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1Q:2023 Strategic Investment Outlook

Four Strategic Allocation Issues for Asset Owners in 2023

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Introduction

In this note, we explore four key issues that asset owners will need to face in 2023, rather than a typical list of forecasts for market outcomes in the year ahead. They relate to more strategic problems—but ones that asset owners will need to grapple with this year.

Any macro discussion can never stray too far from inflation. We won't discuss forecasts directly as one of our themes—instead, we address inflation's impact on asset allocations. The US breakeven inflation rate dropped abruptly in the latter part of 2022, as investors adjusted their expectations of how hawkish the Federal Reserve would be. Whatever inflation forecasts one may have had six months ago are presumably lower now, given the Fed's commentary.

However, the Fed's current actions impact inflation over the next one to two years, not the next decade, and we continue to believe that long-term equilibrium inflation will be higher, given that the post-pandemic era represents a new regime. Different long-term forces are at work on inflation—notably deglobalization, demographic changes and environmental, social and governance (ESG) considerations.[1] It will take a lot of work from investors to adjust strategic asset allocation to a higher-inflation world.

In our view, the key allocation questions include the appropriate weight of private assets and the near-term outlook for risk assets, such as equities. We think the topic of liquidity will be much more prominent, and that changes in funding levels and inflation expectations will drive very large differences in risk attitudes among investors. Another relevant theme we won't discuss here is the impact of geopolitical risk on allocations, since we've addressed it elsewhere. We'll end this note with a comment on what we see as the diverging outlook for supply and demand for equities and bonds over the next five years.

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[1] For our discussion of this see The Intimate Linkage of ESG and Inflation, May 23, 2022

Details

Theme One: What weight to place on private vs. public assets?

There's probably no question of strategic allocation that ranks higher on CIOs' to-do list than public versus private asset allocations, specifically: Should allocations to private assets continue growing?

In our client conversations, we find very different views. We spoke recently at a Canadian pension plan conference, where 70% of those in the room said they intend to increase their private-asset exposure over the next year. In the UK and Holland, by contrast, some pension plans have been trying to offload private assets.

Based on the asset allocations of 10 of the 20 largest US state pension plans with published and updated asset-allocation data in 2023 shows that the average allocation to private equity exceeds the medium-term allocation target by more than 3% (Display 1).

DISPLAY 1: PENSION PRIVATE EQUITY ALLOCATIONS ARE ABOVE TARGET
US STATE PENSION FUND ALLOCATIONS TO PRIVATE EQUITY VERSUS TARGET

Date	Fund	Current Private Equity Allocation	Target Allocation
Sep-22	CALPERS	11.5%	9%
Nov-22	CALSTRS	15.1%	13%
Sep-22	Florida ERS	10.1%	6%
Aug-22	Texas Teachers	17.2%	14%
Jun-22	NY State Teachers	10.8%	8%
Apr-22	STRS Ohio	12.1%	9%
Jun-22	Georgia ERS	3.3%	0-5%
Sep-22	Virginia RS	19.0%	16%
Jun-22	Ohio Public Employee	14.6%	12%
Oct-22	Oregon PERS	26.9%	20%

Historical analysis and current estimates do not guarantee future results.
In all cases, current private-equity allocations were below the maximum allowed, so this does not imply a need to sell.
As of December 20, 2022
Source: Public Plans Database and AB

In previous research, we've detailed[2] why the allocation to private assets should be higher than historical levels: 1) expected returns are lower on many assets compared to the average the past 40 years; 2) diversification is needed if bonds are not as effective in that role; 3) inflation protection is needed and; 4) there's a dearth of young, high-growth companies launching initial public offerings.

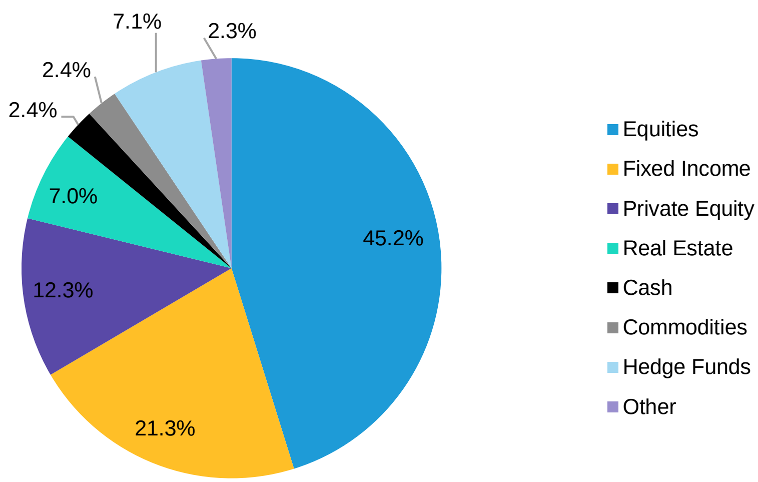
All of those forces remain in place, but the case for private assets must be translated into a very different context today. In recent years, return expectations were very depressed and central banks were providing plenty of liquidity. Now, two specific headwinds are set against the positive case for private assets.

[2] Inigo Fraser Jenkins Private Assets and the Future of Asset Allocation, December 2021

The first is the risk of a liquidity problem, which we'll examine later in this note. The second is the "denominator effect" of the relative move in public and private asset valuations, given the abrupt market repricing of 2022. Public equity and debt markets have quickly reflected the changed monetary policy backdrop, but there hasn't been an equivalent marking to market of most private segments.

One could argue that if public market losses will be rapidly re-traced, no adjustment is necessary. But if the growth downturn is set to be more prolonged, a mark-to-market adjustment in private assets may be needed. Meanwhile, this situation has boosted portfolio allocations to private markets: the aggregate asset-allocation of US public pension plans, pro-rated for 2022 returns, suggests an overall 12.3% allocation to private equity (Display 2).

DISPLAY 2: SUBSTANTIAL PRIVATE EQUITY ALLOCATION FOR US STATE AND LOCAL PENSION PLANS



Historical analysis and current estimates do not guarantee future results.

