BlackRock.

Investment perspectives
Strategic asset allocation
February 2024

A bigger role for active strategies

The new regime of greater macro and market volatility rewards an active approach. For those able to consistently pick skilled managers, we think active strategies could play a bigger role in portfolios today.

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Summary

- **Financial markets are adjusting to the new regime of greater volatility, uncertainty and divergence in market performance**. A more dynamic portfolio approach is needed – and if investors have confidence in their ability to pick good managers, active strategies should play a bigger role in portfolios today, in our view. Active strategies include dynamic approaches to indexing.
- **Static asset allocations – or set-and-forget portfolios – are a reasonable starting point but we don't think they will deliver as in the past.** The era of ultra-low interest rates is in the past and future expected returns look less attractive. We believe excess returns over cash will be much lower for static exposures as a result.
- **Macro uncertainty has ballooned since the pandemic struck – and dispersion of returns has increased.** The new, more volatile and more uncertain regime has led to heightened dispersion in some markets. There's less conviction about the path ahead – the range of estimates on key macro data like inflation has grown wider. The range of U.S. stock returns has grown markedly wider. That means there are more opportunities for skilled managers to find and deliver active returns, in our view. We define active returns as above-benchmark returns that can't be explained by static exposures to macro and equity style factors.
- **We find that alpha-seeking managers acting more frequently on their insights may be better rewarded in this new regime.** Does that mean *skilled* managers have added more active returns? Our research suggests so, even after excluding the pandemic's most volatile periods.
- **Professional managers as a group have not become more skilled at delivering active returns overall – but we do find today's environment is more conducive for skilled managers to deliver more active returns.** The top-performing developed market (DM) equity and hedge fund managers have been delivering more active returns by exploiting the new regime's uncertainty and dispersion. We assume a fee for active returns in DM equities based on a manager fee survey, as fees can vary and be negotiated. For hedge funds, active returns are net of fees, as overall hedge fund returns are reported net of fees.
- **All this only matters if investors can reliably pick top managers**. Why? Delivering top-ranking active returns consistently is difficult. Finding managers that do requires extensive research and monitoring, which can be costly. That's more important now as the new regime more clearly separates the outperformers from the rest. Investors with a preference for rules-based strategies or those with limited governance budget may choose to keep their entire portfolio in index tools.

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Contents

Beyond simple approaches	**3**
Uncertainty fuels dispersion	**4**
Greater potential rewards for skill	**5**
Appendix	**6-9**

Beyond simple approaches

We've long argued that the defining feature of the post-pandemic era is greater macro and market volatility. Persistent supply constraints along with mega forces, or big structural shifts like the low-carbon transition and demographic divergence, means the stable growth and inflation of the Great Moderation won't be returning, in our view. Such an environment powered joint bull markets in stocks and bonds in the four decades leading up to the pandemic.

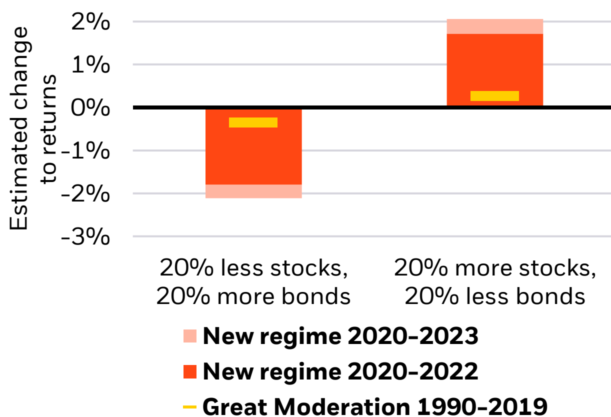
We don't see stocks and bonds rising together in the same way going forwards. In the decade leading up to the pandemic, developed market (DM) stocks and bonds outperformed the returns from cash by roughly 10 and 2 percentage points respectively, per Bloomberg as of 31 Dec. 2023. We believe the future excess return over cash from stocks will be much lower, as persistent inflationary pressures and mega forces keep interest rates above pre-pandemic levels. **Getting the asset mix right matters much more now**. See the left chart. It shows the estimated impact of choosing to hold 20% more or less stocks than a hypothetical traditional portfolio mix (with 60% in stocks and 40% in bonds) – shown for illustrative purposes – during the Great Moderation (yellow lines) and the new regime (orange bars). We find the return impact – even with a different asset mix – is likely much lower in the past. This isn't about the starting point of a traditional portfolio being better or worse today – that will always depend on an investor's objectives. But changing the portfolio mix has a much greater impact today than it did in the past – those choices matter more.

