

Are Higher Fixed Income Allocations Warranted Today?

The low interest rate era that followed the Global Financial Crisis challenged many individuals and institutions that required a specific level of return—whether a public pension with a 7% or greater return target, an endowment seeking to distribute 5% per year, or an individual seeking a 7–8% return.

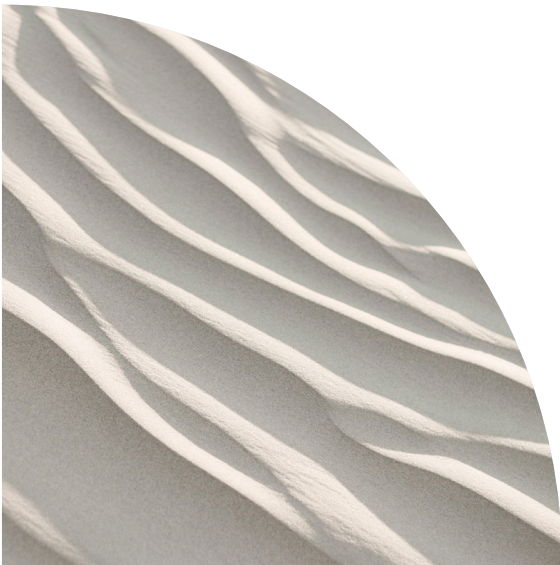
Until recently, these investors may have believed their targets were unattainable without taking inappropriate amounts of risk. But today, the opportunity set is much more aligned with these total return benchmarks than it was only two short years ago. In this brief note, we discuss how capital market assumptions (CMAs) have changed since late 2021 and what's driven them. Our analysis reveals that most investors can pursue the return targets enumerated above with portfolios as conservative as 20% equities and 80% fixed income. Generally, we conclude that a greater reliance on fixed income is warranted for a range of desired outcomes on a go-forward basis.

BY SYSTEMATIC EDGE

How have CMAs changed?

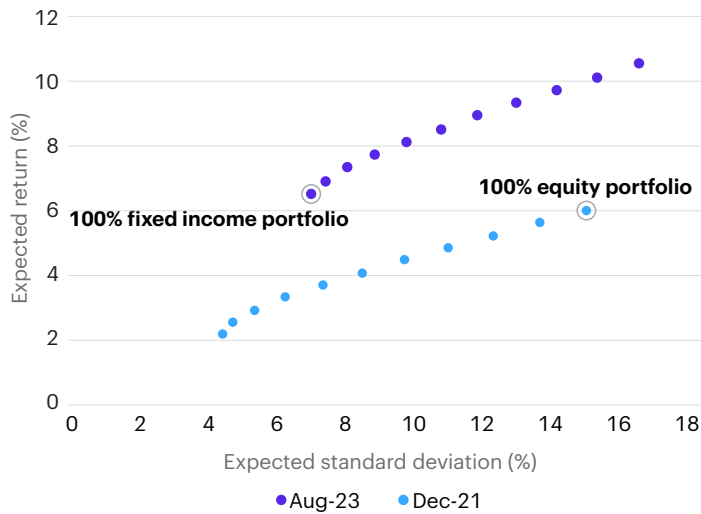
Since year-end 2021, the efficient frontier for an equity/fixed income portfolio has shifted to the northeast, according to our evolving CMAs (see chart on the following page). The efficient frontier plots the 10-year expected returns and volatility of a two-asset portfolio consisting of hypothetical combinations of the MSCI Global ACWI Equity Index-Hedged and the Bloomberg Global Aggregate Bond Index-Hedged. The severity of this shift is notable in that a 100% fixed income portfolio today has a higher expected return and markedly lower expected volatility than a 100% equity portfolio at year-end 2021. More generally, all possible equity/fixed income allocations currently exhibit greater efficiency from a risk/return perspective in spite of moderately higher expected volatility.

So, what accounts for this drastic shift, and what does it mean for selecting an optimal allocation?





ALLSPRING 10-YEAR HORIZON CMA TOTAL RETURN FRONTIERS



Source: Allspring. The chart presents 10-year expected annualized return and risk assumptions for hypothetical combinations of the MSCI Global ACWI Equity Index-Hedged (equity) and the Bloomberg Global Aggregate Bond Index-Hedged (fixed income) from December 2021 and August 2023. For illustrative purposes only.

Higher cash returns

It is important to remember that expected cash returns are embedded in both fixed income and equity CMAs. The rate hiking cycle that began in March 2022 has been among the most rapid in history. According to the Federal Reserve Bank of St. Louis, the effective federal funds rate of 0.08% in December 2021 rose to 5.33% in August 2023, marking a 5.25% jump in less than two years. It is not reasonable to expect that cash yields will persist at current levels indefinitely. However, of the current 6.4% CMA for fixed income and 10.3% for equities, fully 4.4% comes from a higher cash return assumption over the 10-year forecast period.¹ This compares with a 1.5% cash return assumption in December 2021, suggesting that almost 3.0% of the shift in the frontier is attributable to cash returns alone.

CMA	Cash return	Fixed income return	Equity return
December 2021	1.5%	2.1%	6.0%
August 2023	4.4%	6.4%	10.3%
Change	+2.9%	+4.3%	+4.3%

Source: Allspring. For illustrative purposes only.

Higher expected returns and volatility for risk assets

Notwithstanding the cash return contribution to this shift, we note that December 2021 marked peak or near-peak levels in both fixed income and equity markets, reflecting the very powerful post-COVID-19 rebound. The ensuing period brought a significant drawdown across the spectrum of risk assets. Required risk premiums for fixed income and equities since then have jumped and are embedded in our updated CMAs, which now have higher expected returns and higher volatility.

Are higher fixed income allocations more appropriate?

Many investors have a specific return target that they need to achieve to fulfill their desired investment outcomes. For most, return targets of 7% to 8%-plus today may be well within the scope of traditional equity/fixed income allocations. The dramatic increase in cash returns we have seen over the past 18 months means that these investors may take much less equity exposure to pursue their targets. If cash returns do start to retreat, then this may need to be revisited. But, for now, other things equal, a (significantly) higher allocation to fixed income may be appropriate for many investors.



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1. Cash return assumptions are based on Systematic Edge team research estimates combined with Federal Reserve long-term estimates.

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