DIVERSIFYING ASSET ALLOCATIONS, AN EXERCISE IN PORTFOLIO CONSTRUCTION

Chris Hill, Senior Research Consultant
Sean Gill, Partner, Portfolio Construction Team

BLOG POST

August 28, 2020

The Goal: The NEPC Portfolio Construction Team is implementing a unique approach in some client portfolios as institutional investors seek out new and diverse asset classes and streams of cash flow. To that end, NEPC is working with these clients to develop *diversifying asset* (DA) allocations.

The aim of the DA portfolio is to construct a group of exposures to assets not generally found elsewhere in the portfolio. These assets are expected to be uncorrelated to primary drivers of portfolio returns such as equity and credit betas. Clients will often include a formal performance objective for DA strategies such as a Libor plus target or an absolute-return target. To be sure, the strategies and allocation may not be suitable for all institutional investors because of the illiquidity and other risks that accompany many of these assets, as outlined below. However, the purpose of this paper is to provide an overview for those interested in this investment approach.

The Background: The list of potential DA strategies has changed over time as new approaches are developed and then mature to become mainstream. For instance, distressed debt as an investment strategy emerged in the 1980s and became more established in the 1990s and 2000s. Many DA approaches that exist today were birthed at the proprietary trading desks of investment banks over a decade ago or were sub-components of multi-strategy hedge funds. The regulatory reforms put in place for investment banks following the financial crisis in 2008, combined with the shrinking universe of multi-strategy hedge funds, forced these atypical strategies to exist as stand-alone mandates. Today, most of the strategies discussed below are single-investment mandates operated by experienced specialists.

The Process: Clients are incorporating these strategies as a sub-allocation within a private-markets program or as a stand-alone allocation. In either case, we are recommending investors take a varied approach to any DA allocation as the risks to any one strategy can be high. Manager selection is key as well as the establishment of a clear definition of the goals and parameters of a DA allocation.

We have worked with clients to develop a list of strategies that we believe are part of the DA spectrum. In the table below, we discuss some of these potential strategies and their pros and cons.

Strategy	Benefits	Potential Pitfalls
Aircraft leasing	• Provides contractual cash flow • Risks can be mitigated by diversifying by aircraft age, body type, and terms and age of the lease	• Broad sensitivity to economic growth and idiosyncratic credit risk with individual airlines and geographies • May require leverage to produce attractive returns
Art	• Fragmented market and small universe of institutional investors • Broad opportunity set • A diversifying investment not viewed as a financial or operating asset	• Valuation is challenging • Buyer tastes may change over time • Thin market liquidity • No cash flow or income
Asset-based lending (ABL)	• Includes exposures to transportation assets such as railcars, shipping vessels, and financing of corporate equipment • Collateral is a hard asset • Usually, lending on low loan-to-values with structural enhancements to mitigate risk	• Leverage may be needed to produce attractive returns for institutional investors • Broad exposure to economic activity, including global shipping and rates, as well as possible country-specific exposures for assets such as railcars • Credit risk • Asset obsolescence or valuation challenges
Distressed debt	• Anti-cyclical strategy • Broad manager/fund universe • Can perform even in benign environments • Liquid (trading) and illiquid (control) sub-strategies available for investment	• Credit exposure embedded in the strategy • Timing can play an important role in capturing the best returns
Insurance-linked strategies	• A variety of options related to strategy and exposure • Can be a solution for the regulatory burden faced by an insurance company • Attractive structure and collateralization can work in investors' interests	• Investors generally will have to diversify by vintage year and establish a program • Difficulty in modeling "Act of God" events • High level tail risk • Potential capacity constraints in some areas • Varying historical performance • In many instances, this is essentially a short-volatility strategy

Life settlements	• Longevity risk is a different exposure relative to most other asset classes • Provides a liquidity solution for life insurance policy owners who want/need liquidity • Probability-driven modeling • Growing market	• Strategy return is associated with cash flows from life insurance policies • Headline risk for institutional investors • Longevity risk • Regulatory risk • May require leverage to produce attractive returns
Litigation finance	• Growing universe of institutional opportunities • Different litigation types can be targeted, for instance, commercial or class-action	• Binary outcomes • Headline risk for institutional investors • Growing asset levels focused on this opportunity have compressed expected returns
Royalties	• Can provide consistent stream of cash flow • A variety of strategy and exposure options, including entertainment, gaming and healthcare • Can provide balance sheet solutions and capital for research and development for drug development companies	• High economic and sector-specific sensitivity • Can represent a single-asset risk such as an individual drug exposure • Large amount of institutional assets focused on the space • Leverage often used to generate higher returns
Sports finance	• New opportunity set and limited institutional money focused on the space	• Opaque area of investment • Fewer number of investment opportunities • Credit risk to clubs/franchises • Often, only minority interests are available for investment
Trade finance	• Can provide a steady stream of cash flows • Loans are often short term and can de-risk quickly • Broad opportunity set	• Global economic sensitivity and credit risk to counterparty • Exogenous risks such as sovereign intervention and broad geopolitical risk • Leverage often needed to achieve attractive returns

As DA opportunities mature, NEPC will be looking to evaluate these potentially unique sources of returns and discuss our findings with clients considering these types of exposures. For more information, please contact your NEPC consultant.

BOSTON | ATLANTA | CHARLOTTE | CHICAGO | DETROIT | LAS VEGAS | PORTLAND | SAN FRANCISCO
255 State Street, Boston, MA 02109 | P. 617.374.1300 | F. 617.374.1313
www.nepc.com

DISCLAIMERS AND DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

The information in this report has been obtained from sources NEPC believes to be reliable. While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.

The opinions presented herein represent the good faith views of NEPC as of the date of this report and are subject to change at any time.

BOSTON | ATLANTA | CHARLOTTE | CHICAGO | DETROIT | LAS VEGAS | PORTLAND | SAN FRANCISCO
255 State Street, Boston, MA 02109 | P. 617.374.1300 | F. 617.374.1313
www.nepc.com