Asset-allocation data for 2021 pro-rated with 2022 returns. Equities: S&P 500 Index, fixed income: 10-year US government bond returns, real estate: US public REIT returns, Commodities: Bloomberg Commodities Index, hedge funds: asset-weighted HFRI index. For private equity, the latest available data is as of June 2022 for Cambridge Associates US Private Equity Index. Other assets represented by returns of Cliffwater Private Debt Direct Lending Index through September 2022.

As of December 31, 2022

Source: Bloomberg, Cambridge Associates, Cliffwater, HFRI, Public Plans Database, Thomson Reuters Datastream and AB

In theory, a year which sees a large move in marked assets shouldn't immediately lead to a reassessment of strategic asset allocation—by its nature, it usually should not be at the mercy of short-term volatility. However, the recent experience of UK pension plans in the liability-driven-investing (LDI) crisis of 2022 and the awareness of liquidity needs make this more of a near-term concern.

In our view, this should be a long-term question and only addressed in a staggered way. However, if the current allocation appears overweight private assets compared with target allocations, it may raise questions about whether this should limit additional near-term allocations to private assets.

The bottom line is that despite the changes in the liquidity environment and starting valuations, we think a case for higher private asset allocations remains for many investors. That has become more finely balanced, though, so the pace of allocating to private markets in will slow in aggregate, and at the individual investor level will depend on liquidity needs.

There's also a question of whether expectations for the average return on the average private equity investment have gone too far; we outline our forecast for private equity in the following section. We expect the net-of-fee return on the average private equity investment—one that assumes no alpha component—to be in line with returns for public equity. This suggests that marginal flows into private assets would head for other areas, and with inflation protection still a preeminent concern, we suggest that those areas will be private debt, private natural-resources assets, real estate and infrastructure.

Estimating Private Equity Returns

We can write an expression for the expected return from the average private equity investment as:

$$Private\ Equity\ Return = (unlevered\ retrun) + \ Financial\ Leverage * (unlevered\ return - cost\ of\ debt) + Multiple\ Expansion - fees$$

Where:

$$Unlevered\ return = (Income\ Yield + Real\ Growth\ )$$

We assume a 2% income yield. That's slightly higher than the current dividend yield for public US small cap equities at 1.4%, because private-equity firms tend to target cheaper firms. We model real growth the same way as we do for public equities: 1.5% real gross domestic product (GDP) growth per capita and 0.5% per-year population growth based on United Nations estimates. We also add a 2% growth premium, because private equity tends to have a sector skew in favor of faster-growing sectors compared to public markets.

Financial leverage is calculated using a 1.2x debt/equity ratio, and the real cost of debt is modeled as a LIBOR base rate at 3% and a 3.5% spread, adjusted by a 3% inflation rate.

We assume no multiple expansion—in recent years, private equity has been acquiring targets at very elevated Enterprise Value/EBITDA multiples compared with history, which we believe leaves very limited room for further multiple expansion. We also stress that we're forecasting the return for private equity in aggregate. While a successful turnaround may be expected to lead to multiple expansion, we can't assume this for the industry writ large. Bringing all of this together (Display 3), we get a gross real return forecast of 9%.

DISPLAY 3: PRIVATE EQUITY RETURN FORECAST

Income Yield	Real Growth	Debt/Equity Ratio	Real Cost of Debt	Levered Return	Multiple Expansion	Gross Real Return
2%	4%	1.2x	3.5%	9%	0%	9%

Historical analysis and current estimates do not guarantee future results. Simulated or hypothetical trading programs in general are also subject to the fact they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve returns or a volatility profile similar to those being shown.

As of December 31, 2022

Source: Bloomberg, FactSet, Federal Reserve Economic Data (FRED) and AB Simulated or hypothetical performance results have certain inherent limitations.

However, we need to adjust this estimate for the substantial fees of private equity funds. Academics Doskeland and Stromberg[3] cite a study by CEM Benchmarking that estimates total private equity fees at 5.7%. We expect lower returns by historical standards, so the performance element of total fees should be lower going forward. We think fees will be closer to 5.5% per year for a net real return of 3.5%. Assuming a 3% inflation rate 10 years forward, this translates into a 6.5% net nominal return.

Borrowing cost is a big source of uncertainty for future private-equity returns. Over the past 10 years, it has benefitted from a structural decline in interest rates and in the real cost of debt. We believe this trend is now going into reverse, and could turn into a significant headwind for returns in the future. As such, we model two scenarios (Display 4) with 1% higher and 1% lower

[3] Døskeland, T. M., and P. Strömberg. 2018. "Evaluating Investments in Unlisted Equity for the Norwegian Government Pension Fund Global (GPFG)." Report for the Norwegian Ministry of Finance

borrowing costs versus our base case. In a higher-borrowing-cost scenario, net real return falls to 2.3%; lower-than-expected borrowing costs would increase the net real return to 4.7%.

DISPLAY 4: PRIVATE EQUITY RETURNS UNDER DIFFERENT BORROWING-COST SCENARIOS

	Income Yield	Real Growth	Debt/ Equity	Real Cost of Debt	Levered Return	Multiple Expansion	Gross Real Return	Net Real Return
Base Case	2.0%	4.0%	1.2	3.5%	9.0%	0.0%	9.0%	3.5%
Higher Borrowing Costs	2.0%	4.0%	1.2	4.5%	7.8%	0.0%	7.8%	2.3%
Lower Borrowing Costs	2.0%	4.0%	1.2	2.5%	10.2%	0.0%	10.2%	4.7%

Historical analysis and current estimates do not guarantee future results. Simulated or hypothetical trading programs in general are also subject to the fact they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve returns or a volatility profile similar to those being shown.

As of January 13, 2023
Source: FactSet, FRED and AB.

