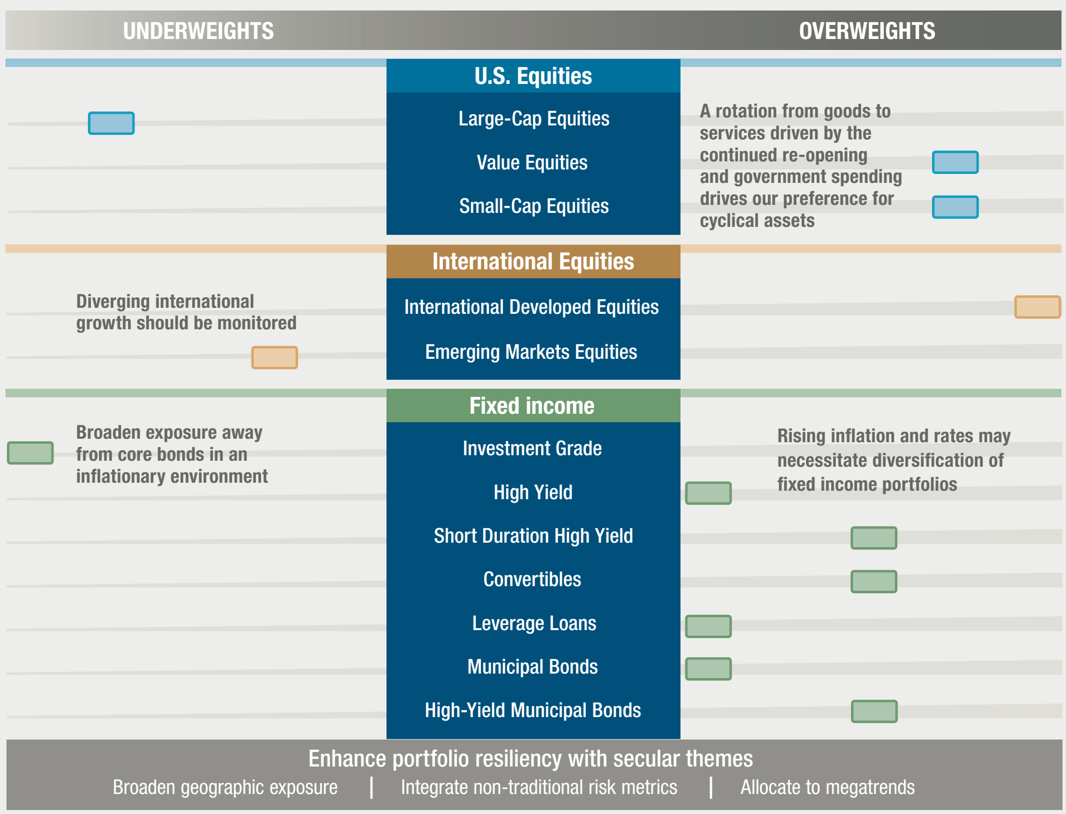
# Broader allocation in public markets

BROUGHT TO YOU BY THE MULTI-ASSET SOLUTIONS TEAM

2022 MARKET OUTLOOK

Given the unknowns surrounding the post-pandemic environment, how does an investor adapt? In fixed income, strong corporate fundamentals drive our interest in adding tactical credit risk. Rising interest rates create an incentive to broaden exposure away from core bonds. In equity, potential growth in current cash flows rather than shifting macroeconomic sentiment drive the story. While we favor cyclical exposures such as international and value stocks, we believe it's a stock-pickers' market.

On a portfolio-level basis, these trends are developing in a global context in which ex-U.S. growth is likely to be sluggish. Despite cyclical increases in U.S. rates, a "lower for longer" investment environment is likely to return. Therefore, as investors reconsider their tactical allocation, we encourage a structural broadening of investment mandates to include more flexible, global mandates, as well as exposure to emerging megatrends.




Source: New York Life Investments Multi-Asset Solutions, 2021. For illustrative purposes only.

