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## Top of Mind: The allocator's checklist for 2024 and beyond

January 2024



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As we embark on a new year, I want to offer 10 simple steps to help allocators evaluate their positioning and think about actions they can take in pursuit of portfolio objectives. Given the uncertainty and potential for volatility in the current market environment (see my [recent article on the cyclical outlook](#)), it may be especially important to plan ahead, which can help prepare stakeholders for a range of outcomes, limit the tendency toward a behavioral or emotional response to market events, and manage risks including those related to liquidity.

### 1. Review the trailing year

A recap of 2023 is a good starting point. It was a solid year for equities, with Japan leading the pack on a local-currency basis (but for unhedged US investors, it trailed the S&P 500). US large cap was very strong on a cap-weighted basis, but notably weaker on an equal-weighted basis — largely a reflection of the exceptional performance of the “Magnificent Seven” technology stocks. Meanwhile, US small-cap stocks and emerging market equities lagged, with emerging markets trailing their developed market counterparts by more than 10%. In fixed income,

riskier markets did relatively well, including high yield and emerging markets. US aggregate bonds had more modest gains. On the other hand, higher interest rates resulted in one of the best years for cash in some time. Finally, returns were strong for gold and Bitcoin, but broader commodities were one of the few asset classes to have negative returns for the year.

From a macro standpoint, there were some surprises in 2023, including the fact that the US economy, by all indications, ended up on course for a soft landing — a good reminder, perhaps, that higher interest rates don't automatically tighten the economy if the fiscal picture and the consumer are strong. We also saw central banks broadly succeed in efforts to tame inflation sooner than expected, although core inflation remains well above the levels of recent years. On a related note, 2023 offered a reminder that inflation is not necessarily bad for corporate earnings or even for valuations. Another outcome that was largely unexpected was the inability of the Chinese economy to bounce back after reopening from zero-COVID policy. And although it has since declined, many were surprised to see the 10-year Treasury yield reach 5% last fall.

Along with reviewing market results, I think allocators should spend some time looking back at their managers' results. Wellington's Head of Manager Research, Kat Price, uses a framework that can be helpful in this exercise, with a focus on the role the manager's strategy can play in a portfolio, the risks being taken, and the residual alpha potential (i.e., manager skill). Read more about the framework [here](#).

One last caveat on performance analytics: There can be a tendency to anchor decisions to calendar-year results, but there's nothing especially meaningful about a calendar year compared to any other 12-month period. So, before drawing any strong conclusions, it might pay to look at rolling 12-month periods for confirmation.

## 2. Consider your opportunity set

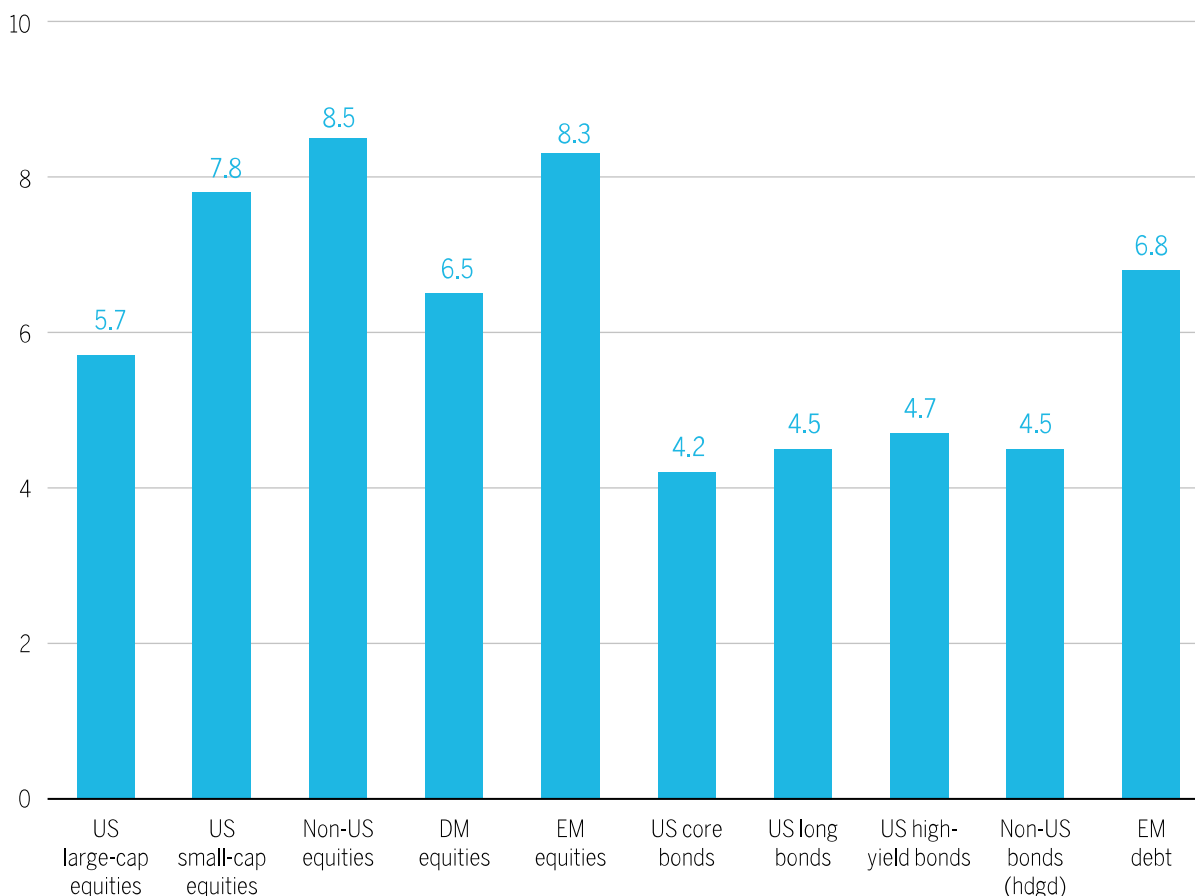
After looking backwards, let's turn our attention to what may lay ahead in terms of opportunities. Allocators may want to consider this from several vantage points:

**Capital market assumptions for a range of broad asset classes — Figure 1** shows Wellington's intermediate (10-year) capital market assumptions (CMAs). We expect small-cap US equities, non-US equities, and emerging market equities to outperform US large-cap equities. This is driven largely by valuations, and to a lesser extent by dividend yields and, for non-US equities, by currency. It's not driven by earnings growth, which we think will be quite healthy for large-cap US equities. For fixed income, the picture is very different from a few years ago, including notably higher return assumptions for high-yield bonds and emerging market debt, rivaling equity returns in some cases.

## Figure 1

### Intermediate capital market assumptions

Assumed annualized gross return (%)



This reflects our Investment Strategy Group's intermediate capital market assumptions as of 31 December 2023 for various asset classes. Intermediate assumptions reflect a time period of approximately 10 years. They are assumed nominal returns that are expressed in annualized, geometric terms. Return assumptions are shown for unhedged currency exposure (unless otherwise stated) using the US dollar as the base currency. This is for illustrative purposes only and the returns and other assumptions provided are hypothetical and not representative of an actual account or Wellington Management strategy. As the analysis relies upon assumptions and other expectations of future outcomes, it is subject to numerous limitations and biases including subjectivity. Data does not consider transaction costs, management fees, or other expenses associated with actual investing. **ACTUAL RESULTS MAY VARY SIGNIFICANTLY AND AN INVESTMENT CAN LOSE VALUE.** Investments cannot be made directly into an index. | **Please review in conjunction with the "Important disclosures – Capital market assumptions" at the end of this article.** | This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares, strategies or other securities. References to future returns are not promises or even estimates of actual returns a client may achieve.

**The valuation landscape** — Another way to evaluate the opportunity set is on the basis of valuations. Looking at fixed income spreads, global investment-grade and global high-yield bonds are currently quite expensive relative to history, well below the long-term median. Emerging market debt, on the other hand, is slightly cheap (though that is driven largely by the riskiest part of the market).

Equity valuations are a mixed bag. The US is expensive on the basis of both the trailing price-to-book ratio and the Shiller P/E ratio. Europe looks better but is not cheap. Japan isn't cheap

