FOR PROFESSIONAL CLIENTS AND QUALIFIED INVESTORS ONLY

BLACKROCK®

Portfolio Insights

Asset allocation and trends within EMEA portfolios

H1 2019 EDITION

BlackRock Portfolio Analysis & Solutions (BPAS) is part of BlackRock's global consulting platform, a team of over 60[1] portfolio and investment professionals aiming to help BlackRock clients achieve their investment goals. Fully dedicated to EMEA investors, BPAS consult with investors to empower them to implement their chosen asset allocation, across all asset classes and investable vehicles. Consultations utilise the risk capabilities of Aladdin® – a leading risk management and portfolio construction platform – in conjunction with BlackRock Investment Institute's macro insights, BlackRock's expertise in portfolio construction and breadth of our products.

1 Source: BlackRock, as at May 2019. Subject to change.

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Introduction

Over the last two years, the BlackRock Portfolio Analysis & Solutions (BPAS) team has analysed the asset allocation and strategy trends of over 600 client portfolios. We have also carried out deep-dive interviews with 15 clients to understand forward-looking changes in their portfolio construction process. This paper outlines the key trends we observed, and the future portfolio trends we may see in the years ahead.

Methodology

We analysed an estimated 600 portfolios submitted by EMEA wealth managers, financial advisors and family offices between January 2017 and December 2018. The portfolios represent investors from 13 countries: Austria, Belgium, Denmark, France, Germany, Israel, Italy, Monaco, the Netherlands, Oman, Sweden, Switzerland and the UK. The combination of these portfolios amounts to an estimated USD 160 billion in assets under management and have been analysed through our multi-asset risk platform, Aladdin®.

For the purpose of this study, the portfolios have been grouped into three target risk categories – conservative, moderate and aggressive – based on the classification the investors provided or through total risk as calculated by Aladdin. We refer to these sets of portfolios as 'risk category portfolios'.

Please note:

- The portfolios under review represent a subset of the EMEA wealth industry. **We do not aim to analyse the industry in its entirety. Biases are present as the portfolios included in this analysis are those received by the BPAS team.**
- 'Alternatives' include funds that fall within the Morningstar broad asset class categories of alternatives, direct property, convertible bonds, miscellaneous and commodities.
- 'Multi-asset' includes funds that fall within the allocation Morningstar broad asset class category.
- 'Cash' includes money market funds and pure cash allocations.

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Executive summary

In this ever-changing industry, we want to help investors drive effective and intended changes in their portfolio construction processes, to better achieve their investment objectives. We expect the years to come to be challenging. To meet their objectives, investors may need to shift their focus from chasing asset class returns to creating the best resilient portfolios, which are more equipped to withstand uncertainty.

This paper outlines trends seen and heard from EMEA investors, and our inputs on how clients may better achieve their investment objectives.

Section 1: Portfolio Attributes. Includes a summary on the asset allocation, risk allocation and investment trends we observed, partnering with over 600 investors on evolving their allocation from January 2017 to December 2018. Key trends we identify relate to the evolution of average fees, index and alpha blending and number of vehicles investors use in portfolios. We estimate the portion of the EMEA wealth industry we analysed to account to ~USD160 billion of assets under management across 13 countries in EMEA.

Section 2: Three Themes Observed in Portfolios. Provides a deep-dive into three areas of EMEA investors' portfolios and our suggestions on how clients could consider building more efficient portfolios in relation to these themes.

Theme 1: Alternatives allocation – or the favoured allocation?
Throughout the period, and when comparing annual averages for 2018 vs. 2017: alternatives continued to be a key asset class in our sample portfolios, averaging 21% – 25% of allocation across risk categories in portfolios analysed throughout the last calendar year. This is either equal to or greater than the allocation observed to fixed income. Most of the alternatives allocation came from hedge funds, and in particular fundamental long/short strategies.

Our input? We believe investors could further enhance their portfolios if a dynamic and diversified blend of alternatives investments were to be considered – whether within commodities, hedge funds or private markets – rather than remaining siloed within a particular strategy. Risk management tools and technologies are vital to understanding the benefits of alternatives in multi-asset portfolios, and to implementing such efficient blends.

Theme 2: Foreign Exchange risk – or investors' forgotten risk?
Investors often make strategic decisions based on their asset class views, but asset allocation does not equal risk allocation. The failure to diagnose unintended risk bets in portfolios can lead investors to stray away from their long-term goals. We observed foreign exchange risk to be the second most prominent risk in portfolios after equities across all risk categories, and this can often be unintended.

Our input? Focus on the intended risk and investment tools – as these can help investors estimate and understand the total contribution of the different risks in their portfolios. This ultimately enables them to diagnose any unintended bets and ensure risks are deliberate, diversified and scaled.

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Theme 3: Certain about cash – or uncertain about the future?
Cash allocations remained at high levels in our sample portfolios analysed throughout 2018, at an average of 9%. Within conservative portfolios, we observed this to be 13% on average across 2018 portfolios. Investors require cash for a variety of reasons, however, we invite investors to ask themselves if the reason for holding cash is due to certainty about cash or simply uncertainty about the market.

Our input? While a cash buffer is needed for certain investors (e.g. liability-driven or for cash flow management purposes), investors may benefit from moving part of these cash holdings closer to their strategic asset allocations if the reason for holding cash is mainly due to lack of conviction in any particular strategy. This could allow the portfolio to reduce unintended tilts in risk or potential cash drag in return, and – ultimately – to better achieve their long-term investment goals.

Section 3: Emerging Trends. Complementing the historical perspective of the previous two sections, our focus here shifts to the future. During Q4 2018, we carried out 15 deep-dive interviews with investors across EMEA. In this section, we share these investors' expectations of future changes in their portfolio construction processes, their views on the drivers that are behind such changes, and how they plan to implement changes in their portfolios. Three clear, shared themes emerged: continued pressure on fees, an interest in sustainable investing and a move towards incorporating megatrend views in portfolios.

