ALM · STRATEGY

Why Your ALM Strategy Might Be Doomed to Mediocre Returns

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A Nash equilibrium wake-up call for asset–liability management, 2026–2030.

Asset–liability management (ALM) is frequently framed as a technical optimization challenge: building a portfolio that maximizes expected return while respecting liability risks and contribution constraints.

In practice, this view is incomplete.

ALM is more accurately viewed through the lens of John Nash's non-cooperative game theory. A pension fund does not optimize in a vacuum. Its funded-status outcomes depend on the concurrent choices of other major long-term capital providers: public pensions, insurers, sovereign wealth funds, and large asset managers, all facing comparable regulatory, governance, and macroeconomic pressures.

The "career risk" equilibrium

A Nash equilibrium arises when no single fund can significantly enhance its funded status by unilaterally altering its strategy, assuming others hold theirs fixed. In institutional investing, this often manifests as a "career risk equilibrium": for many decision makers and investment committees, it is safer to fail conventionally alongside peers than to risk failing unconventionally by deviating from the pack.

This dynamic helps explain the massive convergence we observe in institutional portfolios, and why expected returns frequently compress precisely when confidence, and allocations, peak.

The case study: the private credit convergence

Nowhere is this equilibrium more visible than in the multi-year rush into private credit.

From 2023 onward, private credit was widely viewed as the "holy grail" for yield-starved long-term investors. Individually, increasing allocations to capture the illiquidity premium was rational. However, when thousands of institutions move simultaneously into the same space, several things happen at once.

Yield and spread compression has been pronounced, with direct-lending spreads tightening significantly, from peaks above 500 bps pre-2023 to levels frequently in the 300–400 bps range by late 2025 or early 2026 in many segments. Covenant-lite structures have become more common as competition for deals intensifies. Net returns in many recent vintages, after fees and illiquidity drag, have narrowed toward, and in some cases approached, public high-yield or leveraged-loan equivalents, particularly in larger, more liquid segments of the market.

In a Nash equilibrium, the individually rational move, to allocate more to private credit, becomes collectively return-dampening: the very crowding that justifies the initial allocation erodes the premium it was meant to capture.

This is not a failure of manager selection. It is an equilibrium outcome.

The escape hatch: total portfolio approach

If convergence is the trap, the Total Portfolio Approach (TPA) offers a pathway to partial escape for funds with the governance and capabilities to use it effectively.

TPA shifts from rigid, siloed strategic asset allocation targets to a holistic, factor-based framework that treats the entire portfolio as a unified whole. It empowers CIO-led dynamic decisions focused on marginal contributions to total fund outcomes, return, risk, liquidity, and flexibility, rather than forcing rebalancing to pre-set asset-class buckets.

Leading adopters such as CPPIB have historically demonstrated meaningful advantages through this approach, often in the range of 50–130 bps annually in risk-adjusted performance relative to more traditional SAA peers, driven by greater nimbleness, internal management efficiencies, and non-consensus positioning.

The 2026 catalyst is significant: CalPERS, one of the largest U.S. public pensions, officially transitions to TPA effective July 2026, signaling broader potential adoption. Yet TPA is no panacea. As more funds embrace factor-based thinking, herding risks simply migrate from asset-class convergence to convergence at the factor level, for example similar exposures to inflation protection, equity risk premia, or private illiquidity.

Sustainable advantages are non-replicable

To consistently outperform in a crowded equilibrium, funds must lean into attributes that peers cannot easily replicate: verifiably long investment horizons that genuinely ignore short-term peer rankings and quarterly noise; governance structures that enable rapid, decisive action, such as pre-approved "dry powder" protocols for opportunistic deployment; and functional liquidity management, distinguishing true liquidity by purpose,

such as cash for margin calls or rebalancing, rather than by asset label, public versus private.

These characteristics allow a fund to operate meaningfully outside the prevailing equilibrium rather than compete inside it.

The real game-winner: thinking outside the equilibrium

From 2026 to 2030, ALM success will depend less on superior macro forecasting and more on accurately identifying where equilibrium behavior is crowded, fragile, or poised to shift.

The goal is not merely to find the theoretically optimal portfolio. It is to find the portfolio your peers are too constrained, by career risk, governance, or benchmarking, to hold.