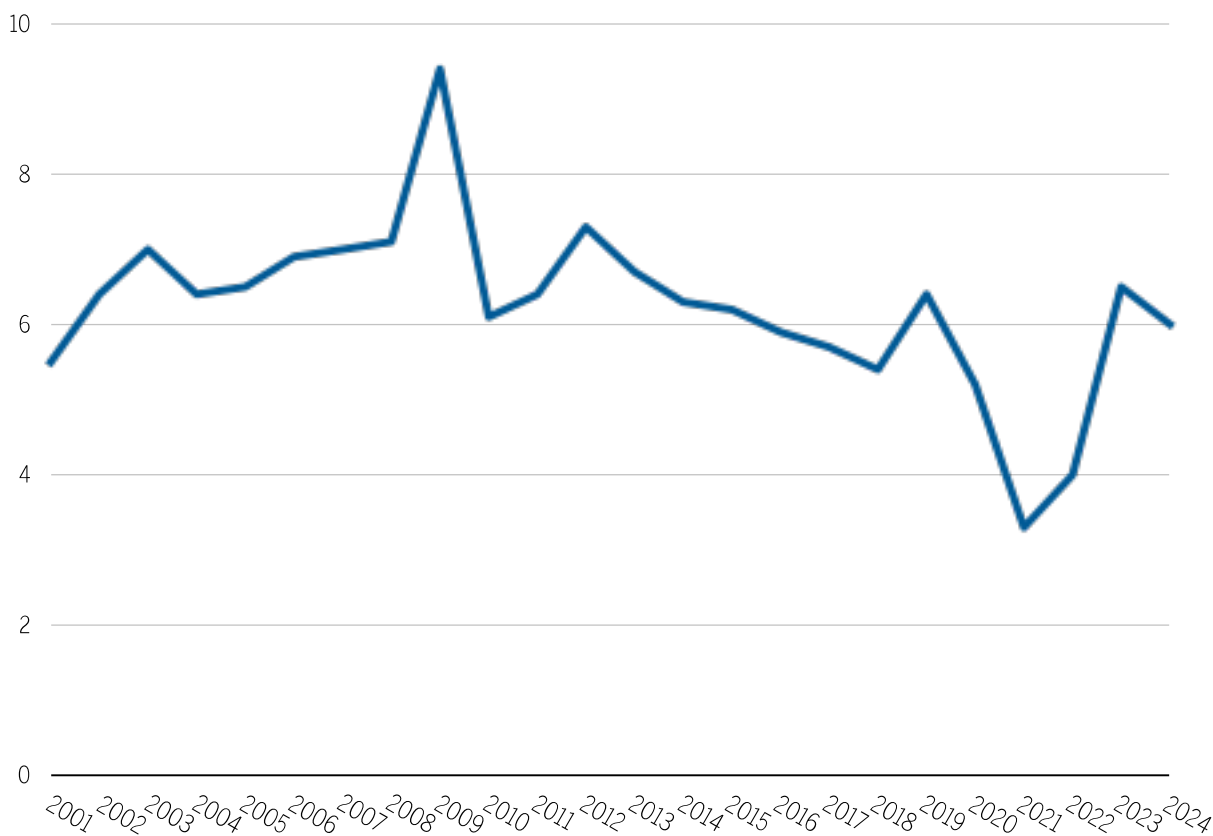
either on a price-to-book basis, but it has a more attractive Shiller P/E ratio. Emerging markets are the standout from a valuation perspective.

**A view on the overall risk-taking environment** — My colleague Ian Spencer used our current CMA methodology, rolled back to 2001, to calculate the 10-year expected return for a 60% equity/40% fixed income portfolio (**Figure 2**). As of the end of December 2023, it stood at 6.0%, slightly below the average of 6.2% for the full period shown. That may suggest that allocators should be cautious about how much risk they take in the current environment.

## Figure 2

### Think about “60/40” (or your reference portfolio)

The expected 10-year return on a 60/40 portfolio has varied through time (%)



The 60/40 portfolio shown is 60% global equities and 40% US core bonds. The expected returns are based on Wellington Management's intermediate capital market expectations as of 31 December 2023. **ACTUAL RESULTS MAY VARY SIGNIFICANTLY AND AN INVESTMENT CAN LOSE VALUE.** Investments cannot be made directly into an index. | Please review in conjunction with the “Important disclosures – Capital market assumptions” at the end of this article. | This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares, strategies or other securities. References to future returns are not promises or even estimates of actual returns a client may achieve.

**Capital needs and investment opportunity** — Finally, it may be wise to focus on areas where capital could be scarce — for example, companies needing to refinance after enjoying a long period of very low rates. There may also be challenges in the commercial real estate market, especially in the office space. There has also been underinvestment in commodity production. Two areas where there has been more investor interest but where capital needs

remain very high are the energy transition and artificial intelligence. The deglobalization trend is also driving capital needs, to meet the costs of onshoring and nearshoring production.