So simple, static approaches don't go as far when combining stocks and fixed income – both are unlikely to rise together the same way, in our view. But is that true for single asset classes too? Our work explains why we believe a dynamic investing approach that acts on insight and expertise more frequently could be better rewarded in the new regime. See the right chart. It assumes an investor's predictions for future U.S. equity sector returns turn out to be accurate. Acting on this hypothetical ability more frequently would have paid off much more since 2020 (see the right bars) than in the four years prior (left bars). Even if we exclude 2023 from the analysis – a year when a handful of mega cap tech stocks contributed strongly to overall U.S. equity returns – we find the same results. The orange bars – a simple, static approach of buying and holding – are much lower than the yellow and green bars, even with this hypothetical ability. The upshot? It's not just good insight, but also acting on it in a timely manner, that would have yielded greater rewards than buy-and-hold strategies since 2020. This hypothetical exercise highlights how skill and insight may be better rewarded in the new regime – we think investment expertise is likely to give portfolios an edge.

We define the outperformance of market benchmarks that aren't explained by broader macro, market and style factors as active returns. We calculate active returns in line with our framework for blending returns: stripped of factor exposure and assume a fee for active returns in equities (hedge fund returns are reported net of fees). Fees can reduce and potentially eliminate active returns when applied. See more in Assumptions section of the appendix. We find active returns are more disperse among some alpha-seeking managers in the new regime – and that means skilled managers are delivering more active returns – and other managers less – since 2020.

Bigger impact

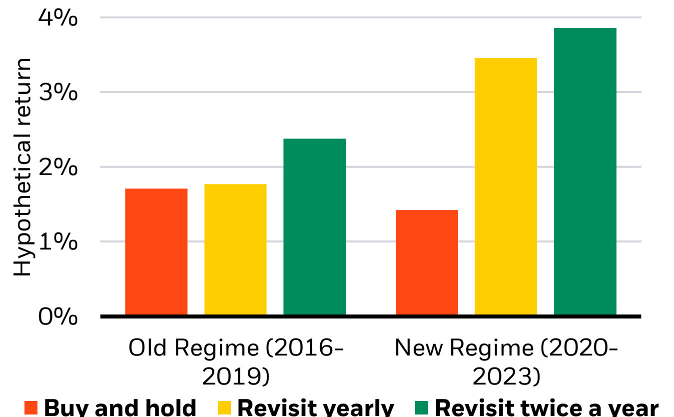
Deviating from a hypothetical 60/40 portfolio



Past performance is not a reliable indicator of current or future results. Index returns do not account for fees. It is not possible to invest directly in an index. For illustrative purposes only. These do not represent actual portfolios and do not constitute investment advice. This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance. Source: BlackRock Investment Institute with data from LSEG Datastream and Morningstar. Returns data as of September 2023. Notes: The chart illustrates the contrast between estimated average annual relative performance of two hypothetical portfolios against a 60-40 global equity-global bond portfolio since January 2020 over the Great Moderation era (Jan 1990-Dec 2019) of stable growth and inflation. We show hypothetical performance of portfolios comprising a 40%-global equity-60% global bond split and an 80% global equity-20% global bond mix. Index proxies: MSCI AC World for equities and the Bloomberg Global Aggregate Index for bonds. We use the actual returns for both indexes using LSEG data to estimate portfolio returns.

Greater rewards for good insight

Hypothetical impact of acting on U.S. sector insight



Past performance is not a reliable indicator of future performance. Index returns do not account for fees. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, MSCI with data from Bloomberg, January 2024. Notes: The chart shows monthly U.S. equity returns – based on the MSCI USA – in the old and new regime under three scenarios: keeping the holdings unchanged (buy-and-hold), yearly rebalances and semi-annual rebalances. The rebalances optimize the hypothetical portfolio for returns, diversification and risk with perfect foresight of equity sector returns in the MSCI USA index. This analysis uses historical returns and has been conducted with the benefit of hindsight. Future returns may vary and these results may not be the same for other asset classes. It does not consider potential transaction costs that may detract from returns. It also does not represent an actual portfolio and is shown for illustrative purposes only.

