# Narrowing the Return Gap: 10 Steps in the Right Direction

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## Gauging the Return Gap

In working with public pensions, we have seen return targets come down over the last 15 years, but only modestly. With large US plans, for example, the current average is still nearly 7.1%, versus 8% a decade ago. Return targets of corporate plans, endowments, foundations, and financial institutions have also declined somewhat, but they still pose a high hurdle when compared with capital market return expectations. Exhibit 1, on the next page, draws on data from six major investment consultants. On average, global equities are expected to provide a return of just under 7% and diversified, high-quality fixed income a return of just over 3%. Using those averages, a 60% equity/40% fixed income portfolio would provide a return of less than 5.5%— a far cry from the returns most investors need.

Even if we replace some core equity and fixed income with assets that have higher expected returns, including private equity, high-yield bonds, and emerging market debt, a 60%/40% "plus" portfolio (bottom half of Exhibit 1, next page) would still have an expected return below 6%.

The low return expectations can be chalked up to several factors, the most underappreciated of which may be the low risk-free rate of return. Prior to the global financial crisis, the risk-free rate in the US was 4% – 5%, which meant institutions were seeking to add 3% – 4% by holding risky assets. Today, of course, the risk-free rate is lower. Even if we use the 10-year US Treasury bond as the risk-free asset (with a yield of roughly 3% at the end of November 2018), investors are still looking to their risk exposures to generate excess returns of 4% – 5% or more above the

**Capital market expectations are low**

| | Return expectations (%) | |
|---|---|---|
| | Average | Median |
| Global equities | 6.8 | 6.8 |
| Core fixed income | 3.1 | 3.0 |
| **Implied 60/40 portfolio** | **5.3** | **5.3** |
| Private equity | 7.7 | 7.7 |
| High yield | 4.5 | 4.8 |
| Emerging market debt | 4.7 | 4.7 |
| **Implied 60/40 "plus" portfolio** | **5.6** | **5.6** |

Average return expectations were sourced from six major investment consultants. Available estimates for each asset class were averaged. 60/40 portfolio: 60% global equities/40% core fixed income. 60/40 "plus" portfolio: 45% global equities/15% private equity/30% core fixed income/5% emerging market debt/5% high yield bond. | Source: Wellington Management | Data as of December 2017; most current data available.

**Exhibit 1**

risk-free rate. Also contributing to the muted return outlook are high equity valuations, the expected growth headwind of aging populations in many developed and emerging markets, and the lower returns being provided by alternatives, as many formerly "alternative" strategies become more mainstream (and therefore more crowded).

## Where Do You Go From Here?

Confronted with this gap between return targets and return expectations, institutions might consider two very different paths.

**Do nothing —** This idea is not as crazy as it may sound. The capital market expectations (CMEs) we highlighted in Exhibit 1 generally have a horizon of 10 years, but institutions' return targets often have a horizon of 30 years or more. Opting not to make significant portfolio changes and essentially waiting out a period of low returns would avoid the risk of a bad decision or an overreaction to the current market environment. On the other hand, it could mean digging an even deeper hole, especially if the low return regime lasts substantially longer than expected. Our research suggests that this approach may work for pension plans that are well funded and have minimal net cash outflows (plan contributions minus benefits paid). But for most plans, even a strong run of asset returns in the future may not compensate for the damage done by 5 – 10 years of underperformance.

**Ramp up risk —** At the other extreme, institutions might view Exhibit 1 as an argument for substantially increasing risk in pursuit of return targets. That typically means reducing exposure to bonds or other lower-risk assets and adding to stocks and other higher-risk assets. The problem is that such a shift also entails more exposure to drawdown risk — and at a time when there are valid concerns about equity valuations. In addition, the required changes in asset allocation could be dramatic. Let's assume an institution has a 7.5% return target and sets an expected return of 8% for global equities and 4% for core bonds. (These numbers have to be higher than the roughly 7% and 3% assumptions in Exhibit 1, or the task will be impossible.) Achieving a 7.5% return target would then require an allocation of 92% global equities and 8% core bonds (Exhibit 2). Historically, that mix would have experienced drawdowns with which many institutions would not be comfortable.

