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weathering change

Ensuring a balanced portfolio come rain or shine

Mercer identified five key areas of focus for wealth advisors to consider. One of these areas referenced Mercer's view regarding lower forward-looking returns for a traditional balanced portfolio. In this paper, we discuss the expected challenges of managing a traditional balanced portfolio of 60% equities and 40% fixed income in the face of sustained low interest rates, high equity valuations and reduced return expectations.

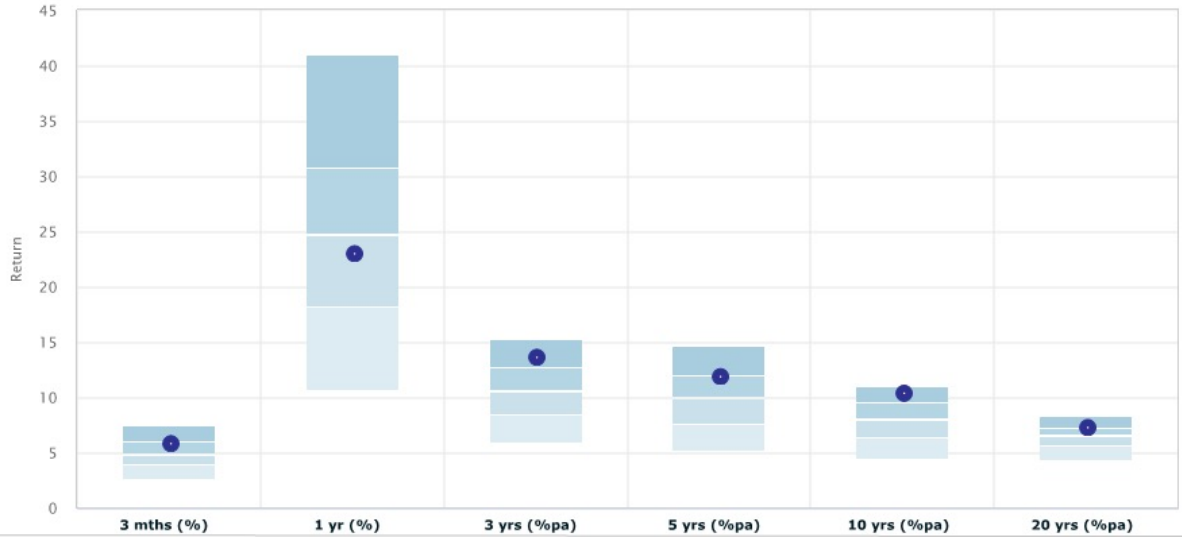
We believe wealth management advisors and their clients can be better prepared to weather the expected lower-return environment by adding investment exposures outside the traditional framework — such as private equity, private credit and other diversifying alternative strategies. Advisors will need to educate clients and clearly identify the risks these investments may introduce to the portfolio. Similarly, advisors should understand the complexity of performing due diligence on these strategies to help ensure they consider potential opportunities from both investment and operational perspectives to reduce risk and increase client return potential.

Challenges on the horizon for the traditional 60/40 portfolio

Over the past five years, a traditional 60/40 balanced portfolio, comprising 60% S&P 500 Index and 40% Bloomberg Barclays US Aggregate Index, has provided double-digit returns and generally met or exceeded investors' return expectations. Even over longer periods, such as the most recent trailing 10-year period, returns for a 60/40 balanced portfolio have been greater than typical return targets of 5% + CPI. Additionally, diversifying away from the S&P 500 to small-cap and non-US equities as well as alternative assets has, in general, detracted from overall absolute results over the past decade.[1] However, based on current interest rate and equity valuation levels, forward expectations suggest returns may be lower over the next 10 years.