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Uncertainty fuels dispersion

Why could there be a greater reward for being more dynamic today? One defining aspect of today's environment is its heightened macro uncertainty. The widening range of economist estimates on data like inflation is one indicator of how uncertain the new regime is. See the left chart. It shows the dispersion in near term U.S. and euro area inflation forecasts from a survey of economists. Since 2020, that dispersion has spiked. Even though inflation was unlikely to persist at such elevated levels coming out of the pandemic, we believe structural supply constraints and geopolitical fragmentation mean there will be less consensus about key macro variables than we've become used to. Mega forces like the transition to a low-carbon economy, demographic divergences and geopolitical fragmentation are set to make inflation more volatile – and we think it's set to rollercoaster, resurging in 2025. Forecasters are less certain about what lies ahead – such is the uncertainty of the new regime.

Another driver underpinning the current environment is the heightened dispersion of market returns in the new regime. See the right chart. It shows how far the monthly returns of individual S&P 500 stocks deviate from the overall average. Those returns have been more dispersed since 2020 (green line) than in the decade prior (yellow line). We believe that reflects the new regime's elevated macro uncertainty, and how companies are coping with higher borrowing costs and increased pressure on profit margins.

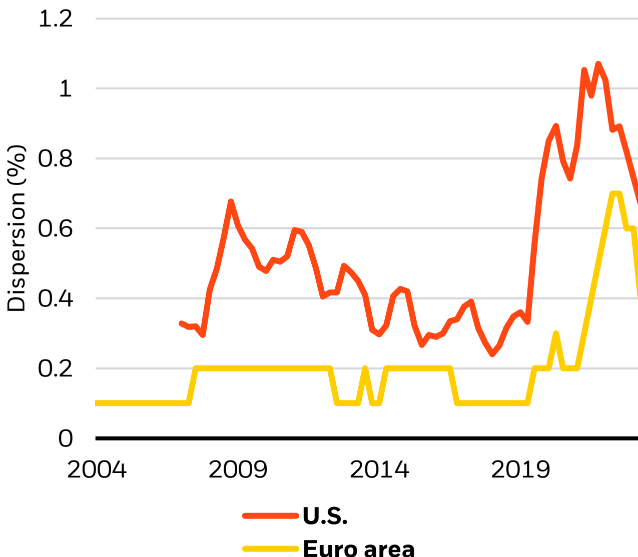
What's the potential upside to greater uncertainty? Investment expertise could prove more valuable as those with deeper market insights could exploit the resulting increase in market dispersion. This potential for greater rewards from combining a dynamic approach with investment skill is why we believe active strategies could play a bigger role in some portfolios now.

Active returns can be generated in different ways. We think investors with the resources and skills to find top-performing managers could pivot portfolios towards active strategies and away from static broad market exposure, sometimes called beta. Being dynamic with index strategies is also a source of active returns. An active approach to indexing would allow investors to exploit their skill in timing markets and their ability to consistently pick exposure to the right sectors, regions and styles. But that preference for active strategies would hinge on the ability to reliably pick skilled managers and depends on fee constraints, portfolio objectives and the governance budget allocated to cover the costs involved in finding top alpha-seeking managers and monitoring their performance.

The new regime's heightened uncertainty and greater dispersion mean investment insight and expertise could be better rewarded today than in the past. So how have alpha-seeking managers fared in this new environment?

Heightened uncertainty

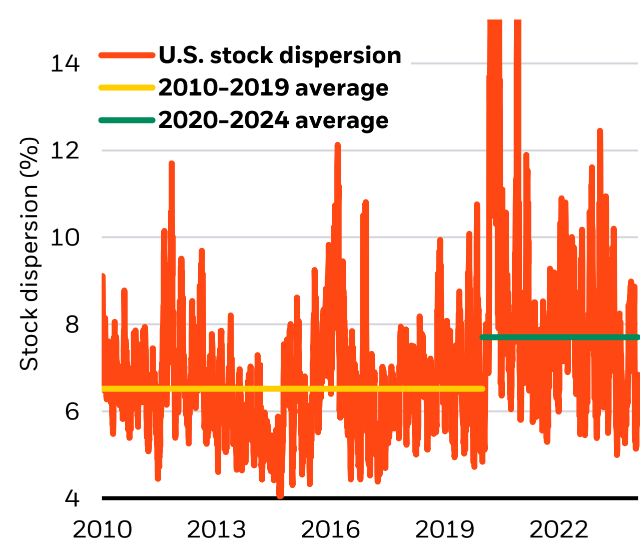
Dispersion of inflation forecasts, 2004-2024



