

Los Angeles Fire & Police Pensions



To Serve Those Who Protect

# *Thinking About Strategic Allocation*

**Pension Consulting Alliance, Inc.**

**JANUARY 2009**

# *Thinking About Strategic Allocation*

**A Highlight of Current Trends**

**Potential Outcomes**

**Thoughts About a Generalized Framework**

**Examples of Current Plan Sponsor Trends**

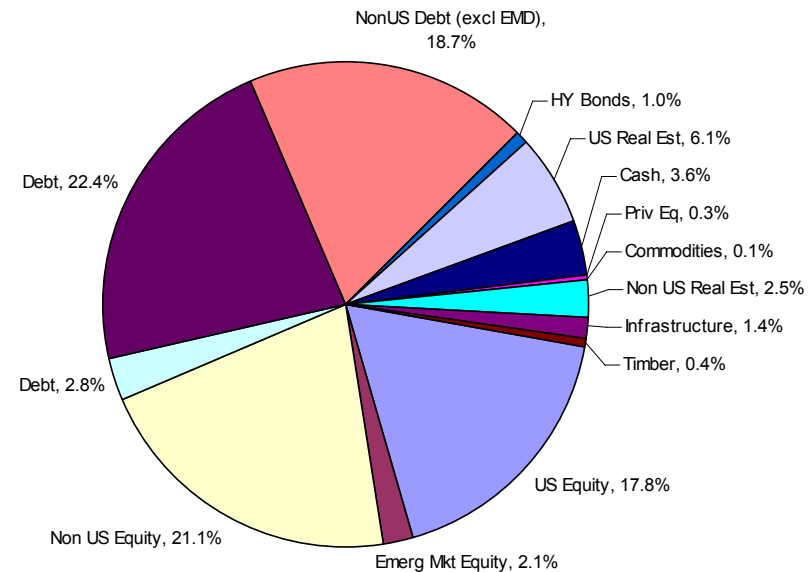
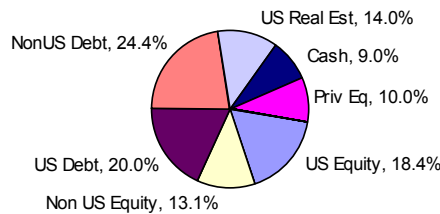
**What We are Seeing and Advocating**

# Thinking About Strategic Allocation – Current Trends

Remember those “Good Old Days“ of 2007....?

\$109 Trillion, as of 12/31/2007

\$10 Trillion, as of 12/31/1983



- Today, markets are worth closer to ≈\$80-85 Trillion
- In 2008, the only uncorrelated investment classes were hedged global government debt and cash
- Still, complexity and expanding opportunities continue to unfold

# Thinking About Strategic Allocation – Current Trends

## Additional Thematic Thoughts from 2008:

- Every broadly diversified large-scale investor was scathed by the current crisis
  
- “Mean-variance is broken”
  - While the intuitive aspects of Modern Portfolio Theory remain, MPT is losing its credibility as a risk management tool
  - The foundation of stable, continuous, random, normally-distributed investment returns, correlations, and risks is weakening
  - The tension between long-term investment strategy and “appropriate” risk management has increased
  
- Risk management has become much more of a priority, yet increasingly complex, issue
  
- Successful investors will likely develop new techniques that are much more proactive (perceived to be “tactical”) in measuring, monitoring, and acting on changing risk environments

# Thinking About Strategic Allocation – Current Trends

- Alpha-Beta separation (i.e., financial engineering) will likely continue, but is under serious review
  
- Regulatory requirements continue to cause a dispersion of objectives
  - Corporate plans & FASB
    - The search for immunization and the desire to defease
  
  - Public plans & GASB
    - Continued search for the “Stable 8”
    - Increased focus on managing healthcare liabilities/portfolios
    - Current debate about public plan/private plan structural differences
  
- Increasing willingness to add asset classes in an attempt to seek diversification
  - Commodities
  - Currencies
  - Hedge funds / absolute return strategies
  - Infrastructure

# Thinking About Strategic Allocation – Future Directions

- A more generalized, goal-oriented approach to allocating capital
- Broader discretion in investment policies, procedures and guidelines
- Result: Higher levels of customization and complexity
- Higher levels of “maverick risk” as investors attempt to be nimble/proactive
- An increased recognition that risk management deserves additional resources
  - Quantitative – factor-based risk allocation and attribution
  - Qualitative – quant model weakness is the lack of an ability to interpret the signals leading to the next event

## Thoughts about a Generalized Allocation Framework

- Substitute the term “asset class” with something more relevant
  - “Risk class” or “Risk basket”
  - “Return class” or “Return bucket”
  - The common thread is a focus on the *design* of the return pattern
  
- Example:
  - Return/Risk classes:
    - Liquidity
    - Principal protection
    - Immunized
    - Real return or inflation protection
    - Absolute return (of some level)
    - Moderate growth
    - Aggressive growth or levered growth
  
- The investor then decides where and how to insert vehicles/strategies into these classes
  - In this framework, allocation to asset classes becomes more fluid

