2021: TIME FOR YOUR PORTFOLIO'S ANNUAL WELLNESS CHECK

NEPC'S 2021 ASSET ALLOCATION LETTER

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NEPC Asset Allocation Committee

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For many, 2021 couldn't come quickly enough. Be it the isolation of quarantining, the mourning of lives lost to COVID-19, the anguish over the pervasiveness of racial inequities, or the despair around the divisiveness of our country's politics, this past year has been exhausting and relentless.

Still, even in these harshest of times, there are silver linings: We remain thankful for the health and wellbeing of our loved ones, friends and neighbors. We keep in mind the frontline workers who have tirelessly put their lives on the line to better ours. We are grateful that many of us can work from the safety of our homes and for the privilege of greater togetherness with our families. We are inspired by the growing resolve to act against systemic racism and injustice. And we are thankful that our democracy, even when under assault, prevailed.

Despite the devastation that 2020 brought, there were silver linings for investors too. It was a banner year for investment portfolios, with capital markets benefiting from the extraordinary infusion of monetary and fiscal support as central banks and governments stepped in to contain the economic fallout from the pandemic. Furthermore, these returns—around 20% for equities and 7.5% for bonds—come on the back of 2019, also an extravagant year for investments.

We suggest a higher strategic equity allocation and a commitment to safe-haven fixed-income exposures

In light of these gains, we encourage investors to begin this year with a wellness check for their portfolios to ensure that their long-term financial goals are aligned with their strategic asset allocation. In a landscape that benefits stocks over bonds in the long term, we suggest a higher strategic equity allocation. Despite our belief that accommodative monetary policies and federal spending will bolster market sentiment, we recommend our clients confirm a commitment to safe-haven fixed-income exposures to withstand outcomes different than this base case and to ensure adequate portfolio liquidity. While we are hopeful for better days and months ahead, we remain committed to disciplined rebalancing and diversification—hallmarks of a healthy portfolio—as only time will reveal 2020's lasting impact on our community and the economy.

WELLNESS CHECKLIST FOR INVESTMENT PORTFOLIOS

✓ Understand the lay of the investment land

At NEPC, our investment outlook is informed by our key market themes that influence asset allocation and portfolio implementation. While *virus trajectory* remains a critical theme, our expectation (and hope) is that its importance fades over the course of 2021, aided by an effective inoculation plan that provides the global economy with a much-needed shot in the arm. We believe our key market theme of *permanent interventions* will dominate this year, with the understanding that fiscal stimulus will likely lead the way, given the limited wiggle room for monetary policy with rates already at zero or even negative territory. This environment of unprecedented market liquidity will likely continue to benefit risky assets even though recent gains may have eroded return expectations for equities. To that end, stocks appear quite favorable compared to low-yielding bonds and other safe-haven assets.

✓ Trust long-term themes over short-term instincts

Combining 2019 and 2020, U.S. equities have rallied more than 50%. A run like that typically signals pressure for a correction of some kind. While a short-term correction will likely arrive at some point in 2021 or beyond, we suggest investors resist the temptation to underweight risky assets after their strong performance. Instead, focus on the *permanent interventions* theme and the tailwind it offers to equities and credit. In fact, we ask you to seriously consider increasing strategic equity targets to capture the higher returns stocks offer relative to fixed income as risk assets benefit from our permanent interventions theme. To be clear: this is not a call to abandon rebalancing, which we believe is a core investment principle. Disciplined rebalancing remains critical as a governance tool once strategic targets have been determined. As markets have demonstrated consistently, investors can take advantage of an overbought consensus with an effective rebalance program; bouts of volatility may be used to not only rebalance, but also increase targets to equities.

> ***Our key market theme of permanent interventions will dominate this year***

✓ Don’t count out risk

We encourage investors to recognize the potential dangers lurking in markets and the importance of diversification. Despite the advantages it offers, our permanent interventions theme comes with risks: If not managed deliberately, an unrestricted flow of liquidity and stimulus can devalue currencies and stoke inflation, forcing a repricing of assets. On the other hand, tightening monetary and fiscal support can send markets into a tailspin, exacerbating deflationary pressures. To that end, we recommend defining the role of and properly sizing each beta exposure, so your portfolio can withstand the wide spectrum of potential economic outcomes. This expression of a portfolio’s strategic views includes:

1. Diversification within equities: Confirm that your equity allocation—typically the largest risk exposure in a portfolio—is appropriately diversified with representation across capitalizations, sectors and geographies; diversification should also include a balance of styles, maintaining exposure to value relative to growth stocks. For those willing to depart from market weights, we favor a modest overweight to U.S. and emerging markets that is funded by an underweight to international developed (EAFE) equities.

2. Exposure to safe-haven fixed income: While the general trajectory of risk assets may be favorable, a portfolio should be prepared to withstand economic shocks and disruptions. We believe a pure safe-haven exposure through a blend of Treasuries and TIPS—even at their current level of low yields—can provide returns during periods of losses for stocks and be a source of liquidity during a potential market freeze. This allocation should be meaningfully sized, allowing the portfolio to take on more incremental risk.

3. Return-seeking fixed income: In addition to a dedicated safe-haven exposure, we believe credit risk—as a return-seeking asset (and not a shock absorber to growth assets)—is a core beta exposure necessary for portfolio diversification. Separating safe-haven allocations from return-seeking fixed income allows each to play its independent role in a portfolio. The menu available to investors building a return-seeking credit allocation is vast: High-yield corporate bonds, specialized credit hedge funds, and illiquid private markets can all play a role. Sizing within an allocation will depend on each investor's individual tolerance for risk.

4. Inflation-hedging assets: Inflation has not been a prime concern for investors for over 30 years and, therefore, is easy to dismiss. While our base case outlook for inflation is subdued, we cannot rule out the potential for disruption fueled by higher inflation levels. Extraordinary fiscal stimulus puts money in the hands of spenders, and potentially ratchets up the risk of higher consumer price inflation. Furthermore, due to the decade-long lackluster performance of real assets, many portfolios are severely under-allocated to inflation-sensitive beta exposures. Investors should assess their long-term objectives and the impact of potentially higher inflation on their portfolio to determine whether building this allocation offers an appropriate diversification benefit relative to its potential return.

CONCLUSION

While 2020 was a year unlike any other, altering nearly every aspect of life as we knew it, the core principles of investing remain unchanged. We encourage investors to evaluate their strategic objectives, while keeping up with disciplined rebalancing and being watchful of market liquidity. To that end, we recommend a strategic equity allocation that favors U.S. and emerging market stocks. Also, mindful of the wide range of potential outcomes related to the economic fallout from COVID-19, we favor an appropriately-sized exposure to safe-haven fixed income, including a dedicated allocation to Treasuries and TIPS. While we are cautiously optimistic that we are at the beginning of the end of the pandemic, we believe our commitment to diversification and rebalancing will ensure the health of investment portfolios in the face of the unknowns that lie ahead. We wish you a healthy 2021 and look forward to a time, hopefully soon, when we can safely meet in person again. Meanwhile, please keep well and stay safe.

Commitment to diversification and rebalancing will ensure the health of portfolios

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