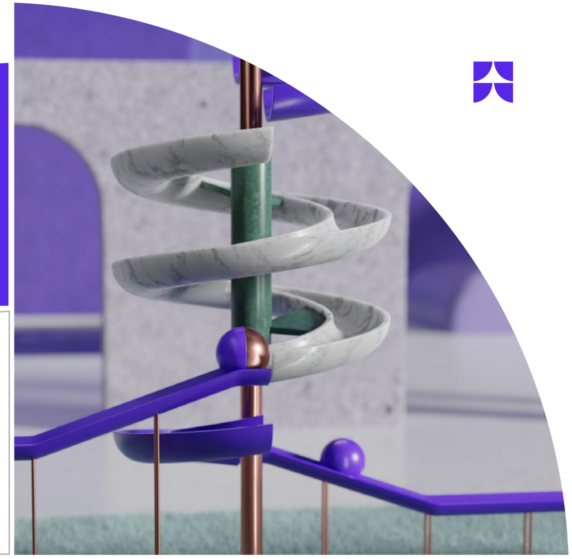
Purposeful Refinement:
Positioning Multi-Asset Portfolios for Tomorrow



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In the depths of the COVID-19 crisis in early 2022, the market expected a gradual recovery back to the long-term averages for inflation and growth. It didn't work out that way. COVID-19 didn't cause a typical demand-driven slowdown that could be corrected by the traditional policy response of easier monetary policy plus loose fiscal policy. Instead, the pandemic triggered a wave of demand crashing against a wall of supply-chain disruptions. By late 2021, higher prices caused central banks to tighten monetary policy. At the same time, governments were confronted with the effects of higher rates.

With unusual policies and economic consequences, major asset classes didn't behave in their traditional fashion during most of 2022. This led to some disappointing results for multi-asset investors. But that doesn't mean traditional approaches are doomed to disappoint in 2023.

We believe the traditional approaches just need *purposeful refinements*—adjustments based on our firm's assessment of how assets may perform and correlate differently in a potentially changed environment.

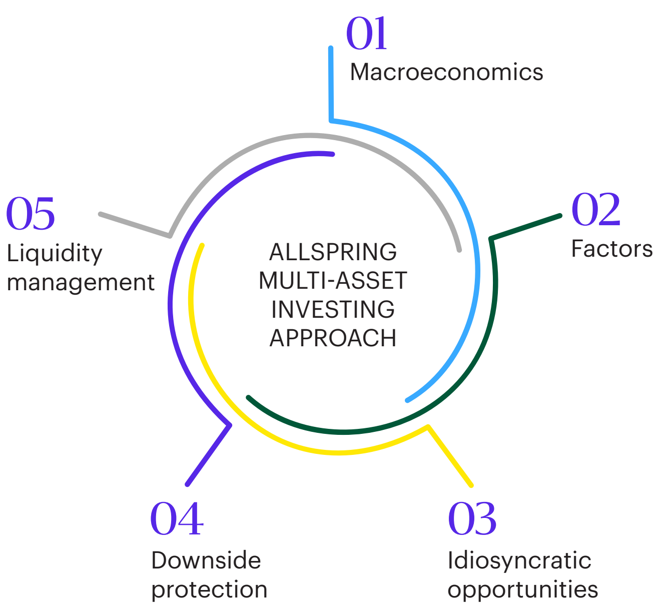
Did any traditional approach work for us in 2022?

Yes—downside risk management worked. Our risk management framework considers the time horizon of the protection needed, the reactivity of the downside protection, and the protection's costs. If wrongly designed, downside protection can be very costly and may not provide enough protection.

From 2019 through 2022, there were two significant equity drawdowns—for very different reasons and with very different drawdown profiles. These events confirmed our prior research that no single protection strategy works all the time and that a combination of carefully assembled strategies may work better. For example, our futures-based downside strategies worked very well in 2020 because the drawdown was quick and the recovery was aggressive. The drawdown of 2022 was very different: It was more like a grinding drawdown without a sharp downside move until late summer.

