



Asset Allocation

Expected Returns on Major Asset Classes

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Expected returns are arguably the most important input into investment decisions. Many investors determine their expectations for returns on investments in highly subjective ways, based on discretionary views. More objective predictions are anchored on historical experience, financial theories and observation of prevailing market conditions.

This book calls for broadening the traditional paradigm of expected return estimation in two ways: (1) moving beyond the narrow perspective of asset class investing to focus additionally on expected returns for strategy styles (active management) and for underlying factors and (2) reducing the focus on historical performance and widening the set of inputs used. Two key implications follow: better-diversified portfolios (avoiding exclusive reliance on the equity premium as the source of beta return) and more forward-looking analysis.

Even though many investors have improved portfolio diversification by shifting from home-biased holdings to truly global investments and by expanding their asset class opportunity set, they still largely rely on the equity premium for long-term returns. Both 60%/40% stock/bond portfolios and “endowment model” portfolios (which make significant investments in alternatives) have high stock market betas, and equity risk often accounts for 90% of the portfolio risk budgets in either type of portfolio.

This book covers in detail the building blocks of asset class diversification: the equity premium, term and credit premia in fixed income, and the performance of the principal alternative assets (real estate, commodities, hedge funds, and private equity).

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