Vanguard®

Asset allocation report

June quarter 2019

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The importance of cost in retirement

Retirement is complex, and in spite of the volumes of research on the topic, there are rarely simple answers to the many questions that are raised for those moving into retirement.

Detailed planning around goals, risks and financial resources is critical to manage a long retirement, and a lack of sufficient planning makes retirees financially vulnerable to the risks of outliving retirement savings, overreacting to market volatility, holding inappropriate portfolios and being unprepared for unexpected costs.

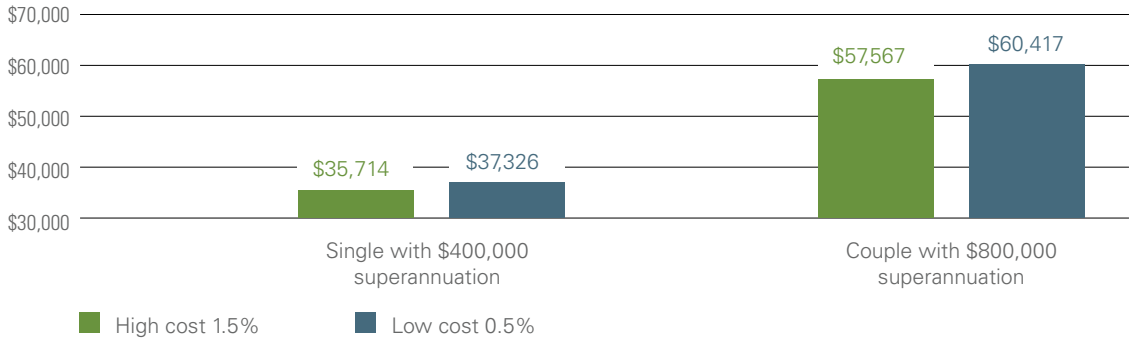
There is however one simple concept that is universally true when it comes to choosing an investment product, and it is something that is more important than ever when you are in the draw down phase, and that is, all else being equal, that a lower cost product will produce more retirement income than a higher cost product.

Think about that for a second. We spend a lot of time as investors, looking for ways to increase retirement income, and one of the easiest ways is often overlooked.

To illustrate how important costs can be, we have taken a look at income from both the age pension and superannuation drawdown, and the amount a retiree can spend in real terms each year for 30 years with 95% certainty, and we compare two cost scenarios. The first assumes that the retiree is invested in a high cost product charging 1.5%, and the second is a lower cost product charging 0.5%. The differences are striking.

For a single retiree with a $400,000 superannuation balance at retirement, they are able to spend over $1,600 (a 4.5% increase) more per year, adding up to more than $48,000 over the course of their 30-year retirement, if they use the lower cost investments. For a couple with a combined $800,000 superannuation balance, they are able to spend more than $2,800 (a 5.0% increase) more per year, or over $85,000 total, when using lower cost solutions.

Sustainable annual retirement income amount for 30 years



Note: The income levels shown are based on a constant real spending amount over a 30-year horizon with a 95% probability of success. Retirees are homeowners with a balanced (50% equity/50% bond) portfolio. The model incorporates the age pension as at 20 September 2018 and only considers financial wealth and therefore does not consider assets that would not be deemed to earn an income (i.e. home contents) or additional income (i.e. employment income) which would shift eligibility. The model treats superannuation and non-superannuation assets as one pool of financial assets and therefore we have assumed that any minimum withdrawals from super that exceed the retirement income targeted are reinvested in a non-super account. All values are in real terms. The examples used here are general only and do not consider any personal information. Actual age pension received may differ from that represented by the analysis due to a range of legislative and personal factors. The projections or other information generated by the Vanguard Capital Markets Model (VCMM) regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from the VCMM are derived from 10,000 simulations for each modeled asset class in AUD. Results from the model may vary with each use and over time.

Source: Vanguard, June 2018 VCMM Simulation.

The importance of fees actually increases with wealth too. Driven by the higher dependence on superannuation to meet income needs, those retiring with superannuation balances over $1,000,000 will find their sustainable annual retirement income increases 6% to 9% when using lower cost products versus higher cost products.

A key question, always top of mind for those saving for retirement is 'How much is enough'? Or how much do they need to save to be comfortable in retirement.