Source: BlackRock Investment Institute, European Central Bank, Philadelphia Federal Reserve, with data from Haver Analytics, February 2024. Notes: The chart shows the dispersion in near-term inflation forecasts in the U.S. and euro area from central bank surveys of professional forecasters.

Greater dispersion

Dispersion of S&P 500 performance, 2010-2024



Past performance is not a reliable indicator of current or future results, and index returns do not account for fees. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, with data from LSEG Datastream, February 2024. Notes: The chart shows the dispersion in S&P 500 monthly stock returns on a daily basis and the median level of dispersion from July 2010 after the global financial crisis through 2019, and from 2020 through Jan. 31, 2024.

Greater potential rewards for skill

Our thought experiment on page 3 suggests there's greater rewards for investment insight in this new regime. Greater macro uncertainty and market dispersion suggests skilled managers with deeper insights could exploit today's environment. But does the data suggest skill is better rewarded now?

We assessed a broad universe of equity and fixed income managers, and hedge funds to find out. We find that active returns for developed market (DM) equity and hedge fund managers has been more dispersed post-pandemic. The left chart shows the interquartile range of active returns – the difference between the top 25% and the bottom 25% ranks, or quartiles – for DM equity managers has widened since 2020. We find that's true for hedge fund managers too. For DM equity fund managers, the interquartile range of active returns has grown to the highest in more than a decade. Top-performing managers are delivering more active returns than worst-performing managers are. The conclusion: greater dispersion in returns across markets is translating to more dispersion among some alpha-seeking managers.

That's not the case for fixed income. One potential reason: the drivers for active returns in fixed income can be linked to macro factors, like central bank policy rates. DM central banks shared similar policy stances since the global financial crisis (GFC). Pre-pandemic, they mostly kept interest rates low or even negative with constant bond buying to reinforce loose monetary policy. Since the pandemic, they've rapidly hiked rates to battle persistently high inflation. Mostly similar policy stances across DM central banks may have created some active return opportunities for managers quick to bet on rising rates. But it means the active returns on offer didn't necessarily come from regional dispersion. With interest rates peaking, divergences in the outlook for inflation could lead to some policy divergence across DM central banks – and opportunities to exploit. Our analysis reaffirms previous findings: information ratios – a risk-adjusted measure of active returns – are higher in fixed income than in equities, suggesting active risk is more efficiently rewarded in fixed income.

The new, more volatile regime is clearly affecting active DM equity and hedge fund managers too. There is more divergence in manager performance – but that doesn't mean they're more skilful. Our estimates of information ratios – a gauge of manager skill – haven't changed, consistent with Kahn & Grinold's (1999) findings. We find the top-performing managers are delivering more active returns – potentially from exploiting this more uncertain, higher-risk environment.

Our research finds that top-quartile active returns for DM equity and hedge fund managers has risen recently, like the interquartile range has. See Charts in the appendix. This reinforces why we believe this new environment is better for generating active returns, but that critically relies on skill – it's the top-performing, skilled managers delivering more active returns so far. The right chart shows risk-adjusted returns of hedge funds, U.S. stocks and bonds. During periods of low macro volatility like post-GFC when loose monetary policy suppressed volatility, hedge funds underperformed. But we see central banks holding policy tight. That would look more like a pre-GFC world of greater volatility – one more frequently exploited by differentiated skill, insights and a dynamic approach.

