OPPORTUNISTIC INVESTING IN THE STRATEGIC ASSET ALLOCATION FRAMEWORK[1]

Erik Knutzen, CFA
Chief Investment Officer

Introduction

In the spring of 2008, NEPC sent a letter to all of our clients entitled, "When Opportunity Knocks". We recommended that clients create a new Opportunistic category in their Strategic Asset Allocation policies to take advantage of the remarkable dislocation in the global credit markets as well as other opportunities that may present themselves in the future. We recommended that clients allocate 5-10% of their assets to credit strategies, funded with a reduction in equity exposure. This is an example of NEPC's approach to opportunistic investing, where we seek to identify occasional major market valuation extremes and recommend actions for clients over a medium -term horizon.

Opportunistic Investing – A General Framework

At NEPC, we seek to add value through active investment decision-making at multiple steps in the investment process. To do so, we group investment decisions into three categories – strategic, opportunistic, and tactical. Strategic allocations are long-term and reflect forecasts of asset class returns, risks, and correlations over a five-to-seven year time horizon. These allocations shift gradually through time reflecting changes in asset class assumptions and in an investment program's risk and return parameters. We expect strategic asset allocation to drive the majority of an investment program's risk and return.

For most long-term portfolios we believe that some form of opportunistic investing is appropriate, although we recognize that taking advantage of near-term opportunities can be outside the traditional asset allocation process. We also understand that outsized opportunities do not always exist in global markets. Therefore we recommend that funds establish an Opportunistic category with a maximum allocation of 10% and a target allocation of 0%. We recommend that allocations in this category be made with a time horizon of one-to-three years. They should be made to asset classes that are large enough and at sufficient extremes in valuation that price movements can have a meaningful impact on a fund's risk and return profile. Also, the opportunity must be actionable in terms of investment vehicles and strategies, and within an investor's normal decision-making process.

WE RECOMMEND MOST FUNDS ESTABLISH AN OPPORTUNISTIC ASSET ALLOCATION CATEGORY WITH A MAXIMUM ALLOCATION OF 10% AND A TARGET OF 0%.

Lastly, tactical opportunities are those that are of a short-term nature (less than one year time horizon) and/or in relatively small segments of the global capital markets. Tactical opportunities should be pursued by active managers within an overall investment program.

Credit Opportunities

In the case of the recent dislocation in the bond market, we recommended that clients build exposure to the credit markets beginning in the sum-

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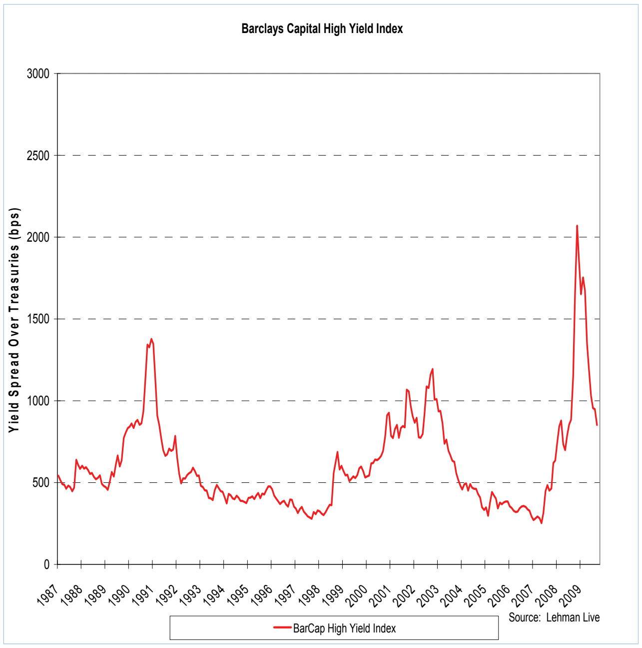
mer of 2008. This unique opportunity was created by the global credit upheaval catalyzed initially by the sub-prime mortgage meltdown and then cascading across financial markets. As an example, Exhibit I shows U.S. high yield bond spreads, which by the fall of 2008, had widened to more than twice the previous record levels. In framing this opportunity, we indicated to clients: 1) the horizon for the investment should be two-to-three years; 2) it would be hard to follow "standard" due diligence procedures to evaluate the new products coming to market; 3) it would be difficult to make "apples-to-apples" comparisons of these products so diversification by strategy was important; and, 4) the opportunity may improve after the initial investment e.g. prices may continue to fall before they rise.

Exhibit I



We identified, evaluated, and vetted an array of credit products across the liquidity and expected return spectrum from bank loan, convertible, high yield, and opportunistic liquid credit strategies to credit-oriented hedge funds and longer lock-up distressed vehicles. In Exhibit II we show the returns in 2008 and the first ten months of 2009 of three credit benchmarks representative of the liquid strategies pursued by clients as well as common equity benchmarks. The table demonstrates that an allocation to credit strategies added value relative to equities with less volatility throughout the period.

Exhibit II

Index	***2008***	***YTD 2009 (through 10/31/09)***	***7/1/08-10/31/09 (cumulative)***
Barclays Inv. Grade Bond	-3.1%	15.5%	12.5%
Barclays High Yield	-26.2%	51.7%	13.5%
S&P LSTA Lev Loan	-30.5%	46.8%	5.2%
S&P 500	-37.0%	17.0%	-16.3%
MSCI EAFE	-43.4%	27.4%	-19.0%

Source: State Street Analytics

The recovery in credit markets in 2009 has been remarkable; indeed the rebound has happened faster than we expected. In the fourth quarter of 2009 we began recommending that clients begin reducing their liquid-market opportunistic credit exposures. The credit opportunity appears to be evolving toward a longer-term distressed cycle. Investors can take advantage of this through less-liquid strategies such as distressed, mezzanine, and secondaries.

In the increasingly complex investing environment, NEPC works with clients to add value. We believe opportunistic investing can be an important component of this process.