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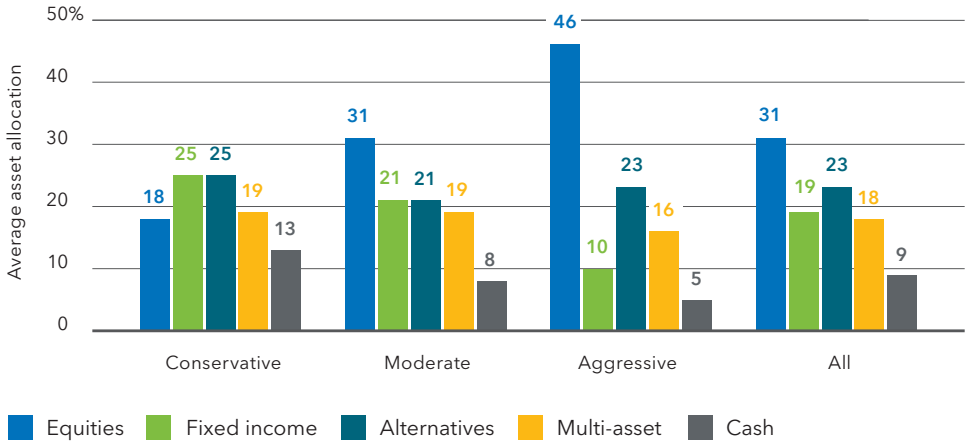
Section 1: Portfolio attributes

The aggregation of the portfolios we analysed has yielded the portfolio attributes. These attributes underpin the trends and themes discussed in Section 2.

Average asset allocation and risk allocation

The average asset allocation within each risk category, as well as the overall, showed that alternatives play an important part in portfolio construction. We discuss this in more detail on page 8 under Theme 1.

Figure 1: Average asset allocation in 2018



Source: BPAS, portfolios received from January 2018 – December 2018. For illustrative purposes only.

Compared to 2017 average asset allocations, the 2018 average asset allocations saw the majority of the changes to be within multi-asset funds and cash, see Figure 2 below. Equities allocation largely remained from 2017 to 2018 in conservative and moderate risk portfolios, whereas a reduction of 3% is observed in equities within aggressive risk portfolios. We discuss the decrease in cash and increase in multi-asset funds in more detail on page 14 under Theme 3.

Figure 2: Changes in average asset allocations from 2017 to 2018

We have highlighted any changes above 1%. Red is a decrease from 2017 and green is an increase from 2017.

	Conservative		Moderate		Aggressive		All	
	2018	2017	2018	2017	2018	2017	2018	2017
Equities	18%	18%	31%	30%	46%	49%	31%	33%
Fixed Income	25%	26%	21%	23%	10%	14%	19%	22%
Alternatives	25%	26%	21%	24%	23%	21%	22%	23%
Multi-asset	19%	11%	19%	12%	16%	11%	18%	11%
Cash	13%	19%	8%	11%	5%	5%	9%	11%

Source: BPAS, portfolios received from January 2017 – December 2018. For illustrative purposes only.

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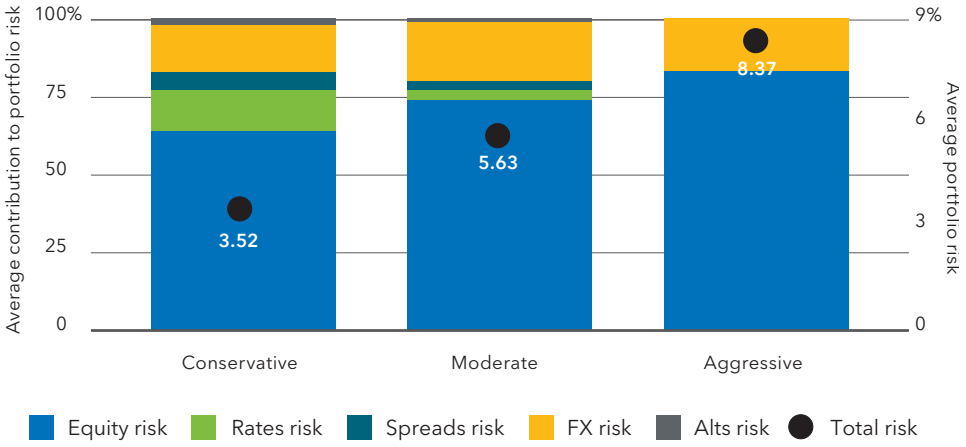
The average risk allocation for each risk category portfolios showed dominance of equity and FX risk. We discuss this in more detail on page 12 under Theme 2.

Figure 3: Average portfolio risk and contribution to risk in 2018



Source: BPAS, portfolios received from January 2018 – December 2018. For illustrative purposes only.

Investments

The charts on the following pages show the average allocation of the key asset classes to index mutual funds, ETFs and alpha-seeking mutual funds, and their ongoing charges.

The average across all asset classes in our portfolio database show that 76% of vehicles used in 2018 were invested in alpha-seeking funds. This is a large shift from the average allocation to alpha-seeking funds observed in our previous portfolio insights which stood at 86% in 2017. The biggest contributor to this appeared to be from higher index strategies in fixed income (18% in 2017 to 36% in 2018), closely followed by the increase in equities (20% in 2017 to 38% in 2018). The increase in ETFs allocations was significant, whilst index mutual funds remained the same within our sample of portfolios.

We find the average management fees for funds within portfolios received in 2018 to be 84bps, where the most expensive funds appeared to be in property and multi-asset asset classes (especially those used by our Italian investors). Comparing that to 2017, the average fees of the funds used stood at 82bps. Although the increase in index investing from 2017 appeared to be significant, this increase in fees may be attributed to higher allocation to multi-asset funds from cash, pushing up the average fees higher. We discuss more on the trend of fee pressure and efficient allocation of index and alpha strategies in page 17 under Emerging Theme 1.