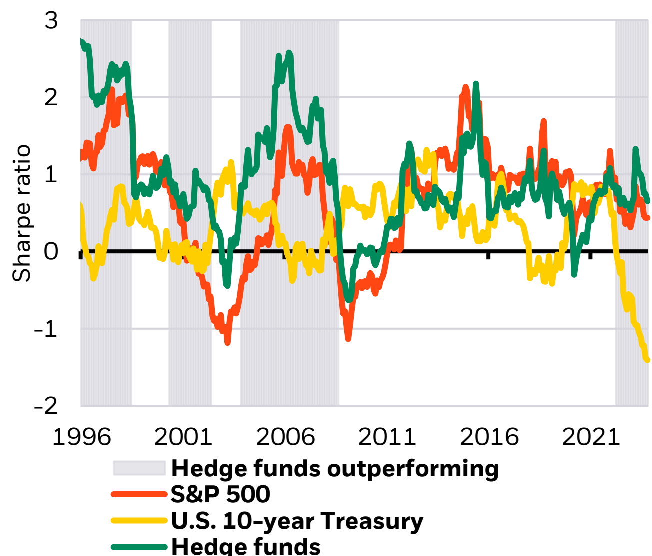
Active divergence

Interquartile range of DM equity active returns, 2007-2023

Past performance is not a reliable indicator of future performance. This information should not be relied upon by the reader as research or investment advice regarding any funds, strategy or security in particular. Source: BlackRock Investment Institute, February 2024. Notes: The charts show the difference between the top quartile (top 25% rank) and bottom quartile (bottom 25% rank) of active returns generated by alpha-seeking managers across developed market (DM) equities. We assume a median fee of 0.6% for DM equity funds based on a manager fee survey. Actual fees may differ. Fees can reduce and potentially eliminate active returns. See more in the Assumptions section of the appendix. We use regression analysis to estimate the relationship between alpha-seeking manager performance and market conditions. Regression analysis is backwards-looking and is only an estimate of the relationship. The future relationship may differ. See more in the Limitations section of the appendix.

Getting active

Sharpe ratios for equities, bonds and hedge funds



Past performance is not a reliable indicator of future performance. Index returns do not account for fees. It is not possible to invest directly in an index. This information should not be relied upon by the reader as research or investment advice regarding any funds, strategy or security in particular. Source: BlackRock Investment Institute, HFRI with data from LSEG Datastream, December 2023. Notes: The chart shows the Sharpe ratios for the S&P 500, U.S. 10-year Treasury and hedge funds. The index proxy used for hedge funds is the HFRI Weighted index. The Sharpe ratio measures an asset's risk-adjusted returns. It is calculated by dividing the asset's excess returns (typically over cash) by its standard deviation, which represents its risk.

Appendix

Our framework

As we outlined in our 2022 update to our framework, we believe alpha – returns delivered by managers beyond market benchmarks – falls into two categories: 1) returns that can be replicated systematically and cost-efficiently by broad market and factor indexes, and; 2) returns that are driven by true investment skill and cannot be systematically captured through an index. Our views:

Factors: Macro and equity style factors are important drivers of returns. It is important to separate this source of return from any manager's excess return relative to a benchmark to understand the return that is an investor pays for.

Returns and fees: What matters are returns net of costs. Product fees cut into returns and can reduce or, in some cases, eliminate the alpha an investor receives. Yet these fees vary widely and change over time. Some index and factor products can also have large fees. Investors should fully account for fees in portfolio construction.

Governance costs: Governance costs – those required to find and manage managers – are an essential consideration. We believe manager selection and oversight are vital to achieve alpha.

Methodology

We use time series regression analysis to strip out the impact of macro and equity style factors, and other market indices from excess returns to estimate the underlying active returns directly attributable to manager skill for our left chart on page 5 and both charts on page 9 in the appendix. We go beyond the usual Ordinary Least Squares technique to reduce overfitting and use Ridge regression analysis instead. While none of these approaches can completely eliminate overfitting – explained in the limitations section below – and will only produce approximate estimates of active returns, Ridge regression aims to minimize the impact of overfitting. Our equities and fixed income data on returns in excess of a fund's performance benchmark come from eVestment data. These returns are reported gross of fees for 2,898 managers (as of June 2023) across asset classes in public markets. We use MSCI indices as a proxy for equity style factors and market benchmark indices as a proxy for macro factors across asset classes. For hedge funds, we use the funds within the Hedge Fund Research (HFR) Index universe (of roughly 1,168 funds, as of October 2023) and the returns are reported in excess of the cash rates and net of fees. The index proxies used are on the next page.

