BRIDGEWATER

Building a Balanced and Scalable Strategic Asset Allocation to Meet Financial and ESG Impact Goals

With investors increasingly focused on ESG and sustainability considerations, we have been examining how best to achieve both financial and sustainability goals in large, liquid, multi-asset portfolios. The below introduces our approach to building a strategic asset allocation balanced across economic environments, using assets aligned to the United Nations Sustainable Development Goals.

This research is featured as a chapter within the publication, *Sustainable Investing: A Path to a New Horizon* edited by Herman Bril, Georg Kell, Andreas Rasche.

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For decades, Bridgewater has engineered scalable portfolios to help institutional investors achieve their goals. In the past, these goals have typically been financial (e.g., return and risk targets), but now many investors are also seeking to achieve environmental, social, and governance (ESG) impacts through their portfolios. We believe the best way to achieve both financial investment goals and ESG impact goals is through portfolio engineering that incorporates these objectives holistically, beginning with crisply defining an investor's goals, systematically looking across a variety of asset classes to find assets that are aligned to these goals, and then combining those assets to create a portfolio that is designed to achieve the highest possible ratio of return to risk.

In our research paper, we demonstrate how we would use this approach to build a scalable strategic portfolio that is designed to help achieve financial goals while using assets that further the UN Sustainable Development Goals (SDGs). We have chosen to focus on building a strategic (beta) portfolio because ~90% of the risk in typical institutional portfolios is in the strategic asset allocation, so engineering a quality strategic asset allocation represents a crucial foundation for investors' financial and impact goals.[1]

From an impact perspective, we systematically select assets that are aligned to the UN SDGs at the beginning of the portfolio construction process, leading to a portfolio more aligned to the SDGs than market indices. From a financial perspective, we utilize Bridgewater's time-tested and stress-tested All Weather portfolio construction process designed to collect market risk premiums as efficiently as possible.

We break our approach to building this portfolio into three key steps:

1. **Setting clear goals for the portfolio.** To illustrate our approach, we have chosen a representative set of financial and ESG impact goals for our strategic portfolio: the financial goal is to generate positive, consistent returns across a range of economic environments, and the ESG impact goal is to further the UN Sustainable Development Goals. The SDGs are a collection of 17 global goals set by the United Nations General Assembly for the year 2030 that have been ratified by 193 countries. While investors can have many ESG impact goals, we have selected the SDGs because of their wide acceptance by governments and asset owners, their orientation toward positive environmental and social impact, and because the UN has defined indicators that can be used to measure the activities of asset issuers. Because we want to create an allocation that can achieve both financial and ESG impact goals at scale, we will also build the portfolio so that it can be held at institutional sizes.

2. **Selecting assets aligned with the portfolio's goals.** Once we have clearly defined the portfolio's goals, we look across the universe of global assets and systematically select those that are aligned to the UN SDGs and can be held at institutional scale. By systematically selecting assets at the start of the portfolio construction process, we can ensure the assets in the portfolio meet the goals we have set out. It also allows us to re-evaluate which assets meet the portfolio's goals over time as existing markets evolve and new markets become available.

3. **Using assets aligned with the portfolio's goals to build the most efficient strategic portfolio possible.** Having defined a universe of assets that are aligned to our goals, we apply Bridgewater's All Weather portfolio construction framework using these assets. The All Weather framework – which we have used as an asset manager for over two decades and stress tested over 100 years and across many countries – is based on balancing the macroeconomic drivers of asset returns (i.e., growth and inflation) to create a strategic asset allocation that collects market risk premiums as efficiently as possible. Importantly, the expected performance of this portfolio is a result of this beta portfolio construction approach, not from our use of SDG-aligned assets (which we do not expect would materially affect the portfolio's performance given our approach).

[1] We believe it is important for investors to separate strategic exposure (beta) from active views (alpha). The research piece also contains a discussion of ESG integration as a potential source of alpha.

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In our research paper, we describe each of these steps in more detail. Our hope is that this example of building a scalable portfolio that is designed to efficiently collect market risk premiums and further the UN SDGs will be applicable to a wide range of investors. However, we believe the three-step portfolio construction approach can be applied to any set of financial and ESG impact goals that investors might choose.

More on *Sustainable Investing: A Path to a New Horizon*

This book tells the story of how the convergence between corporate sustainability and sustainable investing is now becoming a major force driving systemic market changes. The idea and practice of corporate sustainability is no longer a niche movement. Investors are increasingly paying attention to sustainability factors in their analysis and decision-making, thus reinforcing market transformation.

In this book, high-level practitioners and academic thought leaders, including contributions from John Ruggie, Fiona Reynolds, Johan Rockström, and Paul Polman, explain the forces behind these developments. The contributors highlight (a) that systemic market change is influenced by various contextual factors that impact how sustainable investing is perceived and practiced; (b) that the integration of ESG factors in investment decisions is impacting markets on a large scale and hence changes practices of major market players (e.g. pension funds); and (c) that technology and the increasing datafication of sustainability act as further accelerators of such change.

The book goes beyond standard economic theory approaches to sustainable investing and emphasizes that capitalism founded on more real-world (complex) economics and cooperation can strengthen ESG integration. Aimed at both investment professionals and academics, this book gives the reader access to more practitioner-relevant information and it also discusses implementation issues. The reader will gain insights into how "mainstream" financial actors relate to sustainable investing.

Visit the Routledge website for more details.

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