Figure 1. Traditional 60/40 portfolio performance*

Return in $US over 3 mths, 1 yr, 3 yrs, 5 yrs, 10 yrs, 20 yrs ending June-21
Comparison with the Mutual Fund US Balanced universe (Percentile Ranking)



	3 mths (%)	1 yr (%)	3 yrs (%pa)	5 yrs (%pa)	10 yrs (%pa)	20 yrs (%pa)
SP60BC40	5.8 *(28)*	23.0 *(59)*	13.6 *(13)*	11.9 *(25)*	10.4 *(9)*	7.3 *(22)*
5th Percentile	7.3	40.9	15.1	14.6	10.9	8.2
Upper Quartile	5.9	30.7	12.7	11.9	9.5	7.2
Median	4.8	24.6	10.6	9.9	8.0	6.6
Lower Quartile	3.9	18.2	8.4	7.6	6.3	5.6
95th Percentile	2.6	10.7	5.9	5.2	4.5	4.3
Number	388	383	361	343	290	153

* Past performance is no guarantee of future results.
Sources: S&P, Bloomberg, Datastream and Mercer as of June 30, 2021.

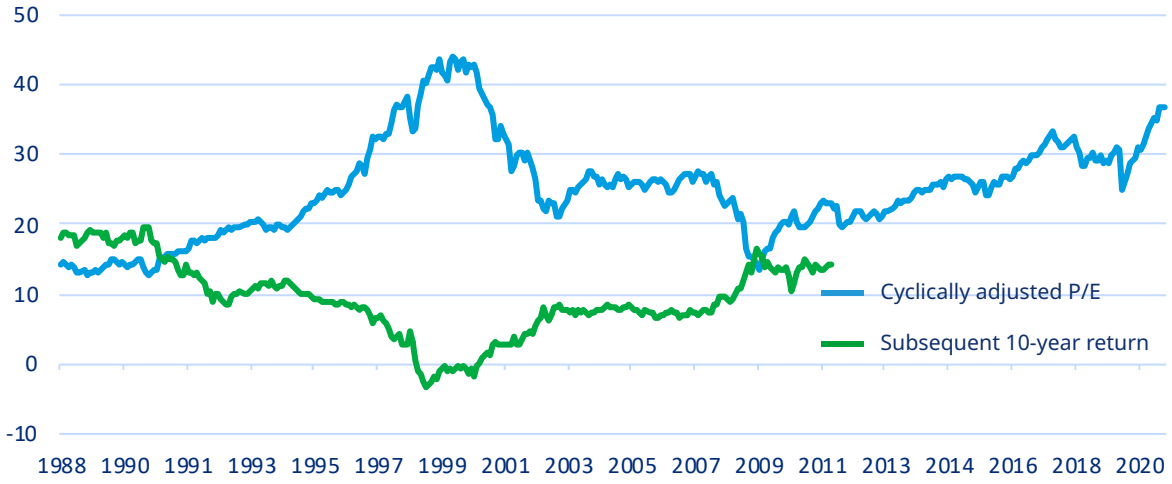
[1] S&P, Bloomberg, Datastream and Mercer as of June 30, 2021.

Equity challenges

The rationale for lower equity return expectations is based on equity valuation levels. US trailing P/E ratios have risen to high levels by historic measures. The P/E ratio based on 12-month forward earnings looks more reasonable but is still high by historic measures. International developed and emerging market equities appear more fairly priced relative to US equities. As presented in Figure 2 below, P/E ratios have historically had negative correlation with returns in the 10-year period that follows.

US trailing P/E ratios have risen to high levels by historic measures.

Figure 2. S&P 500 historical P/E and subsequent returns



Sources: S&P, Datastream and Mercer as of June 30, 2021.