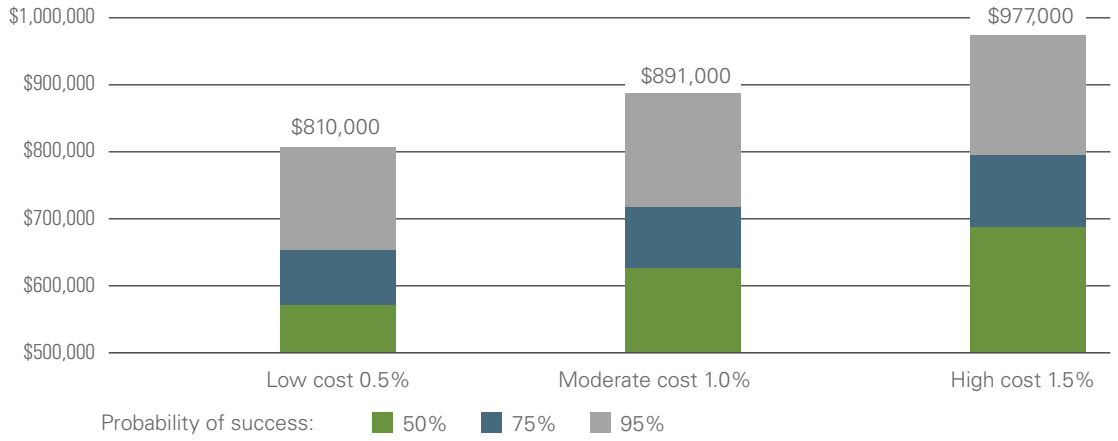
There are many complex planning elements that must be considered in answering that question, but our universal truth on the importance of controlling costs in order to maximise retirement income still holds.

To illustrate this for investors, below we assume a couple planning for retirement would like to spend the ASFA Comfortable Retirement Standard ($60,604 in real terms) for 30-years and would like to see the wealth needed to meet that goal with different probabilities of success.

Again we have incorporated both the age pension and superannuation drawdown, and we look at the superannuation balance needed to meet this income objective with 50%, 75%, and 95% probability while paying low (0.5%), moderate (1.0%), or high (1.5%) costs.

Focusing on the 95% probability, we see that roughly for every 50 bps increase in costs, the couple needs an additional 10% in their superannuation to meet their goal, and comparing the high cost 1.5% scenario to the low cost 0.5%, we can see a difference of $167,000 in wealth needed to meet the same objective.

Wealth needed for a couple to meet the ASFA Comfortable Retirement Standard



Note: The ASFA Comfortable Retirement Standard as at June 2018 is $42,953 per year for a single and $60,604 per year for a couple. We have assumed 0.5%, 1.0%, and 1.5% annual investment fees, the retirees are homeowners and a balanced (50% equity/50% bond) portfolio. The model incorporates the age pension as at 20 September 2018 and only considers financial wealth and therefore does not consider assets that would not be deemed to earn an income (i.e. home contents) or additional income (i.e. employment income) which would shift eligibility. The model treats superannuation and non-superannuation assets as one pool of financial assets and therefore we have assumed that any minimum withdrawals from super that exceed what is needed to meet the ASFA retirement standard are reinvested in a non-super account. A non-homeowner would need to consider rental costs in addition to the Retirement Standards. All values are in real terms. The examples used here are general only and do not consider any personal information. Actual age pension received may differ from that represented by the charts due to a range of legislative and personal factors. The projections or other information generated by the VCMM regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from the Vanguard Capital Markets Model (VCMM) are derived from 10,000 simulations for each modeled asset class in AUD. Results from the model may vary with each use and over time.

Source: Vanguard, June 2018 VCMM Simulation.

Now, there's no doubt that you will almost certainly need to pay some investment costs for a quality product (with some choosing to pay higher fees for the prospect of outperformance), and there is more to investing than costs alone, such as the value of quality financial advice.

But in the end, cost is one of the few things you can control, and keeping an eye on costs is a great way to boost your retirement income prospects.

This article originally appeared in Cuffelinks.