Assumptions

For equity, we use both style factors and regional equity, and account for currency hedging in our analysis. For example, for U.S. large cap funds, we account for U.S. large cap style factors and do the same for emerging market (EM) and Europe, Australasia and Far East (EAFE) equities. Our regression model accounts for currencies for any exposure to EAFE stocks. We assume managers can take a hedged exposure – that is try to reduce the impact of currency moves on their returns – and use the DXY dollar index as a proxy to do so.

For fixed income we use credit ratings (for example, Treasury, investment grade and high-yield) and other markets (for example, emerging market debt) in our analysis. We do not use any fixed income style factors as there is not enough history covering the time span of manager returns to determine fixed income factors – persistent drivers of returns.

For hedge funds, we use a few style and credit factors along with an oil factor in our analysis. Oil is one factor used to explain hedge fund returns in academic research to capture the short-term macro environment.

Fee assumptions	Index or beta	Alpha-seeking
Equities	0.15%-0.5%	0.4%-0.8%
Government bonds	0.15%-0.3%	0.2%-0.25%
Investment grade credit	0.1%-0.3%	0.2%-0.25%
Sub-investment grade credit	0.4%-0.5%	0.4%-0.5%
Private markets	N/A	0.5%-5.0%

Source: Mercer Global Asset Manager Fee Survey, 2017. Morningstar, BlackRock estimates. Note: Fee assumptions are given as ranges given the wide range of asset classes, currencies and datasets we consider in our calculations.

Appendix

Limitations

Our regression technique cannot completely eliminate overfitting – where including too many potential explanations (our explanatory variables) for the nature of a relationship can overstate or understate the impact of the variable on the relationship we're observing. For example, in the case of this paper, overfitting would be considering too many variables for manager performance – and it could overstate or understate the impact some of those variables have on manager performance. Regression analysis is backwards-looking with the benefit of hindsight and complex – it may not reliably predict the future relationship between manager performance and market conditions. Expert judgement from a manager research team on an individual fund manager could bring better clarity on how they performed. In-depth and practical manager research can improve on econometric techniques and analysis, like regressions, to build a better picture of how a fund manager might perform in the future.

Data sources

eVestment fund database

Asset	Number of funds
U.S. equities - large-cap value	315
U.S. equities – large-cap growth	237
U.S. equities – large-cap blend	295
U.S. equities – mid-caps	209
U.S. equities – small-cap	505
EM equities	352
DM ex-U.S. equities	152
UK equities	83
Europe equities	90
U.S. corporates and credit	151
U.S. high yield	152
U.S. fixed income – core	217
EM hard currency debt	66
Europe corporates	74
Total	**2898**

Hedge Fund Research

Strategy	Number of funds
Equity hedge	492
Macro	188
Event-driven	129
Relative value	208
Other	151
Total	1168

Source: BlackRock Investment Institute with data from eVestment and Hedge Fund Research, January 2024. Note: The tables show the list of funds by asset class we considered for our analysis. eVestmentis and Hedge Fund Research are third-party data providers. More detail s are available at https://www.evestment.com/research/trends/ and https://www.hfr.com/

Index proxies used to calculate outperformance

Hedge fund factors	Index
U.S. market	MSCI USA
Value	MSCI USA Value
Growth	MSCI USA Growth
Duration	Lehman Brothers U.S. Treasury Index
U.S. investment grade	Lehman Brothers U.S. Credit Index
U.S. high yield	Lehman Brothers U.S. Corporate High Yield Index
Oil	Dow Jones UBS Crude Oil Total Return Index

