Construction Zone:
ASSET ALLOCATION FOR THE NEXT DECADE
Recently, whether they know it or not, decision makers at diverse allocators across the industry are making a synchronized reach for their chisels and aiming them at the most foundational processes of their work: their asset allocation models.

We surveyed over 50 industry-leading allocators on how they think about the most foundational question of their day jobs: What is the most strategic way to allocate our assets today and build a portfolio for the market’s next chapter?

Their answers converge on at least one point: Re-construction.

We looked under the hood of more than 50 different organizations with vastly different investing objectives and styles, and despite their differences, our conversations revealed an industry-wide appetite for re-thinking stale or simply outdated processes and optimizing them for the future. Though strategic portfolio construction is often as individualized an endeavor as reading a 23andMe report—with endless levers of alignment to consider—many investment teams are echoing each other on a point of revision, re-jiggering, and re-design. This has significant implications for asset managers, counterparties, and advisors as they plan for the future.

Why is this happening now? For one, allocators find themselves armed with a trove of new data and analytic capabilities at their fingertips—allowing them to diligence, evaluate, benchmark, and track investments in more sophisticated, efficient, and granular ways than ever before. From manager-specific transparency to proprietary, portfolio-level risk monitors, this data and the ability to analyze and leverage it in-house have revolutionized portfolio construction in profound and lasting ways.

Meanwhile, this re-constructive spirit is only further encouraged by the current market cycle. After a decade-long equity-driven bull market, investors are trying to understand what will drive the next decade of returns.

At this turning point, as allocators across the industry are re-constructing the very process of portfolio construction, we are publishing Construction Zone: Asset Allocation for the Next Decade. We surveyed over 50 allocators to understand how they are thinking about the future of asset allocation—from granular analytics to portfolio construction at the most fundamental level.

Given that asset allocation and strategic portfolio construction encompasses a daunting universe of topics, we zeroed in on one corner of it that seems to be top of mind for institutional allocators: alternatives funds. As one put it: Where do these hedge funds fit in a portfolio? “Everywhere.” Beyond this, we dig into allocators’ divergent thoughts on global investing and benchmarking.

Driven by analytical advances, market movements, and sheer intellectual innovation, the project of portfolio planning and strategic asset allocation is entering a construction zone—with lasting implications for the future of investing and the ecosystem of allocators, service, providers, and funds that make up our industry. Here, we delineate what strategic asset allocation looks like to investors right now, and what it might look like for portfolios in the years ahead. We hope this paper inspires discussion around how to revamp familiar processes around asset allocation with fresh parameters.

Contacts

Lily Calcagnini
LCalcagnini@Jefferies.com
+1 (212) 323.7596
Prime Services Strategic Content

Shannon Murphy
Shannon.Murphy@Jefferies.com
+1 (212) 336.1139
Prime Services Strategic Content

Leor Shapiro
LShapiro@jefferies.com
+1 (212) 336.6267
Global Head, Jefferies Capital Intelligence
**Understanding Infrastructure: Asset Allocation from the Top Down**

Fundamentally, the objectives for asset allocation vary widely: from capital preservation, capital growth, diversification, meeting annual spend requirements, matching assets with liabilities, or some combination of these objectives.

Let’s start with the basics, the metaphorical infrastructure of a strategically constructed portfolio of assets: the sub-categories or investment buckets to which assets are allocated. More than 50 conversations with allocators have dissolved the myth that there is a “traditional” asset allocation model, whether the “60/40 approach” or otherwise. It’s possible this was always an oversimplification. It certainly obscures the sophistication of the industry today and going forward.

Portfolio infrastructure is not static. And with new products and market dynamics, it would be hard to be. As a result, some of the most thoughtful and sophisticated allocators revisit their most basic assumptions frequently. Allocators largely fall into two schools—those who bucket by asset class and those who bucket by risk/return profile.

---

**Participators + Experts Consulted**

- Public Pensions
- Private Pensions
- Endowments
- foundations
- Hospital Systems
- RIAs
- Funds of Hedge Funds
- Single-/Multi-Family Offices
- Consultants

---

**Buckets by Risk-Return Profiles**

A small but growing subset of allocators report having spent the last year questioning the model of bucketing allocations by asset class.

Increasingly, this group is replacing the asset class framework with a risk profile framework. This approach can be broadly conceptualized as being composed of two buckets: one aimed at *Capital Growth*, the other *Capital Protection*.

Their M.O. — “asset class bucketing isn’t a thing” for us anymore.

Nearly 15% of surveyed allocators bucket their investments based on risk/return profile and exposure to market volatility.

They believe the benefits of this approach are many. As one allocator explains, it allows them to be “more simplistic and purpose driven.”

Another believes that asset class bucketing “gives a false sense of safety and diversification.”

