BlackRock
Investment
Institute

Portfolio construction

Capital market assumptions

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Data as of 30 September 2020

BlackRock

Summary

Risks assets have rebounded sharply from their March lows as the unprecedented *joint fiscal-monetary policy revolution* stoked a global recovery from the Covid-19 shock. Yet the structural trends such as "even lower for even longer" interest rates, deglobalization and the shift to sustainability roll on. We discussed in our paper *Readying for real resilience* how reviewing strategic asset allocations (SAAs) to ensure portfolios are resilient to the supercharged trends is the most important action investors need to take. We update our Capital market assumptions (CMAs) and investor-specific portfolios to the end of the third quarter. Market moves have driven some changes to asset class expected returns yet our asset class views (see below) are largely in-line with those we outlined last quarter. The long-lasting impact of the policy revolution will manifest across fixed income and equity expected returns, in our view. We still see negative expected five-year returns for government bonds and investment grade credit. Tightening credit spreads have eroded expected returns for investment grade and high yield compared to last quarter, yet we still see spreads for high yield offering attractive risk reward. Richer valuations for equities, particularly in the U.S. and in emerging markets (EM) following the rally, have lowered our expected returns for the asset class. Our private equity expected returns have risen due to cheaper valuations and higher average economic growth expectations over the next five years.

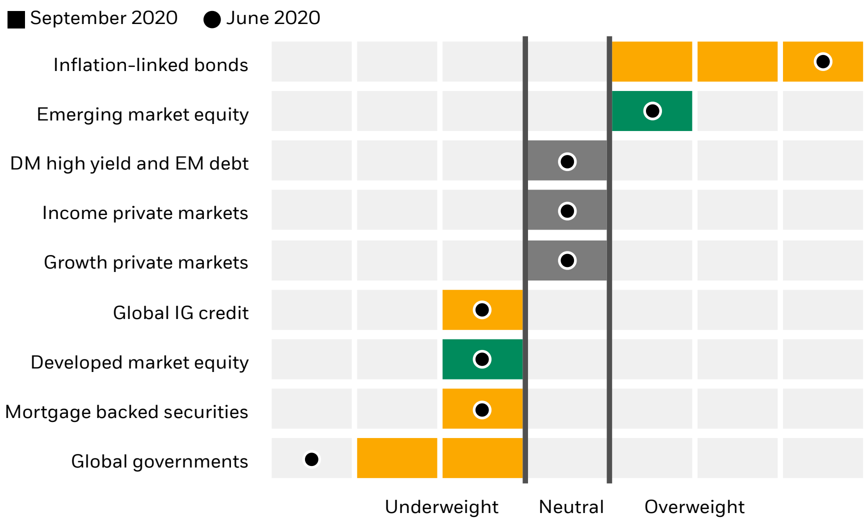
BlackRock strategic views

Our strategic asset class views show our asset class preferences over a 10-year horizon relative to a long-term, cycle-agnostic equilibrium asset allocation. We also contrast our strategic preferences with representative multi-asset portfolios in the U.S., euro area and UK. Based on our cyclical views and current market valuations, asset classes may be more or less favorable compared with a long-run, steady-state environment. The chart on the next page summarizes our current views. We maintain our underweight on nominal government bonds, a preference for inflation-linked bonds, private markets as potential portfolio diversifiers, and deliberate geographical exposures to prepare for a bifurcated world with two poles of growth – one U.S.-centric and one-China centric. A key pillar of our strategic assets views is a rise in inflation expectations rising over the medium-term as detailed in our paper *Preparing for a higher inflation regime*. The policy revolution – particularly central banks' willingness to cap bond yields to avoid a tightening of financial conditions – means asset prices may not react the same way to inflationary pressures as they have in the past. Our upcoming *Portfolio perspectives* will dig into this aspect in more detail. We maintain our strong underweight in developed market government bonds as the strategic case for the asset class has diminished further since we first laid out our argument in *Bonds and ballast: testing the limits*. We find inflation-linked bonds and Chinese government bonds as increasingly attractive as part of a whole-portfolio approach to resilience. We prefer high yield credit over investment grade and maintain an overall neutral stance on equities with a tilt toward emerging markets, particularly China. We see private markets playing a core role in modern portfolios. Our *investor-specific SAAs* typically have greater allocations to private markets than many similar multi-asset portfolios: see the representative portfolios below. Sizing allocations depends on client specifics such as cashflow requirements and manager selection.