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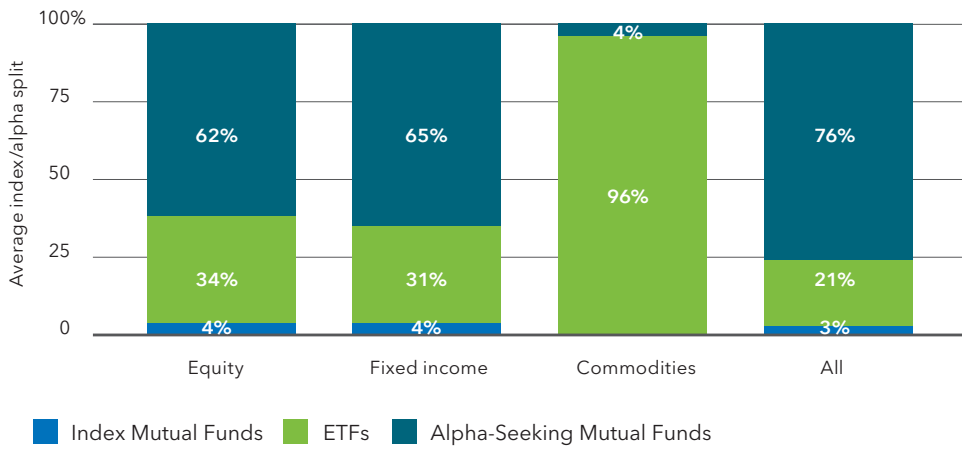
Figure 4 : Index/alpha split 2018



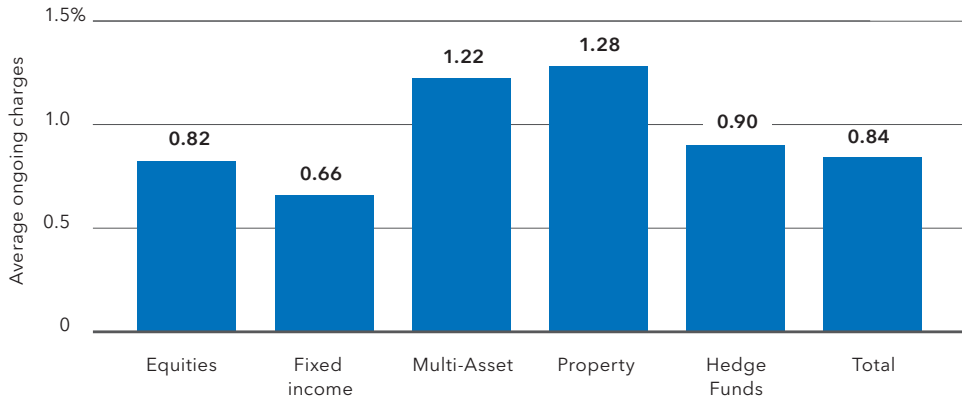
Source: BPAS, portfolios received from January 2018 – December 2018. For illustrative purposes only.

Figure 5: Index/alpha split from 2017 to 2018

	Index Mutual Funds		ETFs		Alpha-Seeking Mutual Funds	
	2018	2017	2018	2017	2018	2017
Equity	4%	5%	34%	15%	62%	80%
Fixed income	5%	5%	31%	13%	65%	82%
Commodities	0%	0%	96%	81%	4%	19%
All	**3%**	**4%**	**21%**	**10%**	**76%**	**86%**

Source: BPAS, portfolios received from January 2017 – December 2018. For illustrative purposes only.

Figure 6 : Average fees in 2018



Source: BPAS, portfolios received from January 2018 – December 2018. For illustrative purposes only.

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We also observed a reduction in the average number of investments used in our sample portfolios, from 23 average investments in 2017 to 20 in 2018. The biggest reduction was seen in equities. This suggests some portfolio clean-up in the challenging year of 2018.

Figure 7 : Average number of investments in portfolio

	Total	Equities	Fixed Income	Allocation	Hedge Funds	Direct Property
2018	20	8	5	2	2	1
2017	23	11	6	3	3	2

Source: BPAS, portfolios received from January 2017 – December 2018. For illustrative purposes only.

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Section 2: Three themes observed in portfolios

Markets experienced their fair share of highs and lows in 2018, and the need for risk diversification was crucial. The use of alternatives in achieving that diversification continued to be prevalent. In this section, we discuss the implications of these and look at ways to improve the use of alternatives as a core strategic asset class in clients' portfolios. In addition, we look at potentially unintended risks that can divert investors from their chosen bets, and we challenge the use of cash as protection against uncertainty in the market.

Theme 1: Alternatives allocation – or the favoured allocation?

Regardless of the target risk profile of the portfolio, there was one consistent theme where many asset allocators were in agreement: the importance of alternatives within portfolios.

We observed alternatives to be most consistently allocated across the risk profiles in our sample portfolios, with an average allocation of 25% in Conservative, 21% in Balanced and 23% in Aggressive portfolios (Figure 1). Within our portfolio consultations in 2018, we continued to observe appetite in building resilient portfolios which perform better in volatile market conditions using alternative investments.

"We're using more alternatives to fill in the gaps, because of the challenges we're finding in getting alpha from fixed income. But the challenge is getting the right products."

UK wealth manager interviewed

Alternatives used for yield enhancement

Our analysis found that European investors are using liquid alternatives strategies as a portfolio diversifier, away from traditional fixed income as the search for yield in bond markets continues.

Alternatives used to diversify risk in multi-asset portfolios

Asset allocation does not always equal risk allocation. Whilst average asset allocation of alternatives ranged from 21% to 25% across the three risk profiles in our sample of portfolios captured throughout 2018, we found after analysing the portfolios through Aladdin® that alternatives averaged at only 2% of risk allocation. This could imply that the majority of alternative investments in our sample of portfolios acted as effective risk diversifiers for multi-asset investors.

