CAIA ASSOCIATION®

Portfolio for the Future™

A practitioner's guide to the five essential marks of effective capital allocation

Executive Summary

BY JOHN L. BOWMAN, CFA

Economic super cycles are far from a new topic. Perhaps the most famous examples are the technically inspired Elliott wave and the technologically grounded Kondratiev wave, named after Soviet economist Nikolai Kondratiev, who was executed for his evangelism of the topic. Despite the general dismissal of long-wave theory by economists and the academy, no one can deny that when the history gods periodically align geopolitical tailwinds and technological breakthroughs, extended periods of economic vitality, wealth creation, and capital market returns can occur. Han Dynasty paper, the British navy, the steam engine, electrification, and more recently the internet are arguably just a few examples.

These transitions should not be likened to market timing opportunities that demand asset allocation tweaks, but rather tectonic shifts of the global economic crust that alter history and reset normalcy. At CAIA Association, we believe we are in the twilight of a four-decade economic super wave. But the next phase will neither be constrained by sovereign borders nor necessarily inspired by one killer app. This new era will have more far-reaching implications, particularly for the asset management profession.

Since their peak in 1981, developed market interest rates have precipitously declined due to unprecedented accommodative monetary policy by the central banks across the G7. Ten-year yields in the U.K. and U.S. averaged ~12% in the 1980s and ~6% in the 1990s. German and Japanese yield cycles were not as pronounced but followed the same pattern. As the global financial crisis (GFC) paralyzed global credit markets and burst the real estate bubble a dozen years ago, the expansionary intervention only accelerated with asset purchases and liquidity injections, sending rates down to near zero and even below in parts of Europe. The "Greenspan put" symbolized a lengthy period of desperation by global policymakers to prop up financial assets and provide near limitless and free access to credit.

This long period of cheap capital and easy money has catalyzed innovation, created countless jobs, and provided a relentless tailwind for capital market returns. In fact, a plain vanilla U.S.-based 60/40 portfolio has compounded at more than 10% since 1980, and the return has been even more attractive in the last decade. CAIA Association data suggests that global investable assets reached $153 trillion at the end of 2020, with 12%, or $18 trillion allocated to alternatives. Meeting an 8% actuarial return at a pension, a 7% retirement return expectation for a family, or a 5% real spending rate at an endowment has not been a challenging hurdle. But professionals must ask whether this environment is truly normal or has been an extended holiday that is due to finally sunset.

As we enter 2022, yields are flat to negative around the globe, inflation seems to be awakening from its 40-year hibernation, and global strategists expect the 60/40 portfolio to return a meager 3-4% in the next 10 years. How will tomorrow's investment professional meet the demands of their clients under these conditions? We are here to declare the rise of a new era, one where fiduciaries will need to work smarter and more creatively to deliver investor outcomes.

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CAIA Association believes the Portfolio for the Future™ will exhibit five distinct marks, and we’ve enlisted friends and respected thought leaders to help us explore their implications:

1. Broadly Diversified

Commonfund CEO and CIO Mark Anson, CAIA, argues that responsible portfolio management consists of collating a series of uncorrelated beta and risk premia that offers a combination of income, inflation protection, capital preservation, and principal growth to meet a required return. During recent years the unlikely narrative has been heralded that financial assets, particularly public equities, eternally march upward. The proliferation of new, low-cost products has created complacency and “beta creep.” As such, fiduciaries must be more creative in expanding their investment opportunity set. That begins with a return of the foundational principle of diversification across asset classes, geography, sector, and purpose.

2. Less Liquid

The traditional 60/40 public equities and fixed income allocation has provided extraordinarily well in the last decade. But **Andrea Auerbach, Cambridge Associates global head of private investments,** counsels us not to take solace in the recent past. Investment professionals will have to look to differentiated sources of return, notably private capital, to increase the potential of being able to fully meet their obligations with responsible control of risk.