### 3. Assess the near-term outlook

It's a good idea to start the year with a view on where we're headed in the near term. In its latest 6 – 12 month outlook, our Investment Strategy Group notes that while the global economy remains resilient and inflation is falling, markets are pricing in little risk that growth disappoints, reigniting recession fears, or reaccelerates, putting upward pressure on inflation. Against that backdrop, the team offers its asset class views, including an overweight view on Japanese equities, a neutral duration stance on government bonds, a moderately underweight view on credit, and an overweight view on commodities. Read more [here](#).

### 4. Get a read on the market consensus

In addition to considering your own viewpoints on the near-term macro and market outlook, I think it's helpful to try to understand what the market is pricing in. My own view is that the market is assuming the following:

- After a volatile 2022, inflation is now much more under control.
- Central bank tightening is largely behind us.
- The US economy is heading toward a soft landing.
- The Fed will cut rates five to six times in 2024.
- Earnings will grow in the 9% – 11% range year over year.
- The labor market remains strong.
- Household spending remains intact.
- China faces too many headwinds to be investable.

### 5. Consider possible surprises in 2024

The flipside of thinking about consensus is thinking about surprises we could see in the year ahead. With humility and full acknowledgement to the late Byron Wien, who for decades published an annual list of economic and market surprises, I offer my own take on potential scenarios that could surprise markets:

- **US economic growth** accelerates in the second half of the year and GDP ends up more than 2% above consensus (i.e., in the mid to high 2% range). In other words, what if a soft landing is not the best-case scenario?

- **China** issues consumption vouchers, like what we saw in Hong Kong during the pandemic, helping to reignite the domestic economy.
- **Emerging market equities** outperform the US, driven by stronger global growth.
- **Inflation** slows in the first half of 2024 but then picks up again in the second half, prompting another Fed hike by year's end.
- **The 10-year US Treasury yield** hits 6%, driven by inflation fears and perhaps some fiscal concerns.
- **The IPO market** reopens for private equity exits, but the returns on many legacy leveraged buyouts (e.g., deals struck in the mid-2010s) are compressed by higher interest rates and end up underperforming the public market.
- **Commercial mortgage-backed security spreads** blow out as a number of high-profile loans default and spook investors.
- **US Republican hardliners** succeed in shutting down the government, prompting a US debt downgrade by Moody's, a sell-off in the US dollar, and renewed interest in cryptocurrencies.
- **The 2024 US presidential election** is shaken up by the emergence of a third-party candidate who plays spoiler and alters expectations for the outcome in November.
- **As the use of artificial intelligence grows**, the prevalence of "deepfakes" around the US presidential election drives concerns and activity among federal regulators, creating a market hiccup.

## 6. Think about the long term

Notwithstanding the importance of near-term considerations, many allocators may be particularly focused on longer-term policy decisions. In late 2022, I wrote about [investment leadership cycles](#), as it became clear to me that we were approaching the end of a post-GFC cycle marked by nonexistent inflation, slow but steady growth, low and falling interest rates, and the dominance of growth stocks. Today, we appear to find ourselves in a post-COVID cycle where inflation is more prevalent; even if central banks continue to make progress controlling inflation, they'll need to remain more vigilant going forward. Their willingness to tighten even in the face of a potential recession may translate to more volatile business cycles and a greater likelihood that "stable" stocks will dominate. The right-hand column in **Figure 3** offers investment ideas that may be well-suited to this new regime.

### Figure 3

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## Scoping out the next investment leadership cycle

Post-GFC investment cycle	Post-COVID investment cycle	Investment ideas
Non-existent inflation	Inflation prevalent	<ul style="list-style-type: none"> <li>• Real assets</li> <li>• Inflation-sensitive sectors</li> <li>• Broader “diversifier” portfolio</li> </ul>
Slow but steady economic growth	Volatile business cycles	<ul style="list-style-type: none"> <li>• Defensive equities</li> <li>• Opportunistic investing</li> <li>• Hedge funds</li> </ul>
Low and falling interest rates	Higher and rising interest rates	<ul style="list-style-type: none"> <li>• Fixed income returns may be more compelling</li> <li>• Fixed income hedging less certain</li> </ul>
Growth stocks dominate	“Stable” stocks may dominate	<ul style="list-style-type: none"> <li>• Defensive equities</li> <li>• Value equities</li> <li>• Income equities</li> </ul>

Source: Wellington Management

Allocators thinking about the long term should also consider thematic investing, which has been an active area of research for our Investment Strategy team (read our research on [incorporating thematic investments into a multi-asset portfolio](#)). Thematic strategies are typically focused on enduring structural trends (e.g., the energy transition and artificial intelligence) and, as a result, may be less tied to the economic cycle and less reliant on strong economic growth to drive returns.