Fundamental long/short strategies were the most popular type of alternatives used

As seen in Figure 8, hedge funds represented 43% of allocations within the alternatives asset class for portfolios we analysed in 2018. Within this hedge funds allocation in the sample, we find that fundamental long/short strategies continued to be the most popular, making up 21% of the hedge fund allocation, in particular global long/short equity strategies. Directional trading strategies such as global macro hedge funds made up 13% of allocation and event-driven strategies made up only 4% of allocation.

Hedge funds strategies can be effective diversifiers during market downturns. When assessing hedge funds strategies during the maximum drawdown period of MSCI World Index in the last 15 years, we find long/short equity hedge funds (HFRX Equity Hedge Index) resulted in excess annualised returns of 24%, event-driven strategies (HFRX Event Driven Index) of 29% and macro/CTA strategies (HFRX Macro/CTA Index) of 54%. This disparity implies that whilst hedge funds strategies can be effective diversifiers and potential return enhancers, strategies can differ vastly from one another. So, we invite investors to consider holding diversified exposures to multiple hedge funds strategies in the long term, whilst dynamically allocating to short-term opportunities that may present themselves in certain hedge fund strategies as we move across market cycles and regimes.

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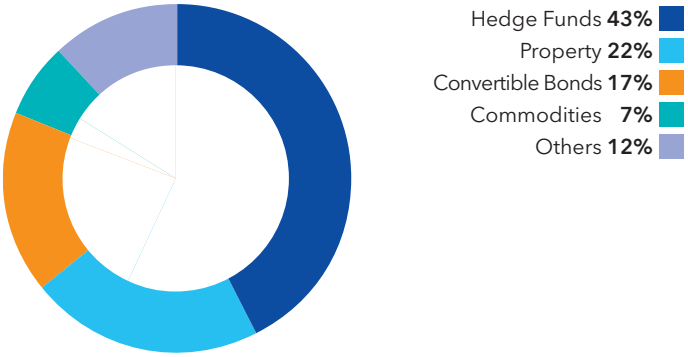
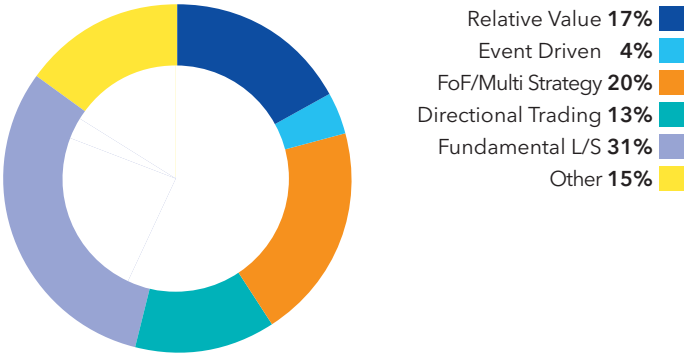
Figure 8: Median allocation within Alternatives and Hedge Funds

Median allocation within Alternatives



Median allocation within Hedge Funds



Source: BPAS, portfolios received from January 2018 – December 2018. For illustrative purposes only.

A deliberate approach to alternatives in multi-asset portfolios is vital

Within UK, Swiss and German portfolios, alternatives are increasingly becoming a core strategic asset allocation. Yet, many investors still adopt a siloed approach that focuses on allocating within alternative segments, rather than across them over time. Below, we outline areas of consideration when building effective alternatives allocation in multi-asset portfolios:

- **Take an outcome-orientated approach** when building the alternative allocation within the strategic asset allocation process. Alternatives can play many roles in multi-asset portfolios, starting with risk diversification and return enhancement to income opportunities and potential inflation protection. For example, investors seeking capital growth can consider private equity or distressed credit exposures, whereas stable income investors could consider allocations from renewable power assets to long-lease property funds. Clients with a focus on inflation protection could look to infrastructure investments or liquid and low-cost exposures using index-based commodities strategies. Before using alternatives, we encourage clients to first outline their objective for these investments in their overall portfolios.

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- **Finding strong and consistently outperforming alternative managers can be challenging.** The skill, time and cost associated with carrying out due diligence on such investments must not be underestimated. If there is limited capacity for this in the investment process, we encourage clients to seek efficient alternative fund-of-fund or multi-strategy investments, or alleviate some of the cost and time demand in other areas of the portfolio, by using cost-effective index strategies within the long-only equities and fixed income sleeves. This also allows investors to manage risk and use their risk budget for sourcing true uncorrelated alpha through alternative investments.

- **Look for alternatives that contain unique return drivers that are uncorrelated and diversified to market direction.** These could be real asset investments whose cash flows have low beta to the market, such as funds that invest in renewable energy. However, we encourage investors not to underestimate the skill and time that are required to undertake this.

- **Consider long-lease commercial real estate** as it has a highly predictable cash flow and the potential to outperform other real estate when secure income and stable returns are highly prized, such as in a market downturn.

- **Have a buffer of liquid assets** such as core bonds, which is key to meeting any liabilities. We encourage clients to consider low-cost bond exposures through ETFs and index strategies, in order to maintain the cost budget of the portfolio.

The right tools are imperative for making the right alternative investment decisions

Investing in dynamic and multi-alternative strategies can present challenges and we encourage clients to use sophisticated multi-asset risk management platforms, such as Aladdin®, or be assisted by specialist third-party teams to allocate to the most suitable investments. This type of risk management solutions can provide an effective start to building a core and resilient addition to the total portfolio. It can help investors:

- **Identify the underlying risk factors** that explain the behaviour of investments throughout the alternative allocation.

- **Understand the behaviour of a given investment.** Every investment can be viewed as a group of exposures to distinct risk factors or risk premia. Equity (or economic growth) risk, credit risk, inflation risk and interest rate risk are among the primary risks investors are paid to bear. Secondary risk factors represent narrower classes of risk premia and are associated with individual strategies – for example, the small cap risk premium, represented by the Fama-French SMB (small minus big) factor.