Theme Two: More Weight Needed on Liquidity Considerations

Concern about liquidity will likely occupy the minds of CIOs and other investors for the near future. It's a challenge created by the confluence of three distinct big-picture themes:

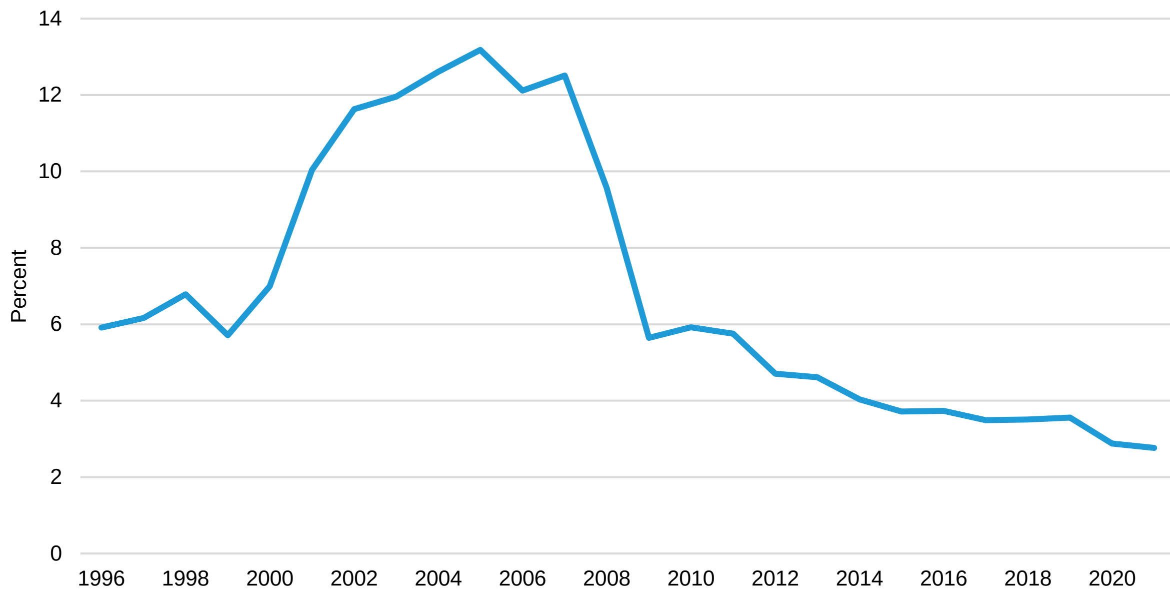
1. Asset owners have transitioned to more illiquid portfolios over the past decade in a hunt for returns.
2. Central banks are reducing macro liquidity as they pivot from quantitative easing (QE) to quantitative tightening (QT).
3. A change in market structure—for example in the relative importance of different participants in public markets.

We think the UK LDI "crisis" is a canary in a coalmine in this regard. It highlights the need to assign more weight to liquidity considerations in an environment when the interest-rate cycle has definitively turned, inflation volatility is expected to be higher, and the business cycle is back—as opposed to the most elongated period of economic expansion we've ever seen leading up to the pandemic.

Evidence of less liquidity can be seen in many ways. It's evident in the increased weight of illiquid assets in portfolios and in central bank policy. It's also apparent from microstructure issues the equity market, such as the rise of high-frequency traders and changes in trading behavior—trading volume in closing auctions has grown from 3% to 10% over the last decade[4] , narrowing the window for effective price discovery. Liquidity is also down in fixed-income markets, with lower trading volume in Treasury securities (Display 5) a notable example.

[4] https://www.sciencedirect.com/science/article/abs/pii/S0304405X21005092

DISPLAY 5: US TREASURY LIQUIDITY HAS DECLINED
US TREASURY SECURITIES TRADING VOLUME AS % OF TOTAL OUTSTANDING



Historical analysis and current estimates do not guarantee future results.

As of January 5, 2023

Source: SIFMA and AB

The confluence of big-picture themes cited previously is the reason why liquidity will remain a key issue in 2023. Different kinds of liquidity aren't always comparable, but macro liquidity, portfolio liquidity and market functioning all point in the same direction. That third category itself has several distinct underlying drivers, which we laid out in more detail in *Global Quantitative Strategy: Liquidity poses a strategic challenge to investors* and summarize below:

- **The rise of high-frequency traders**, who account for much of market liquidity, has shifted the intraday profile of trading volume compared with 2009, with a much larger proportion in the closing auction. The Financial Policy Committee in the UK identified the "fragility of market liquidity" as a key risk to market resilience[5] . The committee notes that high-frequency traders exacerbate market fragility because they occupy a "sweet spot" of liquid mega-cap names and don't trade during more volatile regimes or highly news-driven markets. So, market liquidity tends to evaporate when it's needed most.

- **A dearth of active investors**. Globally, passive investing now accounts for more than 40% of assets under management (AUM). Passive investors tend to trade at a low percentage of the volume around index rebalancing dates. They use less-aggressive algorithms than an active investor trading more urgently based on news flow. And in recent years, the AUM of active value investors has seen a particularly big decline. Thus, investors who are able to step in and buy assets that are oversold now account for a much lower share of overall assets.

- **The move from quantitative easing to quantitative tightening**. After years of very accommodative monetary policy and balance-sheet expansion, all major central banks around the world have aggressively pared down balance sheets in 2022.

More-fragile liquidity isn't in itself a reason to be bearish—markets could continue to behave in an orderly fashion. But it would be a mistake to ignore it. And because the forces at work are slow-moving trends of policy, market structure and the illiquid tilt of many strategic asset allocation approaches, the liquidity issue is unlikely to pass quickly.

[5] Financial Stability Paper No. 34 (bankofengland.co.uk)

This implies several action points for investors: They should prepare for an extended period of larger amplitude market moves in response to news flow, an effect distinct from expecting a higher level of volatility as we move away from pre-pandemic trended markets. Allocations are impacted, too: other things equal, a greater focus on liquidity implies a need for higher public-market exposure versus private assets than would otherwise have been the case. Another implication is the need to give greater credence to cash-flow driven investing approaches than just focusing on liability-driven views.