New York Life Investments

# Fixed income in a rising rate environment: Expand exposure beyond core bonds

While the initial pandemic shock created severe economic concerns, many companies have capitalized upon ample policy support and improving demand to build liquidity and shore up their balance sheets. Now, despite challenges related to the cost and availability of material and labor inputs, corporate fundamentals are strong. The cost of debt is lower than the prior decade's average, and corporates have extended their weighted average debt maturity to resist rising rates. In our view, this creates a compelling case for favoring credit exposure to a fixed income portfolio.

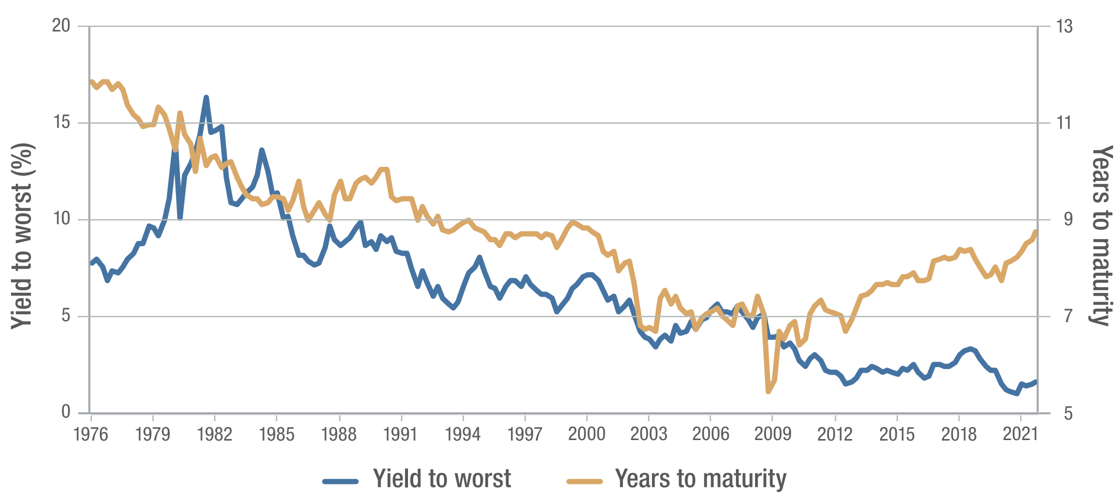
At the same time, valuations across fixed income asset classes are high. This could increase risk for investors, particularly as interest rates look set to rise. In our view, the combination of rising rates and higher inflation makes additional and diversified allocations to non-core bonds a compelling investment thesis.

## Exploring the risks of core-bond allocations

Core bonds serve an important purpose in investor portfolios. For some investors, duration exposure is required to meet liabilities. In these cases, barbell strategies — those that match necessary liability streams with higher quality, longer-duration assets (while enhancing income with incrementally higher yields found in lower quality instruments) may be suitable. For other investors, duration exposure provides an important ballast in risk-off markets.

However, the diversifying benefit that core bonds often carry for investors focused on risk-adjusted returns may be changing. The average maturity of core bonds has climbed over the past decade, yields are near historic lows, and inflation is on the rise. In this type of environment, we are concerned that core bonds may not be an appropriate tactical allocation.

