Investment outlook and Asset Allocation in US Pension Funds

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Abstract. The classic balanced portfolio for more than 7 decades has been the blend of equities and bonds in the ratio of 60% to 40% respectively. But declining interest rates have forced investors to divert from this investing strategy and look over other alternatives. This has affected bond returns. And once again due to pandemic interest rates were cut down to near zero resulting in very little returns in bonds. To overcome this, alternative investment opportunities should be looked for and several factors which are important in deciding the future investments are to be considered. Some of them are interest rates, valuations, volatility, etc. Based upon the factors and other parameters, the best alternatives will be Equities (cyclical industry, stocks providing dividends, etc), Corporate bonds (with higher investment grades), and government bonds of emerging markets (like China and Peru). These alternatives will act as better investment alternatives to traditional 60/40 asset allocation in the current scenario.

Keywords: 60/40 Asset Allocation, Investing, Allocations, Interest rates, Covid-19, Bonds/Fixed income.

Executive Summary

1. Traditional asset allocation has been on a setback due to low returns. There are different types of asset allocation which have provided good returns over the years.
2. 60/40 asset allocation in equities and bonds was an optimal portfolio allocation for many years with less risk and an ideal option for low-risk investors.
3. Over the years, interest rates have been cut and presently they are nearing zero. This has affected bond returns.
4. Due to the pandemic, interest rates were cut once again, giving almost no returns in bonds.
5. Several factors which are important in deciding the future investments are to be considered. Some of them are interest rates, valuations, volatility, etc.
6. Based upon the factors and other parameters, the best alternatives will be Equities (cyclical industry, stocks providing dividends, etc), Corporate bonds (with higher investment grades), and government bonds of emerging markets (like China and Peru).
7. These alternatives will act as better investment alternatives to traditional 60/40 asset allocation in the current scenario.

Introduction

Covid-19 has given a massive shock to the whole world and almost everyone is struggling because of the invisible organism. Every organization, company and institutions are struggling to keep running their operations. With lockdowns all over the world, the supply chain has been disrupted resulting in billions and trillions of losses. In such times it is necessary for every individual or company or institution to keep its emergency relief ready. But at the same time, it is of utmost importance to save and invest because there’s a lot of uncertainty when we look to the future. We don’t know whether the worst is yet to come or not. Hence everyone must be ready to face what lies ahead.

In this paper we look for some possible alternatives to traditional asset allocation where we can possibly invest and expect good returns compared to the traditional ones.

Traditional Asset Allocation

60/40% asset allocation in Equities/Bonds

The classic balanced portfolio for more than 7 decades has been the blend of equities and bonds in the ratio of 60%
Other Types of Asset Allocation

There are other types of asset allocation like 70/30% or 50/50%, but haven’t been considered in the scope of study for this paper.

The Strategy

As we saw that 60/40 asset allocation is no longer optimal allocation and we must have a diverse portfolio to increase returns. In order to do that we need to assess some important factors to understand the market and the actions taken by various governments which indirectly affect securities and assets. Addition to that we must study the major steps taken by central banks of various countries to mitigate the damage done by the pandemic. Not only the current or previous steps taken by major entities like government and central bank, but also, we need to predict the upcoming most possible actions taken by these to support the crippling economy. Then post assessing these, we can have a diverse portfolio and invest according to one’s risk profile.

First, we look at several important factors which play an important and influential role in investment opportunities we look for. We haven’t gone in depth describing each of them, but presented it crisply including information on the current scenario of the same.

Second, depending on the factors and their outlook, we go on to recommend some alternative opportunities which can be explored to increase returns than a traditional 60/40 asset allocated portfolio.

An Outlook for Upcoming Years

Higher Government Debt

Government has been on a borrowing spree to support the crippling economy and provide some major relief to specific sectors most affected by the pandemic. This debt will keep piling until some real positive sign of recovery is seen.

The other aspect to this is cheap debt due to low interest rates. The expenses due to debt is not bothering much to the US government.

