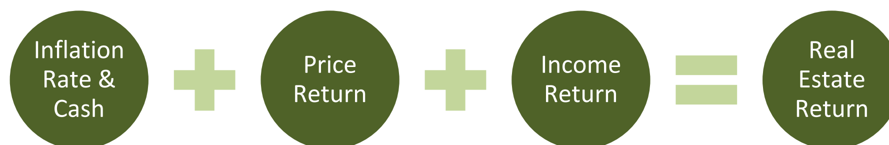


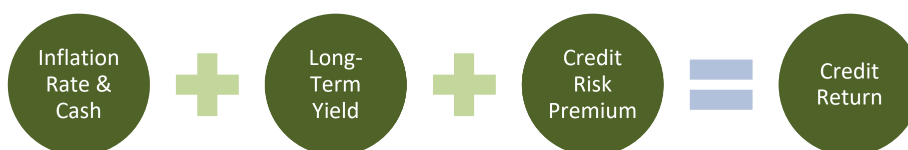
Diversifying

The expected return from government bonds is the most important component for the Diversifying class. Like the dividend yield in Global Equity and income return in Real Estate, the yield – a measure of the current income returns in Fixed Income – is a key driver of future returns. When yields are higher, expected returns are higher (and vice versa). The expected return for Fixed Income combines the cash and inflation return with the additional yield for longer-term bonds:

The common theme in the major components of capital markets assumptions is the idea that current level of prices and yields for different assets influences the future expected returns. The long-term assumptions used by CalSTRS combines relatively short-term expectations that are influenced by current asset prices with long-term historical averages.

Credit

Much like Fixed Income, the expected return of the Credit strategic class is a function of current income returns or yields. All Credit includes an additional premium derived from the perceived credit worthiness of the debt issuer and Private Credit includes an additional liquidity premium. As a result, Credit is expected to have higher returns than Fixed Income at the tradeoff of higher expected risk.



When economic conditions worsen, Credit risk premiums generally increase which can put downward pressure on the prices of Credit instruments. In the short run, this repricing can lead to lower returns for existing Credit holders. Over the long run however, higher Credit premiums are expected to improve returns as investors are compensated with higher yields on new debt.