns** (e.g., pairing higher risk premium and lower beta strategies).
- **Adding alternatives for enhanced returns/diversification** (e.g., real estate, infrastructure, private debt/equity, etc.).

Looking back to Figure 1, we also illustrate an enhanced portfolio that has incorporated examples of all three types of changes. This portfolio clearly exhibits a superior risk/return profile, having the same return as the all-equity portfolio but with two thirds of the downside risk. The improvement is primarily attributable to the meaningful introduction of specialty strategies, with 65% of the portfolio invested outside of traditional bonds and equities. This involves considerations beyond the risk/return trade-off as these types of exposures are often:

- More **complex** and require more **time and effort** to implement and monitor.
- More **costly**, with notably higher investment management fees.
- Inherently **less liquid**, which could create cash flow management and rebalancing issues.

Therefore, a different set of challenges can emerge from an increasing reliance on specialty strategies.

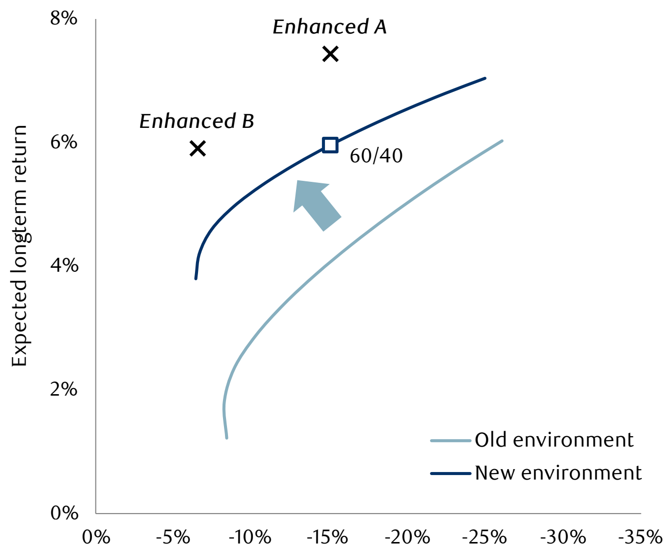
> While expanding the investment opportunity set was perhaps a necessity in such a challenging return environment to maximize the chances of meeting objectives, there is always a trade-off associated with increasingly higher allocations to specialty strategies.

Portfolio construction in the new return environment

Now, if we fast-forward to the present and undertake the same portfolio construction exercise anew with updated capital market assumptions (2023), we can see a notable shift in the equity/bond efficient frontier.

Firstly, there is a shift to the left due to improvements in portfolio downside risk; this is especially noticeable at higher fixed income allocations due to the more material reduction in that asset class's risk. Secondly and most importantly, there is a significant shift upwards as return expectations for both equities and perhaps more notably bonds have improved. As a result, there is a more compelling risk/return trade-off for investors across the efficient frontier of traditional equity/bond portfolios. Investors that previously could only have expected a 6% return on a high-risk 100% equity allocation can now attain that same expected return with a traditional balanced portfolio of 60% equities and 40% bonds, which clearly has a more reasonable risk profile. This gives rise to an important question: with the radical improvement in the new investment environment, does this upend the merit of the enhancements implemented in the old regime? The short answer is no, but the **necessity** is perhaps not as strong as it was.

Figure 2: Risk/return trade-off in the new environment



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As can be seen in Figure 2, the portfolio tailored for the low-return environment (Enhanced A) now has an expected return of 7.5% with a downside risk of -15%, and remains far superior to any portfolio comprised solely of core fixed income and equities. By way of comparison, this portfolio has the same risk profile as the traditional 60/40 reference portfolio, but with a considerably higher expected return (+1.5%). Hence, despite a change in the return environment, all the previous enhancements via specialty strategies continue to be effective at improving a portfolio's risk/return profile. However, in the new return environment, an investor might not need that high a level of expected return to support their long-term objectives. In fact, whereas before investors **had** to consider taking on increased risk and complexity to reach their return targets, there are now viable portfolio options at lower levels of risk and/or complexity. For example, using a similar but more constrained opportunity set of specialty strategies, we created a portfolio tailored for the new return environment (Enhanced B) that has the same expected return as the 60/40 (6%), but with significantly less downside risk (-6.5% versus -15%).