### Investors are not compensated for interest rate risk in core bonds



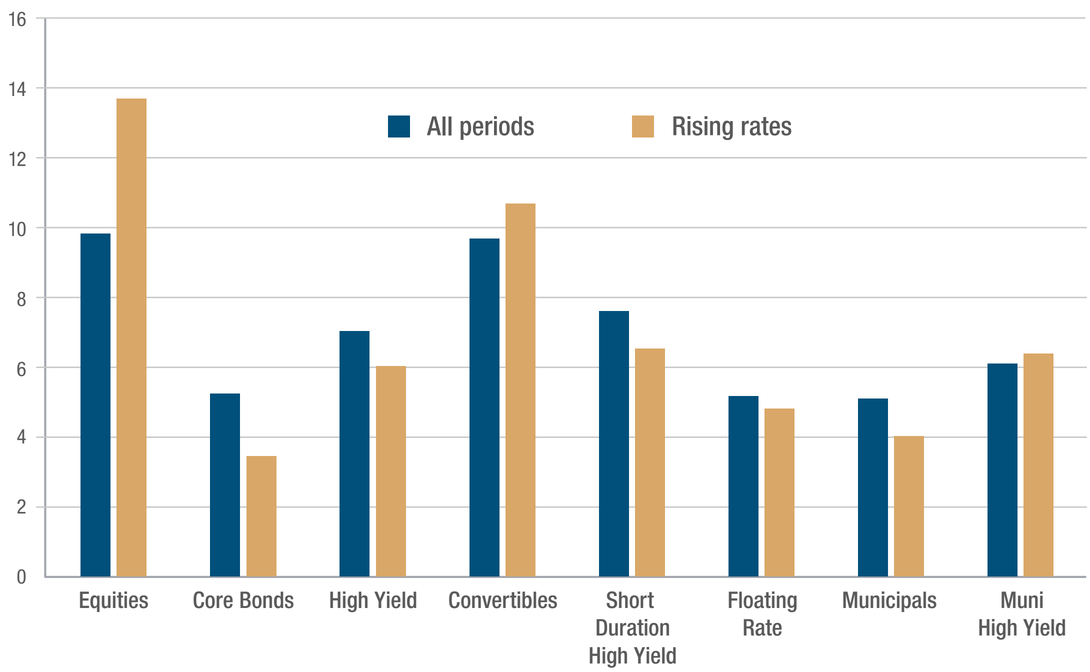

Sources: New York Life Investments Multi-Asset Solutions, Bloomberg Finance LP, 11/15/21. Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting. It is a type of yield that is referenced when a bond has provisions that would allow the issuer to close it out before it matures. Maturity is the duration or date when a bond's principal amount is repaid with interest. Core bonds are represented by the Bloomberg Barclays US Aggregate Bond Index. Index definitions can be found at the end of this report.

With this in mind, we explored past rising-rate regimes for lessons about more appropriate potential allocations. Since 1997, roughly half of the period (148 of 298 months) is characterized by rising rates, where the 2-year U.S. Treasury yield is above its 12-month moving average. In rising rate regimes, core bonds' returns were 40% lower cumulatively, while non-core asset classes remained relatively more resilient (see below). The riskiest and the most diversified asset classes — equities, convertibles, and high-yield municipal bonds — even saw *better* performance in these episodes.

With this in mind, we have high conviction that broadening a fixed income portfolio to include global and non-core themes such as shorter duration, floating rate, and alternative sources of credit may improve risk-adjusted returns as rates rise.

## As rates rise, core bonds become less attractive

**Adjusted historical excess returns, CAGR, 1997–2021, %**




Sources: New York Life Investments Multi-Asset Solutions, Bloomberg Finance LP, 11/15/21. We use monthly historical total returns, including coupons or dividends, from Jan 1997 to Oct 2021 and estimate monthly returns in excess of the Federal Funds Rate, then average those for the period using the compounded annual growth rate (CAGR) of excess return. After that, we add back the level of the Federal Funds Rate that the FOMC currently views as the most likely longer run level (2.5%). This enables us to adjust historical return to be more aligned with the current interest rate environment. Equities are represented by the S&P 500 Index. Core bonds are represented by the Bloomberg Barclays US Aggregate Bond Index. High yield is represented by the ICE BofA High Yield Corporate Bond Index. Convertible bonds are represented by the ICE BofA US Convertible Bond Index. Short duration high yield (SDHY) is represented by ICE BofA 1-3 Year US Cash Pay High Yield Index. Floating rate is represented by The S&P/LSTA Leveraged Loan Index. Municipal bonds are represented by the Bloomberg US Municipal Index. Muni high yield is represented by the Bloomberg Barclays High Yield Municipal Bond Index. Past performance is no guarantee of future results. An investment cannot be made in an index. Index definitions can be found at the end of this report.

## Diversify fixed-income with non-core bonds

Our research shows that adding a meaningful allocation of non-core fixed income to a portfolio, rather than maintaining a core-bond-only fixed income allocation, has historically improved risk-adjusted performance. It achieved better portfolio-level returns, reduced drawdowns, and recovered losses more quickly.

For illustrative purposes, we examine return levels, volatility, and the risk-adjusted return of the traditional 60/40 portfolio across both rising and falling interest rate environments. We use standard mean-variance optimization frameworks to evaluate how a given investment affects the overall portfolio's risk and return. Using a static risk benchmark — such as the traditional 60/40 portfolio — allows us to clearly explore the investment outcomes, maximizing potential return for a given level of risk.