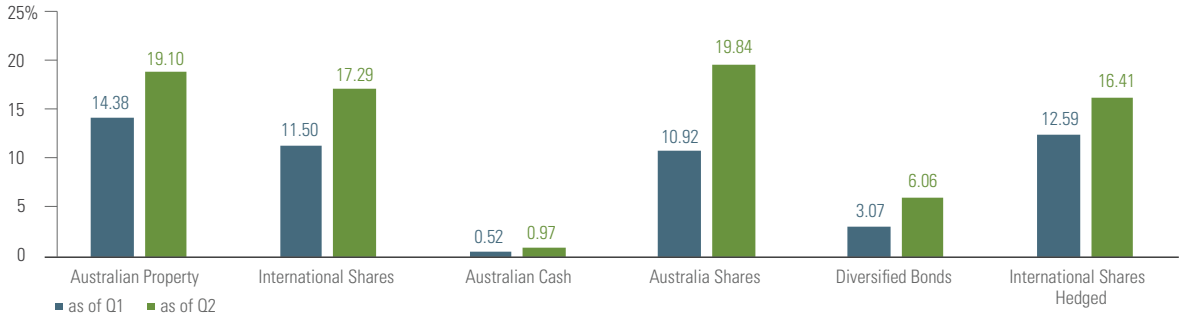
Quarter in review

Anyone hoping for an eventful second quarter was not disappointed.

The US yield curve flirted with inversion, China economic data softened, and both the RBA and RBNZ cut cash rates. The Brexit plan became more uncertain, markets began speculating about potential 'insurance' rate cuts by the Federal Reserve, and trade tensions continued to simmer.

One would be forgiven for looking at the year-to-date market returns in disbelief. Even after a couple of volatile trading days, returns through 30 June for international and Australian shares are just shy of 20%. Market returns – except cash – do not appear drastically different from what they are in good economic times.

Figure 1: 2019 Q1-Q2 market returns for shares may surprise your clients



Notes: Australian Property represented by the S&P/ASX 300 A-REIT Index, International Shares by the MSCI World ex-Australia Index, Australian Cash by the Bloomberg AusBond Bank Bill Index, Australia Shares by the S&P/ASX 300 Index, Diversified Bonds by a composite (30% Bloomberg AusBond Composite 0+ Yr Index, 70% Bloomberg Barclays Global Aggregate Float-Adjusted Index hedged to AUD), and International Shares Hedged by the MSCI World ex-Australia Index hedged to AUD.
Source: Vanguard.

We anticipated that 2019 would be a challenging year for all investors, amateur and professional, active and index. The temptation to change — to try market timing, to underweight certain sectors or countries, or even to reduce overall equity exposure 'strategically' — is ever-present.

It's easy to look back and proclaim that sticking to a plan worked, as it underplays the emotions we all feel as we try to do the best for our clients. Market returns that fly in the face of economic uncertainty only exacerbate our feelings of unease about the decisions we make.

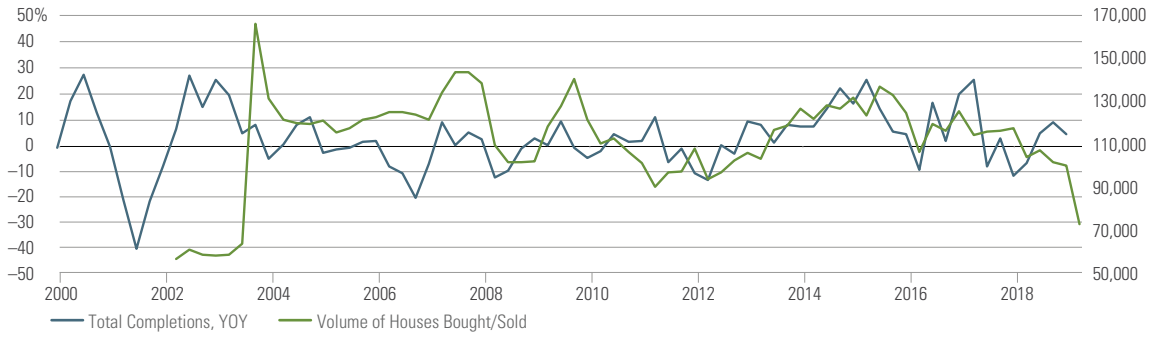
Economic outlook

Naturally, clients try to resolve uncertainty by looking to the economy for clues. Not much has changed from the past quarter: unemployment rates are still low and inflation is below most central banks' targets. Trade activity has deteriorated as businesses pull back and watch the US-China trade dispute unfold.

Locally, the same story holds. Interestingly, while the uptick in the unemployment rate (from 5.0% to 5.2%) is seen as a bearish signal, labour force participation reaching an historical high (66.0%) is cast aside in the haste to join the chorus of negativity.