- **Obtain a granular view of the factor exposures.** Hedge funds employ active trading strategies which can result in non-stationary, time-varying risk factors. For private market asset classes such as real estate or private equity, industry-wide valuation practices result in return smoothing that can hinder the ability to gauge underlying risk factors through statistical regression techniques. But with advances in statistical and fundamental models of underlying asset behaviour, whether for hedge fund or private market strategies, we believe it's possible to identify the factors that help drive returns across alternatives.

To read more on the core role of private markets in modern portfolios, click here.

To read more on extracting returns in private markets, click here.

How BlackRock analyse alternative exposures

BlackRock use three categories of exposures to explain risk in alternatives:

- *Traditional (or primary) risk factors, such as equity beta for private equity or duration risk for illiquid fixed income.*
- *Alternative (or secondary) beta exposures, such as catastrophic weather risk, to which investors might have exposure through reinsurance contracts, oil futures or other assets.*
- *Idiosyncratic exposures, such as the price risk associated with a public company's organisational change, or the risk that an individual real estate tenant does not renew an office lease.*

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Conclusion

Simply ticking the box of alternatives investing is not enough to build a resilient portfolio. Firstly, it is important to decide the outcome its role in the strategic asset allocation aims to achieve. Secondly, we invite investors to manage alternatives dynamically across various strategies, such as within commodities, hedge funds and private markets, rather than remain siloed within one segment. Finally, we invite clients to adopt the right investment strategies, whether alpha seeking or index to build a more efficient portfolio, and be able to have the capacity and budget to get the most out of alternative investing.

Theme 2: Foreign Exchange risk – or investors' forgotten risk?

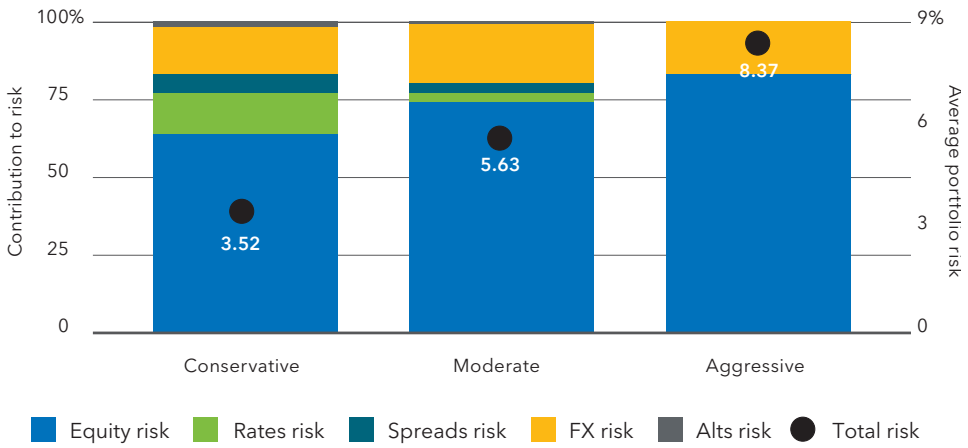
Investors often make strategic asset allocation decisions based on their views of asset classes and regions. However, failing to consider overall risk allocations on top of asset allocations can lead to unintended bets in the portfolio, and can ultimately be a key determinant of returns.

Our client consultations often bring to the surface the issues of forgotten risk and the fact that asset allocation is not the same as risk allocation. This is easy to go unnoticed in client portfolios without proper risk management tools and can lead to surprises that stray investors away from their investment goals. We believe that all risks undertaken in portfolios should be deliberate, diversified and scaled.

Foreign Exchange (FX) risk

A good example of investors' unintended risk-taking could be FX risk. Whether it be equities, fixed income or alternatives, FX risk on unhedged strategies can seep through and materially affect portfolio risk and returns. Our analysis has found that FX risk is on average the second largest portfolio risk contributor, after equities, within all three risk categories. Therefore, we believe it requires careful assessment and management.

Figure 9 : Average portfolio risk and contribution to risk



Source: BPAS, portfolios received from January 2018 – December 2018. For illustrative purposes only.

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Investors may have unintended risk as a result of not explicitly considering FX exposures when stepping into international markets within their portfolio construction phase. So, whilst cost of hedging matters, and can eat at returns generated, how much FX is onboarded when investing in a certain strategy, such as international fixed income, is important.

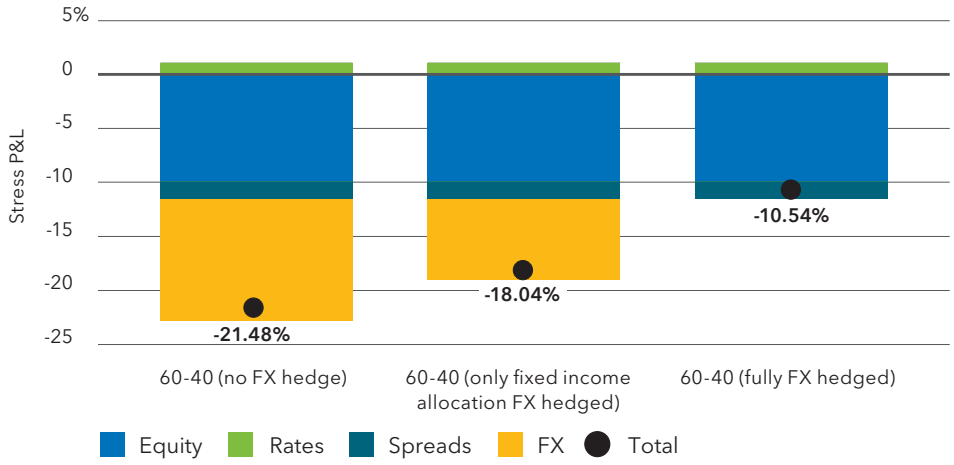
Trying to time currency swings can be difficult and this is where hedged share classes can be a substitute to consider if no particular FX views exist. The drivers that matter most for a given currency – from interest rate differentials and monetary policy to investment flows and investor sentiment – can change quickly. And currency swings themselves can affect central bank policy and investment flows, as well as company fundamentals. The magnitude of this risk is of particular importance to investors holding global investments, especially within global bond investments where FX can govern fixed income strategies' income whilst yields are low. It is important to remember that currency exposures can also seep through within asset classes. Equities can have currency risk beyond the currency of denomination, for example a domestic company that relies on an international market for most of its revenues.

