Overview

Decision makers at diverse allocators across the industry seem to be making a synchronized reach for their chisels and aiming them at the most foundational processes of their work: their asset allocation models.

In 2H2018-1H2019, the Jefferies Capital Intelligence Team surveyed over 50 allocators to understand how they approach the most foundational question of their day job: *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.*

*Construction Zone: Asset Allocation for the Next Decade* explores how a broad and sophisticated group of allocators are rethinking long-held assumptions about portfolio construction and why this a turning point, reflecting a paradigm shift that goes beyond the basic dynamism of portfolios.

We dig into:

- Why this is happening **now** – in short, it’s *driven by data, demand, and differentiation in the alternatives product space*
- What makes **this industry change different from any other before it**
- What this **means for the future of our industry.** That there was ever a “traditional” asset allocation model is...questionable. Certainly, today’s data explosion means asset owners can more precisely define and obtain their objectives. This has profound implications for the portfolios of the future and the funds within them.

**Participants**

- We explored the holdings, attitudes and outlook across Single- and Multi- Family Offices, Funds of Hedge Funds, Endowments/Foundations, Wealth Advisors/RIAs, Consultants, Hospital Systems, Asset Managers & Pensions
- Allocators spanned the U.S. (Tri-State, Mid-Atlantic, Midwest, West Coast, Texas and Boston), and **Europe** (London, Switzerland)
- Sources included in-depth interviews with senior decision makers, publicly available data (board minutes, etc.) and Jefferies Capital Intelligence proprietary data
- In all cases, the goal of each conversation was to understand how investors are re-constructing the very process of portfolio construction and what this means for portfolios in the years ahead, as they look to make allocations to hedge funds in the next 24-36 months.
- Jefferies Capital Intelligence team is focused on actionable intelligence to more effectively understand what moves the needle when it comes to making allocations
- All information has been aggregated and anonymized
Construction Zone | 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.

So let’s start with the basics, the portfolio infrastructure: investment buckets. 50+ conversations with allocators dissolved the myth that there is a “traditional” asset allocation model, whether the “60/40 approach” or another. It’s possible this was an oversimplification. It certainly obscures the sophistication of the industry today.

Portfolio infrastructure is not static. Some of the most thoughtful and sophisticated allocators revisit their most basic assumptions frequently. Allocators largely fall into two schools of thought on the matter:

**Buckets by Risk-Return Profiles**
- A small, growing subset of allocators report having spent the past year questioning the model of bucketing allocations by asset class. Increasingly they are 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: “It allows [us] to be “more simplistic and purpose driven.”

Another allocator 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 myriad dimensions 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 or vehicle structures, and they manage and group their investments accordingly.
- Amongst allocators who take this approach, **the trend of the day is to simplify**. Lately, minimizing the number of buckets in the portfolio is key.
- 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.”

**Participants + Experts Consulted**
- Public Pensions
- Private Pensions
- Endowments
- Foundations
- Hospital Systems
- RIAs
- Funds of Hedge Funds
- Single-/Multi-Family Offices
- Consultants
Despite witnessing redemptions and muted performance during the volatile environment at the end of 2018—which served as the backdrop for a substantial portion of research for this project—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. Perhaps, the volatility was the ideal setting in which to identify managers who hedge effectively and can be counted on to protect on the downside.

Allocators express continued faith in active management, countering recent headlines that oversimplified healthy skepticism following volatility in 2018.

These days, “we are very heavy alternatives and hedge funds.”

“We are committed to hedge funds.”

Where do hedge funds fit in a portfolio?

“Everywhere.”

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.

Why do investors continue to focus on alternatives funds? As we noted in The State of Our Union 2019 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.
Construction Zone: Digging Deeper: What Counts as a “Hedge Fund” and What is its Purpose?

Given the overwhelming 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.

Allocators define hedge funds broadly -- anything that generates excess return while retaining liquidity that falls somewhere between a private investment and cash.

Allocators seem to define hedge funds more by their liquidity and time frame for expected returns than by their hedging activity:

Variables that matter to allocators when defining “hedge funds”

How allocators define hedge funds has profound implications for managers 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.

If you do have a bucket devoted to hedge funds, what are some of your sub-buckets?

• Equity Long/Short
  Generalists
  Sector specialists (most common: HC, Tech, Energy)
  Regions
• Macro
  Systematic
  Discretionary
• Credit
• Absolute Return
• Credit Long/Short
• Event-Driven
• Multi-Strategy
• Relative Value
• Fixed Income Arbitrage
• Distressed Credit

What is the purpose of hedge funds in your portfolio?

• "Steady returns and ballast"
• Uncorrelated returns
• Diversification of return stream
• Mitigate market risk
• Provide liquidity
• Capital protection
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.

Motivation for Benchmarking

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

Approach to Benchmarking

Of those who do benchmark, the approach is tactical, thoughtful, and customized:

- Most benchmark on multiple levels, using one benchmark for the overall portfolio and subsequent benchmarks for each individual asset class.
- 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 play a role in compensation. Analysts’ investment decisions and the performance associated with them can determine their yearly pay based on performance trailing anywhere from 1 to 3 years. In an industry where career trajectories are jagged and pivots common, how many analysts actually enjoy the fruits of their labor?
Construction Zone: 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.

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

- Allocators 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.

- Allocators 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.

- Allocators who use consultants for asset allocation guidance. In these relationships, allocators do not depend on consultants for ODD or IDD services.

- Allocators 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 like 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.”
Construction Zone: 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, **fear feeds 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), or the market overall.

What’s Keeping Some Asset Allocators Awake at Night?

"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.

One theme we heard often in conversations with allocators was that **private investments drove performance in 2017-18**. Thus, it is a focus going forward.

The trailing 5-year performance for PE is over 13%, as compared to 11% for public equity.

In addition to PE and VC, allocators surveyed report that performance in 2017-18 was largely driven by hedge funds.

"In October, when equities got hammered, our hedge funds were still down only 14-15 bps."

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.

Searching for short-term yield.
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.  

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JAFFERIES | TECH-TONIC SHIFTS
We'll close our deck 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:

**Speed Round: Popularity of Various Instruments in Portfolio Construction Process**

- **High-Level/Broad Hedging**: 10%
- **Passive Instruments**: 17%
- **SPACs**: 7%
- **Risk Parity**: 7%
- **Art, Wine, Royalties, or other Niche Assets**: 4%
- **Derivatives**: 20%

*Due to the variable nature of how allocators define “high-level/broad hedging,” we consider this an estimate. While some implement a formal, portfolio-level hedging strategy others take similar but different approaches worth including in this count.

**HOW JEFFERIES CAN HELP**

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- **Ongoing strategic market intel**: We provide clients with the tools and information they need to make strategic insourcing/outsourcing decisions, assistance on developing organizational culture and building teams.
- **Tactical content**: We have knowledge of the Technology sector by virtue of the Jefferies franchise across Investment Banking, Equity Capital Markets, and Trading.
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