While steady declines in residential property prices garner widespread attention, the volume of property transactions has not. Fewer properties are changing hands, depressing stamp duties, brokerage commissions, and other business revenues. While high household leverage and tighter credit are likely factors, we wonder if the market is still working off the multi-year construction boom. In thinking of property as an investment, the data suggest that few buyers are willing to pay for property at current price levels.

Figure 2: Property transactions are at an all-time low

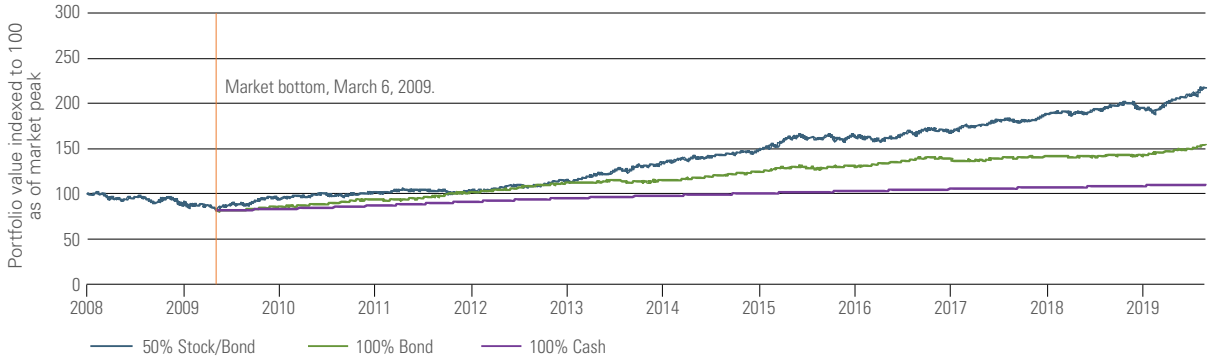


Source: Vanguard calculations, using data from the Australian Bureau of Statistics.

What can investors control?

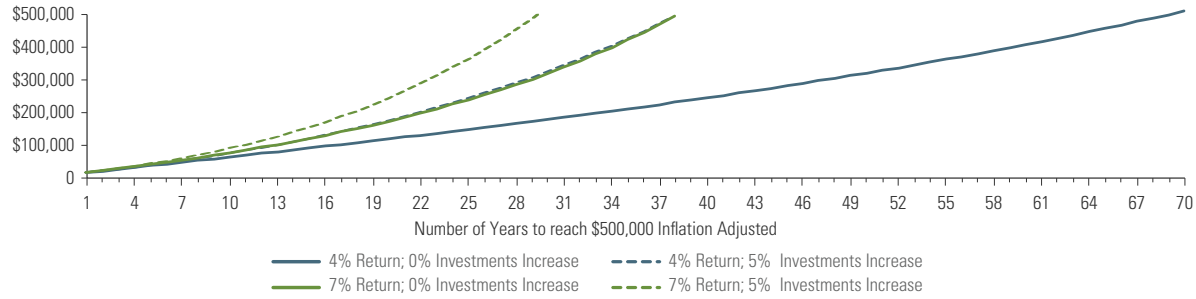
Beyond the near term, we should continue to anticipate surprises. Slight changes in long-term return forecasts are not sufficient to justify a wholesale change to portfolio strategy. We'd caution clients against taking the bait and timing markets, lest one emotional decision compounds into a costly habit. "Stay the course. No matter what happens, stick to your program." John C Bogle, founder of Vanguard, famously stated that this was the most important single piece of investment wisdom he could give to anyone. As Figure 3 illustrates, staying the course has its rewards. Australian investors who stuck with a 50/50 stock/bond portfolio have come out well ahead of those who sold out for bonds or cash at the bottom of the market. When the urge to change is strongest, the benefit is usually the weakest.

Figure 3: 'Staying the course' rewarded those who stuck with their stock/bond portfolio



Notes: 1 Nov 2007 represents the Australian equity peak of the period, and has been indexed to 100. Assumes all dividends and income are reinvested. Equity portfolio formed with 40% Aus Equity, 60% Intl Equity. Bond portfolio formed with 30% Aus Bonds, 70% Intl Bonds. Portfolios rebalanced monthly. All returns in AUD: Aus Equity - ASX 300; Intl Equity - MSCI World ex-Aus unhedged; Aus Bonds - Bloomberg AusBond Composite 0+ Yr; Intl Bonds – Bloomberg Barclays Global Aggregate Index Hedged to AUD to March 31, 2019, Bloomberg Barclays Global Aggregate Float-Adjusted Index Hedged to AUD thereafter; Cash - Bloomberg AusBond Bank Bill Index.
Source: FactSet. Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Figure 4: Regular investments can turbo charge returns



Note: hypothetical data and scenarios used for illustrative purposes only.
Source: Vanguard. Assumptions: $10,000 starting balance; $500,000 objective adjusted for inflation; $5,000 annual contribution made at beginning of year; Annual inflation of 2%; Return assumptions of 4% or 7% adjusted for inflation. For scenarios where we increase investments, we assume an annual increase of 5%.