A highly diversified portfolio may find some currency risk is offset after considering correlations of several investment strategies within this diversified portfolio. However, it's in times of stress that correlations amongst asset classes spike up and that we find the toll of FX risk to be visible.

Case study

To illustrate this, we analyse the stress results of a hypothetical 60-40 global portfolio under the credit crisis scenario of 2007, through the lens of Aladdin, and compare this with the result of the same portfolio with only fixed income allocation hedged and, finally, compare these to a fully FX hedged portfolio.

Figure 10: Evaluating the effects of FX in a 60-40 portfolio under the credit crisis (2007)



There is no guarantee that stress testing will eliminate the risk of investing in this strategy nor that the profit and loss movements depicted in the stress testing will be replicated in the future.

Source: BlackRock Aladdin, as at 29 March 2019. Portfolios are showing 60% allocation to MSCI All Country World Index and 40% allocation to Bloomberg Barclays Global Aggregate Index in EUR base currency. This stress scenario shows instantaneous shock to the current exposures of the portfolios with factor shocks and correlations as observed during the credit crisis between 1 July 2007 to 1 July 2008.

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Within this stress scenario, we found that:

1. **FX moves were the second largest determinant of stress P&L after equities.** This was also the case when fixed income allocation was hedged out.

2. **FX exposures can have significant and varying degrees of effect for different currencies.** For a GBP investor, we found total FX contribution within the same credit crisis scenario to be positive due to exposures to USD and JPY. However, this was opposite to the results observed for a EUR-based investor, which saw large drawdowns to their exposures from USD. The difference between the stress P&L results under credit crisis for a EUR investor was 17% lower than the stress P&L results for a GBP investor with the same portfolio holdings.

Conclusion

Whilst making decisions on FX in portfolios is challenging, regional diversification is important. The right investment management tools can help clients estimate and understand the total FX risk contributing to the portfolio. This ultimately enables investors to diagnose any unintended bets in the portfolio. We encourage clients to consider their own risk tolerance, their portfolio's overall risk profile, and the costs and complexities of dynamically hedging FX exposures. To gain more insights on currency hedging and risk, please read here.

Theme 3: Certain about cash – or uncertain about the future?

Another feature of our sample is that cash levels remained at high levels in the portfolios we analysed throughout 2018, with an average of 9% in all portfolios (albeit lower on average than in portfolios analysed in 2017). This continued high allocation could partly be due to market volatility throughout 2018. However, as investors, we must ask ourselves whether this allocation is made because we are certain and have conviction in cash, or whether we simply have no conviction at all?

While some US dollar investors may have acted with conviction as short-term treasury bond yields increased to similar levels of long duration bond yields, the challenge for euro and sterling investors persists. For those investors, we believe uncertainty about the future should bring them closer to their strategic asset allocation, rather than push them to sit in cash.

9% average allocation to cash in 2018

Whilst average cash allocation in our 2018 portfolio sample remained high, ranging from 13% in Conservative, 8% in Moderate and 5% in Aggressive risk portfolios, we observed reductions in cash allocation in 2018 compared to portfolios received in 2017. This appeared to be a move away from cash allocations to multi-asset strategies.

Creating liquid sleeves that bring portfolio closer to it's strategic asset allocation (SAA) during uncertain times

Having a 'liquid sleeve' that mirrors investors' strategic asset allocation using low-cost equity and bond ETFs may be a way for clients to react to market uncertainty. Converting cash allocations into low-cost multi-asset sleeves that replicate an SAA ensures that (1) the long-term asset allocation is left intact and (2) SAA can often be replicated with ETFs which provide liquidity and ease to step in and out of investments when decisions/certainties change. Ultimately, we encourage clients that uncertainty about the future does not automatically equate to certainty about cash for all investors.

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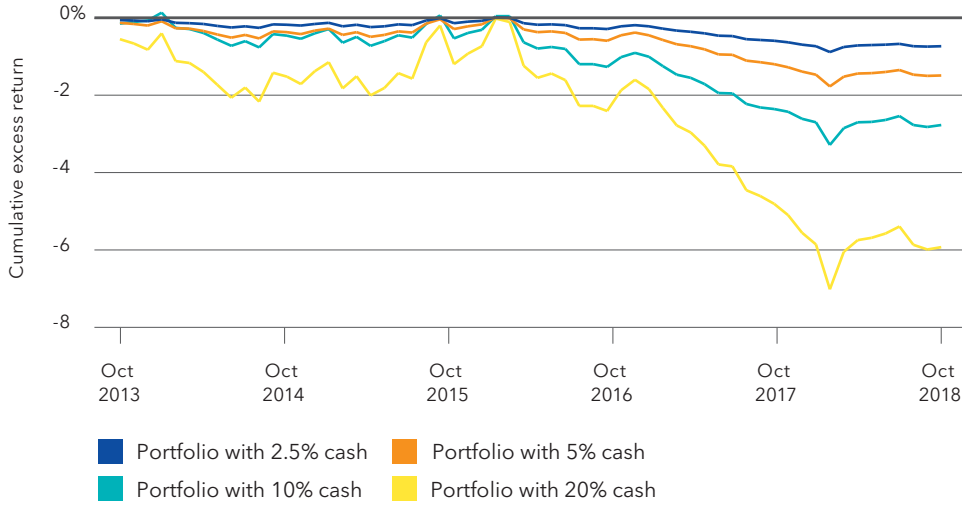
Figure 11 : Cumulative cash drag on a hypothetical multi-asset portfolio



These figures relate to the past. Past performance is not a guide to future performance and should not be the sole factor of consideration when selecting a product or strategy. Source: Morningstar, BlackRock. Time period: October 2013 – October 2018. Currency: USD. For illustrative purposes only. Hypothetical multi-asset portfolio consists of 60% MSCI All Country World Index and 40% Bloomberg Barclays Global Aggregate Index. 'Portfolio with x% cash' pro-rates out x% of the hypothetical portfolio and replaces it with ICE LIBOR 1 week USD.

