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BlackRock

The Portfolio of the Future

A spotlight on portfolio trends

An essential series of guides to effective portfolio construction

EDITION 03.

Blurring of lines: index and active

A more volatile and uncertain investment regime shaped by structural shifts calls for portfolio builders and distributors to make more dynamic asset allocation reviews and adjustments and to implement their views through an expanded and innovative product toolkit, in our view. We believe that in the 'Portfolio of the Future' there is a place for both index and active strategies. A 'whole portfolio' implementation approach – which is focused on the end outcome and uses differentiated, precise, cost-efficient and flexible wrappers in public markets, from index ETFs to active ETFs to active mutual funds – is crucial for ongoing success and wealth creation for investors.

> **Gone are the days when portfolio implementation was limited to 'index only' or 'active only' strategies. The portfolio of the future uses an expanded investment toolkit that blurs the lines between the two.**

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An evolving implementation toolkit

The historical approach to implementing the portfolio strategic asset allocation was often siloed, with a clear divide between index-only strategies aimed at delivering the market return – frequently executed through an exchange-traded fund (ETF) – and active-only strategies aimed at delivering long-term above-market returns, or alpha – frequently expressed through active mutual funds. This bifurcation led to numerous inefficiencies. For example, index-only implementation often resulted in missed opportunities to enhance market returns or mitigate risks. Meanwhile, active-only implementation could lead to performance shortcomings related to the consistency of alpha after fees, potential unintended bets between the target and implemented portfolios, and governance costs and operational complexity due to high active manager turnover. Such inefficiencies rarely came to light, however, as decades-long bull markets in equities and fixed income meant that more or less every investment choice 'worked'.

The impact of the Global Financial Crisis

The Global Financial Crisis marked a pivotal moment in the investment landscape. In its aftermath, new regulations were introduced and there was a significant shift in client demand. Increased transparency of traditional fee structures started to drive changes in revenue models. Digital wealth evolved rapidly, with clients demanding more value for their money and increased scrutiny on financial products. This environment catalysed the blending of index and active strategies, as investors sought to optimise their portfolios in the new regulatory and market climate. Beyond the ability to capture broad market exposures at a low cost, distributors increasingly recognised the benefits of blending index ETFs into their propositions alongside active mutual funds for various use cases, including:

- Implementing tactical views across sectors, countries, themes and style factors
- Providing an interim cash alternative without compromising on liquidity
- Serving as a core portfolio holding to express strategic asset allocation views in a flexible but precise manner.

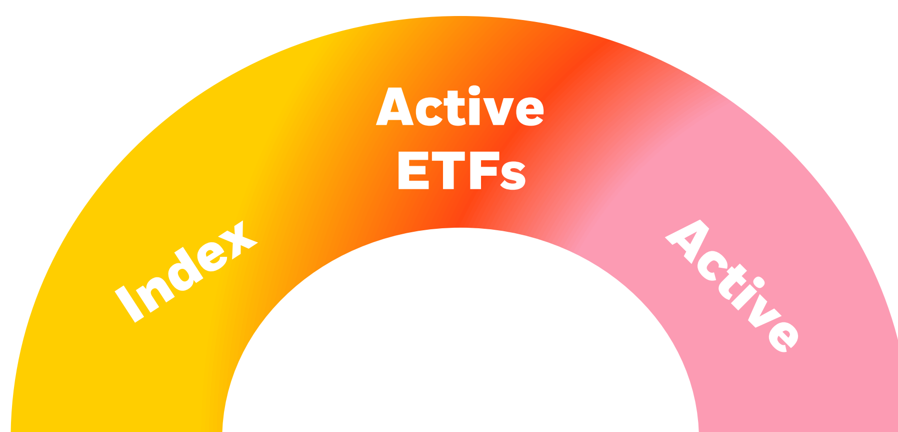
Adapting to a new market regime

The post-pandemic market regime – characterised by structural shifts such as the transition to a low-carbon economy and the rise of AI, coupled with higher uncertainty and dispersion, higher interest rates and sticky inflation – has raised the performance bar for investors. This new environment has underscored the importance of understanding the sources of risk and returns in portfolios to regain control over portfolio outcomes. It has highlighted the necessity of efficient allocation to portfolio building blocks that can be used to implement a more dynamic asset allocation, across multiple market scenarios, while controlling for risk. Investors now seek solutions that offer sustained risk-adjusted alpha while being nimble, precise and cost-efficient.