None of us can control the market, so it's important to help your clients focus on the levers they can control: Goals, Balance, Cost and Discipline.

Here's a checklist for your clients:

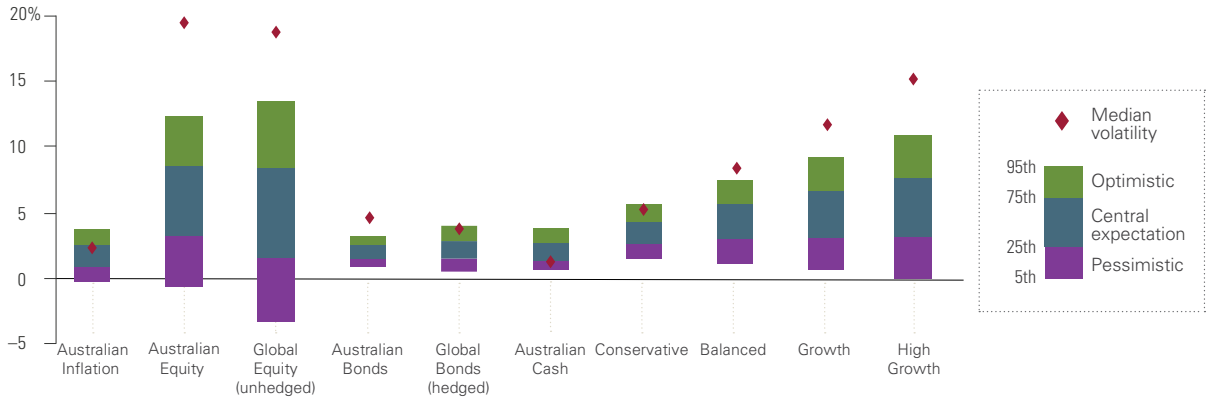
- Goals – have they changed? Probably not – but it's a good time to re-state them.
- Balance – check - they already in a diversified fund with Vanguard
- Costs – check – at Vanguard, we're all about low costs
- Discipline – stay the course

With the market full of drama it's more likely that your clients will be feeling uncertain, worried, and be tempted to time the market - or even make a wholesale change. 'Stay the course' may be just what they need to hear.

Long-term market outlook

The chart below shows the Vanguard Capital Markets Model® (VCMM) return forecasts over the next 10 years for a range of asset classes and Vanguard's Diversified Funds.

Figure 5: Projected 10-year nominal return outlook



Source: Vanguard, 31 March 2019 VCMM Simulation

It shows two concepts: the range of annualised 10 year nominal returns and the median volatility experienced.

The bars show the range of return outcomes over a 10 year period. The central return expectations for the asset class or portfolio are shown in the middle of the bars. Observations in the optimistic or pessimistic regions should not come as a surprise though; goals and portfolios should always be positioned with these possibilities in mind.

The red diamonds show the median volatility forecasts. This represents the volatility of the asset classes that can be expected over the 10 year period. The chart shows that equities are expected to produce a higher return over a 10-year period than bonds, however the trade-off is that an investor can expect a more volatile experience and greater uncertainty over the end point, which could be a much wider range of outcomes.

An important point to remember is that asset returns are not perfectly correlated, which means that if an Australian equity return over 10 years is in the optimistic range, this does not necessarily mean that Australian bond returns will also be in the optimistic range. Combining assets can therefore present strong diversification benefits.

The next two charts show the trade-off between targeting a CPI+ return target and the risk of a loss along the way.

Probability of achieving real return target

Downside risks

Conservative | Balanced | Growth | High Growth

Source: Vanguard, 31 March 2019 VCMM Simulation

Taking more risk means that an investor increases the probability that they will achieve their target over 10 years.

Highlighting the importance of managing expectations, it also means there is the increased probability of experiencing a negative return or a large annual loss in at least one year over the 10 year period.