## 7. Spend some time in the alternatives world

Alternatives represent a significant area of exposure for many allocators and warrant a dedicated review to begin 2024. In the illiquid space, the focus should be on developing a commitment plan for the year ahead. This requires a detailed review of the opportunity set, prospective returns, current positioning relative to targets, and broader liquidity needs (discussed in more detail below). In the hedge fund space, review your major allocations, including at the hedge fund category level (e.g., macro, equity long/short, and relative-value strategies). How have they performed? What are the potential headwinds or tailwinds? Are there any crowding concerns?

In terms of the current environment for alternatives, here's my take:

**Hedge funds** — I know some investors are concerned about higher interest rates, but I think hedge fund returns will ultimately benefit (on a nominal basis) from higher cash yields. In particular, funds that are more market neutral and balanced long and short typically pass through the alpha from their relative positions on top of cash. So, for a hedge fund targeting, say, cash plus 3% – 5%, the total nominal return in the decade ahead may be very different from the past decade, when cash yields were historically low.

I also think global macro strategies could benefit from the less synchronized world that I described earlier, with more volatile and varied business cycles in different countries and the potential for more volatility in currency markets, for example. Finally, in this higher interest-rate environment, hedge fund allocations may also be a valuable portfolio building block if fixed income is less effective in the role of downside mitigation.

**Private equity** — Here, the impact of higher rates may be less positive. As I noted in my list of potential market surprises, there may be a cost for returns on legacy LBOs that were financed in the previous lower-rate regime, are not ready to be exited, and now need to refinance at higher rates. More broadly, the higher cost of capital may limit the range of investments that make sense for private equity buyers.

I think allocators should consider a global opportunity set, which may allow for tapping into pockets of attractive valuations and perhaps some “governance alpha” in markets outside the US where there is appetite for improving governance and performance. There may also be opportunities in niche areas of the private equity market that are not as reliant on debt financing.

**Private credit** — This is where we could see the flipside of the higher interest-rate challenge facing LBOs, as refinancings drive some transfer of value from private equity holders to private debt holders. However, as I've noted before, allocators should be attentive to the risk of crowding in areas of private credit that have grown at high rates for an extended period. This is also a relatively new asset class that has really not been through a period of significant market stress, which argues for remaining very focused on managers' underwriting standards, use of leverage, and ability to be opportunistic if the asset class does face challenges down the road.

## 8. Rouse your inner risk manager

I've talked a lot about returns, so let me offer some thoughts on risk in 2024. Last year, the major risks turned out to be the market dominance of the Magnificent Seven and the impact that had on portfolios that were underexposed to US mega-cap stocks; the degree of interest-rate volatility, with rates swinging meaningfully in both directions; and the interest-rate sensitivity of some equity sectors, including banking, real estate, and utilities.

So, what risks should allocators be contemplating for 2024? I think credit spreads bear watching, as does the potential for a recession in Europe. There are also ongoing risks that some have overlooked, including the possibility the US dollar eventually breaks the trend and moves in a different direction and that there are more episodes of positive stock/bond correlation like we saw in 2022.

How do you bring all of this into your risk-management process? I'd suggest two approaches.

The first is scenario analysis — sketching out different scenarios for how some of these things could go awry and trying to understand what that means for a portfolio. The second is stress-testing portfolios with some extreme outcomes. If you're comfortable with the results, you'll be better positioned to manage through such a scenario. If not, it may be an opportunity to do some hedging or adjust your asset allocation.

## 9. Evaluate your liquidity picture

Spend some time planning for your liquidity needs and thinking about factors that could change those needs in the coming year. Is there a potential economic outcome that might have an impact? For example, could a recession create a call on capital from stakeholders? Have there been any shifts in strategic priorities that might alter liquidity needs or are there any sources of unexpected liquidity demand (e.g., calls on private assets, margin calls on leveraged assets, or regulatory changes)? I think allocators should also regularly stress test one- and three-year liquidity needs, and I offer a framework for testing liquidity in normal and stressed conditions [here](#).