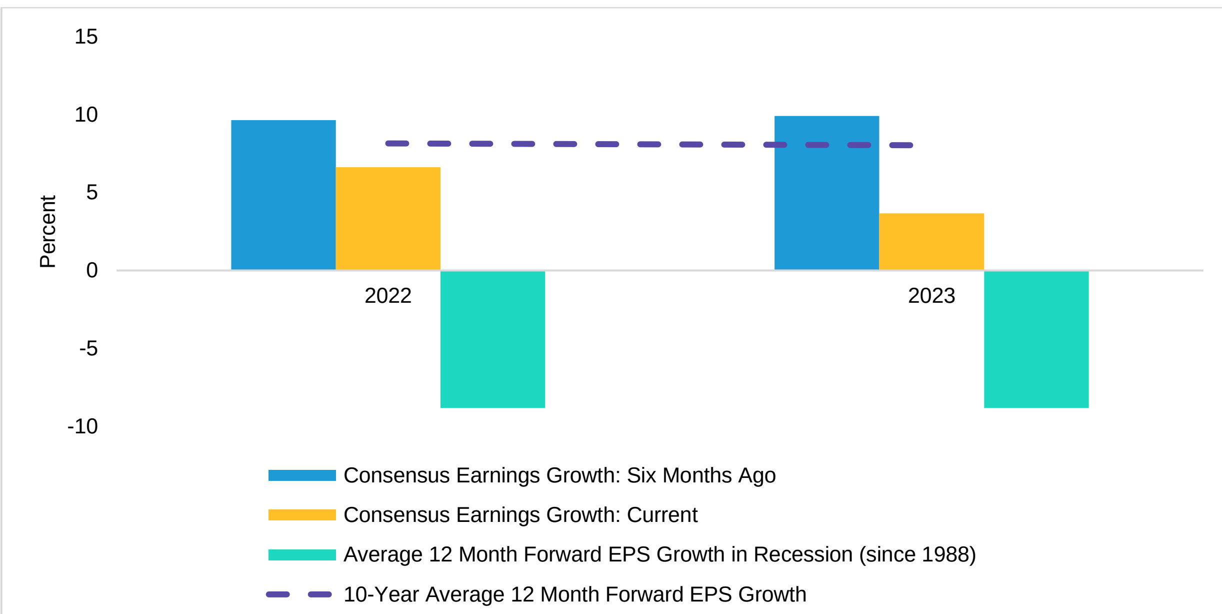
Theme Three: Risk Assets When Growth Is Falling—Caution, But Not Bearishness

After the significant asset-price adjustment in 2022, when should we expect equities to find a floor? Part of the answer to this question is linked to the debate about the path of Fed policy, but when earnings cuts and adjustments in investor sentiment have been sufficiently adjusted are also important.

On one level, analysts' apparent unwillingness to cut earnings forecasts to a level near previous recessionary periods has been a key topic of debate for the past six months. Over this time frame, the consensus forecast for 2023 earnings per share (EPS) growth for US equities has been cut to 3.4% from 9.5% (Display 6). This number looks odd, and somewhat frightening when juxtaposed with the average –9% average decline in forecast earnings in prior recessionary periods since 1988.

But there are mitigating circumstances. Equity analysts operate in a nominal forecasting world, while economists forecast in real terms. That difference matters now…a lot. Corporations are able to pass on at least some proportion of price increases, however imperfectly. So how far should earnings fall—are cuts in expectations finished?

DISPLAY 6: US EARNINGS EXPECTATIONS ARE DOWN…SOMEWHAT
NOMINAL EARNINGS GROWTH FOR US EQUITIES



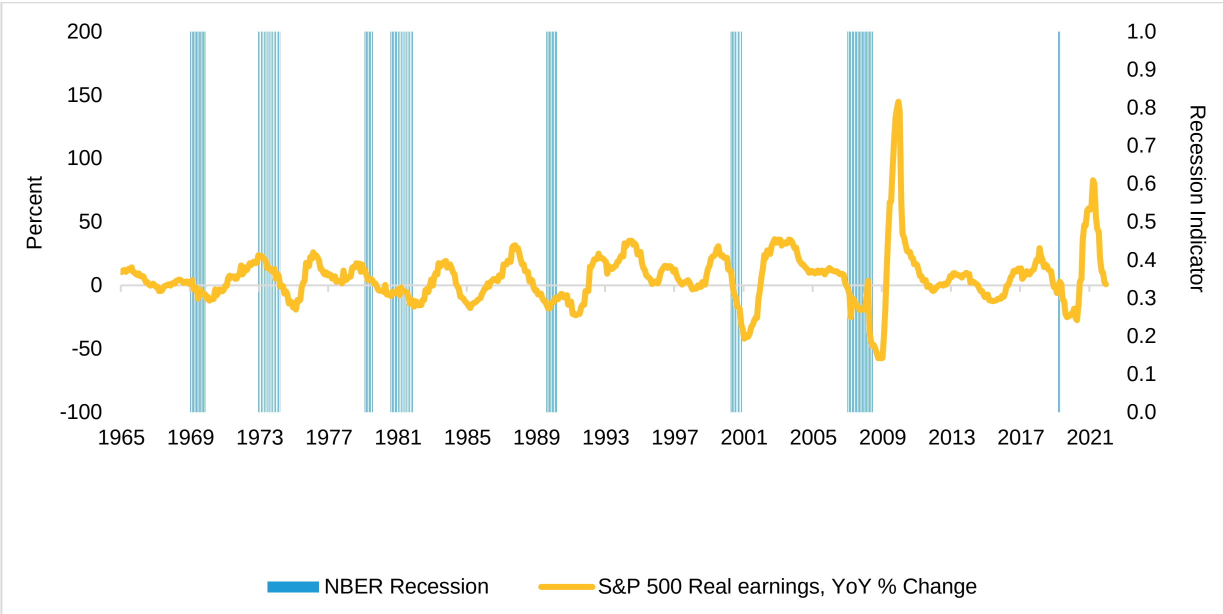
Historical analysis and current estimates do not guarantee future results.

