

# The Capital Issue

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## The Nonprofit Minute A commentary by Adam J. Smith, CFA, CAIA

### ESP for Asset Allocation: Efficient, Strategic, Purposeful

It is widely accepted that all investors seek the highest return for a given level of risk; however, each investor's tolerance for risk is unique. An institution's risk tolerance should be defined by its embedded liabilities, such as a target rate of return for pension plans, a spending policy for endowments and foundations, or debt covenants for institutions with outstanding debt. Given that virtually all institutions have embedded liabilities, institutional investors should be just as concerned with minimizing the volatility of returns as with maximizing the absolute level of returns.

#### Asset Allocation

Two major studies conducted within the past 25 years have shown asset allocation to be the primary driver of return volatility. A study of the asset allocation of 91 large pension funds, published in 1986 by Gary Brinson, Randolph Hood and Gilbert Beebower, found that, "Investment policy dominates investment strategy (market timing and security selection), explaining an average of 93.6% of the variation of total plan returns."

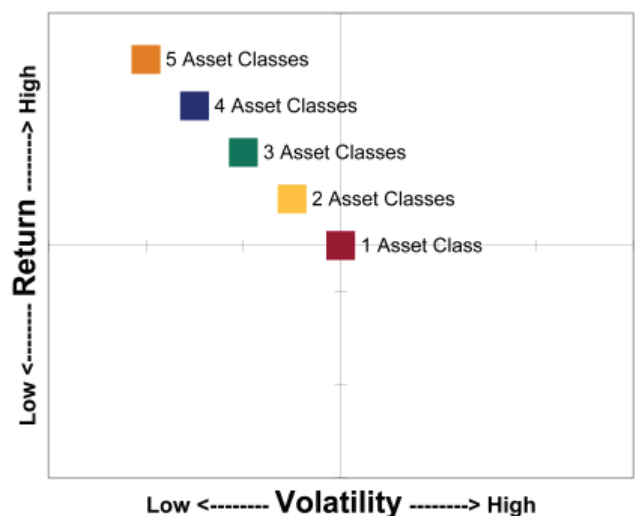
Additionally, Roger Ibbotson and Paul Kaplan's 2000 study of the asset allocation of 94 U.S. balanced mutual funds and 58 pension funds found that "asset allocation explains about 90% of the variability of a fund's return over time."

Institutions should therefore focus on asset allocation as a means to reduce the volatility of returns. An Efficient, Strategic, and Purposeful (ESP) asset allocation model can accomplish this.

#### Efficient

According to Modern Portfolio Theory, an efficient portfolio is one that maximizes return for a given level of risk or, conversely, minimizes risk for a given level of return. This concept is critical to an ESP framework in that when an asset class is added to the portfolio, the result should be a higher level of return or a lower level of volatility (risk). This is illustrated in the chart below.

Investors are able to increase the return and decrease the risk within their portfolio if they add an asset class that has a low correlation with



In an ESP asset allocation, adding more non-correlated asset classes to a portfolio both reduces volatility and increases returns.

# The Capital Issue: The Nonprofit Minute

other asset classes already in the portfolio. Just as important is to view the concept of increased efficiency at the aggregate portfolio level rather than at the individual asset class level. For example, although commodities have higher volatility than stocks or bonds, adding commodities can reduce the volatility of returns within a portfolio due to the low correlation of commodities with stocks and bonds. As a result, diversifying the portfolio with uncorrelated asset classes leads to a more efficient portfolio (i.e. higher return and/or lower volatility).

## Strategic

A strategic asset allocation is one that is consistent with each client's unique risk tolerance. Although an institution's embedded liabilities define its risk tolerance, risk tolerance is further defined by an institution's acceptance of equity-like volatility in order to generate higher returns and demand for fixed income-like volatility in order to reduce the volatility of the portfolio in aggregate. In addition, virtually every asset class can be classified as having equity-like volatility or fixed income-like volatility. For example, although high-yield bonds are fixed-income instruments, they have volatility and return characteristics that are more equity-like. As a result, a well-thought-out strategic asset allocation recommendation seeks to balance equity-like volatility with fixed-income-like volatility in order to match the unique risk tolerance of each client.

## Purposeful

The final part of the ESP methodology is to assign a specific purpose to each asset class that is included in the portfolio. Too often, investors implement asset allocation policies based purely on a quantitative model that seeks to maximize return or minimize risk. For example, an institution may make an allocation to commodities simply to reduce volatility due to the low correlation between commodities and other asset classes. While this is an important reason to own commodities, hedging against inflation is another strong argument to own commodities within a well diversified portfolio. Therefore, commodities serve a specific purpose, in addition to providing diversification benefits, within the Lancaster Pollard Investment Advisory Group ESP framework.

## Availability

Prior to the 1990s, it was difficult for smaller institutional investors to construct well diversified portfolios that included a number of different asset classes

due to the dearth of available vehicles. Typically, if an institution wanted to invest in commodities or emerging market stocks, it had to open a separate account with a specialized investment management firm. The minimum investment required to open a separate account was often as high as several million dollars, which restricted these asset classes to only the largest institutions in the world. Within the last 10-15 years, however, the number of investment vehicles with lower minimums has increased significantly. Specifically, institutions today can invest in virtually every asset class through institutional mutual funds with lower minimums or exchange-traded funds (ETFs), which offer no minimums and low fees. As a result of these new vehicles, Lancaster Pollard Investment Advisory Group's ESP framework includes a number of asset classes previously unavailable to smaller institutions.

## Liquidity

Over the past decade, many institutional investors underestimated their liquidity needs and increased their allocation to illiquid investments, such as hedge funds and private equity funds. The importance of liquidity was again brought to the forefront as the market declined significantly during the past 18 months, when a number of hedge funds limited or prevented investor withdrawals, while private equity funds continued to make capital calls in the face of lower or even no distributions from previous funds. Due to the importance of liquidity to institutional investors, the ESP model utilizes only asset classes where there are liquid, publicly traded vehicles available.

## Conclusion

Given their embedded liabilities, institutional investors should utilize asset allocation to reduce the volatility of returns within their investment portfolios. The ESP asset allocation model, developed in response to the need to account for these liabilities, provides a disciplined framework that institutions can utilize to help reduce the volatility of returns.