Keep in mind, two funds investing in the same underlying securities can have vastly different risk profiles and volatility parameters.

Taking a step back, two allocators invested in the same fund may too be driven by different motivations. Today, there are countless variables behind every allocation decision.

---

**Buckets by Asset Class**

Just over three quarters of allocators use an asset class driven framework for portfolio construction.

Allocators in this group largely believe in diversifying by the underlying products rather than fee, vehicle, or volatility structures, and they manage and group their investments accordingly.

Some allocators report taking this approach, to simplify their portfolios and maximize agility while tactically allocating across cycles.

We spoke to allocators in this group who have or are unbundling their “Hedge Fund” buckets and reclassifying managers into broader Equity or Fixed Income buckets.

“Equity is equity. It makes no sense to bucket investments by structure.”

---

**Diving Deeper: Who is the 13%?**

Allocators in the small but growing mindset that “asset class bucketing isn’t a thing” represented a diversity of profiles. AUM spanned $1 billion to tens of billions, and included university endowments as well as hospitals.
Let’s turn to hedge funds – one of the most interesting but often misunderstood “corners” of asset allocation. Allocators we surveyed often chorused positive sentiments on hedge funds. Despite witnessing redemptions, headline closures, and muted performance during the volatile market environment at the end of 2018—which served as the backdrop for a substantial portion of our research for this paper—most investors hold steady in their commitment to invest in alternatives funds. In some cases, they expressed an active commitment to double down on their allocations to the space going forward. In fact, the volatility may have served as the ideal setting in which to identify those managers who hedge effectively and can be counted on to protect on the downside.

This continued faith in active management counters recent headlines that oversimplify an environment tinged by healthy skepticism, especially on the back end of a decade-long bull market led by growth in equities. Why are investors focused here? As we noted in a recent whitepaper “The State of Our Union 2019: The Future is Already Here,” the alternatives space is increasingly defined by product specialization. Allocators are more confident than ever before that they can find exactly what they need—either the product already exists, or managers will tweak a product they are already running to meet allocators’ precise levers of alignment.

While making a point to allocate to hedge funds, allocators are also creating space for them in their portfolios. Perhaps in the spirit of streamlining bucket labels allocators mentioned no less than 13 different buckets that can accommodate a hedge fund in their portfolio, some of which are delineated in the chart below.
DIGGING DEEPER: WHAT COUNTS AS A “HEDGE FUND” AND WHAT IS ITS PURPOSE?

Given the overwhelmingly positive sentiment we heard about alternatives, we wanted to dig deeper into what allocators are talking about when they discuss hedge fund strategies. Could it be that when one described “50-55% of the whole portfolio in hedge funds” and another insisted that he received “no pushback recently on any products that are hedged or less liquid,” they were truly talking about the same investments?

In short, yes.

When allocators discuss alternatives, they define hedge funds broadly—as anything that can generate excess return while retaining a certain liquidity profile that falls somewhere between private investments and cash. To take this a step further, allocators define hedge funds more by their liquidity and the time frame for expected returns than purely by their hedging activity.

This has profound implications for managers of alternatives funds now and in the future—not only as they structure share classes, fee structures, liquidity parameters, and carve-outs, but also as they consider where they may fit into allocators’ portfolios and build out their marketing strategies accordingly.
Benchmarking Performance

The role of benchmarking in portfolio construction is intertwined with the concepts of performance, target returns, and payouts. Put simply, “benchmarking” is the process by which an investment team compares their portfolio’s returns to those of a chosen instrument with similar characteristics. The goal is to match or beat the returns of the chosen benchmark, and thus it may aid in setting expectations for target returns, or the portfolio’s expected performance.

This also appears in headlines citing “out” or “under” performance of one asset class vis-à-vis another. But two-thirds of respondents don’t benchmark their portfolios, and those who do tend to take a tactical, thoughtful, and customized approach. Most allocators will do so on multiple levels, using one benchmark for the overall portfolio and subsequent benchmarks for each individual asset class.

Some allocators we spoke to create custom benchmark to match their allocation policy, while others use pre-existing portfolio-level benchmarks such as the MSCI ACWI, S&P 500, or Barclays Aggregate for the total portfolio.

Further, many allocators will determine, identify, or create a benchmark for each bucket, asset class, or manager that they are diligencing to properly assess performance. These are often either a blend of pre-existing indices or a peer group. Many groups who benchmark pride themselves on the proprietary nature of their analytics.

Of those who benchmark, roughly a third choose to take a simplified approach and benchmark to a single index. Another third use a blend of indices. The remaining third take the highly sophisticated and work-intensive approach of creating their own proprietary benchmark.