As of January 17, 2023
Source: Datastream, IBES and AB

US real earnings growth has declined by 9.1% on average in recessionary periods since the 1960s (Display 7). (Because earnings cycles don't always neatly fit into recessionary periods, we've extended the period to include the full decline in earnings around a recession). If we adjust the current nominal earnings-growth consensus of 3.4% by the latest US Consumer Price Index increase of 6.4%, we end up with the current real earnings forecast of –3%.

There are reasons to believe that this recession should be somewhat milder than average. Our own earnings indicator, based on a range of activity, sentiment and monetary inputs suggests nominal earnings growth near zero for 2023. The bottom line implication: we're most of the way through the process of earnings cuts, but not quite there yet—more cuts are to come.

DISPLAY 7: US REAL EARNINGS GROWTH IN PREVIOUS RECESSIONS
REAL EARNINGS GROWTH AND RECESSIONS



Historical analysis and current estimates do not guarantee future results.

Real earnings growth is adjusted by the Consumer Price Index.
As of December 31, 2022
Source: FRED, I/B/E/S, NBER, Thomson Reuters Datastream and AB

If earnings are supported by inflation pass-through rather than real growth, it's implied that those earnings should command a lower valuation multiple. Arguably, that's what has taken place though the de-rating of equities in 2022. However, because of cuts to earnings forecasts and the relatively strong showing of markets in recent months, the US equity market only briefly touched its average recessionary multiple in October 2022, and now trades two price/earnings (PE) points higher. European markets are close to recessionary valuation levels (Display 8).

DISPLAY 8: EQUITY VALUATIONS VERSUS PRIOR RECESSIONARY BOTTOMS

Average 12-Month Forward P/E Multiple During Previous Cycles Based on OECD US Leading Economic Indicator

	North America	Autos & Housing	Capital Equipment	Commodities	Consumer Cyclicals	Consumer Staples	Defense	Energy	Financials	Healthcare	Real Estate	Technology	Communications	Transports	Utilities
Recovery	17.80	N/A	17.70	20.10	22.10	16.90	15.70	18.00	13.10	17.00	20.50	22.60	17.80	23.40	14.40
Expansion	16.80	18.80	17.60	16.40	20.00	17.90	16.20	18.20	12.60	19.00	17.00	20.40	16.40	16.30	14.00
Slowdown	16.40	13.80	16.80	14.80	19.50	17.90	15.50	17.20	12.20	18.80	16.30	19.30	15.90	14.90	14.80
Recession	15.50	14.30	14.70	15.80	18.60	17.10	13.80	14.70	11.60	16.70	18.20	19.40	15.70	15.20	14.40
Current Multiple	**17.50**	**17.04**	**17.68**	**16.01**	**21.47**	**20.73**	**21.63**	**9.97**	**12.13**	**19.61**	**30.10**	**22.09**	**16.37**	**17.38**	**18.93**

Average 12-Month Forward P/E Multiple During Previous Cycles Based on OECD European Leading Economic Indicator

	Europe	Autos & Housing	Capital Equipment	Commodities	Consumer Cyclicals	Consumer Staples	Defense	Energy	Financials	Healthcare	Real Estate	Technology	Communications	Transports	Utilities
Recovery	15.30	17.40	15.90	16.00	18.50	16.30	15.70	13.70	12.90	16.10	16.70	21.60	16.70	24.60	13.70
Expansion	14.90	13.50	15.20	13.60	17.60	16.70	15.70	13.50	13.00	18.00	16.70	20.70	17.30	15.30	14.20
Slowdown	14.20	11.90	14.00	12.20	16.80	16.70	15.10	12.30	12.20	17.80	15.40	19.50	16.60	13.40	14.10
Recession	12.50	10.20	12.20	11.50	15.40	15.80	13.30	10.50	10.20	16.00	14.10	17.10	15.10	11.90	12.60
Current Multiple	**13.42**	**10.09**	**15.16**	**13.22**	**19.87**	**17.92**	**18.10**	**7.39**	**9.49**	**17.63**	**14.07**	**20.66**	**13.96**	**10.49**	**13.81**

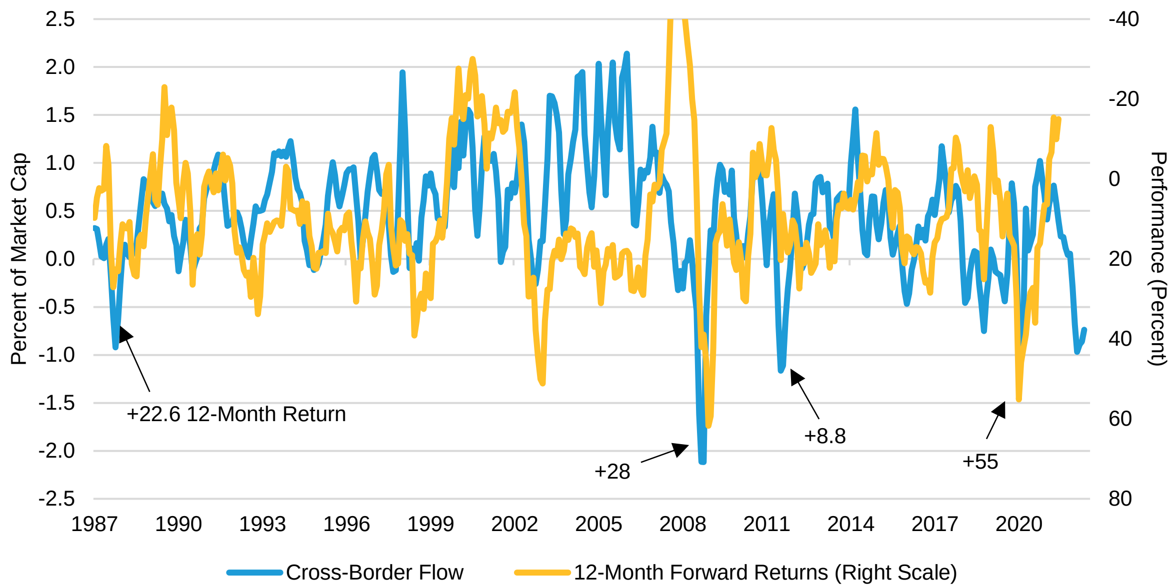
Historical analysis and current estimates do not guarantee future results.

