Research Presented by HEK’s Idea Development Forum:

The Opportunity Allocation

A Tool to Provide Maximum Flexibility with Implementation

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The Opportunity Allocation: A Tool to Provide Maximum Flexibility with Implementation

It is widely accepted that the asset allocation decision is the single most important decision dictating an investor's success (and risk.) A long-term focus is appropriate for such broad issues. The constraints of a formal asset allocation policy should not, however, impede investors’ ability to implement attractive opportunities or innovative ideas as they arise.

To overcome the rigidity of a formal asset allocation design and provide maximum flexibility in implementation, we recommend that clients consider an Opportunity Allocation as a means to be nimble to take advantage of market opportunities as they arise.

The Concept

The Opportunity Allocation is not an investment in and of itself; rather, it is flexibility created in the Investment Policy Statement that allows investors the ability to make investments that may not fit within a traditional asset allocation construct. The reasons to create such policy flexibility include:

- Implementation of investment ideas that are purely "opportunistic" in nature or to hedge against specific market risks. By definition, such opportunities tend to be short-lived and require quick action. Examples include: the TALF and PPIP programs (2008), distressed credit and bank loans (2009 – 2010), middle market lending (2011), and European credit (2012).

- Investment opportunities often don’t fit neatly within asset class boundaries and/or often straddle two or more asset classes. For instance, managed futures strategies and middle market lending.

- Commitment to opportunities that may be relatively small and not warrant the creation of a dedicated asset class at the present time. This is often the case when an investor seeds a category of investments or seeks to make a small allocation to gain comfort before graduating an asset category to a dedicated allocation. For instance, commodity and currency strategies, frontier market investments, reinsurance funds, etc., may fall into this category for many investors.

HEK does not believe that the constraints of traditional asset allocation design should preclude investors from taking advantage of investments that could add to return and/or help diversify risk. As a result, we recommend that clients consider an Opportunity Allocation to provide maximum flexibility. HEK believes that such an allocation is most optimal for investors that already have well-diversified portfolios that encompass both traditional and alternative classes and are seeking additional flexibility.
Opportunity Allocation: Desirable Attributes/Qualities of Investors

A robust governance structure is critical to success with the use of an Opportunity Allocation. Some of the attributes of investors that we believe are desirable to be successful with the use of an Opportunity Allocation include:

- A high degree of comfort with various constituents (e.g., staff, consultant and/or decision-making body) developing and promoting new ideas of interest
- Nimble, but sound, decision-making process
- Comfort with ideas that do not fit neatly into “traditional” investing
- Willingness to be different than peers at times
- Willingness (and ability) to allocate additional time to investigate and monitor new ideas
- Ability to terminate managers as needed

Challenges Associated With an Opportunity Allocation

Listed below are some of the major challenges associated with initiating an Opportunity Allocation:

- **Complexity:** As with any investment strategy, ideas will need to be properly vetted and reviewed. Potential investments considered for an Opportunity Allocation can be more complex. As a result, the due diligence to vet these investments will need to be more rigorous as compared to traditional investments.

- **Time/Objective Defined:** Unlike most traditional asset classes, investors will need to pre-determine time horizons and/or key metrics to measure the success for investments that fall into this category. The graduation mechanism for strategies that might ultimately graduate to a dedicated allocation should be identified in advance. Criteria may include, but not be limited to, an explicit time horizon, degree of comfort with strategies and reasonable comfort with strategies’ track record. Some investments might graduate to a dedicated allocation using a streamlined process (as opposed to the process for a new policy allocation to an asset class with which an investor has no prior experience). Not all strategies will prove to be successful – there needs to be appropriate mechanisms in place to end an investment that is not working.

- **Illiquidity:** Some strategies that may be considered for inclusion may be illiquid. In considering investments for the Opportunity Allocation, investors should take into account overall illiquidity across their portfolios, including the need for liquidity across potential stress environments.

- **Higher Fees:** Fees for strategies in this category may be higher than traditional investment strategies. There should be high conviction that this higher fee will be rewarded with favorable return and/or diversification of specific risks.
Benchmarking: Given the unique, and sometimes esoteric, nature of investments within this category, it may be hard to benchmark investments and measure the success of the individual investments or the category as a whole.

