

Which asset classes are most beneficial in a portfolio?

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Executive Summary

This paper examines how different asset classes contribute to more efficient, diversified portfolios using mean variance optimization (MVO). The study evaluates portfolios across Conservative, Moderate, and Aggressive risk levels by progressively expanding the asset set.

Key findings include:

- **Equities** | Adding size and style diversification dramatically improves potential portfolio outcomes. While international options do improve diversification, the allocations are below market weights in the global market.
- **Fixed Income** | Bonds provide diversification and stability benefits, with high yield bonds, as a hybrid between equity and fixed income, displaying meaningful allocations in the mid-level risk portfolios.
- **Supplemental** | Non-core assets like REITs, emerging market bonds, TIPS and commodities play an important role in expanding the efficient frontier opportunity set, with the latter assets providing key hedging characteristics during inflationary environments.

Overall, the analysis confirms that diversification across asset classes produces better and more stable portfolio outcomes. Mesirow's Core Asset Class framework offers a strong foundation, while carefully selected supplemental assets can further improve risk-return efficiency.

Which asset classes are most beneficial in a portfolio?

Traditional mean variance optimization (MVO) is one type of asset allocation modeling that is an example of single period modeling.¹ It is used to determine efficient frontier allocations to different asset classes ranging from equities to fixed income based on the investor's target return and risk tolerance. It focuses on different risk levels for one specific horizon period.



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The key inputs for MVO are return, risk (standard deviation or variance) and correlation. While most studies are focused on return, the degree of efficient asset combinations are sensitive and dependent on correlation. Low volatility means low variation in the average return that we expect from one period to another, while correlation indicates how the different asset returns historically move in relation to each other. In a broadly diversified portfolio, assets that move differently from each other and the most beneficial. A lower correlation coefficient between two assets means less related movement between them. If an asset has a higher return and lower volatility and correlation with other assets in a portfolio relative to a competing asset, then it will dominate the less efficient asset in a portfolio context.

One utility mean variance optimization analysis is used to demonstrate how different asset classes stack up. An efficient frontier shows "efficient" exposure to the left of a return on risk plot. The portfolio along the frontier produces higher expected return at lower expected volatility. A higher efficient frontier means that there is a portfolio combination that produces higher return at the same level of risk or lower risk at the same level of return relative to any point on a lower efficient frontier.

To evaluate our analysis, we create three different risk level portfolios of equalized investment allocation (50% US, 50% US and 50% US) that we label as Conservative, Moderate and Aggressive. By comparing these portfolios of a constant expected risk level on each efficient frontier, we can see how the optimal combination of assets changes as the opportunity set of asset returns changes, as well as how the expected return improves for the same expected volatility level.



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1. Markowitz, H. (1952). "Portfolio Selection: Efficient Diversification of Investments." *Journal of Financial Economics*, 1(1), 25-51.

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