RVKuhns
& ASSOCIATES, INC.

# MEMORANDUM

**To:** Wyoming State Treasurer's Office
**From:** R.V. Kuhns & Associates, Inc.
**Re:** Wyoming Asset Allocation – Executive Summary
**Date:** April 9, 2009

**Introduction**

Over the course of the past several months we have been asked to re-examine the risk profile, portfolio structure, external manager quality, and level of external manager fees as they relate to the State's investment portfolios. What follows is a summary of our recommendations to the Wyoming State Treasurer's Office regarding asset allocation, portfolio structure, investment manager retention and searches, and a variety of other important topics. We are extremely excited to share these recommendations with you and our supporting rationale at our March 16th meeting in Denver, Colorado.

**Executive Summary**

Below is an outline of specific recommendations, which are explained in more detail in the body of this document.

- Asset Allocation (Long-Term Targets)
    - Permanent Funds
        - Modest decreases to equity categories (most significantly to small/mid cap US)
        - Increases to value-added real estate and absolute return
        - Modest increase to fixed income
    - Workers Compensation
        - Decreases to small/mid cap US equity
        - Increases to absolute return
- Equity Portfolio Structure
    - Recommend 25% of large cap US to be transitioned to an enhanced index management style
- Manager Review
    - Recommend search to replace Fisher
- Recommended Searches
    - Value-added real estate
    - International equity
    - Enhanced US large cap equity
- Asset Allocation Implementation
    - Additional allocations to absolute return and fixed income can begin immediately

- Begin search process for value-added real estate, reserving funds in the internally managed bond portfolio for these opportunities
    - Continue rebalancing by allocating additional funds to underweight equity categories over a longer period of time (6 – 12 months)
        - Do not exceed maximum total equity targets (inclusive of small/mid cap)
        - Monitor unrecognized gain/loss position on small/mid cap portfolios and opportunistically shift to other equity categories and/or allow natural portfolio growth to shrink relative size of positions
    - Utilize new Harris fund for additional investments in ARS and this manager
- Overlay Strategy
    - Recommend increasing notional exposure to market value of large cap US equity portfolio with an annual reset process going forward

***Asset Allocation***

The attached presentation covers a wide range of topics, all of them critically important but to varying degrees. The most important topic is the long-term asset allocation structure. We remain convinced that long-term asset allocation remains the central and most important decision in managing a high quality, institutional investment portfolio.

*Permanent Funds*

We recommend the following new long-term target for the Permanent Funds:

| **Asset Class** | **Old Target** | **New Target** | **Change** |
|---|---|---|---|
| Large Cap US Equity | 16% | 15% | -1% |
| Small/Mid Cap US Equity | 8% | 3% | -5% |
| International Equity | 14% | 13% | -1% |
| Fixed Income | 43% | 45% | +2% |
| Real Estate – Core | 4% | 4% | - |
| Real Estate – Value Added | 1% | 3.5% | +2.5% |
| Absolute Return | 5% | 7.5% | +2.5% |
| Private Equity | 4% | 4% | - |
| Convertibles | 2% | 2% | - |
| Cash | 3% | 3% | - |

As can be seen in the table, we are recommending an overall reduction in equity categories (most significantly small-mid cap US) in favor of alternative categories that we believe offer equity-like returns with less risk. A modest increase in fixed income is also recommended as spread-widening has created greater opportunities in various bond categories that have warranted a small increase to our long-term fixed income return assumptions. We have run stress test scenarios for all of the portfolio mixes under consideration, and the new portfolio target offers better downside protection with an approximately equivalent long-term return expectation. In value-added real estate, we believe there are significant opportunities to generate attractive income returns through debt-oriented investments. Absolute Return Strategies have been severely tested in the past year, and although the results have been disappointing from an absolute return perspective, they have preserved value much better than traditional equities. Market dislocations have created a very fertile opportunity set for these opportunistic managers in an environment that now has significantly less competition by virtue of lower quality hedge funds and investment banks exiting the asset class. While we have seen significant issues in this industry including, investment blow-ups, and liquidity challenges, both of your managers have navigated the terrain with well-diversified and researched portfolios that have kept them largely away from these issues. It is also important to specifically note that both managers specifically avoided investments with fraudulent managers as a result of their comprehensive due diligence work.