# Thinking About Strategic Allocation – Future Directions

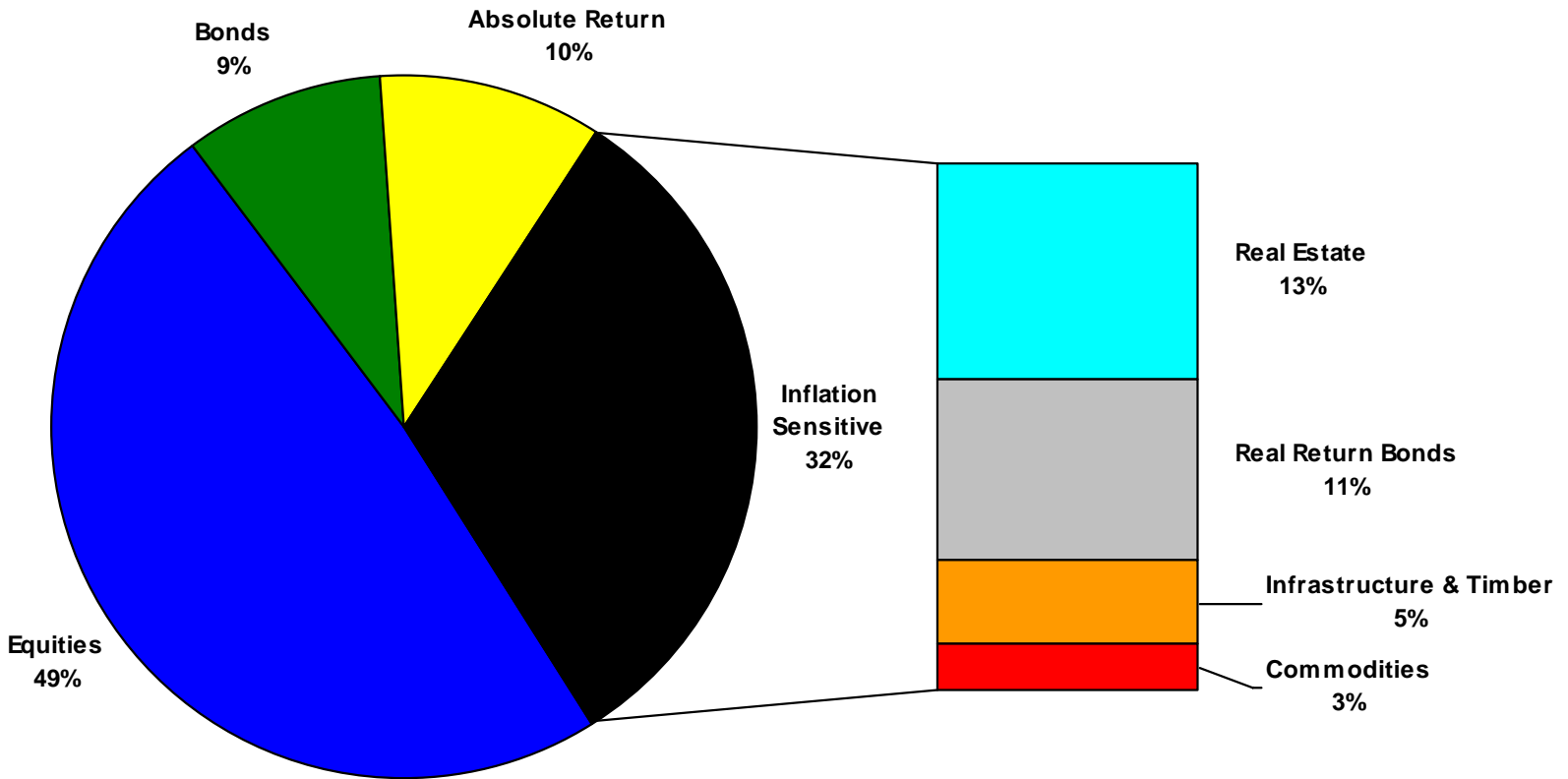
- Conceptually, a portfolio can be organized by investment objective and risk tolerance with asset classes and segments becoming “feeders”

Strategic Category	
<b>Growth Oriented</b>	Continue to focus on equity-oriented strategies. Portable alpha and return-driven strategies. For example, highly levered/opportunistic real estate would be placed here.
<b>Inflation Oriented</b>	Broad collection of asset classes: TIPS, infrastructure, commodity-oriented, timber, core real estate. These sub-classes are likely not amenable to traditional optimization approaches. One approach is to determine core holding position and then fund other investments on a more opportunistic basis.
<b>Protection Oriented</b>	Fixed income and fixed income substitutes, but also protection against market event risk. Absolute return strategies could fit here as well as in the inflation-oriented category. Emphasis for these strategies is low volatility and stable total returns. Long duration Treasuries may actually stabilize the asset class and prevent against event risk. Structured product also viable.

- Such a structure is expected to be more complex, but also more flexible (e.g., real estate)
- Many plan sponsors are beginning to move in this direction, structuring a “real return” class

# Thinking About Strategic Allocation

## Example: Ontario Teachers



- 42% of portfolio not tied to specific asset classes at strategic level

# Thinking About Strategic Allocation – Summary

## Key Considerations in Developing Generalized Classes

- Significant discussion should take place to outline the appropriate class structure
  - What underlying segments should be included?
  - How much exposure does the plan sponsor already have to the underlying segments?
  - Review of assumptions of underlying components
  - Recognition that any model for the class is likely, at best, to be indicative and not overly precise
  - Implementation of any one of several structures may take an extended period of time
  - How is investment risk measured and monitored?
  
- Many of the underlying segments may not lend themselves favorably to mean-variance optimization
  - There is limited history, *at best*
  - Many segments/classes are not marked-to-market
  - Stress testing of assumptions and disclosure of modeling difficulty is a critical step to developing an initial awareness of the challenges of investing in certain underlying segments