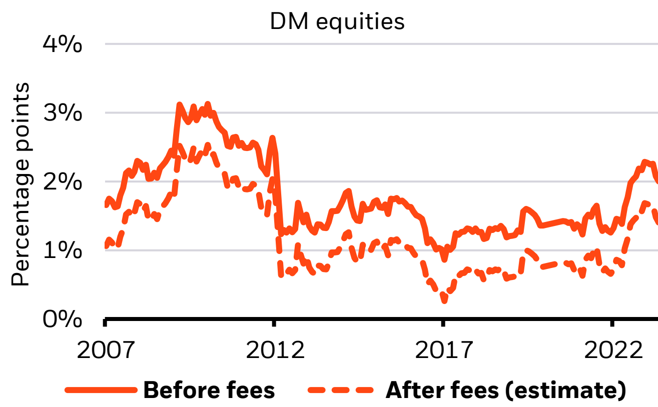
Equity factors	Index
U.S. large-cap value	MSCI USA Enhanced Value
U.S. large-cap quality	MSCI USA Sector Neutral Quality
U.S. large-cap min-vol	MSCI USA Minimum Volatility
U.S. large-cap momentum	MSCI USA Momentum
U.S. small cap	MSCI USA Small Cap
Emerging markets (EM)	MSCI EM
Developed markets (DM), ex-U.S.	MSCI EAFE
U.S. large-cap	MSCI USA
DM, ex-U.S. value	MSCI EAFE Value
DM, ex-U.S. quality	MSCI EAFE Quality
DM, ex-U.S. min vol	MSCI EAFE Minimum Volatility
DM, ex-U.S. momentum	MSCI EAFE Momentum
DM, ex-U.S. small-cap	MSCI EAFE Small
Europe large-cap value	MSCI Europe Enhanced Value
Europe large-cap quality	MSCI Europe Sector Neutral Quality
Europe large-cap min-vol	MSCI Europe Minimum Volatility
Europe large-cap momentum	MSCI Europe Momentum
Europe small-cap	MSCI Europe Small
Europe large-cap	MSCI Europe
UK large-cap value	MSCI UK Value
UK large-cap quality	MSCI UK Quality
UK large-cap min vol	MSCI UK Minimum Volatility
UK large-cap momentum	MSCI UK Momentum
UK small-cap	MSCI UK Small
UK large-cap	MSCI UK
EM value	MSCI EM Enhanced Value

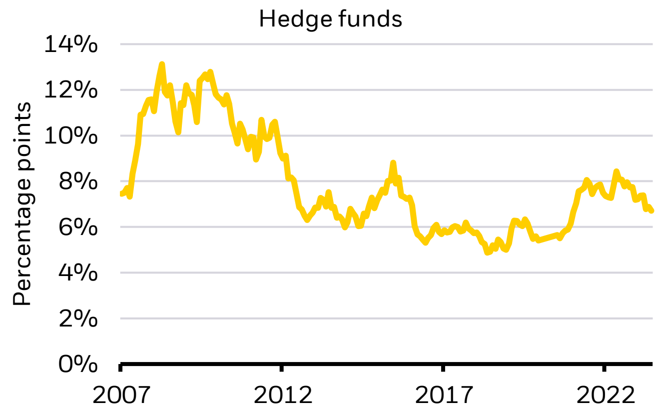
Fixed income factors	Index
U.S. high yield	IBOXX $ Liquid High Yield
U.S. corporates and credit	IBOXX $ Liquid Investment Grade
EM, hard currency debt	JPM EMBI Global Core Index
U.S. long-dated government bonds	ICE BofA 7-10 Year US Treasury Index
EM debt	JPM GBI-EM Global Diversified Composite
U.S. inflation-linked bonds	Bloomberg U.S. Treasury: U.S. TIPS USD
U.S. government bonds	Bloomberg U.S. Aggregate USD
Europe corporates	ICE BofA Euro Corporate
Europe high yield	IBOXX Euro Liquid High Yield
Europe long-dated government bonds	ICE BofA 7-10 Year Euro Government Index
Euro inflation-linked bonds	ICE BofA Euro Inflation-Linked Government Index

Charts

Top-performers delivering more

Top quartile active returns, 2007-2023





Past performance is not a reliable indicator of future performance. This information should not be relied upon by the reader as research or investment advice regarding any funds, strategy or security in particular Source: BlackRock Investment Institute, February 2024. Notes: The charts show the top quartile (top 25% rank) active returns generated by alpha-seeking managers across developed market (DM) equities and hedge funds. We assume a median fee of 0.6% for DM equity funds based on a manager fee survey. Actual fess may differ. Active returns for hedge fund managers is net of fees – as the overall returns are reported net of fees. Fees can reduce and potentially eliminate active returns. See more in Assumptions section of the appendix. We use regression analysis to estimate the relationship between alpha-seeking manager performance and market conditions. Regression analysis is backwards-looking and is only an estimate of the relationship. The future relationship may differ. See more in the Limitations section of the appendix.

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