*Workers Compensation*

We recommend the following new long-term target for the Workers Compensation Fund:

| **Asset Class** | **Old Target** | **New Target** | **Change** |
|---|---|---|---|
| Large Cap US Equity | 8% | 8% | - |
| Small/Mid Cap US Equity | 4% | 1% | -3% |
| International Equity | 7% | 7% | - |
| Fixed Income | 65% | 65% | - |
| Real Estate – Core | 3% | 3% | - |
| Absolute Return | 3% | 6% | +3% |
| Convertibles | 3% | 3% | - |
| Cash | 7% | 7% | - |

The direction of recommended change for the Workers Compensation Fund is similar to the Permanent Funds; a reduction in equities in favor of less volatile alternative investments. Again, we have stress-tested the portfolios, and believe this change will result in similar long-term returns, achieved with lower levels of return volatility.

*State Agency Pool and Tobacco Trust*

We have not recommended any changes to the mix for these funds, as we believe liquidity needs and capital preservation should continue to drive the mix between various fixed income and cash investments.

***Domestic Equity Portfolio Structure***

We recently completed structure optimization studies for the domestic equity portfolio. Currently, the large cap portfolio is 100% passively managed and the small/mid cap portfolio is

100% actively managed. This is supported by our view that the large-cap market is more efficient than the market for smaller companies. A couple of additional factors do come in to play – the current market environment, and the impact that high turnover active managers can have on net income in a severe market downturn.

Our recommendation is to move 25% of the large cap portfolio from pure passive to an enhanced index strategy. Although many investors and market theorists believe that the large cap markets are largely efficient, a number of enhanced strategies have historically provided incremental return at low levels of active risk and lower fee levels than many traditional active managers. We do believe it possible that active management may add value over indexing in a recovery; an enhanced manager has an opportunity to participate. We are not recommending an active management approach with a greater degree of active risk due to the need to keep fees low and mitigate the potential for large relative realized losses.

We continue to support active management of small/mid cap equity; both of your managers have added value relative to their indices. While Freiss's high turnover style has recently resulting in the realization of unwelcome losses, we believe the asset allocation decision to significantly reduce small/mid cap US equities should help to reduce this impact in the future.

***Manager Review***

We have focused our review on the State's active equity managers (Gabelli, Friess, Capital Guardian and Fisher). Based on the qualitative and quantitative review, we believe that with the exception of one, we are confident that you do have good managers. It is important to not become overly focused on near-term results as even the best managers are likely to stumble from time to time and it is too easy (and expensive) to unsuccessfully chase returns by seeking to pursue managers possessing the best recent performance. It is therefore important to focus on long-term results, risk-adjusted performance, and a qualitative review of the manager's credentials, decision-making process, and structure. The long-term performance records support the view that you have good managers.

From a qualitative perspective, we are least confident in Fisher and recommend a replacement search. Since inception with Wyoming (now nearly 5 years), they are the only manager of the four active equity managers that has not beaten their primary performance benchmark. Our high level concerns center around the depth of the team (relatively thin at the top), proliferation of products across multiple asset categories, and significant focus on retail investors.

***Manager Search Priorities***

Based on the asset allocation study, portfolio structure, and manager reviews we anticipate four potential manager searches:

- value-added real estate,
- international equity,
- enhanced US large cap equity, and
- long duration fixed income.

Long duration fixed income is a remaining unfinished activity resulting from last fixed income structure review. We continue to place a low current priority on a search for this fixed income sub-asset class due to the currently low level of interest rates. Investors are not paid with significant incremental yield for extending duration, and the risk in a rising rate environment anticipated at some point in the future could be unfavorable.

With regards to the other three investment manager searches, we would recommend the following order of priority:

1. International Equity
2. Value-Added Real Estate
3. Enhanced US Large Cap Equity

***Implementation***

For funds that are mature, fully diversified, and relatively close to their prior long-term targets, we offer the following guidance on implementation:

The largest negative variances from the new target are value-added real estate and absolute return.