Transformative product innovation

The new market regime has called for transformative product innovation. One significant development in public markets has been the convergence of wrappers and the emergence of active ETFs, which have further blurred the lines between index and active strategies. These innovative products combine the benefits of both approaches, offering investors greater flexibility and efficiency in achieving their investment objectives.

Figure 1: Active ETFs blurring the lines between index and active



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Active ETFs: a new frontier

The new regime of heightened macro and market volatility has fuelled the need for dynamic portfolio asset allocation and, as a result, an adaptable product implementation. An 'active' portfolio approach leveraging a blend of index and active strategies, implemented through an expanded product toolkit, could provide the additional flexibility needed to react to the fast-changing market environment.

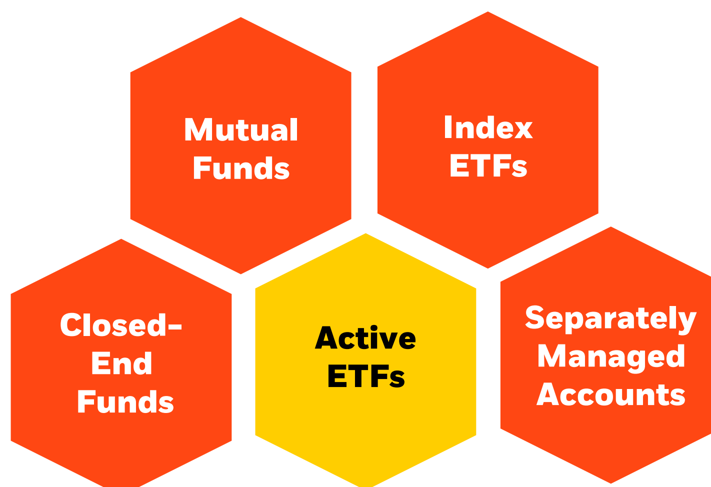
Investors are increasingly seeking actively-managed strategies amid today's higher market volatility and dispersion. They are frequently choosing to access these strategies through ETFs, among other investment vehicles, due to the wrapper's benefits, including liquidity, cost efficiency and transparency.

1. An **active approach to indexing with ETFs** could allow investors to exploit their skill in timing markets and their ability to consistently allocate to the right sectors, factors and regions over strategic and tactical horizons, in a precise, nimble, cost-efficient and highly liquid manner, while having **full control over asset and risk allocation.**

2. **Capturing enhanced returns with active ETFs** could allow investors to benefit from sustained outperformance at low cost, while still **retaining flexibility and control over asset allocation, with minimal active risk.**

3. Leveraging ETFs in both index and active strategies, can **free up fee budget for more highly-skilled alpha-seeking managers, where ETF solutions are not available**, potentially generating even higher returns while **outsourcing some of the asset allocation and onboarding more active risk**, for investors who have the ability to consistently pick such managers.

Figure 2: An expanded toolkit fit for the new regime



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Getting active with ETFs

The active ETF universe is broad, with three distinct categories: alpha-seeking (looking to outperform the underlying market), outcomes (such as higher income or downside mitigation) and exposures in areas of the market where indexing is difficult (such as cash or securitised assets). We see active ETFs becoming an important part of the investor implementation toolkit, alongside index ETFs, mutual funds, closed-end funds and separately managed accounts.