**Boosting risk could mean bigger drawdowns**

| **Assuming 1% alpha** | |
|---|---|
| Global equities (%) | 8 |
| Core bonds (%) | 4 |
| **Getting a 7.5% return with those assumptions** | |
| Stock allocation (%) | 92 |
| Bond allocation (%) | 8 |
| Largest drawdown since 1926 (%) | -80 |
| Largest drawdown in last 30 years (%) | -47 |

Average return expectations were sourced from six major investment consultants. Available estimates for each asset class were averaged. | Stocks: S&P 500; bonds: Jan 2014 – Dec 2017 Bloomberg Barclays US Govt Intm Bond, 1926 – 2013 Ibbotson US Intm Govt Bond. Portfolio rebalanced monthly. | There can be no assurance the performance objectives or characteristics will be met or maintained. Actual results may vary from the example provided. | Sources: Ibbotson, Datastream, Wellington Management | As of December 2017; most current data available.

**Exhibit 2**

# A Third Path: 10 Stepping Stones

Is there another way to address the gap between asset class expectations and portfolio return targets? While many hope to "bridge" it in one go — a tall order, in our view — we propose a series of "stepping stones." While they each entail some measure of risk, we believe that in a world with no perfect answers, these incremental steps can help move portfolios in the right direction.

## Get More Active in Equities

First, a caveat: Investors should generally be wary of asset managers overpromising on their ability to help solve return problems. That said, we think active equity approaches are appealing today. The medium-term outlook for traditional risk assets is below average. But the medium-term outlook for active risk may be at or even above average. Many active managers have underperformed in recent years, and active management has historically demonstrated some mean-reversion characteristics. What's more, the volume of assets that has flowed into passive or other index-like approaches means there is less capital chasing active management opportunities, potentially providing more scope for active managers to add value.

Investors seeking to use active risk in equities to boost returns should learn from past mistakes and take advantage of new approaches (Exhibit 3). They should look beyond the traditional "style box" to a broader range of active equity styles, including contrarian, momentum, and quality strategies, in order to build a more diversified stream of alpha sources with a higher riskadjusted return. We believe it's also important to avoid strategies with low active share and high turnover, sources of "friction" that we think have impeded active management's success over time. Finally, investors should seek to avoid the "hamster wheel" of hiring and firing managers, which often occurs when institutions hire managers in the wake of a period of very strong performance, setting themselves up to be disappointed when performance weakens and they move on to hire the next "hot" manager. One way to avoid the hamster wheel is to shy away from hiring managers with the strongest near-term track record, but it may be more realistic to create a structured and deliberate process that will foster patience — with a formerly high-performing manager who might struggle out of the gate, for example.

**Active management lessons learned**

- Look beyond the style box
- Pay more attention to active share and turnover
- Avoid the hamster wheel of hiring/firing

**Exhibit 3**

## Find Cash-Flow Compounders

Getting more active in equities is about adding alpha to the lower expected equity returns we saw in Exhibit 1, but strategies we call "cash-flow compounders" try to sidestep those expected returns completely. Cash-flow compounders are equity strategies that seek to invest in companies with strong free cash flows relative to their market price. Assuming those cash flows are reasonably stable — and assuming company management deploys them effectively (whether via dividends, buybacks, capital investment, or prudent acquisitions) — then shareholders should reap long-term growth regardless of what happens in the broader market. In other words, the expected return from current and future cash flows may be higher than the expected return for the stock market as a whole.