Given that P/E ratios for public equities are above their historic averages, if history repeats itself, equity returns over the next 10 years could potentially underperform the previous 10-year period. Mercer's capital market expectations, which take valuation levels into account, suggest mid-single-digit returns for equities.[2] Although equities appear less attractive from a historical perspective, public equities look fairly priced relative to bonds, with a risk premium of approximately 2.6% above the long-term Treasury yield as of the end of the second quarter of 2021.[3]

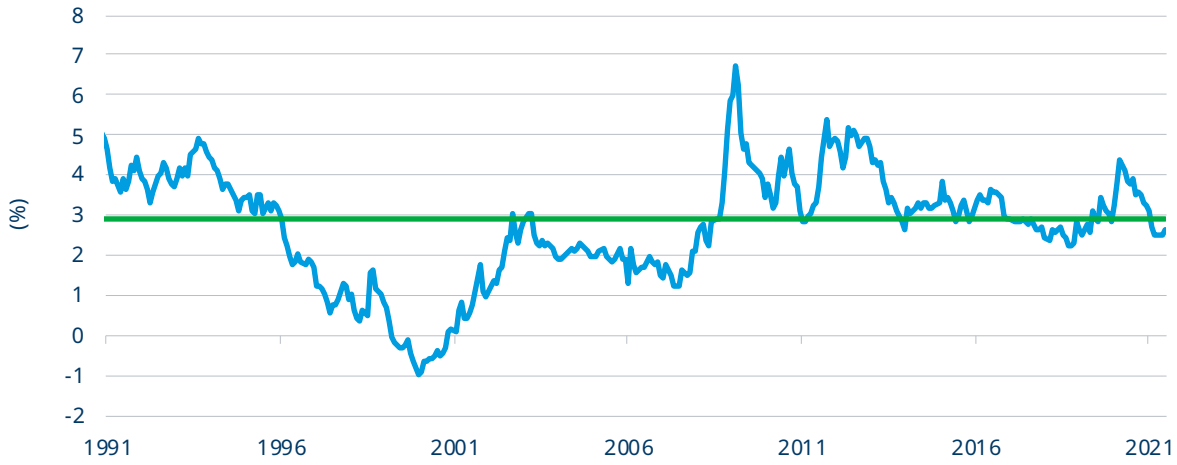
[2] Mercer. "US Capital Market Outlook," July 2021. Return expectations are forward looking and reflect Mercer's Capital Market Assumptions, as defined by asset class and incorporating return, standard deviation and correlations.
[3] Ibid.

Figure 3. P/E ratios for public equities*

	Current 6/30/21	Previous 3/31/21	Avg: Trailing 10 years	Mercer assumption
3-month nominal yield	0.05	0.03	0.49	2.50
10-year nominal yield	1.45	1.73	2.47	3.20
30-year nominal yield	2.06	2.31	3.27	3.30
10-year real yield	-0.87	-0.63	0.47	1.10
US large-cap P/E ratio	31.8	31.2	20.9	19.0
Non-US devel. large-cap P/E ratio	19.2	18.9	14.7	16.5
Emerging markets P/E ratio	16.6	16.4	14.1	14.8

* P/E ratios are MSCI indices using cyclically adjusted earnings.
Source: Mercer. "US Capital Market Outlook," July 2021.