Private capital has become increasingly attractive for earlier stage, new economy, and growth companies. And, because private capital is detached from the short-term machinations of public markets, it liberates investors to take advantage of market dislocations, information asymmetry, and out-of-favor or countercyclical opportunities. Avoiding private capital in a portfolio denies access for clients to an increasingly large portion of the global economy. Of course, private markets are far from a silver bullet given their opacity, high fees, need for patience, and wide risk-return dispersion, and therefore must be carefully considered in light of client liquidity, income needs, and risk tolerance. Extensive due diligence and thoughtful, deliberate manager selection is imperative.

3. Rooted in a Fiduciary Mindset

Investment management is an agency business. Asset managers exist to deliver trust, care, and expertise to clients. **Roger Urwin, Global Head of Content at the Thinking Ahead Institute,** explains how a fiduciary mindset begins with an existential understanding of purpose, alignment, and service to the client. "Systems leaders" are responsible for translating these values into behavioral norms that influence ownership structure, client communication, compensation, fees, talent recruiting, culture, and definition of success (benchmarks). The investment profession—and each client's Portfolio for the Future™—still has work to do on this journey through mitigating conflicts of interest, asymmetric payoffs, incentive dislocations between limited partners (LP) and general partners (GP), and unnecessary financial engineering.

4. Actively Engaged

The age of the universal owner has arrived. Clients are demanding both positive financial and social outcomes from their capital allocation and underlying holdings. No one knows this better than **Anne Simpson, Global Head of Sustainability, Franklin Templeton and former Managing Investment Director of Board Governance & Sustainability, CalPERS.** With a devastating global pandemic, climate consciousness, and the pursuit of clean energy alternatives at a fever pitch, investment professionals are integrating sustainability elements such as carbon footprint, progress on diversity, equity and inclusion (DEI), human-rights records, and labor practices into their security evaluation, risk management, and return expectations. Further, non-financial disclosures, as well as ESG ratings, are becoming more accepted as a regular, integrated part of security analysis. The Portfolio for the Future™ will be much more insistent and proactive in ensuring that it contributes to a more inclusive and sustainable tomorrow.

5. Dependent on Operational Alpha

The modern investment profession is highly competitive. New sources of comparative advantage are being cultivated among enterprising professionals, writes **Ashby Monk, PhD, Executive Director, Stanford Research Initiative on Long Term Investing.** Firm culture, governance, and technology are much more predictive of sustained performance than previously thought and should be emerging priorities for any leader. The Portfolio for the Future™ will be driven by firms that innovate and exploit new organizational and operational models to save cost, reduce risk, and pioneer new investment ideas.

The industry needs to be reoriented back toward a north star of sophisticated portfolio construction, one that prioritizes client and beneficiary outcomes and works tirelessly to achieve those outcomes in a long-term, sustainable way. This essential definition of professionalism will usher in a new identity of enlightened self-interest that culminates in a much-improved public warranty. The Portfolio for the Future™ is CAIA Association's contribution and call to action for that transformation.

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The CAIA Association is a global professional body dedicated to creating greater alignment, transparency, and knowledge for all investors, with a specific emphasis on alternative investments. A Member-driven organization representing professionals in more than 100 countries, CAIA Association advocates for the highest ethical standards.

Our Vision

Global capital allocation is the engine for delivering pension benefits and individual retirement goals as well as preserving university, foundation and sovereign savings. Efficiently distributing both financial and human capital across the investment industry catalyzes innovation, cultivates societal wealth, and raises the integrity and quality of human flourishing. That virtuous purpose is incumbent on a properly functioning capital market system where training is robust, ethical conduct is consistent and enforced, and incentives of all parties are aligned. It is also dependent on a long-term, diversified approach to allocating that patient capital.

Since 2002, CAIA Association has sought to serve investors by educating industry stakeholders on the most current knowledge and best practices across the ever-changing landscape of alternative investments. Through credentialing of investment professionals, advocating with regulators and senior leaders, and developing world class thought leadership, CAIA aims to raise the standards of the industry. As a member organization, we are joined by CAIA Charterholders in 100 countries on a mission to collectively foster a true profession that serves the public good.

Our Mission

CAIA Association seeks to improve investment and societal outcomes of capital allocation through professional education, transparency, and thought leadership across all investor alternatives in our industry.

CAIA Association is headquartered in Amherst, Massachusetts, USA, and has regional office locations in Hong Kong and Geneva.

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