It is also worth mentioning that benchmarking can also play a role in compensation, which is to say that analysts’ investment decisions and the performance associated with them is said to determine their pay on a yearly basis. Analysts may be paid based on trailing performance anywhere from 1 to 3 years. In an industry where career trajectories are jagged and pivots are common, this begs the question: how many analysts actually have the opportunity to enjoy the fruits of their labor?
THE SHIFTING RELATIONSHIP WITH CONSULTANTS

We noted a vast diversity in the nature of relationships with consultants—which is also to say that we have uncovered a considerable shift in our industry in terms of what is standard best practices in terms of how, when, and to what extent allocators use consultants in their daily workflows.²

More than half of allocators we spoke to have no relationship with a consultant at all.

For those who do use a consultant, their relationships fall into four groups:

- Allocations who use consultants for full advisory and ODD services. This includes full review of the portfolio, looking at everything from exposures to attribution analyses to performance. These contracts will also include a number of bespoke projects per year.
- Allocations who use consultants for data and ODD, but no advisory services. These contracts do not include full advisory analyses, but do offer the ability to perform high-level comparative studies.
- Allocations who use consultants for asset allocation guidance. In these relationships, allocators do not depend on consultants for ODD or IDD services.
- Allocations who use consultants only for access to their data. The majority of allocators we spoke to only pay consultants for their database of hedge fund performance and color. They do not rely on consultants for any idea generation.

Driven by Dynamism: Sophisticated allocators think about their relationship with their consultants as a growing, shifting, and ever-changing interaction. As such, they allow it to change and shift from year to year: “There are years we pay [our consultant] more and years we pay less.”
Built to Last through...Which Storms?

We asked allocators what issues are top of mind as they construct their portfolios and look to allocate assets as strategically as possible to position themselves for success over the next 24 to 36 months. Their answers tended to coalesce around a few.

For the majority of asset allocators, unease rests on one factor: Fear of Missing Out, or FOMO. That’s right. Even ten years into an equity bull market, we found that decision makers are most afraid of under-allocating in a variety of ways—be it to downside protection (via hedged products), growth in certain regions of the world (via pure equity), disruptive and groundbreaking ideas (via private investments). Some simply fear being under-allocated to the market overall.

**Chart 2**

What’s Keeping Some Asset Allocators Awake at Night?

- **Being underinvested.**
- **Being underweight private investments.**
- **Being underweight equity.**
- **Being underweight hedge funds.**
- **Due diligence.**
- **Searching for short-term yield.**

“Volatility isn’t a risk.” Despite market volatility in 4Q2018, allocators are focused on **putting money to work effectively**—whether in equities, hedged products, or even less liquid instruments like private equity.

Allocators largely view cash as simply a drag on performance.

By and large, investors still have faith in equity as an asset class.

One allocator told us, “our equity orientation helped in 2017.”

Increasingly, investors desire equity portfolios with global footprints. The next section will delineate where they are extending their purviews.

In this age of data ubiquity, allocators are giving new thought to governance issues, especially as they diligence new launches.

With more transparency comes higher standards for accountability.

Finally, most allocators expressed a desire “stop playing defense” as volatility settles.

While investing in illiquid vehicles holds promise for high returns, allocators fear this trade is crowded and are on the lookout for ideas with short-term yield too.
GOING GLOBAL: ASSET ALLOCATION IN TERMS OF REGIONAL EXPOSURE

As far as global allocation goes, one thing is clear: in 2019, allocators are turning their focus out of the United States and searching for returns elsewhere in the world.

While some allocators are motivated to expand their global exposure to fill country-specific sub-buckets within the portfolio, we more frequently heard allocators explain that regional footprint expanded more organically—as the byproduct of a bottoms-up approach to finding managers.

We spoke to a number of allocators adding exposure to emerging markets at the expense of the United States.

The United States
While allocators plan to continue investing in the US to take advantage of the opportunity set, most seem poised to decrease exposure over time in favor of new markets. In particular, European investors seem wary of the US given the uncertainty around US rates, high valuations, and a lack of trust in the American political system, which they perceive to be the cause of market volatility.

China and Greater Asia
 Allocators like exposure to Asia to complement their US exposure because many see this market as less efficient. For one allocator, it’s as simple as this: “Prices in the U.S. are pretty rich. Ex-US is pretty cheap.”
Many choose to have broad regional exposure to Asia, especially to capture growth in the China healthcare and tech spaces. When they choose country-specific exposure, they look to China, followed by Japan and India.

Europe
Allocators view Europe as fertile ground for opportunities in private equity—an asset class that is at the forefront of allocators’ minds going into 2019. As well, they are exploring opportunities in private debt and real estate.
In some cases, the directive to focus on allocating more to Europe came directly from members of the investment committee.