The beginning of the year is also a good time to assess current and anticipated market liquidity. Based on input from our trading team and other colleagues, our take is that liquidity was fairly normal in 2023, aside from the US regional banking crisis and a few challenges in EM debt markets. Looking ahead, we expect relatively normal conditions in 2024, but we could see some volatility related to the US elections and central bank events. That may be reason to keep an eye on US Treasury liquidity.

## 10. Set a finite number of 2024 priorities

As a final step, I think allocators should narrow their priorities to a manageable list for 2024. To help with the prioritization process, you might ask a few key questions. For example, when contemplating any change in a portfolio, how big a change will it be and how much of an impact could it have (i.e., does the change provide enough “bang for the buck”)? Does the change address a strategic or long-term objective? Is it synergistic with other goals (i.e., does it help to move your portfolio collectively in a particular direction)? What are the governance hurdles involved and can they be overcome without undue expense?

When it comes to priority setting, many allocators wrestle with the balance between opportunities and risks. I would encourage tilting toward the former. Research on human behavior suggests we tend to focus on risks and the downside. It's important not to let that thinking eclipse the opportunities to invest for the future and the potential for things to go right.

## Final thoughts on where we are and where we're headed

Having shared a wide range of ideas and views, let me wrap up by summarizing where I think things stand from a macro and market standpoint. First, we just wrapped up a very good year, especially for monetary policy. But I think we're also in a tug-of-war between the two regimes I touched on earlier: the post-GFC regime of very slow growth and the post-COVID regime of higher volatility. On balance, I think that leaves us in a fragile but not overheated state (more on this late-cycle phenomenon [here](#)).

So, where do we go from here? If we do have a recession, it could be painful but would also address some imbalances. A rebound, on the other hand, might feel great in 2024, but it could also sow the seeds of future crises if inflation expectations become unanchored. In the end, I think "muddling through" this year (perhaps similar results to 2023) might not be so bad. At the same time, that may delay the shift to the next regime, making the process of planning for regime change more challenging.

I hope this checklist is helpful. If we can be a thought partner on any of the topics discussed or your specific objectives, we would welcome the opportunity for an in-depth discussion.

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### Important disclosures: Capital market assumptions

#### Equities

General — Assumed market returns are based on the Investment Strategy Group's expectations for future dividend yield, earnings growth, and valuation change. Assumed risk and correlations are based on historical analysis of the representative indices.

Indices used are as follows:

US large-cap equities: S&P 500

US small-cap equities: Russell 2000

Non-US equities: MSCI EAFE

Developed market equities: MSCI World

Emerging market equity: MSCI Emerging Markets

#### Bonds

General – Assumed risk and correlations based on historical analysis of the representative indices.

High quality, sovereign bonds – Return assumptions are based on starting yields and the expectation that yields move towards our estimate of a terminal interest rate over the time period. Using these inputs and the duration of the respective bill, note, or bond, we then calculate the income and capital gains/losses associated with these changes. We assume zero downward adjustment for downgrades and defaults for high

quality, sovereign bonds.

Credit risk premia – For non-sovereign and corporate bonds, excess return assumptions are estimated. The excess return assumption is a function of excess spread, a downward adjustment for downgrades and losses and reversion to median spread levels. The excess spread is readily observable in market pricing. The downward adjustment for downgrades and defaults is based on our proprietary research and the long-term historical experience.

Indices used are as follows:

Core bonds: Bloomberg US Aggregate Bond

US long bonds: Bloomberg US Long Government/Credit Bond

US high yield bonds: Bloomberg US Corporate High Yield

Non-US bonds (hedged): Bloomberg Global Aggregate ex-USD Bond (hedged)

Emerging market (EM) debt: JPMorgan EMBI Global (i.e., USD denominated)

## Currencies

Return assumptions are shown for unhedged currency exposure, unless stated otherwise.

Hedged — Hedged currency return assumptions are based on current and forward-looking estimates for interest-rate differentials.

Unhedged — Unhedged currency return assumptions are formulated based on forward-looking estimates of real carry returns, normalization of real exchange rates, and an adjustment for productivity growth.

## General

Period — Intermediate capital market assumptions reflect a long-term time period of approximately 10 years. If we developed expectations for different time periods, results shown would differ, perhaps significantly. Additionally, assumed annualized performance and results shown do not represent assumed performance for shorter periods (such as the one-year period) within the 10-year period, nor do they reflect our views of what we think may happen in other time periods besides the 10-year period. The annualized return represents our cumulative 10-year performance expectations annualized. The assumed returns shown do not reflect the potential for fluctuations and periods of negative performance.

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