## Seek Upside by Limiting Downside

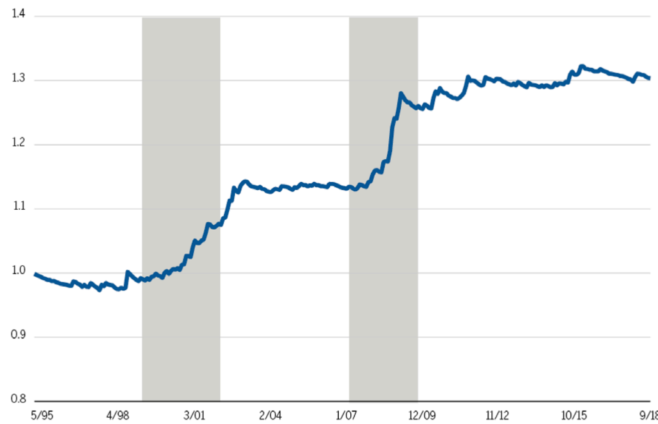
Investors sometimes overlook strategies that seek to add alpha by outperforming when markets struggle. Exhibit 4 illustrates a hypothetical strategy that captures 95% of the return of the S&P 500 in up months but only 85% in down months. Not surprisingly, the strategy adds value when the S&P 500 falls, including during bear markets (shaded areas). But it also holds its own in bull markets, when it might have been expected to struggle. Strategies that seek to limit downside in essence take advantage of the power of compounding. In an environment that is likely to be rocky, strategies with the potential to mitigate downside risk may help smooth the path to a target return.

## Invest Thematically

Thematic investing is an unfamiliar approach for many investors, but it represents another way to truly break out of the style box and away from cap-weighted indexes. Thematic investments by their nature try to take advantage of secular trends — and, as a result, are often delinked from the global business cycle. Consequently, their returns — like those of the cash-flow compounders described earlier — are likely to be decoupled

**The value of outperforming in down markets**

Relative performance of 95% upside participation/85% downside participation strategy in bull (white chart background) and bear (shaded areas) markets vs the S&P 500




Source: Wellington Management | Period analyzed from January 1995 through 30 September 2018 based on monthly returns. The 95%/85% strategy is for illustrative purposes only, and is not representative of an actual account managed by Wellington Management. Hypothetical returns were calculated with monthly S&P 500 Index returns. Each positive monthly return was multiplied by 0.95 and each negative monthly return by 0.85. The resulting monthly return stream was then used to calculate hypothetical performance and characteristics for the 95%/85% strategy. | PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. This strategy is hypothetical and is not offered by Wellington Management.

**Exhibit 4**

from capital market expectations. Examples of themes investors are pursuing today include advances in biotechnology and development trends in emerging markets, such as the growth of the middle class.

## Optimize Fixed Income Exposure

Fixed income is a substantial allocation in many portfolios, but in the current environment it is not carrying its weight with respect to return generation. Historically, bonds offered liquidity, income and protection against financial crises or deflation, as well as reasonable returns. Today, "core" fixed income may pursue the first two or three of these, but not the fourth, given current interest rate levels. Ultimately, portfolios anchored to the Bloomberg Barclays Aggregate Index may be limited in their potential for return generation (Exhibit 5, on the next page). And "core plus" strategies often have only modest allocations to higher-returning segments of fixed income.

We believe investors may be better served by separating the defensive exposures from the return-seeking exposures in a fixed income portfolio and optimizing each independently. The defensive component might include government bonds and perhaps high-quality investment-grade securities, and could take on more duration risk than the Barclays Aggregate. The return-seeking exposures could include opportunistic strategies that rotate across different credit sectors according to their attractiveness or absolute-return, relative-value strategies, which are sometimes overlooked by fixed income investors. Exhibit 5 shows the attractive current yields on two of the more return-oriented fixed income sectors, but return-focused strategies and managers can tap into an even wider opportunity set.