Figure 4. S&P 500 — Equity risk premium versus long-term Treasuries



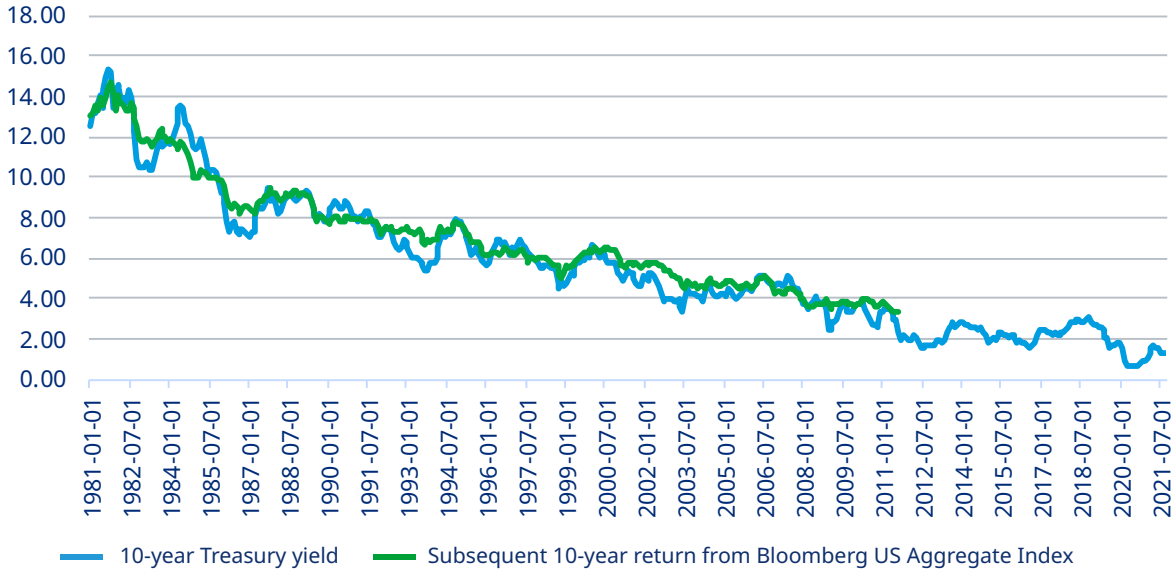
Sources: Bloomberg, Datastream and Mercer as of June 30, 2021.

Fixed income challenges

Return expectations for fixed income have declined as well. An extended period of monetary easing has pushed fixed income yields to historically low levels and compressed credit spreads below their historic medians. Looking back, intermediate-term fixed income returns have been highly correlated with the starting yield on bonds, which creates a challenge given the low starting point for yields today.

Return expectations for fixed income have declined as well.

Figure 5. 10-year rolling return versus intermediate Treasury yield



Sources: Federal Reserve economic data and Bloomberg.

If rates do rise, traditional fixed income investments may experience significant headwinds, as the duration on most bonds has increased over time.

Looking forward, what role should fixed income play in client portfolios? Traditional fixed income investments have often been used to stabilize investment portfolios with income and to provide diversification and downside protection. We still expect this to be the case directionally, but the lower starting point for yields limits the absolute return potential from defensive fixed income in a risk-off market environment. Additionally, the low base yield means relatively small moves in interest rates may have a larger impact.

Forward yield curves suggest that interest rates will increase. If rates do rise, traditional fixed income investments may experience significant headwinds, as the duration on most bonds has increased over time. Further, if yields increase, default risks may also increase given the additional cost of debt to borrowers. On a positive note, rising rates will improve long-term expected returns due to a higher starting yield, but this may lead to mark-to-market losses over the short term.

Figure 6. Cumulative total returns

Cumulative total returns in %	Q1 2020 COVID-19	Q4 2018 taper tantrum	2008 GFC	Duration 6/30/2021
S&P 500 Index	-19.6	-13.5	-37.0	
Bloomberg Aggregate Index	**3.1**	**1.6**	**5.2**	**6.5**
US intermediate Treasuries	8.2	2.6	13.7	6.9
MBS	2.8	2.1	8.3	3.9
Corporates	-3.6	-0.2	-4.9	8.4
High yield	-12.7	-4.5	-26.2	3.9
US aggregate yields	2.31%	3.47%	4.90%	

Source: Bloomberg.

Private equity funds are expected to provide higher returns by allowing skilled managers to build or reorganize companies and capitalize on opportunities not accessible through public equity markets.

Credit markets have recovered significantly from the COVID-19 sell-off in the first quarter of 2020. As a result, spreads have narrowed below their historical median levels. This means investors will have to accept lower yields or move out on the risk spectrum for additional yield. The latter has consequences in terms of correlations to growth assets and increased downside risk — is the increased yield worth the risk of potential loss if credit markets deteriorate?