About Vanguard's Investment Strategy Group

Vanguard's Investment Strategy Group is a global team of economists and investment and portfolio construction strategists with a wide variety of specialties, ranging from monetary policy to index construction to market trends. Their research serves as the basis for Vanguard's investment principles and methodology, guides Vanguard's global leadership and influences decisions about our investment offerings and portfolio construction.

Research-based investment approach

As part of Vanguard's broader Investment Management Group, ISG plays an essential role in developing Vanguard's investment methodology, which is carried through in the implicit and explicit advice solutions available to our clients. Our global chief economist and head of ISG reports directly to Vanguard's global chief investment officer. We work closely with Vanguard's in-house portfolio managers. Notably, our global chief economist is integrated into Vanguard Fixed Income Group through our portfolio management process. Through that process, ISG advises our fixed income investment managers on the macroeconomic outlook, expected monetary policy and other factors to support day-today portfolio management. Vanguard's investors around the world benefit from our collaborative approach to investment management, research and thought leadership.

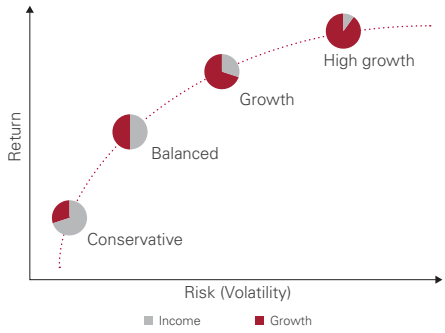
Vanguard Capital Markets Model

The VCMM projections are based on a statistical analysis of historical data. Future returns may behave differently from the historical patterns captured in the VCMM. More important, the VCMM may be underestimating extreme negative scenarios unobserved in the historical period on which the model estimation is based. The Vanguard Capital Markets Model® (VCMM) is a proprietary financial simulator developed and maintained by Vanguard's Investment Strategy Group. It is a long term tool that takes into account current macroeconomic conditions and equity and bond valuations to forecasts distributions of future returns for a wide range of asset classes and portfolios. The primary value of the VCMM is in its application to analysing potential client portfolios. VCMM asset-class forecasts—comprising distributions of expected returns, volatilities, and correlations—are key to the evaluation of potential downside risks, various risk–return trade-offs, and diversification benefits of various asset classes.

Asset allocation

Vanguard's approach to asset allocation is to provide long-term returns that match investors' desired level of risk. The broad allocations to defensive (fixed income) and growth (equities) are the main factors influencing the risk/return profiles of our asset allocation strategies.

Our asset allocation approach is designed with a medium to long-term investor in mind (a time horizon of at least five years), reflecting the reality that the majority of Australian investors need to accept some market risk in order to reach their investment goals.



Why diversification matters

We believe that a successful investment strategy starts with an asset allocation suitable for its objective. In practice, diversification is a rigorously tested application of common sense: Markets will often behave differently from each other—sometimes marginally, sometimes greatly—at any given time.

Owning a portfolio with at least some exposure to many or all key market components ensures the investor of some participation in stronger areas while also mitigating the impact of weaker areas.

Many investors lack the time, interest, or skills, and can become overwhelmed by the choice of investment options, asset classes, and other implementation hurdles such as choosing between index and active management. Investors also face behavioural risks in adhering to their investment plan over time due to the temptation of performance chasing or overreacting to market events.

Vanguard Diversified Funds provide professionally managed portfolio solutions designed to help medium to long-term investors achieve their goals and overcome these challenges.

Risk and return overview

Vanguard Diversified Funds peer group comparison

30 June 2019

The shaded boxes display the total return percentile rank of the Vanguard Fund within its peer group*, as shown by the colour code, with the number reflecting the Vanguard Fund return in excess of the peer group median return (%). The numbers below the shaded boxes indicate the number of funds in the peer groups across each time period.

