As we get further into the current, more volatile economic cycle and as equity valuations continue to be
expensive, many investors are looking for ways to diversify risk and enhance returns beyond traditional stocks and bonds. Across multi-asset portfolios—especially within the absolute-return-driven solutions—we’ve talked about the value in having further diversity from the things in-between—that is, those asset classes that have long-term returns between U.S. equity and U.S. core bonds, but have lower correlations with those two traditional asset classes, potentially providing clients with a smoother path to long-term outcomes.

In the past few quarters, we’ve been emphasizing the increasingly attractive benefits of these areas. U.S. equity valuations remain higher than historical average, while data points to lower-than-average returns projections and higher-than-average drawdown risk (chart below). So these asset types may become even more valuable, as we forecast them to have a similar long-term return as U.S. equity, but significantly less drawdown.
These *in-between* asset classes could be frustrating when the U.S. equity market is up over 20% in a year like 2017, because some of these assets *only* returned 5-12%. But for disciplined investors who plan for the long haul, they play an important role in creating the returns required, with a smoother ride that is survivable.

The latest round of market volatility reminded us of the value of these asset classes have to offer. U.S. large cap equities spent years among the top-performing asset classes. But check out the chart below. During February’s market sell-off, U.S. large cap equities were hit the hardest. See how much they underperformed prepayment and bank loans, which actually delivered positive returns, as well as many of nontraditional fixed income sectors and real assets.

How do we gain access to those *things in-between* asset classes in multi-asset portfolios?

1. In the *Design* stage, we include those asset classes in long-term strategic allocations.
2. In the *Construct* stage, we select skillful managers with deep knowledge in those specialized areas, and at the same time we employ risk premia strategies to drive excess return (more to come in a future blog post).
3. In the *Manage* stage, our *dynamic portfolio management* can incrementally take less equity risk and smooth the path towards the end objective.

Now look at that chart again. And let the numbers speak for themselves.

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1 Yale Professor Robert Shiller calculates a Cyclically Adjusted P/E Ratio based on stock price divided by prior 10-year earnings. U.S. stock market is represented by an index created by Professor Shiller. The stocks included are those of large publicly held companies that trade on either of the two largest American stock market exchanges: the New York Stock Exchange and the NASDAQ. Prior to 1926 his data source was Cowles and Associates Common Stocks Index, after 1926 his source has been S&P.

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