Potential solutions for traditional 60/40 portfolios

Investors will likely need to seek opportunities outside the traditional 60/40 balanced framework to help meet return requirements. This process includes understanding the potential risks and opportunities and determining where to allocate investments:

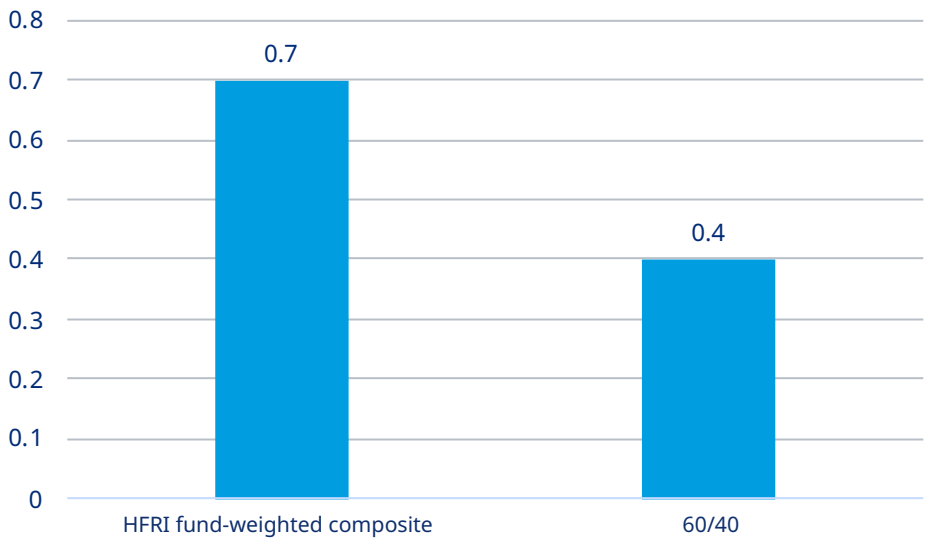
- Revisit clients' liquidity needs to determine their appetite for investing in alternative strategies, and discuss the relevant risks, such as liquidity and fees.
- Explore alternative strategies that have historically only been accessible by institutional investors, and understand their potential to provide higher risk-adjusted portfolio returns over a market cycle.
- Help ensure that the proper level of investment and operational due diligence for asset managers is attainable.
- Revisit clients' fixed income allocations.

Taking on more risk, including illiquidity and complexity, may be necessary to help achieve acceptable return rates. Although investors are wary of illiquidity during market declines, many will likely have the ability to take on more illiquidity to enhance longer-term performance.

As such, an allocation to private equity may be appropriate for investors willing and able to tolerate illiquidity and complexity within their equity portfolios. Although private equity funds generally have a longer investment horizon, such investments are expected to provide higher returns by allowing skilled managers to build or reorganize companies and capitalize on opportunities not accessible through public equity markets. Skilled, top-quartile private equity managers are expected to provide returns in excess of public equities, but such managers can be difficult to identify and access without scale. Investors' ability to access high-quality private equity managers should be taken into consideration when allocating to private equity. Having the ability to collaborate with a third party with potential access to high-quality managers can be instrumental in building out an appropriate private equity allocation diversified by managers and vintages.

Investors may also consider a diversifying allocation to hedge funds as an alternative to public equities, especially for those that are averse to private equity investments with longer lockup periods. Historically, hedge funds have had lower sensitivity to traditional asset classes, such as public equities and fixed income, which can dampen overall portfolio volatility through diversification and downside protection. Hedge funds have also delivered an efficient return profile, with returns in line with a global 60/40 portfolio and lower levels of risk, as shown in Figure 7.

Figure 7. Historical Sharpe Ratio over the 20 years ending December 31, 2020



Sources: HFRI, S&P and Bloomberg.

Although we believe defensive fixed income still has a role in providing liquidity and a bit of defense in portfolios (acting as a risk-reducer or anchor to the overall portfolio), the allocation size will likely need adjustment. Given higher yields (investment grade and high yield), investors will need to supplement government bond allocations with additional credit, along with asset-backed securities and emerging market debt.