Figure 3 compares the asset allocations of the two enhanced portfolios. We can see that Enhanced B has a significant increase in fixed income, a decreased dependency on specialty strategies, considerably more liquidity, and – it stands to reason – lower fees. Depending on an investor's comfort level with different specialty strategies and their liquidity needs, Enhanced B could be preferable from a simplicity standpoint, while being viable from a risk/return standpoint. That doesn't mean to say that Enhanced B is now the superior option, but rather that investors have **more choice** in the new environment when it comes to building their asset mix. In fact, the "optimal" asset mix for a given investor is more likely to fall somewhere between Enhanced A and B, and vary based on specific circumstances and objectives.

Figure 3: Illustrative enhanced portfolios

Modelled expectations	Enhanced A	60/40	Enhanced B
Long-term return	**7.5%**	**6.0%**	**6.0%**
Annual downside risk	**-15.0%**	**-15.0%**	**-6.5%**
Annual volatility	9.6%	9.2%	4.7%
Sharpe ratio	0.5	0.3	0.6
Traditional strategies	**35%**	**100%**	**65%**
Core bonds	10%	40%	50%
Traditional equities	25%	60%	15%
Specialty strategies	**65%**	**0%**	**35%**
Credit & liquidity	15%	0%	10%
Low volatility equities	10%	0%	0%
Emerging markets equity	10%	0%	5%
Private debt	0%	0%	10%
Private equity	10%	0%	0%
Real assets	20%	0%	10%

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While the forward-looking returns on traditional asset classes might have improved, customizing exposures using an expanded opportunity set remains valid for investors who are trying to maximize the risk-adjusted return prospects of their portfolios. The main reason for this is that the fundamental characteristics of specialty strategies, and their roles within a portfolio, have not materially changed. However, investors can potentially work with a smaller subset of specialty strategies and still achieve an efficient risk/return outcome relative to objectives.

Conclusion

The previous low return environment posed a significant challenge for the development of institutional investment policy asset mix, effectively requiring investors to consider the full spectrum of a more complex opportunity set to even have a chance of meeting long-term objectives within the appropriate risk tolerance. However, the new investment regime now allows investors to put greater emphasis on traditional strategies, notably fixed income, and to adopt a more selective approach when considering specialty strategies. This enhanced flexibility makes it easier for investors to construct a portfolio that strikes an optimal balance between risk/return objectives and governance, cost, and liquidity requirements.

Disclosures

The capital market assumptions and data sources used in the modelling analysis are presented below:

Old environment (2021)

Asset classes	Representative data series	Expected long-term return	Expected annual volatility	Expected annual downside risk
Universe Bonds	FTSE Canada Federal Bond Index	1.2%	4.3%	-8.4%
Core Bonds	Custom Index[1]	1.1%	2.3%	-3.8%
Credit & Liquidity	Custom Index[2]	4.6%	9.4%	-19.1%
Canadian Equities	S&P/TSX Composite Index	6.1%	17.0%	-27.8%
Global Equities	MSCI World Index (CAD)	5.7%	14.4%	-25.0%
Global Low Volatility Equities	MSCI World Minimum Volatility Index (CAD)	5.1%	11.6%	-18.2%
Emerging Market Equities	MSCI Emerging Markets (EM) Index (CAD)	7.7%	23.3%	-33.9%
ACWI Equities	MSCI ACWI Index (CAD)	6.0%	14.7%	-26.1%
Private Debt	Credit Suisse Leveraged Loan Index (USD)	4.5%	6.0%	-16.2%
Private Equity*	Refinitiv Private Equity Buyout Index (USD)	6.9%	27.8%	-41.7%
Real Assets*	Custom Index[3]	5.6%	8.7%	-11.9%

*Expected long term annualized return net of fees.
[1] 50% FTSE Canada Short Term Government Bond Index and 50% FTSE Canada Short Term Corporate Bond Index.
[2] 7.5% ICE BofA 3 Month US T-Bills (CAD-H), 35% ICE BofA Global High Yield Index (CAD-H), 11.25% J.P. Morgan Emerging Market Bond Index (CAD-H), 11.25% J.P. Morgan Corporate Emerging Markets Bond Index (CAD-H), 7.5% J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) (CAD-H), 7.5% Credit Suisse Leveraged Loan Index (CAD-H) and 20% Thomson Reuters Convertible Global Focus Index (CAD-H).
[3] 50% EDHEC Infra 300 Index (Local) and 50% MSCI RealPac Canada Property Index.