## Enhance Alternatives with Portable Alpha

We argued earlier that investors should consider taking more active risk in equities. For many, this may be best pursued through a blend of long-only active managers, as we described. But for investors who own (or can construct) a portfolio of market-neutral alternative strategies, portable alpha may offer a more potent way to pursue active equity. (As a reminder, portable alpha combines cash investments in market-neutral absolute-return-seeking strategies with futures that replicate a market exposure, usually stocks or bonds.) Portable alpha in essence seeks to close the gap between capital market expectations and return targets by layering the benefits of absolute return on top of the passive return to a broad asset class. Historically, some managers struggled with first-generation implementations of portable alpha, but there are managers who have strong track records in this area and take a thoughtful approach to the integration of the absolute return and the beta.

## Seek Illiquidity Premium Opportunities

Investors seeking to hit their return targets should leave no stone unturned in pursuit of potential return sources, and that includes pursuing the benefits of an "illiquidity" premium. Currently, however, there is a lot of money on the sidelines in the private equity world, which may mean there is less of an illiquidity premium to be earned. (If too much capital chases the same risk premium, that premium may disappear, at least temporarily.) So, it's important to be thoughtful about exactly which illiquid assets may earn a premium over liquid assets. One area we think is interesting today is late-stage pre-IPO companies. In recent years, venture-capital-backed companies have been opting to stay private longer, a trend that is changing the composition of small-cap indexes (Exhibit 6). If companies are larger and more mature when they go public, then public market investors may be missing out on their early and often rapid growth. An investment in private late-stage companies might be thought of as a completion portfolio for a traditional small-cap allocation.

## Dial Up Infrastructure Exposure

The characteristics of infrastructure investments align well with institutions' risk and return goals, as they potentially offer long-term returns that are steady (or even contractually guaranteed) and often paid out through regular distributions. However, we hear anecdotally that many asset owners who have allocated capital are waiting longer than expected for it to be called and put to work. In the meantime, there is an ample and largely untapped opportunity in publicly listed infrastructure investments, which we believe offer many of the same characteristics as private assets, as well as several advantages, including greater liquidity, the ability to be tactical in sector and geographic allocation, and the ability for managers to outperform by managing for total return in a market that is often focused on yield.

## Find Ways To Be More Contrarian

Adopting a more contrarian mindset in portfolios is a potentially powerful way to enhance returns compared with broad market exposure. Restrained capital market expectations reflect the fact that the growth in intrinsic value offered by investments — the slope of the straight line in Exhibit 7, on the next page — has probably come down over time. But what happens to that line matters less for contrarian investors, who seek to buy at a point of pessimism and then sell when there's more exuberance, thereby tilting the slope of the line in their favor. There are several ways to bring a contrarian discipline to a portfolio: through asset allocation (buy "beaten up" asset classes), manager selection (allocate to strategies that have faced a recent headwind), or security selection (buy securities that engender apathy and avoid those that investors love).