A ‘whole portfolio’ approach focused on the outcome

We believe that to build a portfolio fit for the future, investors need to adapt to an even more cohesive portfolio construction framework, which considers the interplay between asset allocation and product implementation. We believe this approach is best suited to delivering a unified proposition that leverages the strengths of both index and active investments, using the entire product toolkit while focusing on the target portfolio outcome.

Considerations such as the target alpha and risk budget, fee and operational budgets, liquidity considerations, ability to consistently access and pick highly-skilled active managers, and the level of control needed in asset allocation would influence how much to allocate to an asset class and which investment strategies and vehicles to use.

We illustrate an integrated approach to portfolio construction in figure 3, comparing an index-only strategic asset allocation (SAA) with a portfolio solution where the choice of index or active implementation influences the overall assets’ weights in the portfolio.

1 In equities, we assume there is greater opportunity to outperform the index and generate alpha than in other asset classes. Therefore, we see higher allocation to active strategies for the implementation of the equity asset allocation, while the overall equity allocation stays the same, in keeping with the portfolio’s risk budget.

2 In credit, we also see efficient alpha opportunity, particularly relative to government bonds, which results in a blended implementation for credit, but also increases the strategic allocation to credit overall at the expense of government bond exposures.

3 We are left with a slightly reduced and fully indexed strategic government bond exposure.

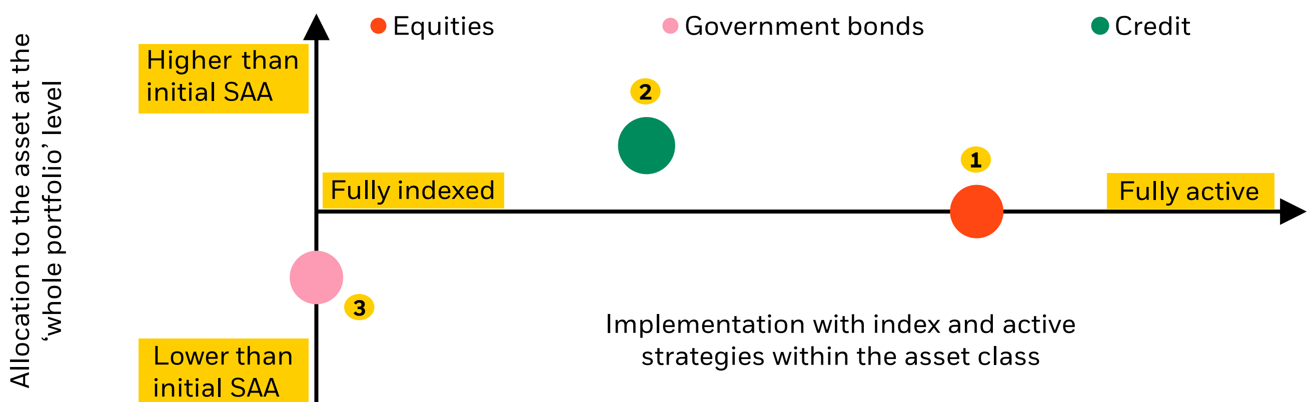
It is worth noting that in this exercise, we assume that investors have the ability to pick consistently top-performing managers within the asset classes. The blended results will not hold if investors lack these manager selection capabilities.

This illustrates how asset allocation preferences can shift based on the portfolio objectives and constraints, but also an investor’s views on alpha availability and its efficiency and magnitude. The choice of how to blend index and active strategies, and which wrappers to use, affects the strategic asset allocation in the portfolio in our example, making one asset class more attractive than another.

The bottom line: in our view, a more dynamic and flexible approach to portfolio construction – where asset allocation and product selection are seamlessly integrated to achieve optimal outcomes – could enhance the ability to generate sustained performance as well as improving risk management and aligning investment strategies more closely with an investor’s long-term goals.

Figure 3: Blending across the whole portfolio

Illustration using a multi-asset approach



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