**A few valuable themes emerge:**

1. Historically, diversifying income sources away from core bonds generated stronger return potential and lower portfolio volatility when sourced with both equities and core bonds.

2. A traditional optimization exercise potentially over-allocates to strategies that have performed well in the past, that may not see similar tailwinds in the future. Investors should always think critically about the results of any optimization exercise.

3. Prioritizing diversification can improve portfolio statistics and historical outcomes. While including a broader portfolio of fixed income asset classes adds operational complexity, greater diversification may improve risk-adjusted returns. Diversification may also support good investor behaviors over a singular focus on maximizing returns should volatility persist.

4. Non-core bonds have shown some correlation to stocks and core bonds. However, the correlation is imperfect, meaning they provide diversification benefit, helping to alleviate downside risk. One such measure of downside risk is historical drawdowns, which are not meaningfully impacted by this allocation change.

***See these themes in action on the next page.***

## Implementing the investment idea

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| Portfolio Allocation | A | B | C |
|---|---|---|---|
| Equities | 60% | 37% | 37% |
| Core Bonds | 40% | 3% | 5% |
| High Yield | 0% | 1% | 6% |
| Convertibles | 0% | 31% | 17% |
| Short Duration High Yield | 0% | 20% | 17% |
| Floating Rate | 0% | 1% | 5% |
| Municipals | 0% | 1% | 5% |
| High-Yield Munis | 0% | 6% | 8% |
| **% Non Core** | **0%** | **60%** | **58%** |

| Portfolio Stats | A | B | C |
|---|---|---|---|
| Return | 7.98 | 8.78 | 8.22 |
| Volatility | 9.3 | 10.55 | 9.28 |
| Sharpe | 0.86 | 0.83 | 0.88 |

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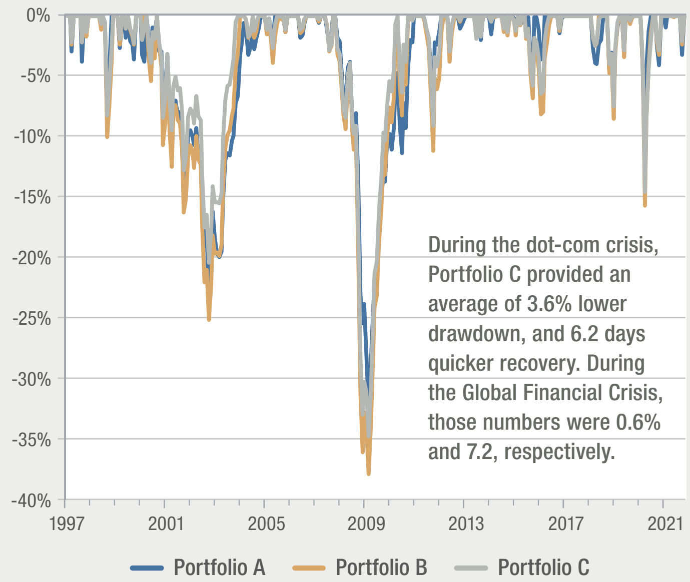
**Discretionary diversification (Portfolio C) generates reduced historical drawdowns**




Sources: New York Life Investments Multi-Asset Solutions, Bloomberg Finance LP, 11/15/21. Annual total return data based on monthly returns annualized 1997-2021. This example uses asset allocation optimization estimates from the New York Life Investments Multi-Asset Solutions team. It is for illustrative purposes only and does not represent an actual investment recommendation. The solutions presented are not appropriate for all investors and is based on a hypothetical 60/40 investor's risk tolerance. Past performance is not indicative of future results. An investment cannot be made in an index. A drawdown is a peak-to-trough decline during a specific period for an investment, trading account, or fund. Drawdowns are important for measuring the historical risk of different investments. A full list of index definitions can be found at the end of this paper. There are certain limitations inherent in hypothetical portfolios and hypothetical results, particularly that they are based on assumptions and do not reflect trading in actual client accounts and do not reflect the impact that material economic and market factors may have had on the financial professional's decision-making had the financial professional actually been managing client funds.