BlackRock strategic views

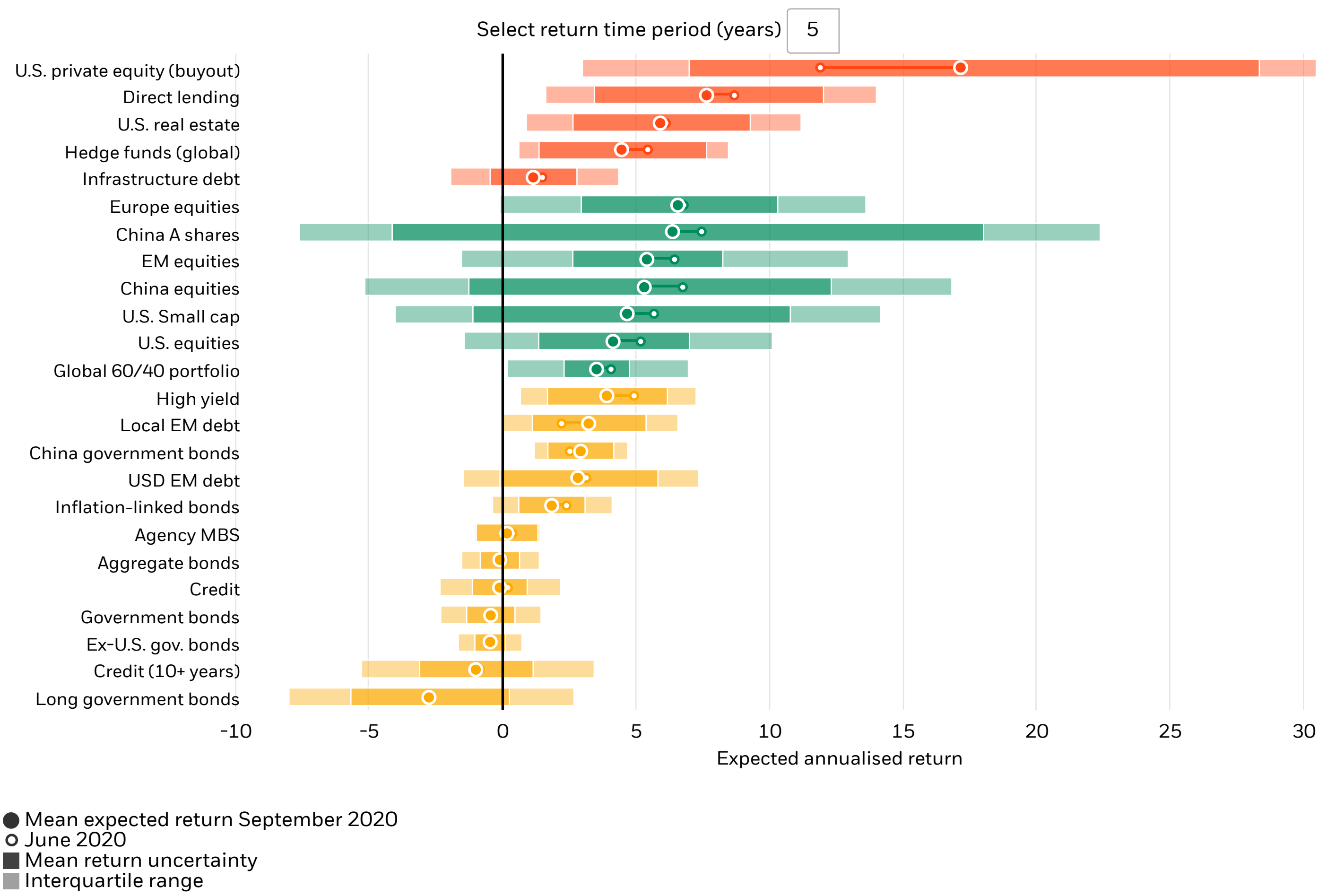
Strategic tilt

Hypothetical US dollar 10-year strategic allocation vs. our equilibrium view



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, November 2020. Data as of 30 September, 2020.
Notes: The equilibrium view tab shows our asset views on a 10-year view from an unconstrained US dollar perspective against a long-term equilibrium allocation. Income private markets include infrastructure debt, direct lending, real estate mezzanine debt and US core real estate. Growth private markets include global private equity buyouts and infrastructure equity. The hypothetical portfolio may differ from those in other jurisdictions, is intended for information purposes only and does not constitute investment advice.

Asset return expectations and uncertainty



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, November 2020. Data as of 30 September, 2020.
Notes: Return assumptions are total nominal returns. US dollar return expectations for all asset classes are shown in unhedged terms, with the exception of global ex-US Treasuries and hedge funds. Our CMAs generate market, or beta, geometric return expectations. Asset return expectations are gross of fees. For a list of indices used, visit our Capital Market Assumptions website at blackrock.com/institutions/en-us/insights/charts/capital-market-assumptions and click on the information icon in the *Asset class return and volatility expectations* table. We use BlackRock proxies for selected private markets because of lack of sufficient data. These proxies represent the mix of risk factor exposures that we believe represents the economic sensitivity of the given asset class. There are two sets of bands around our mean return expectation. The darker bands show our estimates of uncertainty in our mean return estimates. The lighter bands are based on the 25th and 75th percentile of expected return outcomes – the interquartile range for more detail read Portfolio perspectives. Indices are unmanaged and used for illustrative purposes only. They are not intended to be indicative of any fund or strategy's performance. It is not possible to invest directly in an index.

