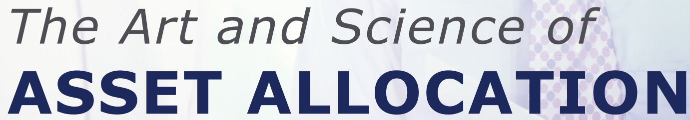
NEPC
PRIVATE WEALTH



The Art and Science of
ASSET ALLOCATION

The selection and weighting of assets within a portfolio has a greater influence on the outcome of returns than any other investment decision that is made – and yet, the asset allocation decision is one of the most difficult for families to get right. Asset allocation is both an art and a science, often based upon historical data that may not repeat or models that may be fraught with shortcomings. Recognizing both the importance of and the potential issues with the asset allocation process allows families and their advisors to effectively structure portfolios that will enable them to meet their goals and objectives.

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THE ART OF LISTENING

There is no single "right" answer to the asset allocation question. Each client has a unique set of goals and objectives, an individual set of circumstances and a personality of their own. Multiple portfolios within an investment structure often introduce an added level of complexity. This is why we spend a great deal of time at the beginning of each relationship getting to know our clients, so we can ensure that we are constructing portfolios that are right for them.

A ROBUST PROCESS AND A MULTI-FACETED APPROACH

At NEPC, we distinguish ourselves through our vigorous asset allocation process, utilizing multiple analytical tools while recognizing the limitations of any particular model. We utilize a goals-based approach for our private wealth clients which takes into account a family's goals, risk tolerances and unique circumstances. This approach is particularly beneficial for families who may have multiple portfolios with varying time horizons, liquidity needs and tax or spending rates.

Although we often start with a goals-based approach, we believe it is critical to look beyond this tool to consider multiple facets of risk when helping families establish the appropriate asset allocation. To this end, while incorporating the use of mean variance optimization as a base, we have pioneered the use of risk budgeting, scenario projections, liquidity analysis, factor analysis and portfolio structuring tools to further enhance our analysis. A brief description of each of these approaches follows:

- MEAN-VARIANCE OPTIMIZATION
- SCENARIO PROJECTIONS
- LIQUIDITY ANALYSIS
- RISK BUDGETING
- FACTOR ANALYSIS
- PORTFOLIO STRUCTURING

Mean-variance optimization accommodates a range of investment requirements, such as maximum or minimum commitments to an asset class, return or volatility targets and permissible asset classes for investment. Nevertheless, mean-variance analysis has shortcomings. For instance, it assumes normal return distributions and static inputs, simplifications that, if ignored, can expose a portfolio to concentrated risks and significant draw-downs.

Scenario projections assess how a portfolio might perform in various economic environments, such as recession or stagflation. This approach provides a valuable alternative perspective to mean-variance analysis, as it is able to accommodate environments of extreme market outcomes and shifting asset-class correlations. When integrated with spending commitments, scenario analysis can assess risk factors across both sides of the balance sheet.

Liquidity analysis gauges the balance between the program's liquidity needs and its liquidity sources. We stress-test potential portfolios by simulating situations of heightened need for liquidity combined with constricted access to liquidity sources. Even before the financial crisis, our liquidity model helped clients "right-size" commitments to private markets investments and recognize risk factors.

Risk budgeting examines potential portfolios in terms of contribution to risk rather than a simplistic allocation of capital. True diversification is achieved by balancing risk exposures more evenly across asset classes and market factors. Our risk budgeting model assisted clients in moving away from equity-centric portfolios well before the global financial crisis of 2008.

Factor analysis utilizes a similar foundation to our risk budgeting analysis but recognizes the key economic factors that drive asset class performance. As an example, US Equities and High Yield are distinct asset classes; however, both asset classes are largely driven by the results of economic growth. Factor analysis recognizes the impact that six key factors have on overall portfolio performance and assigns risk along those factors. The six factors are economic growth, inflation, duration, alpha, illiquidity and foreign currency.

Portfolio structuring looks at decisions within asset classes, such as active/passive, value/growth or domestic/international. It extends our risk budgeting framework to actual or potential manager strategies, providing an integrated view of where active risk is being taken throughout the portfolio. Portfolio structuring provides the critical link between top-down asset allocation and bottom-up manager selection.

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LESS IS MORE

Asset allocation can be intimidating. The amount of information and data that is taken into consideration during the decision-making process can be overwhelming. By distilling the information down to the core concepts, we make it easier for families to evaluate various portfolio scenarios and understand the ramifications of choosing one portfolio over another. Once a decision is made, the process doesn't end but instead evolves over time as the allocation is continually challenged and either reaffirmed or revised based on a family's circumstances or external market factors.

PRACTICE MAKES PERFECT

Asset allocation is an imperfect science, but when approached with a solid understanding of the potential shortcomings and a robust set of tools to quantify and analyze data, it can provide key insights into a range of portfolio outcomes. When this analysis is combined with the knowledge that comes from years of experience working with taxable portfolios, it can yield tangible benefits. Every portfolio we construct for a private wealth client blends our proprietary tools with our qualitative judgement and is customized to the family's unique circumstances, thus ensuring the right mix of assets to help our clients achieve their long-term goals.

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 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.

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