Investors that don't have the ability to access less-liquid alternative investments, such as private credit, may want to consider growth fixed income. Consider allocating a portion of the 40% fixed income investment to multi-asset credit (opportunistic fixed income allocations between high-yield segments, including bank loans, high-yield bonds, securitized debt and emerging market debt). Doing so can help increase return expectations for traditional balanced portfolios because of their higher overall carry and lower duration relative to their investment-grade peers. It should be noted that this doesn't come without increased credit risk and a reduction in overall diversification benefits within the fixed income portfolio due to the higher correlation with equities.

In addition, investors may want to consider alternative investment strategies that diversify risk factors or provide an illiquidity premium to publicly traded debt. Private credit offers diverse strategies that range from a focus on capital-preservation to return-maximization. These broad offerings can be used as a potential substitute for a portion of the publicly traded fixed income allocation in the 60/40 framework, but they do come with credit and illiquidity risk.

Inflation, diversification and correlations

Concerns

Although we believe lower return expectations should be the primary consideration for adding new asset classes to the traditional 60/40 framework, investors should take some additional factors into account. To date in 2021, we have seen a significant rebound in inflation that has exceeded expectations, driven by accommodative monetary policy, supply chain pressures and tightening labor markets. This has led to concerns that monetary accommodation may end earlier than expected. In addition to accommodative monetary policy, a falling US dollar (as we have seen so far this year) could lead to higher inflation in the US compared to other global economies. While the higher inflation experienced in 2021 may ultimately be temporary, longer-term inflation concerns remain on the horizon and should be considered when determining asset allocation policy.

Potential solutions

Concerns around higher inflation in the US due to a falling US dollar can be partially subdued by diversifying the equity portfolio to include non-US equities. However, although global equities have historically performed well in inflationary environments when economic growth and earnings are strong, once inflation moves above 5% annually, equities may underperform. Further, fixed income will perform poorly if inflation causes interest rates to rise. Even if rates do not rise, moderate amounts of inflation may result in negative real yields given the current low-interest-rate environment.

Diversifying portfolios with inflation-sensitive real assets, such as real estate, infrastructure and commodities, can help mitigate the downside effects of a global inflationary scenario. The values and cash flows of these assets are often linked to cyclical inflation, which helps to offset the potential negative impact to equities and fixed income.

Additionally, investors could consider an allocation to gold to combat inflation and provide diversification benefits relative to traditional asset classes. Historically, gold has performed strongly when equities have sold off and is viewed as a good potential hedge for the expansion of the money supply. Depending on the source of inflation, different real assets will provide differing levels of inflation protection.

Value creation is driven by making strategic and operational changes, and the ability to implement those improvements is largely independent of market conditions.

Conclusion

According to numerous well-known industry studies, asset allocation is the primary driver of long-term returns. We believe now is the time to review the asset allocation policy of traditional 60/40 balanced portfolios given the current market environment and lower return expectations.

Although we are mindful that investors' tolerance for complexity and need for liquidity varies, investors should consider diversifying their portfolios away from public equities and fixed income to include alternative asset classes, such as private equity, hedge funds, public multi-asset credit, private credit and inflation-sensitive assets. Investors should carefully consider return, volatility, liquidity and diversification benefits when assessing new asset classes and the role they will play in the overall portfolio. Additionally, investors should focus on manager selection in asset classes that are less efficient but also where the dispersion among top- and bottom-performing managers is the widest (as is the case in alternatives). Seeking to ensure the proper level of due diligence is critical for pursuing better client outcomes.

[4] Larrabee D. "Setting the Record Straight on Asset Allocation," *Enterprising Investor*, February 16, 2012, available at https://blogs.cfainstitute.org/investor/2012/02/16/setting-the-record-straight-on-asset-allocation/.

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