As of January 17, 2023
Source: FactSet, I/B/E/S, Thomson Reuters Datastream and AB

Sentiment is the other key aspect in timing tactical entry points into longer-term strategic trades. The most striking of the indicators we track in this regard is investors' appetite for overseas equity exposure, which has been declining at a record rate (Display 9). Global investors have been pulling back from overseas equity at a rate of 1% of global market cap per annum, mainly through exiting positions in emerging markets (EM) and Europe.

This is one of the fastest rates of asset repatriation to home markets we've seen in 30 years. In previous cycles, this level has implied that sentiment has overshot—with stocks tending to deliver positive returns over the following one to two years. Against the backdrop of more cautious signals from earnings expectations and valuations, this is the more positive input to a view on risk assets.

DISPLAY 9: OVERSEAS EQUITY EXPOSURE HAS BEEN DECLINING AT A RECORD RATE
GLOBAL CROSS-BORDER EQUITY FLOW INDICATOR AND FORWARD RETURNS



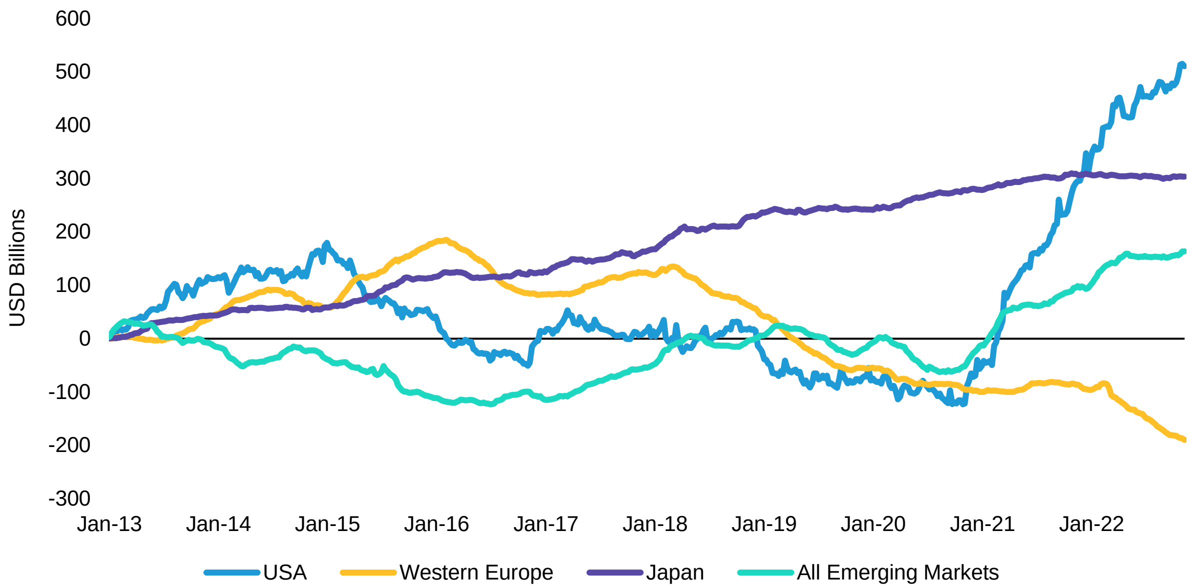
Past performance does not guarantee future results.

Display shows the combined net purchases of overseas equities for the US, UK, Euro area (post-1997), Germany (1987–1997), France (1993–1997) and Japan (post-1997). Data derived from external sector portfolio investment data published in central-bank financial accounts. The series is monthly flows smoothed over three months, annualized and normalized by the market cap of the Datastream World index.
As of October 30, 2022
Source: Bernstein Research, Banque de France, Bundesbank, European Central Bank, Federal Reserve, Japanese Ministry of Finance, Thomson Reuters Datastream, UK ONS, and AB

Our strategic preference over long horizons is for US exposure within global equities, because we see the US as more insulated from the negative effects of deglobalization[6] . However, for investors willing to take more tactical views, Europe and EM stand out as the regions that have been most disliked, while US equities—remarkably—saw only a minimal outflow last year (Display 10). Thus, there's a short-term case for Europe and EM to lead over the course of 2022, which can be relevant as investors look to address their long-term equity allocations.

[6] See Inigo Fraser Jenkins & et al., Investing in a Post-Global World, October 10, 2022

DISPLAY 10: HEAVIER EQUITY OUTFLOWS FROM EUROPEAN AND EM EQUITIES
CUMULATIVE REGIONAL EQUITY FUND FLOWS



Historical analysis and current estimates do not guarantee future results.

As of November 9, 2022

Source: Emerging Portfolio Fund Research and AB

The other problem in analyzing entry points for longer-term trades is the looming question of the US debt ceiling. As with geopolitical risks, markets tend to be bad at pricing low-probability but potentially very negative events. The considerable uncertainty over the handling of the US debt ceiling would be expected to impact markets around the middle of the year.

This is already reflected by shifts in potential hedges for such an event. One-year US Credit Default Swaps are already in line with the level reached during the 2011 debt-ceiling debate, and the price of gold relative to the level implied by real yields is already elevated as it was back then. In the 2011 showdown, it's ironic that Treasuries outperformed. While US equities fell, they outperformed European equities, though Europe was dealing with its own debt crisis at the time.[7]

Last year, in our tactical market update, we set out a cautious view on risk assets in the context of a moderately positive strategic longer-term outlook. Calling exact market turning points is, of course, hard and—and not the point of a note like this. As we see it, the cutting of earnings forecasts is mostly through, but not finished. On balance, we still think a cautious stance is right. The degree to which investors have been retreating from overseas equities and the net buybacks offer a cushion, so we don't think bearishness is appropriate.