**A note on risk:** While adding assets to a portfolio can create a diversification benefit, non-core fixed income asset classes' return distribution varies significantly from core fixed income due to the elevated default risk. Non-core fixed income also historically exhibits return asymmetry — the tendency for more instances of large losses than a normal distribution of returns assumes. Put simply, defaults and write-downs greatly impact the return of non-core fixed income assets.

The key to performance, then, is dependent on (1) prudent risk-taking given the fundamental backdrop and (2) the use of an active manager who has historically generated alpha through loss avoidance.

# Equity investing amid macroeconomic transitions: A stock pickers' market

Within equities, the story is more convoluted. While the same key themes described for fixed income — high valuations, rising interest rates, specific corporate analysis, and diversification — are still relevant, their implementation is less straightforward.

For starters, exceptional asset price increases in 2021 may point to lower returns in 2022. When putting money to work in times of extreme valuations, stock in even strong businesses can produce mediocre outcomes for a period. Large resets in market expectations or changes in investment regime can impact companies of all quality, size, and sector.

**High valuations relative to earnings point to lower future returns**

Historical equity performance under various real earnings yield assumptions


Sources: New York Life Investments Multi-Asset Solutions, Shiller, 11/15/21. Earnings yield is the 12-month earnings divided by the share price. It represents the percentage of earnings for every dollar invested in the market. Earnings yield is one indicator of value; a low ratio may indicate an overvalued stock, or a high value may indicate an undervalued stock. The real earnings yield factors in inflation. Equities are represented by the S&P 500 Index and inflation is represented by the Consumer Price Index. Index definitions can be found at the end of this report.

Second, we believe earnings, not improving macroeconomic sentiment, will likely be a stronger driver of equity returns in the months ahead. A company's ability to meet surging demand, navigate complex supply chain issues, and attract talent falls outside traditional equity size and style boxes. In other words: it's a stock pickers' market. For this reason, we are leaning into cyclical themes — those that benefit from improving economic growth such as value stocks, small caps, and international developed equity — but rely on active managers to identify companies that can generate outsized earnings.

One reason we particularly like value stocks is that they can reduce exposure to portfolio duration, another rising-rates theme. Growth stock prices are disproportionately dependent on future cash flows vis-a-vis value stocks. Therefore, a change in interest rates can have a meaningfully greater impact on their pricing whereas value stocks are comparatively well-shielded. Value investing has also triumphed in periods of panic following the bursting of historic bubbles in valuation, which arguably exists today in some corners of the market.

# Enhance portfolio resiliency with secular themes

Identifying a valuable investment in today's economy may represent a different exercise than in the past. For one, the runway for profit growth is more global, less capital intensive, and more partnership-driven than ever before. Second, due to the democratization of information, identifying whether a company is trading above or below its fundamental value — as determined by balance sheet metrics — is less labor-intensive and strategic than it once was. And third, in a rapidly changing post-pandemic world, uncertainty around potential outcomes is large.

As such, we believe qualitative assessments of secular themes and structural trends are becoming important sources of portfolio resiliency. We are implementing a few key themes into our portfolios:

- **Broaden geographic exposure.** Ongoing differences in the pace of reopening and the direction of policy support mean that global growth rates will vary. As a result, we expect significant dispersion of returns across markets, regions, and even individual countries. We are overweight international developed markets that have quickly mobilized vaccination and are broadly reopen. In other geographies, such as some emerging markets, we are more concerned about pervasive pandemic scarring.
- **Integrate non-traditional risk metrics.** ESG investing seeks to insulate capital from business practices that could prove harmful to investment returns over time. How might extreme weather events affect operations? Can harsh labor practices lead to high turnover or legal costs? Is a business model reliant on scarce resources? These dynamics have always been key to company performance; now, they are key to investor attention. In some cases, these are also externalities that could lead to higher costs and lower sales, and managing them, accordingly, may result in more attractive financial performance.
- **Allocate to megatrend.** New global themes are emerging along thematic lines, in trends such as decarbonization, clean water, and digital transformation. These new areas offer investment opportunities that are both equity-based and income-oriented, and can provide important benefits for today's portfolios. As one example, infrastructure assets tend to provide steady, reliable income streams. They also often offer attractive, competitive returns relative to similar investments among both equities and bonds.