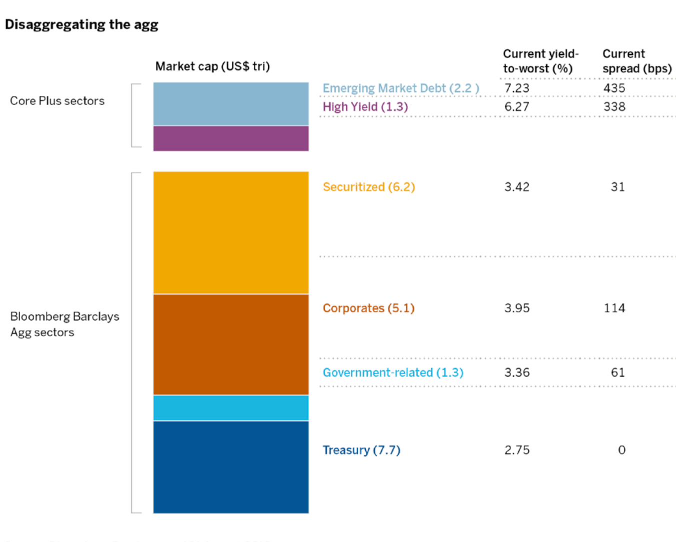



Exhibit 5

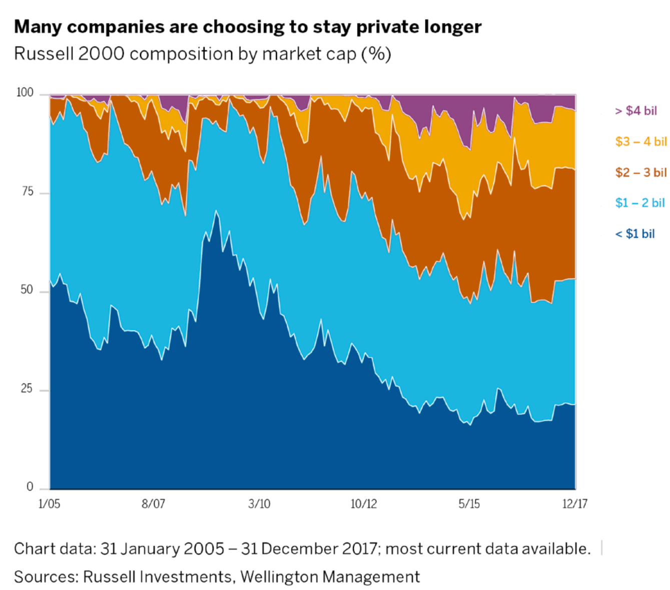



Exhibit 6

## Consider "Core Alternatives"

Many investors are already using alternative investments to help them reach their objectives, but we believe there are opportunities to improve returns by building more efficient alternative portfolios. To help, we propose a core/satellite framework, particularly for hedge funds. The core in the structure — a class of strategies we call "core alternatives" — seeks to generate returns using the same drivers as hedge funds, including risk factors, security selection, macro tilts, and hedging. By implementing these drivers more simply, efficiently, and transparently, core alternatives may help investors free up time and capital to pursue "satellite" strategies that may be more niche-oriented, less liquid, and/or higher-fee. This is not a "one size fits all" framework. The sizing of the core and satellite allocations relative to each other will be a function of several factors, including the institution's risk and return objectives, manager relationships/access to the desired alternatives, and fee sensitivity.

One return driver of many core alternatives is exposure to alternative risk premia — market-neutral exposures to "risk factors," such as carry, trend, convergence, and equity-style premia, that have historically offered a positive return to investors willing to bear them. Investors concerned that traditional risk premia (compensation for taking traditional long-only market risk, as in equities) will offer lower returns in the current environment may benefit from shifting risk at the margin toward strategies that more intentionally target these alternative sources, which have historically provided diversification (relative to each other and the market) and less exposure to stock market drawdowns.

Core alternatives also include a family of strategies we call "8&8" portfolios, because their managers generally seek to generate total return of about 8% with a comparable level of volatility. These strategies are often multi-asset, and they tend to draw on a range of techniques (including several of the stepping stones noted above). They may, for example, balance long and short equity exposures; combine market beta, alternative beta and alpha with an overlay of risk management; or combine multiple hedge fund strategies across disciplines to create a portfolio with only modest beta to global equities.