Liquid sleeve construction may centre around an existing portfolio, to generate a portfolio-aware sleeve – or it can be built independently based on defined criteria and targets around risk, return, yield, duration etc.

Whilst different investors may have different motivations, we highlight four core benefits of deploying cash towards liquidity beta sleeves, which are widely applicable:

1. Operational simplicity. Liquid beta sleeves' trading flexibility and efficient market access enable effective management of cash allocations/cash flows.

2. Risk awareness. The use of risk management tools such as Aladdin enables investors to fully understand the risks of the sleeve in the context of their overall multi-asset portfolio.

3. Cost efficiency. Liquid beta sleeves created with index strategies can be cost efficient to both trade and hold compared to the rest of the portfolio.

4. Focus on the outcome. With complete flexibility around objectives and constraints, liquid beta sleeves' bespoke construction can ensure investment outcomes remain the primary focus.

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Conclusion

Investors require cash in their portfolios for a variety of reasons; however, if the reason for holding the cash is uncertainty about the market or lack of conviction in a particular strategy, liquid sleeves that replicate the strategic asset allocation of the portfolio can be used to allow investors to remain invested and focused on long-term goals. The sleeve allows an investor to easily move in and out of positions in a portfolio without having to move to cash as a holding place. Additionally, if the sleeve is aligned to the overall strategic asset allocation of the portfolio, there is less likelihood of unintended tilts in risk or potential cash drag in return, giving the portfolio a better chance of meeting its long-term objective.

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Section 3: Emerging portfolio trends

In Section 2, we discussed themes that became apparent from the analysis we carried out on portfolios resulting from past investor behaviours and trends. In this section, we summarise forward-looking trends in portfolio construction that emerged from 15 interviews we carried out amongst wealth managers and private banks across EMEA in Q4 2018. These trends include increasing (1) pressure on fees and (2) appetite for sustainable investing; (3) megatrends.

Emerging Theme 1: Pressure on fees affects everyone in the value chain

Fee pressure and increased administrative burden are among the most significant impacts of new regulation, with the former force being more transformational than the latter.

"…Costs are a huge issue. Clients talk about value for money, which is something we didn't use to have conversations around, but it's just because costs are under the microscope across every part of the value chain. So, clients squeeze us, we squeeze our managers…" – UK wealth manager

"…it's important that the fund manager is able to out-perform the index after costs. We face pressure from the client and it's pressure from the regulator." – CE wealth manager

Fees take centre stage in portfolio construction when performance is challenged. This, coupled with end investors shopping around more so than before, puts fees under a microscope.

"…More in general and even when returns disappoint, but in general, clients are much more sensitive to fees than they would have been 15 years ago. It's not just about regulation, it's just about people shopping around when selecting a private bank and, of course, cost is going to be part of that decision." – Global private bank

"We tend to get more pressure on fees when performance is weak or, after a year like 2018, for client retention, you often see a bit more discounting." – CE private bank

However, appetite for alpha-seeking managers remains significant – as long as fund managers are able to show value for money.

"We are willing to pay a fee if it corresponds to the value that is delivered. We don't have a problem with using active strategies when we see value, which doesn't mean out-performing every three months of course, but it means that there is a consistent strategy that is able, and is proven to be able, to deliver value to clients. We have expectations in terms of quality and product development." – Global private bank

"I think for us the most important thing is that we are willing to pay fees for funds that deliver. If they do not deliver any alpha, we do not want to pay fees. And that is a huge topic." – CE private bank

"We are applying cost pressure down the chain because we know it's in the interest of our performance which we report net of fees to clients." – CE wealth manager

Within the theme of fee pressure, we invite clients to consider…

the whole toolbox available – of alpha-seeking, factors and index investing – when building an efficient portfolio. Better understanding of the drivers of risk and returns for alpha-seeking managers can help in doing this. Excess returns of an alpha-seeking manager can be decomposed into following three categories : (1) constant factor exposures, (2) time-varying factor exposures and (3) security selection. This attribution exercise can help clients gain valuable insights into how managers are generating their excess returns and whether a more efficient blend of index/factor strategies that generates similar outcomes while reducing fees can be found. To read more, see BlackRock's approach to blending index and alpha.

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Emerging Theme 2: Growing appetite for sustainable investing

Despite some barriers to the adoption of environmental, social and governance (ESG) investing within client portfolios, this approach is increasingly likely to become central to asset allocation and to move away from discrete strategy selection to a portfolio approach.

"More fund managers and analysts are increasingly applying these factors to their research and their due diligence, and that's absolutely true and I totally buy into that and I think it's great. I've said before, and I'll say it again: I think within 10 to 15 years, ESG won't exist because it'll actually become part of due diligence." – UK wealth manager

We hear from clients how they are increasingly incorporating ESG within their security selection process…

"We are developing internal ESG scoring systems and our equity analysts and fixed income analysts are now incorporating that into their single security selection process…It's something that we're building into our processes as it becomes a mainstream theme." – CE private bank

…and how they expect growth in demand for ESG strategies as millennials enter the markets.