Value-added real estate investments are likely to take some time to develop and it is also important to maintain appropriate pacing of these investments so as to diversify by vintage year. As such, we recommend maintaining an overweight to the internally managed fixed income portfolio specifically targeted at funding potential investments in this area. The State's investment staff is best positioned to monitor when these investments are likely to occur, and position the internal portfolio appropriately.

New investments in absolute return can begin to occur immediately. New investments with Harris could be made in a new onshore fund they are launching May 1st. Due to the limited number of slots in the current fund (499) and increased investor demand; Harris is launching a second fund. The fund is intended to be managed as similarly as possible to the first fund, with an estimated 90% overlap in underlying managers. The primary risk of a new fund launch is the potential for less initial diversification as the fund is developing (and adding underlying hedge funds as assets grow) that could result in a negative return dispersion between the two funds. As such, Harris is interested in attracting larger investors to make a commitment to the new fund. They have offered RVK clients a fee discount on new investments in the second fund for a limited but undefined period of time. The proposed reduced fee arrangement is a 75 bps management fee compared to the existing 100 bps management fee for the current fund. We are comfortable with Harris's ability to manage a new fund launch, particularly in an environment where manager capacity is temporarily not an issue. We would recommend taking advantage of the fee discount and placing new investments with Harris in the new fund, subject to successful review and negotiation of documents. We also recommend additional investments with PAAMCo in the separate account they manage for the State.

In the remaining underweight asset categories, we recommend that fixed income be moved to its new target over the next several months. As equities are more volatile, a longer dollar cost averaging process is recommended over the next 6 – 12 months with new cash flows as well as proceeds from the small/mid cap portfolios.

Selling all of the small/mid cap US equity overweight now would potentially result in additional loss recognition. We recommend that this overweight position be reduced over time by monitoring the unrecognized gain/loss position and looking for opportunities to shift assets to other equity categories and by allowing the shift to occur naturally as new cash inflows and portfolio growth occurs.

Core real estate and private equity investments, which are both illiquid and marginally overweight their targets, should return to target levels naturally over time as new cash flows and portfolio growth occur and/or further market value write downs are experienced. We do not recommend any new investments to either category at this time.

***Manager Fees***

We understand the State's desire to reduce manager fees, particularly explicit fees (i.e. those invoiced and paid as opposed to those netted directly from investment performance) due to their impact on the overall budget of the State Treasurer's Office. We have assessed the impact of our recommendations on manager fees, and estimate that the implementation of these changes would result in a reduction in *explicit* fees paid, as a result of the reduced allocation to equities, specifically small/mid cap equity. It is difficult to gauge the actual fee impact in advance, as changes will happen over time and portfolio values will fluctuate. We would also point out that the decrease in overall assets of the State due to recent market losses would also equate to a reduction in overall explicit fees (year-over-year) in dollar terms, since manager fees are charged as a percentage of market assets.

Note that given the recommended increases to real estate and absolute return, the overall management fees for the State (those explicitly and implicitly paid) may actually increase modestly. We do believe the benefits of investing in alterative asset classes justify the higher fees associated, and that net of fees investment results should continue to be the most important measure of success. The reduced fee being offered by Harris in association with investments in their new fund will help mitigate expected increases.

Lastly, we note that the fees Wyoming has negotiated with external managers are competitive versus industry peers, as highlighted in a fee comparison included in our presentation.

***Covered Call Overlay Strategy (First Quadrant)***

In order to increase income derived from this strategy, we recommend an annual process by which we adjust the notional value of equity exposure over which the covered call strategy is placed. Currently, we recommend increasing the notional exposure to equal the value of the passive large-cap US equity portfolio. Any transition to an enhance index approach does not require a reduction the notional exposure, as the essential market exposure (beta) of the enhanced index strategy will remain virtually unchanged since it will resemble the index.

## Final Thoughts

While investors are currently mired in one of the most difficult investment environments in modern history, we remain opportunistic about the future, and believe that thoughtfully diversified portfolios with exposure to both traditional and alternative asset strategies and an eye towards managing (reducing) downside risk remains the best long-term approach. Our asset allocation advice reflects this thinking and we look forward to discussing with you in detail in the near future.