Lower Interest Rates

The Federal Reserve plans to keep interest rates low for a few years and this might affect the returns on bonds. Also, this is benefitting government as cheap debt is available to them.

Significant Economic Slack

Lockdowns imposed throughout the world have shut many businesses affecting consumers. Thus, the economy has contracted and will take time to recover.
Higher Valuations

Due to high liquidity in the economy and Federal Reserve pumping more money, the prices of assets have been on the rise, which is resulting in higher valuations of assets.

Volatility

Next few years will be more volatile compared to previous few years. A lot of uncertainty is present related to vaccines rollout, re-opening of the economy and the end of partial lockdowns. These are some of the important factors which will be responsible for high volatility.

Central Bank Response

Central Banks will be keeping interest rates low for a few years and will keep pumping money into the economy to avert risk due to Covid-19 and help different entities.

Apart from interest rates Central banks are increasing their balance sheets. The Federal reserve is continuously increasing its balance sheet post the Global Financial Crisis. It started to decrease only in 2018, but only in the span of 2 years it was hit by a pandemic. Thus, it was necessary to support the economy and hence they started increasing it again. It is quite uncertain till when they will keep it increasing as for Global Financial Crisis it spanned for around 10 years.

Lower Growth and Higher Inflation

For a few years several economic indicators will show lower growth compared to pre-covid times. The Central Bank’s response of printing more money (infusing money into the economy) to support different entities and sectors will result in higher inflation. Another reason for high inflation and increasing prices is lockdowns induced due to pandemic. This has disrupted supply chains and hence created a supply/demand crunch, resulting in higher prices.

Alternative Opportunities

Equities

Investing more in equities and especially stocks which provides dividends. But a lot of analysis goes into selecting the stocks/portfolio which will be suitable according to one’s risk profile. A lot of uncertainty is present which depends on Dividends, Buybacks, Earnings, Net issuance, Multiples, Profit Margin, etc.

Corporate Bonds

Alternative to Sovereign Bonds which are currently providing low returns. Higher grades like AA, AAA investment grade bonds can be looked upon to invest which can act as safer instruments relatively.

Emerging Markets/Global Equities

Credit or Debt which is currency hedged can act as a safer alternative instead of investing in treasury bonds. Government Bonds of emerging markets like China and Peru can also act as good investments.

Gold

Gold can act as a safe investment and provide much diversity in the portfolio (instead of bonds). But this is not sufficient for institutional investors.

High Yield Bonds

These have higher yields and are for a longer horizon. Have a positive correlation with Equities and have the same volatility.

Hybrid

Different types of allocation:

- 60/40 – Hybrid/Equities – for safe investors
- 80/20 – Hybrid/Equities – long term investors
- 20/40/40 – Safe Bonds/Hybrid/Equities

Tail Risk Funds

These have huge gains but are not available cheaply and also have high risk.

Real Estate

This can act as a good investment given the government will provide some stimulus to boost this sector. But a lot depends what type of stimulus is provided and how it will be disbursed.

Mortgage-backed Securities

Especially securities from the US Government agencies that are receiving support from the Federal Reserve.

Investment towards Cyclical Industries

Industries like Materials, Semiconductors, Housing and Consumer Durables can act as good alternatives for investment.
Conclusion

Traditional asset allocation of 60/40 in equities and bonds is no longer optimal allocation. There has been a steady decline in interest rates resulting in declining returns in bonds (fixed-income). Hence there is a need to look out for alternatives which will provide more returns to investors and at the same time provide the same risk.

There are different factors which will be critical in the upcoming years and will determine the future of returns from various instruments. These will be important to consider as many instruments are indirectly correlated to these parameters. Therefore, these will have a greater say in what returns the assets will give with what volatility.

Depending upon the factors and key variables and their behaviour in upcoming years, we concluded that Equities, Corporate Bonds with higher investment grades and government bonds of emerging markets are good to invest in among other instruments available for investment. There are other alternatives to these too which are best considering the factors discussed.

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Note: Most of the work done is original and is not referred from any other papers except the one’s listed above.