Vanguard fund Asset weighted peer group MER (% p.a.)	3 mths	6 mths	1 yr	3 yrs	5 yrs	7 yrs	10 yrs
Conservative 0.72	0.92 57	1.88 57	2.50 56	0.94 53	1.62 50	1.36 50	0.82 46
Balanced 0.85	0.95 68	2.04 68	2.69 66	0.87 60	1.51 54	1.23 48	0.91 37
Growth 0.84	0.85 90	1.93 89	2.35 88	1.23 84	1.56 79	1.43 75	1.22 65
High Growth 0.99	0.86 75	1.76 75	2.23 74	0.83 68	1.28 61	1.22 56	1.14 46

Peer group percentile
- Top 5%
- 1st quartile
- 2nd quartile
- 3rd quartile
- 4th quartile

Sources: Vanguard calculations using data from Morningstar Inc.
Past performance is not an indication of future performance. All returns are net of fees and assume reinvestment of income distributions.
Returns greater than 12 months are annualised. There has been no adjustment for survivorship bias.
*The peer groups were constructed by first sourcing a universe of funds from Morningstar having the same category as the Vanguard Funds, but excluding Vanguard strategies. An automated filter was then applied to these original peer groups with the aim of removing identified duplicate investment strategies and retain unique strategies.

Understanding Vanguard's SAA process

For multi-asset funds, such as Vanguard Australia's Diversified Funds, Vanguard's Investment Strategy Group (ISG) conducts an annual review of the strategic asset allocation (SAA) of the funds. The team considers new asset classes, currency exposure, home bias, regulatory and tax impact, investment costs, investor behaviours, and implementation factors amongst others. The ISG team presents a recommendation to maintain or change the SAA to Vanguard's global Strategic Asset Allocation Committee (SAAC), which oversees all of Vanguard's multi-asset funds. The SAAC is comprised of senior leaders from the Investment Management Group and Vanguard's advice businesses and is co-chaired by Vanguard's global Chief Investment Officer and global chief economist. Upon approval of a change to the SAA, Vanguard assesses the feasibility, tax impact, and costs of the recommended changes and presents to the Board of Vanguard Australia for approval prior to implementing the changes.

Vanguard Diversified Funds return contributions for the quarter

Month end: 31 March 2019	3 Month Gross	3 Month Return Contribution (%)			
Fund	Return (%)	VCIF	VBIF	VGIF	VHIF
Vanguard Cash Plus Fund	0.84	0.1	0.0	0.0	0.0
Vanguard Australian Fixed Interest Index Fund	3.45	0.6	0.5	0.3	0.1
Vanguard Global Aggregate Bond Index Fund (Hedged)	10.91	1.3	2.2	3.0	3.9
Vanguard Australian Shares Index Fund	11.61	1.0	1.7	2.4	3.1
Vanguard International Shares Index Fund	12.70	0.3	0.4	0.6	0.8
Vanguard International Small Companies Index Fund	8.85	0.2	0.3	0.4	0.5
Vanguard Emerging Markets Shares Index Fund	12.72	0.7	1.1	1.6	2.0
Vanguard International Shares Index Fund (Hedged) - AUD Class	2.95	1.3	1.1	0.6	0.2

*Figures in the return contribution table are calculated as the product of the monthly gross return and the corresponding actual asset allocation.

Underlying fund asset allocation

The strategic asset allocation (SAA) is provided in the table below. The Diversified Funds leverage Vanguard's international expertise in investment research and utilise a global investment methodology. This approach starts with market capitalisation weightings and from this local market factors are then also considered.

Target asset allocations effective from July 2017	Conservative	Balance	Growth	High Growth
Asset Classes	Asset Allocation (%)			
Vanguard Cash Plus Fund	10.0	0.0	0.0	0.0
Vanguard Australian Fixed Interest Index Fund	18.0	15.0	9.0	3.0
Vanguard Global Aggregate Bond Index Fund (Hedged)	42.0	35.0	21.0	7.0
Total Income	**70.0**	**50.0**	**30.0**	**10.0**
Asset Classes				
Vanguard Australian Shares Index Fund	12.0	20.0	28.0	36.0
Vanguard International Shares Index Fund	8.5	14.5	20.5	26.5
Vanguard International Shares Index Fund (Hedged)	5.5	9.0	12.0	16.0
Vanguard International Small Companies Index Fund	2.0	3.5	5.0	6.5
Vanguard Emerging Markets Shares Index Fund	2.0	3.0	4.0	5.0
Total Growth	**30.0**	**50.0**	**70.0**	**90.0**

How much home country bias is too much

Aidan Geysen
Senior Investment Strategist and Manager with Vanguard's Investment Strategy Group.

The concern among investors over Labor's proposal before the federal election to remove franking credit refunds prompted a valuable conversation on the risks to a portfolio from a significant home bias.

Many investors articulated they invested and planned their retirement income according to the rules of the day, and the income benefits were given prominence throughout the election campaign.

The level of equity home bias in Australian portfolios is among the highest in the world.