Each different type of drawdown calls for a different solution. Given that it's hard to predict what a future drawdown will look like, it makes sense to us to diversify: Use a mixture of explicit downside protection, such as options, or more implicit protection from alternative strategies, like trend-following strategies, which performed very well in 2022.

LOOKING AHEAD, WE HAVE A FIVE-DIMENSION APPROACH FOR POSITIONING MULTI-ASSET STRATEGIES



01 A messy macro mosaic isn't all bad.

We examine the macro drivers of asset returns and risk through the lens of what we call a "macro mosaic." This means we consider the interactions of the level, breadth, persistence, volatility, and uncertainty of growth, interest rates, and inflation. The macro story of 2022 was mostly about inflation. Inflation isn't a problem for traditional assets as long as it starts low, goes slow, and is supported by economic growth. That's what we saw in the first part of 2021. But then, inflation started to rise more meaningfully as growth struggled and became more volatile.

In 2023, the macroeconomic picture might not improve much, but at least markets have had an opportunity to adjust to the uncertainty of rather somber growth and inflation outlooks. Late in 2021, our analysis flagged a possible recession in early 2022, and it also indicated an unusually high amount of inflation uncertainty. Now, we think things have flipped: Inflation is likely to slow materially, and there is unusually high growth uncertainty. Rates may have already reset—if not overshot—to the upside. Considering the equity market drawdown in 2022, we're also constructive on the outlook for the broad equity market.

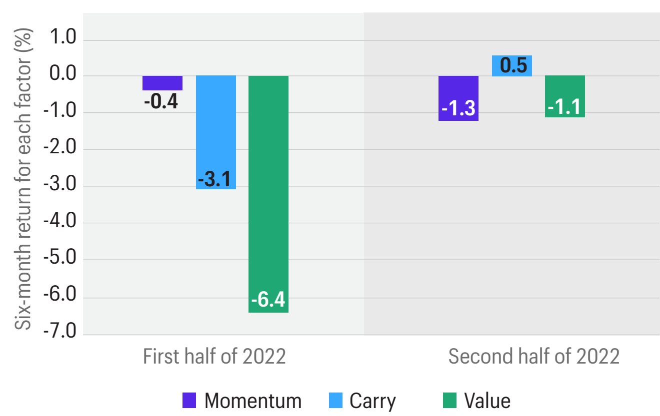
02 Factors flipped in favor of fundamentals.

Factors are the features of assets that matter. There are many factors, but the most basic ones include momentum (how prices moved over the past year), carry (things like dividend yield and interest income), and value (prices relative to long-term fundamentals). Central bank influence over the past 15 years caused higher correlations and lower volatilities across assets, rewarding momentum more than value. In 2022, though, carry and value were resurrected.

In the first half of 2022, momentum did relatively better than value or carry, but the market's worries about waning growth and persistently high inflation triggered a return to fundamentals, prompting investors to refocus on valuations and carry in the second half of the year. We believe investors' preference for strong fundamentals at reasonable prices is unlikely to fade quickly.

Diversifying across factors could potentially make a portfolio more resilient than simply diversifying across traditional asset classes. This is important because a better-diversified portfolio may allow investors to stay invested, avoiding the whipsaw risk of abandoning a long-term strategy at the bottom of the market and missing out on a market recovery. Considering the disappointing performance of traditional assets in 2022, a sharp recovery in 2023 can't be ruled out.

FOR FACTORS, 2022 WAS A YEAR OF TWO PARTS



Sources: Allspring and Bloomberg

The momentum, carry, and value factor returns are represented, respectively, by the returns of the Bloomberg U.S. PURE Momentum Portfolio, the Bloomberg U.S. PURE Dividend Yield Portfolio, and the Bloomberg U.S. PURE Value Portfolio from the Bloomberg U.S. Equity Model.

03 We see an environment of abundant idiosyncratic opportunities.

In any market environment, there are winners and losers. However, when the broad market sells off, as in January–October 2022, the "winners" might only be relative winners, meaning that they declined in value less than others did. So, focusing on finding relative-value opportunities, especially in a year like 2022, can potentially add value to investors' portfolios. For example, we identified a number of companies in consumer staples—a relatively defensive sector without a lot of rate sensitivity—that delivered positive results compared with the broader market during 2022.