But investors must weigh this tactical uncertainty against the likelihood that investors who need to preserve purchasing power will need to increase their strategic allocation to equities. We'll turn to the purchasing power aspect in the next section.

Theme Four: Diverging Views of Risk Among DB and DC Plans

We expect a growing realization of a divergence among investors when it comes to attitudes toward risk, driven by the way the post-pandemic environment is changing the nature of liabilities. We contend that many defined benefit (DB) funds have an incentive to de-risk, but many defined contribution (DC) funds face an imperative to increase risk levels.

[7] During the most acute phase of political brinkmanship around the debt-ceiling episode in late July / early August 2011, US equities suffered a severe bout of volatility—with multiple days where the S&P 500 declined by more than 4% and a peak-to-trough drawdown of 16%.

The surge in bond yields over the last 12 months has helped funding ratios for DB schemes with liabilities set in nominal terms. In some cases, funds have closed funding gaps and are able to enter into arrangements with insurance companies to cover liabilities. Even when that's not the case, higher yields will enable many of these funds to move up the quality spectrum in their asset allocations.

The outlook for DC funds, on the other hand, is very different. The shock of the past year has been the return of inflation, and adjustments still need to be made in adapting asset allocations to reflect an equilibrium level of inflation that's above the pre-pandemic level.

This view of a divergent risk attitudes depends on the long-run prognosis for inflation from here. Taken at face value, the fall in inflation break-even rates in recent months might imply that there's not a problem. However, we see strong reasons to believe that moderately higher inflation is here to stay—a result of deglobalization, ESG and demographics.[8] For DC funds, the "liability" is the ability to maintain and grow purchasing power, because retirement costs, set in the real economy, move with inflation.

This situation will necessitate a more nuanced sense of what "risk" means. In these cases, we would argue that the primary definition of risk should be the probability that end beneficiaries run out of money in retirement. This metric should take precedence over risk measures such as the expected near-term volatility of the asset portfolio.

In recent decades, a world of low inflation and high returns from both duration and equity beta enabled these different kinds of investors to think about the world in a roughly similar way. But higher inflation, elevated discount rates and lower expected asset returns means that the difference in liabilities will accentuate the difference in approaches to risk, and hence strategic asset allocation decisions, that different types of funds take in coming years.

Embedded in the different structures between DB and DC funds is that DB funds can take an aggregate view of risk for the whole portfolio. For DC funds, risk is couched in terms of individuals, so it must be dynamic as participants age. The natures of the individual building blocks of the DC approach make it harder to take illiquidity risk. That limitation is particularly relevant, because illiquidity is one possible response to expectations for lower real Sharpe ratios on traditional investing approaches.

What are the consequences of this divergence?

Many DB funds, at least those with defined nominal liabilities, will likely accelerate their push to de-risk. For DC funds, an acceptance of a new, higher equilibrium inflation level shifts the focus to preserving purchasing power. At moderately higher inflation levels (less than 4%), equities behave like a real asset, forming a key part of a portfolio designed to preserve purchasing power, especially if there are constraints on the ability to buy illiquid real assets. We suggest that moderately higher inflation and lower expected cross-asset returns (compared to the average of recent decades) implies that DC funds should increase equity allocations across all age cohorts, and continue to hold a significant equity weight into retirement.

How should the risk of higher equilibrium inflation be controlled for older cohorts approaching and entering retirement? At higher inflation levels, bonds tend to be less effective diversifiers, so a range of assets are needed to achieve an attractive trade-off between income and diversification. We suggest a mix of real and private assets, factors, and Treasury Inflation Protected Securities (TIPS).[9]

The other way to offset this higher portfolio risk is to pair it with insurance structures designed to avoid the opportunity cost of forgoing investment in growth assets. An example would be a Guaranteed Lifetime Withdrawal Benefit (GLWB), a lifetime-income insurance contract purchased at or before retirement. Guaranteed income is withdrawn from the portfolio, and if the portfolio is depleted a guaranteed minimum payment is covered by an insurance payout.

From the point of view of long-term protection of purchasing power for an overall portfolio, pairing a higher-equity or real asset core portfolio with such insurance offers a way for a participant to remove longevity risk without growth opportunity cost or the return risk to beneficiaries from dying early (known as mortality risk). A system-wide rotation from DB to DC, along with resurgent inflation, will likely make such structures more relevant for a larger pool of assets.

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[8] See [Investing in a Post-Global World](), October 10, 2022

[9] For a broader discussion on this see [What Happens When Diversification Disappears?]() June 13, 2022

A Final Word on Relative Demand for Stocks and Bonds

A final thought, though not really a 2023 theme, is the likelihood of a very different supply/demand dynamic for equities versus government bonds over the next five years. In short, we expect the supply of bonds to rise as demand for bonds falls (Display 11). For equities, we expect the opposite dynamic to prevail (Display 12).

Specifically, in the case of equities:

- Corporations were already the largest demand source in the decade before the pandemic, far exceeding investors' demand. Over the past year, share buyback activity in the US has reached a new record. The current exceptional pace is unlikely to be sustained as growth slows during this cycle, but we still expect robust buyback activity.

- The flip side of the demand trend is that equity issuance has declined. Structurally, there are fewer IPOs, and there's less cyclical need to rebuild capital in this period of low growth compared with previous recessions.

- We suggest that, as more investors adjust their strategic asset allocations to structurally higher inflation, some will need more equity exposure. This applies to investors seeking a real return, so a large swath of DC funds could be in this group. This issue isn't the same for DB funds, but a generational DB-to-DC shift means that DC assets should continue growing in relative significance.