Implementing an Opportunity Allocation

HEK recommends designing the Opportunity Allocation as a maximum allocation as opposed to a target allocation. The allowable range for the Opportunity Allocation should include 0%, so there is no pressure to add investments simply to fill the allocation. For the purpose of benchmarking this allocation at the total fund level, the policy target to the Opportunity Allocation should “float” to generally be in-line with the actual allocation to the category over time. Depending on the investment environment, investors may not achieve the maximum allocation permitted, and may have an irregular pattern of investment in terms of timing and investment allocation.

We believe that the Opportunity Allocation should be 10% or less of total fund assets. The actual allowable target to this category will depend on each fund’s specific circumstances. In general, we have found that clients have allocated between 3% and 5% to this category.

Funding for investments in this category generally should be sourced from the public securities component of a fund and linked to the role of the investment—i.e., return-enhancing ideas generally should be sourced from equities while diversifying investments generally should be sourced from fixed income or other diversifying assets. The policy allocation to publicly traded security asset classes from which funds are sourced to initiate Opportunity Allocation investments should be correspondingly reduced to reflect allocations to the Opportunity Allocation. For instance, assuming an investment for the Opportunity Allocation is sourced from equities based on its risk/return profile, the fund’s policy target to equities should be reduced by the proportion that this investment represents of the total fund, and the target to the Opportunity Allocation should be increased by a corresponding amount.

Potential strategies of interest should provide a higher expected return relative to the rest of the portfolio and/or improve the diversification of the overall portfolio. There should a clearly-defined framework to assess potential opportunities, including:

- Rationale for the investment: specific market opportunity targeted or risk hedged;
- Expected characteristics: investment thesis, risks, liquidity, fees and leverage;
- Review procedures and exit strategy: graduation mechanism or process for exiting investments once the desired thesis/opportunity has played out or does not work as desired;
- Sourcing of funds for specific investments; and
- Benchmarking investments.
Benchmarking the Opportunity Allocation

The overarching objective for the Opportunity Allocation is to provide return enhancement and/or diversification relative to the opportunity cost of capital. The Opportunity Allocation as a whole should be measured against a fund’s mix between liquid return-seeking and risk mitigating assets (i.e., targeted mix between stocks and bonds). The rationale for this framework is a fund’s liquid investments represent the source of funding for investments within the Opportunity Allocation. Such an approach can result in a high degree of tracking error at the total fund level, which may be unpalatable to some investors. In such cases, a weighted average of the underlying strategy benchmarks could be used as the benchmark for the Opportunity Allocation.

The underlying strategies that may be used within the Opportunity Allocation may span the gamut in terms of risk/return attributes. Some investments may not be measurable against standard marketable indices. Investors should identify specific benchmarks best suited to measure success of each investment.

Governance and Execution

A critical element to effectively execute strategies within an Opportunity Allocation is an appropriate and nimble governance structure. Stated bluntly, such an allocation likely will not be terribly effective if decisions have to be vetted and approved in a traditional committee cycle and decision-making process. They also tend to be biased against ideas that are “outside the box.”

If instituted, we believe the governance structure should allow for a small group of decision makers (either at the staff or committee level) to have the discretion to invest in the Opportunity Allocation, subject to general constraints on investment, such as total size in dollars or as a percentage of total fund assets. Such a structure will allow for nimble decision-making and avoid “group think.”

HEK’s Clients’ Use of the Opportunity Allocation Concept

HEK’s clients have utilized the Opportunity Allocation concept for several years now, although we’ve seen an uptick in the adoption of this concept by investors post the crisis in 2008. Listed below are some examples of how clients have utilized an Opportunity Allocation.

- To accommodate strategies that are not easily classified in traditional asset class terms
  - For example: absolute return, activist, inflation hedging

- To take advantage of dislocated markets at times of crisis
  - For example: convertible arbitrage in early 2009

- To promote a level of confidence with non-traditional strategies
  - For example: Reinsurance funds
- To take advantage of timely new product offerings or capital raisings that are outside of traditional asset class boundaries

With the continued development of new products and the almost certain continued periodic dislocations in segments of financial markets, HEK believes the investment universe for the Opportunity Allocation concept will continue to grow over time.
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