## Selecting Stepping Stones and Putting the Risks in Perspective

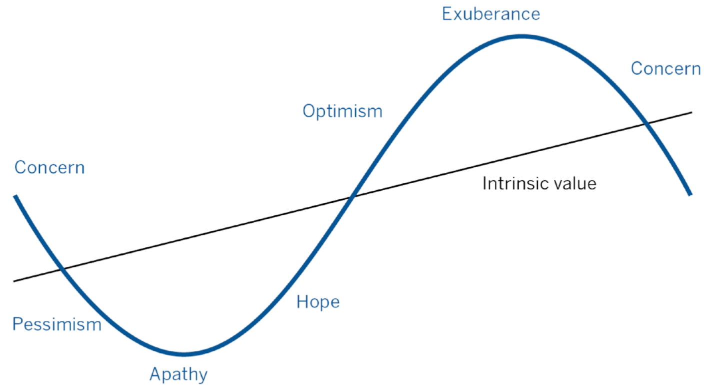
The beauty of the "stepping stones" approach is that there is no single predetermined path to implement them. Investors can seek to improve returns by choosing a subset of steps that are in sync with their investment beliefs and institutional history, and consistent with board priorities. Ideally, the steps should build on the existing expertise of the organization. Investors should choose steps that can be explained logically to constituents, and they should have enough conviction to avoid being pressured to shift out of them if they don't work immediately.

Exhibit 8 offers an illustration of how some of these stepping stones could be incorporated across a portfolio. In the equity allocation, the stepping stones might include a shift from passive to active strategies, an increased role for more defensive strategies, and the use of portable alpha. In the fixed income allocation, one might separate defensive exposures from return-seeking exposures and seek to optimize each — for example, by adding to credit strategies and absolute-return strategies. In the alternatives allocation, there might be a role for core alternatives, including strategies that pursue alternative beta, as well as an increased role for infrastructure exposure via publicly listed investments. And then across the portfolio broadly, one might look for opportunities to be more contrarian and to invest thematically.

The overall approach will vary by investor. It may be to add more alpha from assets whose CMEs are too far below the investor's return targets; to shift from asset classes (or sub-asset classes) with lower CMEs to those with higher ones; or to sidestep the CMEs completely and pursue strategies that may provide returns that aren't closely linked to those of broader asset classes.

In applying these ideas, it's important to remember that some of the stepping stones may increase portfolio risk. For example, portable alpha strategies involve leverage and contrarian strategies may increase volatility. But we think the overall risk impact of these stepping stones on a diversified portfolio should be modest. Adding active risk is often diversifying to the beta in a portfolio, and different sources of active risk can be diversifying relative to each other.

**A contrarian investor mindset**




Source: Wellington Management

**Exhibit 7**

**How to incorporate "stepping stones" into your portfolio**

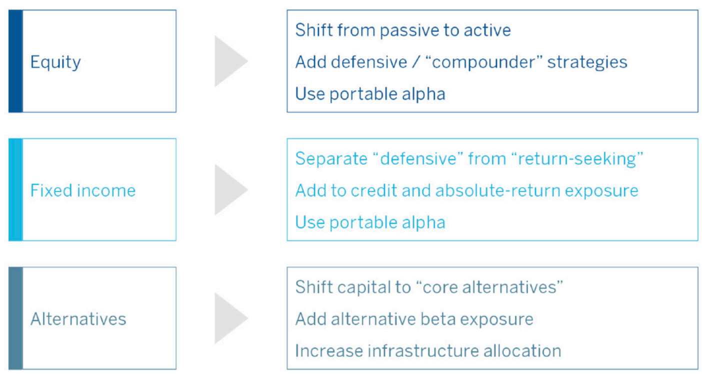



**Exhibit 8**

## Conclusion

The current market backdrop is without question a challenging one, and there's no quick fix and no single "bridge" that will get investors where they need to go. But there are effective steps that can be taken. The challenge for investors is choosing which to take and managing the process of implementation.

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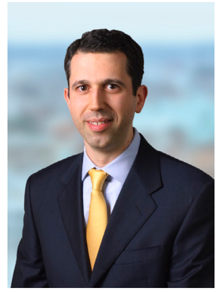
## Author Bio



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Adam is a multi-asset strategist at Wellington Management. He develops research on capital market and asset allocation themes, advises clients on investment strategy and policy issues, and implements investment solutions for clients. Adam earned his M.B.A. from the University of Pennsylvania and his A.B. degree from Harvard College.