For government bonds, the picture is quite different:

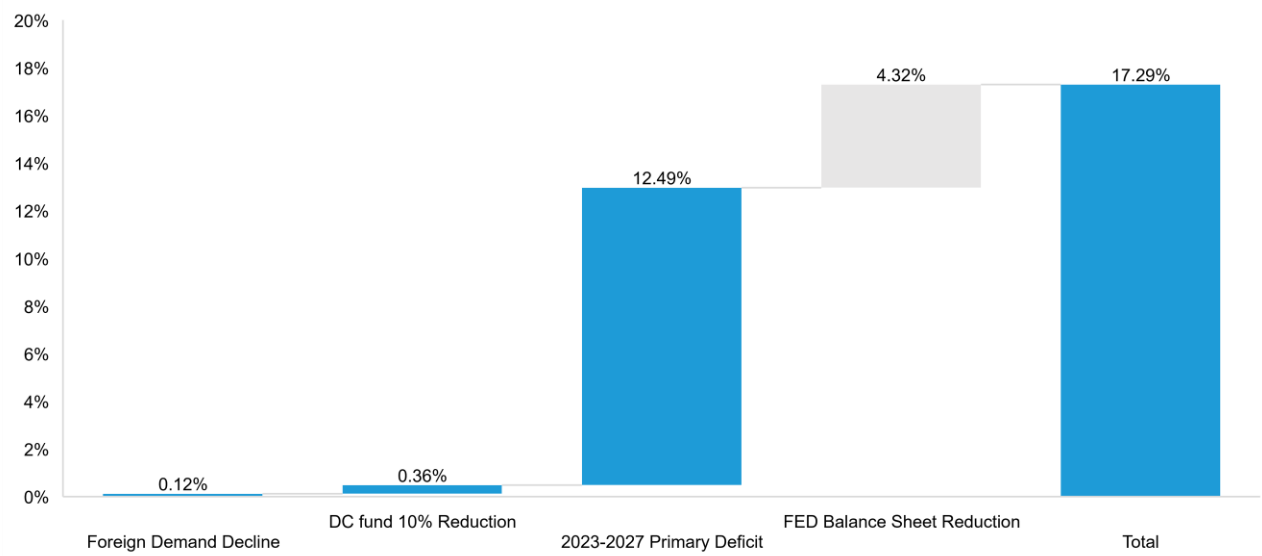
- Issuance is likely to be higher, not just in the near term but over the longer term, too.

- We expect less demand from investors, assuming a tilt in pension assets from DB to DC, with DC requiring more inflation protection. We also expect broader recognition among investors that the diversifying power of sovereign bonds is likely reduced.

- De-dollarization means that foreign investors (especially China) will at least try to reduce their holdings of US Treasury bonds; other countries may try to diversify somewhat.

- As for the transition from QE to QT, there's a debate as to whether it counts as net supply, given that the Fed isn't selling, just reducing its balance sheet. At the very least, it equates to reduced demand versus recent years—even excluding it, there's still a net extra supply of Treasuries.

DISPLAY 11: SOURCES OF US FIXED INCOME SUPPLY AND DEMAND

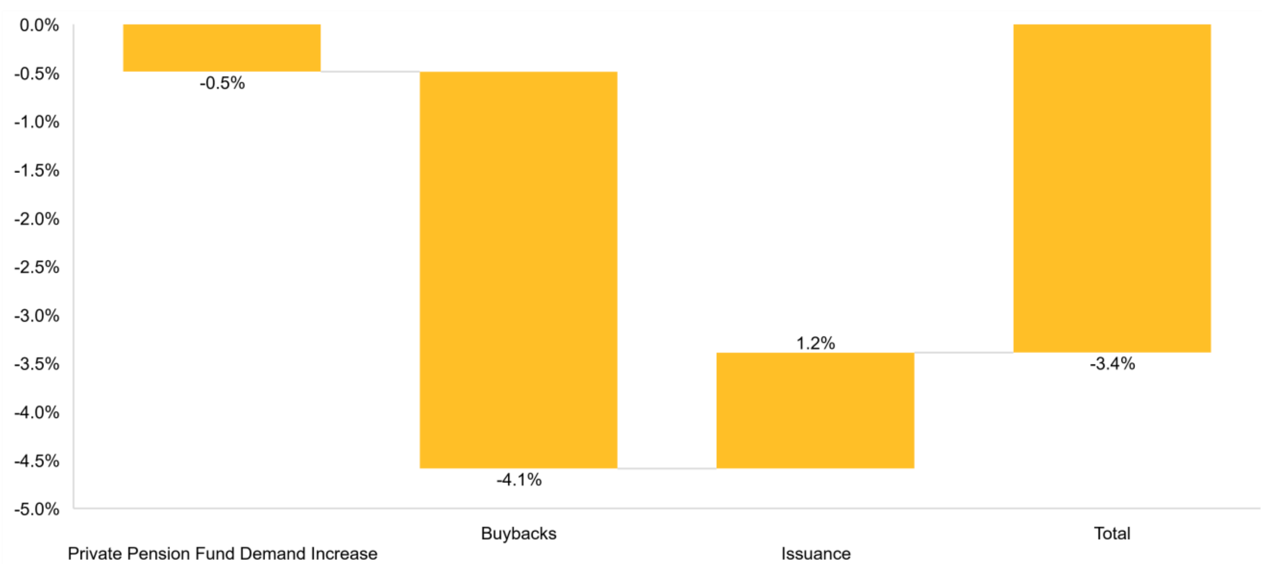


Historical analysis and current estimates do not guarantee future results.

As of December 20, 2022

Source: SIFMA, Thomson Reuters Datastream and AB

DISPLAY 12: SOURCES OF US EQUITY SUPPLY AND DEMAND



Historical analysis and current estimates do not guarantee future results.

As of December 20, 2022

Source: EPFR, Thomson Reuters Datastream, Z1 Financial Accounts of the United States and AB

The value of an investment can go down as well as up, and investors may not get back the full amount they invested. Capital is at risk. Past performance does not guarantee future results.

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