# Why the Multi-Asset Solutions team?

We are New York Life Investment's specialists in multi-asset investing, assisting our partners in their persistent pursuit of investment success.

**Access**

We leverage the depth and breadth of the New York Life Investments platform to support our clients and partners.

**Skill**

We identify smart investments while providing profitable and secure long-term outcomes.

**Navigation**

We guide our partners through the rapidly changing investment environment using research and innovation.

# Partner with us

Our mission is to build, preserve, and grow financial assets alongside our partners with integrity and respect through quality investments, education, and innovation.

**Multi-Asset Strategies**

Asset allocation strategies designed to capitalize on market opportunities within a variety of investment objectives.

- Allocation funds
- Model delivery
- Separate accounts

**Market Insights**

Investment services designed to support our partners and our investors.

- Thought leadership
- Risk analysis
- Investment strategy
- Financial education
- ESG analysis

**Customized Solutions**

Strategic partnerships designed to help meet investment objectives through holistic solutions.

- Global tactical allocation
- Risk modeling
- Income generation
- Inflation protection
- Insurance asset management

## Definitions

**Active investing** (also called active management) is an investment strategy involving ongoing buying and selling actions by the investor. Active investors purchase investments and continuously monitor their activity to exploit profitable conditions. Active management typically charges higher fees.

**Alpha**, often considered the excess return on an investment, gauges the performance of an investment against a market index or benchmark that is considered to represent the market's movement as a whole. The excess return of an investment relative to the return of a benchmark index is the investment's alpha.

A **basis point** is one one-hundredth of one percent.

**Capital expenditures (CAPEX)** are funds used by a company to acquire, upgrade, and maintain physical assets such as property, plants, buildings, technology, or equipment.

**Cyclical stocks** represent companies that make or sell discretionary items and services that are in demand when the economy is doing well. They include industries such as restaurants, hotel chains, airlines, furniture, high-end clothing retailers, manufacturers, and lenders (banks).

**Diversification** is a risk management strategy that mixes a wide variety of investments within a portfolio.

**Earnings per share (EPS)** is calculated as a company's profit divided by the outstanding shares of its common stock.

**Environmental, Social, and Governance (ESG)** refers to the three central factors in measuring the sustainability and societal impact of an investment in a company or business.

**Gross margin** is a company's sales revenue it retains after incurring the direct costs associated with producing the goods it sells, and the services it provides.

**Passive investing** (also called passive management) refers to an investment style for which investors expect a return that closely replicates the investment weighting and returns of a benchmark index.

**The U.S. 10-year Treasury Note** is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance.

A **value stock** is a stock that tends to trade at a lower price relative to its fundamentals, making it appealing to investors.

## Index definitions

**The Bloomberg Barclays High Yield Municipal Bond Index** tracks high-yield municipal securities, with average portfolio duration typically varying within (negative) two years to positive four years of the portfolio duration.

**The Bloomberg Barclays US Aggregate Bond Index** is an index that broadly tracks the U.S. investment-grade bond market. The index is composed of a range of securities from corporate bonds and Treasurys to asset-backed securities.

**The Bloomberg US Municipal Index** tracks the U.S. dollar-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prefunded bonds.

**The Consumer Price Index (CPI)** is an aggregate of prices paid by urban consumers for a typical basket of goods, excluding food and energy.

**ICE BofA 1-3 Year US Cash Pay High Yield Index** is a subset of ICE BofA US Cash Pay High Yield Index. It includes all securities with a remaining term to final maturity less than three years.

**ICE BofA US Convertible Index** tracks the performance of publicly issued U.S. dollar-denominated convertible securities of US companies. Qualifying securities must have at least $50 million face amount outstanding and at least one month remaining to the final conversion date.

**ICE BofA US High Yield Index** tracks the performance of U.S. dollar-denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one-year remaining term to final maturity as of the rebalancing date.

**The S&P 500 Index** is a stock market index tracking the stock performance of 500 of the largest companies listed on stock exchanges in the United States. It is widely regarded as the standard for measuring large-cap U.S. stock market performance.

**The S&P/LSTA Leveraged Loan Index** is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads, and interest payments.

**For more information**

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