Correlations

	Universe Bonds	Core Bonds	Credit & Liquidity	Canadian Equities	Global Equities	Global Low Volatility Equities	Emerging Market Equities	ACWI Equities	Private Debt	Private Equity	Real Assets
Universe Bonds	1										
Core Bonds	0.8	1									
Credit & Liquidity	0.2	0.1	1								
Canadian Equities	0.1	-0.1	0.7	1							
Global Equities	0.1	0.0	0.5	0.7	1						
Global Low Volatility Equities	0.4	0.2	0.2	0.4	0.8	1					
Emerging Market Equities	0.1	0.1	0.6	0.7	0.6	0.5	1				
ACWI Equities	0.1	0.0	0.5	0.7	1.0	0.8	0.7	1			
Private Debt	0.0	-0.1	0.8	0.5	0.3	0.2	0.4	0.4	1		
Private Equity	-0.1	-0.1	0.7	0.8	0.7	0.4	0.6	0.7	0.5	1	
Real Assets	-0.2	-0.2	0.0	0.0	0.0	0.1	-0.1	0.0	0.0	0.0	1

New environment (2023)

Asset classes	Representative data series	Expected long-term return	Expected annual volatility	Expected annual downside risk
Universe Bonds	FTSE Canada Federal Bond Index	3.8%	4.7%	-6.4%
Core Bonds	Custom Index[1]	3.8%	2.4%	-1.3%
Credit & Liquidity	Custom Index[2]	6.7%	8.4%	-16.4%
Canadian Equities	S&P/TSX Composite Index	8.3%	16.9%	-26.1%
Global Equities	MSCI World Index (CAD)	6.7%	14.4%	-24.2%
Global Low Volatility Equities	MSCI World Minimum Volatility Index (CAD)	6.0%	11.5%	-17.7%
Emerging Market Equities	MSCI Emerging Markets (EM) Index (CAD)	8.7%	22.1%	-32.6%
ACWI Equities	MSCI ACWI Index (CAD)	7.0%	14.5%	-25.0%
Private Debt	Credit Suisse Leveraged Loan Index (USD)	7.5%	5.8%	-14.7%
Private Equity*	Refinitiv Private Equity Buyout Index (USD)	9.1%	28.2%	-40.8%
Real Assets*	Custom Index[3]	6.3%	7.8%	-9.5%

*Expected long term annualized return net of fees.
[1] 50% FTSE Canada Short Term Government Bond Index and 50% FTSE Canada Short Term Corporate Bond Index.
[2] 7.5% ICE BofA 3 Month US T-Bills (CAD-H), 35% ICE BofA Global High Yield Index (CAD-H), 11.25% J.P. Morgan Emerging Market Bond Index (CAD-H), 11.25% J.P. Morgan Corporate Emerging Markets Bond Index (CAD-H), 7.5% J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) (CAD-H), 7.5% Credit Suisse Leveraged Loan Index (CAD-H) and 20% Thomson Reuters Convertible Global Focus Index (CAD-H).
[3] 50% EDHEC Infra 300 Index (Local) and 50% MSCI RealPac Canada Property Index.

Correlations

	Universe Bonds	Core Bonds	Credit & Liquidity	Canadian Equities	Global Equities	Global Low Volatility Equities	Emerging Market Equities	ACWI Equities	Private Debt	Private Equity	Real Assets
Universe Bonds	1										
Core Bonds	0.9	1									
Credit & Liquidity	0.3	0.3	1								
Canadian Equities	0.1	0.0	0.8	1							
Global Equities	0.2	0.1	0.6	0.7	1						
Global Low Volatility Equities	0.4	0.3	0.3	0.4	0.8	1					
Emerging Market Equities	0.2	0.1	0.7	0.6	0.7	0.4	1				
ACWI Equities	0.2	0.1	0.6	0.7	1.0	0.8	0.7	1			
Private Debt	0.0	0.0	0.8	0.5	0.4	0.2	0.4	0.4	1		
Private Equity	0.2	0.1	0.7	0.6	0.7	0.5	0.5	0.7	0.4	1	
Real Assets	0.4	0.2	0.1	0.0	0.0	0.3	0.0	0.0	-0.1	0.0	1

Capital market assumptions represent the views of PH&N Institutional for the purposes of illustrating and understanding the potential risk-reward trade-off of different portfolio decisions and are established by considering a variety of qualitative and quantitative sources of information including: different forecasting models; internal and external research; existing and implied future conditions as priced by capital markets; and internal views of our fund managers. Expected long term annualized returns are for a 10-year forecast time horizon. Volatilities, downside risk and correlations are estimated from historical data and adjusted as required to reflect future market conditions. Investors should be aware of the limitations using forward-looking assumptions in that there is absolutely no guarantee that future performance will occur according to any ex-ante expectation.

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