Also, regional divergences were amplified in 2022, so preferring U.S. equities over international equities was helpful. We don't think these regional differences will go away, but the market may have already priced in the U.S.'s brighter growth outlook compared with Europe's and the Federal Reserve's (Fed's) tighter monetary policy compared with the Bank of Japan's, which is still doing quantitative easing.

There are two specific areas we believe may offer tactical opportunities in 2023. The first is currency related. Over the past 10 years, half of emerging market underperformance relative to U.S. equities can be explained by currency moves as the dollar strengthened. We think this may change going forward, with currency moves instead becoming neutral to additive to emerging market performance.

The second potential opportunity we see for 2023 is adding duration back into portfolios. We think the Fed's rate hikes will likely end, the inflation rate will likely fall, and that growth is highly uncertain. To us, this combination seems like a favorable environment for longer-term bonds. However, tactical ideas can change quickly. As the data change—including market prices—so will our views.

04 Downside protection is a strategy for all seasons.

When markets sell off, it can be hard to find places to hide. When inflation risk is the markets' dominant risk, stocks and bonds can sell off together, as we saw in the first three quarters of 2022. Those "nowhere-to-hide markets" call for patience, downside risk management, or both. But nowhere-to-hide markets can give rise to "everyone-wins markets," where stocks and bonds both do well once inflation risk subsides.

During the past few decades, investors got accustomed to "risk-on" and "risk-off" markets, where growth risks were dominant and bonds rallied while equities sold off, or vice versa. These four different regimes—nowhere to hide, everyone wins, risk on, and risk off—are linked to the macroeconomic context and to central banks' reactions to the macroeconomic outlook. When inflation was low and stable, it was easy for central banks to intervene by cutting rates or expanding their balance sheets to deal with any prospective growth slowdown. Now, with inflation at the forefront, central banks are more concerned with inflationary risks than with growth risks.

Whether central banks' retreat from direct financial market intervention via shrinking their balance sheets is a structural (somewhat permanent) change remains to be seen. It's likely, though, that the banks will be more careful in coming back given their recent experience with high inflation. We think that different speeds of monetary adjustment should continue to create interesting relative-value opportunities for investors.

We also believe that the absence of central bank interventions will likely mean that the famous "Fed put" (an implicit safety net provided through ample central bank liquidity) will be missing for a while. Structurally higher volatility is likely back, and it favors downside protection strategies. In our view, diversification is not dead despite its "heart attack" in 2022. However, adding more explicit protection strategies on top of diversification makes sense to us.

05 Prudent liquidity management—overlooked by many investors—gives us the flexibility to be patient.

Many investors have largely ignored liquidity over the past several market cycles. When liquidity was abundant, they tended to seek higher returns and more diversification through illiquid assets. The smoother return streams were artificial because the assets' prices weren't marked to market daily. But the smoothness and knowledge that the money was locked up led them to take a longer view of illiquid investment opportunities.

There can be too much of a good thing, though. We believe some investors likely over-allocated to illiquid assets, which, by their nature, are liquid. It's hard to meet liquidity needs with an illiquid asset.

In contrast, it's our view that cash and short-duration fixed income strategies have value beyond just their yields. Their value includes meeting spending needs and the peace of mind that comes with having the flexibility to be patient in the midst of market volatility.

Multi-asset liquidity management, we believe, can potentially bridge the trade-off between safety of principal and achieving attractive returns by addressing both strategic goals and short-term liquidity needs at the same time.

Learn from the past—don't invest for the past.

In 2022, we saw the aftermath of the traditional monetary and fiscal policy responses to an unconventional problem: COVID-19. Traditional diversification strategies were not up to the task of handling unusual economic consequences. That's why we think investors may want to purposefully refine their view of portfolio construction by holistically considering the potential risks and opportunities of these five key dimensions of multi-asset investment management.

Even if investors weren't well positioned for the year that was, that doesn't mean there weren't lessons learned—or relearned—that can be applied for better years ahead.

For further information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

Contact details

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