"We know ESG is becoming more popular and seems to be particularly so with millennials, so we wouldn't be surprised to at some point expand our product range." – UK wealth manager

"I would say that of course we are interested in ESG and we have been using some in portfolios. We've been talking about it to clients but there's not much interest yet. When you bring it up, it seems to be relevant but it's not a topic for wealthier clients I would say." – CE wealth manager

The debate over performance when investing in ESG continues.

"My view on the performance angle of ESG is I'm not convinced that cutting down the available universe of investments they can pick from helps performance." – UK wealth manager

"You read that there is no disadvantage having an ESG universe. It's difficult to say, but I think long-term, the pressure is not only on the fund industry, but also on the companies. It's very hard to look at all the ESG criteria so I think there will be a benefit doing that more on an ESG-style product. I think it will be a benefit to the portfolio." – CE Private Bank

"There are a lot of different studies out there about whether the sustainable product is able to out-perform or not, I think there are a lot of products that are able to out-perform. It's an investment for clients who are interested in sustainable products, who are interested in the future of the planet." – CE wealth manager

Standardisation of terminology and better availability of data will help in deepening ESG adoption.

"We are very interested in ESG, but it's the screening of the sustainable product that is not that easy because there is always a very personal understanding of sustainability. You have to ask a lot of questions around how a company manages the sustainable product range. They can't just say it's sustainable, it has to be sustainable." – CE wealth manager

Within the theme of sustainability, we invite clients to consider…

implementing ESG across asset classes, long-only equities/fixed income but also within private market exposures, which can help build diversified portfolios whilst also being sustainable in nature.

The more recent generation of products across the industry allows clients to balance achieving similar investment outcomes with their ESG requirements inherently in the way they are designed, allowing clients to have a similar investment experience whilst also addressing ESG risks in their portfolios.

ESG analytics continue to evolve and grow, but they remain a challenge for many investors with much being self-reported and not always comparable. We advocate for greater consistency and transparency. With the growth of the analytical capabilities within ESG, we believe ESG analysis should be an integral part of every investment process. To read more on sustainable investing, please click here.

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Emerging Theme 3: Moving into megatrends

The desire to tell captivating stories about future trends that will shape our economy and society is growing.

"Thematic is a big area for us. There are some compelling stories to tell clients and they can get much closer to those than they can to more traditional investments. There are themes that everyone sees playing out in the media and there's some debate about how to play these. I think they are longer-term holds – like robotics. You think they're going to be for 15 to 20 years, not just three to five years, but clients are okay with that, they understand these are for the longer-term and future-proofing, not tactical plays." – Global private bank

Whilst most clients are looking to add thematic investment strategies as a satellite to their portfolio…

"Clients can actually tilt a discretionary-managed portfolio in a couple of ways, whilst remaining discretionary and within their risk-return limits. We've got an optimised portfolio as a starting point and then up to a certain percentage can be allocated to different thematic ideas." – UK wealth manager

…others are increasingly looking to add them as core positions, due to longer time investment horizon.

"We're putting thematic more and more into play. There's a general sense of more client engagement and I think there is increasingly a decent body of product out there now... so it's something that can only see increasing in importance. There are some challenges around short-term investing from the clients and maybe even from some colleagues, but we're comfortable with a moderate allocation (10-20%)." – Global private bank

Within this theme, we invite clients to consider…

megatrends that can represent an additional dimension in the strategic asset allocation process, on top of regional and sector views. Megatrends can provide a differentiated source of exposure in the portfolio, aligning investments to future trends rather than making decisions looking in the rear-view mirror. The recent inclusion via ETFs in product range within the market means that clients can hold these strategies in cost-effective ways with ETFs.

However, accessing megatrends goes beyond just traditional long-only equities and can span across to real asset investing, such as property and infrastructure funds.

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Conclusion

Having analysed the key trends emerging from our sample of portfolios, while also looking ahead at the key issues impacting our clients, we have identified some ideas that could present new opportunities for investors.

1. Taking a strategic, outcome-orientated approach when allocating within and across alternatives, and using the right risk management tools, are key elements when building resilient portfolios.

2. Risk allocation does not equal asset allocation. Decisions that are not addressed during investment process, such as FX, can end up being large determinants of portfolio returns, especially under uncertain markets. In our view, all risks should be deliberate, diversified and scaled.

3. Uncertainty about markets should lead investors closer to their strategic asset allocation, rather than closer to cash, to ensure long-term investment goals are met.

4. It is increasingly important for investors to be able to demonstrate value for money to their end clients. This doesn't equate to 'cheap', but it does mean being able to prove that end-investors are getting what they pay for. We invite investors to consider the whole spectrum of index, factor and alpha-seeking strategies in order to build time- and cost-efficient portfolios.

5. Risk management tools are at the heart of building and maintaining resilient portfolios during market challenges. Whenever these allow investors to understand past, current and future risk drivers, they empower them to make intended bets in their portfolios.

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Appendix

Portfolios represented by regions

Regions	2017	2018
Europe ex UK	114	239
UK	98	154
Total Portfolios	212	393

Portfolios represented by risk models

Tags	2017	2018
Conservative	42	101
Balanced	104	184
Aggressive	66	108
Total Portfolios	212	393

Source: BPAS, portfolios received from January 2017 – December 2018. For illustrative purposes only.

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Looking for insights into your portfolio?

BPAS aim to help our clients seek to achieve their investment goals, by using:

1. **BlackRock's portfolio construction expertise:** helping with asset allocation with custom objectives and constraints from our clients, and leveraging clients' capital market assumptions or BlackRock's

2. **Aladdin:** multi-asset investment management and risk platform which aids in understanding the risk drivers of your portfolio and benchmark

3. **BlackRock products:** using index, factor and alpha-seeking strategies across multiple asset classes

If you are interested in a consultation with the BPAS team, please contact your BlackRock representative.

While proprietary technology platforms may help manage risk, risk cannot be eliminated. Risk management cannot fully eliminate the risk of investment loss.

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Source: BPAS, as at May 2019. Subject to change.

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