Assumptions at a glance

Asset	Return expectations (geometric, gross of fees)				Long-term expected volatility	Long-term correlation	
	5-year	10-year	15-year	20-year		Global equities	Global government bonds
U.S. high yield	3.9%	4.3%	4.6%	4.8%	8.0%	63%	-1%
Local currency EM debt	3.2%	3.4%	3.5%	3.6%	8.6%	51%	13%
China government bonds	2.9%	3.1%	3.1%	3.1%	4.1%	0%	29%
USD EM debt	2.8%	3.6%	4.2%	4.7%	10.3%	42%	37%
U.S. bank loans	2.7%	3.2%	3.7%	4.0%	8.1%	55%	-12%
U.S. inflation-linked government bonds	1.8%	2.2%	2.6%	2.7%	6.0%	1%	52%
U.S. cash	0.4%	1.0%	1.6%	1.9%	0.0%	0%	0%
U.S. agency MBS	0.1%	0.8%	1.4%	1.7%	1.5%	-26%	35%
U.S. aggregate bonds	-0.1%	0.8%	1.5%	2.0%	4.2%	-11%	76%
U.S. credit (all maturities)	-0.1%	1.0%	2.1%	2.7%	6.8%	18%	63%
U.S. government bonds (all maturities)	-0.5%	0.3%	1.0%	1.5%	5.5%	-38%	77%
Global ex-U.S. government bonds	-0.5%	0.4%	1.2%	1.7%	3.5%	-17%	100%
U.S. credit (10+ years)	-1.0%	0.6%	2.2%	3.2%	12.8%	24%	59%
U.S. government (10+ years)	-2.8%	-1.6%	-0.5%	0.2%	15.2%	-31%	77%
Europe large cap equities	6.5%	7.0%	7.3%	7.5%	18.4%	88%	-11%
Global ex-U.S. large cap equities	6.4%	6.8%	7.0%	7.2%	16.4%	91%	-12%
China A shares	6.4%	6.4%	6.4%	6.3%	31.1%	33%	-7%
Emerging large cap equities	5.4%	6.4%	7.4%	8.0%	21.0%	73%	-10%
China-Broad market equities	5.3%	6.6%	7.7%	8.5%	27.3%	50%	-12%
U.S. small cap equities	4.6%	5.6%	6.4%	6.9%	22.6%	87%	-17%
U.S. large cap equities	4.1%	5.0%	5.8%	6.3%	16.2%	87%	-15%
U.S. private equity (buyout)	17.1%	16.6%	15.9%	15.4%	32.0%	80%	-17%
Global direct lending	7.6%	8.0%	8.3%	8.5%	15.0%	73%	-11%
Global infrastructure equity	6.2%	6.7%	7.1%	7.3%	18.8%	64%	5%
U.S. core real estate	5.9%	6.1%	6.2%	6.2%	12.1%	58%	16%
Real estate mezzanine debt	5.1%	5.7%	6.1%	6.3%	10.4%	69%	10%
Hedge funds (global)	4.4%	5.1%	5.7%	6.1%	7.4%	84%	-19%
U.S. Infrastructure debt	1.8%	3.0%	4.1%	4.8%	10.5%	27%	48%
Developed infrastructure debt	1.1%	2.2%	3.2%	3.8%	9.0%	30%	48%

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Notes: Return assumptions are total nominal returns. US dollar return expectations for all asset classes are shown in unhedged terms, with the exception of global ex-US Treasuries and hedge funds. Our CMAs generate market, or beta, geometric return expectations. Asset return expectations are gross of fees. Forecasted future performance is not a reliable indicator of future results. We use long-term volatility and correlation expectations. We break down each asset class into factor exposures and analyse those factors' historical volatilities and correlations over the past 19 years. Correlations with global equities and bonds are based on global measures excluding domestic equities and bonds. We combine the historical volatilities with the current factor makeup of each asset class to arrive at our assumptions. This approach takes into account how asset classes evolve over time. Example: Some fixed income indices are of shorter or longer duration than they were in the past. Our expectations reflect these changes, whereas a volatility calculation based only on historical monthly index returns would fail to capture the shifts. Indices are unmanaged and used for illustrative purposes only. They are not intended to be indicative of any fund or strategy's performance. It is not possible to invest directly in an index. We use BlackRock proxies for selected private markets because of lack of sufficient data. These proxies represent the mix of risk factor exposures that we believe represents the economic sensitivity of the given asset class.For a list of indices used, visit our Capital Market Assumptions website at blackrock.com/institutions/en-us/insights/charts/capital-market-assumptions and click on the information icon in the *Assumptions at a glance* table.

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