But an important, and often absent, consideration in the conversation is the degree to which franking credits have been factored into stock prices. After all, the tax benefit only exists if it doesn't come at the expense of lower future expected returns. There is a strong argument that franking credits are not fully priced – not all investors in Australian shares benefit equally, and a sizeable portion are foreign-owned where no benefit from franking is derived.

On the other hand, it is also likely that they are at least partially priced in. Superannuation savings make up about 40 per cent of the ownership of Australian shares. Of the super money invested in Australian shares, about a third is in drawdown phase, meaning there is a significant benefit derived from franking credit refunds, in particular for those in the zero tax bracket.

So now the election dust has settled, it is perhaps timely for investors to ask themselves how much home bias is too much.

Risk of complacency

There is a risk that investors have become too complacent about the risks of holding a high concentration of Australian equities, and in many cases the exposure might be made up of just a handful of individual companies. Perhaps the source of complacency relates to Australia's persistent run of luck — almost 30 years of consecutive growth without a recession places us in a unique position globally.

The level of equity home bias in Australian portfolios is among the highest in the world. The average exposure to Australian equities within My Super default funds comprises more than 40 per cent of the equity allocation, as reported by APRA. This compares with Australia's market cap within global indices of about 3 per cent.

There are reasons why investors prefer home country equities, some of which are behavioural and some of which have a sound investment rationale – a preference for the familiar, ease of access, aversion to currency risk, tax benefits and liability hedging, to name a few. For investors who are comfortable with even higher levels of home bias, it is prudent to consider the potential outcomes that such a concentrated position may deliver. Concentration risk may come in the form of a housing market weakness, a China hard landing, regulatory risk (such as the recent tax changes proposed) or contagion risk from global events such as the US-China trade war or Brexit, all of which may affect our market in unexpected ways.

Shift to global assets

If franking credit refunds had been removed – and not all investors would have been affected equally by the change – it is likely it would have been a catalyst for many to review home-bias positions within portfolios, triggering an incremental shift towards more globally diversified portfolios, which could help insulate Australia's savings, much of which is in our superannuation system, from unexpected risks.

Although the right level of home bias may differ by investor, considering key factors such as the diversification benefit of adding foreign securities, local-market sector and security concentration, as well as domestic tax treatment, provide a sound basis for setting allocations. So far, home country bias hasn't carried a high penalty, providing a timely opportunity to review areas of excessive concentration risk. Some of the structural tailwinds that have aided the Australian economy in the past may not play out the same way in the future.

So if Australia's dream run comes to an end, investors may start to feel the pain, particularly when their standard of living in retirement is at stake.

This article first appeared in the Australian Financial Review on 2 June 2019.

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Vanguard Capital Markets Model

IMPORTANT: The projections or other information generated by the Vanguard Capital Markets Model regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. VCMM results will vary with each use and over time.

The Vanguard Capital Markets Model forecasts distributions of future returns for a wide array of broad asset classes. Those asset classes include Australian and international equity markets, several maturities of the Australian Treasury and corporate fixed income markets, international fixed income markets, money markets, commodities, and certain alternative investment strategies. The theoretical and empirical foundation for the Vanguard Capital Markets Model is that the returns of various asset classes reflect the compensation investors require for bearing different types of systematic risk (beta). At the core of the model are estimates of the dynamic statistical relationship between risk factors and asset returns, obtained from statistical analysis based on available monthly financial and economic data from as early as 1960. Using a system of estimated equations, the model then applies a Monte Carlo simulation method to project the estimated interrelationships among risk factors and asset classes as well as uncertainty and randomness over time. The model generates a large set of simulated outcomes for each asset class over several time horizons. Forecasts are obtained by computing measures of central tendency in these simulations. Results produced by the tool will vary with each use and over time.

Although central tendencies are generated in any return distribution, Vanguard stresses that focusing on the full range of potential outcomes for the assets considered, such as the data presented in this paper, is the most effective way to use VCMM output.

The VCMM seeks to represent the uncertainty in the forecast by generating a wide range of potential outcomes. It is important to recognise that the VCMM does not impose "normality" on the return distributions, but rather is influenced by the so-called fat tails and skewness in the empirical distribution of modelled asset class returns. Within the range of outcomes, individual experiences can be quite different, underscoring the varied nature of potential future paths. Indeed, this is a key reason why we approach asset-return outlooks in a distributional framewo rk.

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