Israel
Allocators also mentioned Israel as a region of interest, particularly as they build out their private portfolios in the healthcare, technology, and cybersecurity spaces.
Given the momentum we have seen in the Israeli economy in recent years and predict to accelerate over the next decade, this does not come as a surprise.
**SPEED ROUND: POPULARITY OF VARIOUS INSTRUMENTS IN PORTFOLIO CONSTRUCTION PROCESS**

We’ll close our white paper how we closed our conversations with allocators: with a speed round. We asked allocators whether or not they invested in, looked at, or had interest in a variety of opportunities and strategies that we think will be top-of-mind for decision makers in the years to come:

### Popularity of Various Instruments/Investment Opportunities

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Popularity</th>
</tr>
</thead>
<tbody>
<tr>
<td>High-Level/Broad Hedging*</td>
<td>10%</td>
</tr>
<tr>
<td>Passive Instruments</td>
<td>17%</td>
</tr>
<tr>
<td>SPACs</td>
<td>7%</td>
</tr>
<tr>
<td>Risk Parity</td>
<td>7%</td>
</tr>
<tr>
<td>Art, Wine, Royalties, or other Niche Assets</td>
<td>4%</td>
</tr>
<tr>
<td>Derivatives</td>
<td>20%</td>
</tr>
</tbody>
</table>

*Due to the variable nature of how allocators define “broad- or high-level hedging,” we consider this an estimate. While some allocators do implement a purposeful, portfolio-level hedging strategy and others pointedly do not, many more fall somewhere in between these poles on the spectrum.

**HOW JEFFERIES CAN HELP**

The Jefferies Capital Intelligence team can help managers better understand the competitive landscape and identify emerging themes and trends that could impact their ability to raise, retain and grow their capital base. Our team excels in identifying, analyzing, and recounting industry-wide trends and narratives backed by in-depth and proprietary research. Via ongoing conversations with LPs, we also manage a robust database of outstanding mandates and keep a finger on the pulse of ongoing areas of interest amongst our allocator relationships.

In this time of industry shifts, as the menu of alternative funds is exploding to encompass a broader range of “flavors” and options than ever before, understanding where a manager sits can save time and inform conversations with potential and longstanding LPs. Taking the time to understand how portfolios are constructed and assets allocated—especially given the complex nature of the space—can facilitate more effective targeting and engagement of potential investors.

We welcome your questions and look forward to engaging with you.
IMPORTANT DISCLAIMER

THIS MESSAGE CONTAINS INSUFFICIENT INFORMATION TO MAKE AN INVESTMENT DECISION.

Please contact your Jefferies representative for copies of the most recent research reports on individual companies.

This is not a product of Jefferies’ Research Department, and it should not be regarded as research or a research report. This material is a product of Jefferies Equity Sales and Trading department, and intended for Institutional Use. Unless otherwise specifically stated, any views or opinions expressed herein are solely those of the individual author and may differ from the views and opinions expressed by the Firm’s Research Department or other departments or divisions of the Firm and its affiliates. Clients should assume that this material is not independent of the Firm’s proprietary interests or the author’s interests. For example: (i) Jefferies may trade for its own account or make markets in the securities referenced in this communication (and such trading may be entered into in advance of this communication); (ii) Jefferies may engage in securities transactions that are contrary to or inconsistent with this communication and may have long or short positions in such securities; and (iii) the author of this communication may have a financial interest in the referenced securities.

The information and any opinions contained herein are as of the date of this material and the Firm does not undertake any obligation to update them. All market prices, data and other information are not warranted as to the completeness or accuracy and are subject to change without notice. Past performance is not indicative of future results, and no representation or warranty, express or implied, is made regarding future performance. The Firm is not providing investment advice through this material. This material does not take into account individual client circumstances, objectives, or needs and is not intended as a recommendation to particular clients. Securities, financial instruments, products or strategies mentioned in this material may not be suitable for all investors. Jefferies does not provide tax advice. As such, any information contained in Equity Sales and Trading department communications relating to tax matters were neither written nor intended by Jefferies to be used for tax reporting purposes. Recipients should seek tax advice based on their particular circumstances from an independent tax advisor. In reaching a determination as to the appropriateness of any proposed transaction or strategy, clients should undertake a thorough independent review of the legal, regulatory, credit, accounting and economic consequences of such transaction in relation to their particular circumstances and make their own independent decisions.

OPTIONS ARE NOT SUITABLE FOR ALL INVESTORS. Please ensure that you have read and understand the current options risk disclosure document before entering into any option transaction. The options disclosure document can be accessed at the following web address: http://optionsclearing.com/publications/risks/riskchap1.jsp. Please contact Peter Seccia, Head of New York Derivative Sales for additional information (212-284-2454).

© 2019 Jefferies LLC

2 Jefferies published a whitepaper on the shifting relationship between consultants and alternatives funds, if you are interested in reading more on this subject: “Emerging Trends in the Hedge Fund Intermediary Landscape,” Jefferies Prime Services, June 2017