How an OCIO Might Evaluate Your Existing Portfolio

Please find enclosed a sampling of two different approaches (among others) current in the market.

One OCIO may separate the evaluation between its Investment team and its Risk team. They "snapshot" your current portfolio composition and compare it to their own proprietary allocation.

1) **DOCUMENT REVIEW** - There is a review of your Investment Policy Statement (Objective(s), Goals, Asset Allocation Targets, etc.)

2) **CURRENT HOLDINGS PROJECTED BACKWARDS** - They "snapshot" the current holdings and model them back for 3 years and create a 1-year and 3-year performance profile.

3) **EQUITY COMPOSITION** - They back-test to relevant industry benchmarks: geography and sector, market cap, style. In other words, they evaluate through the lens of key factor analysis.

4) **RETURNS v. FACTORS** - They evaluate the passive and active portions compared to reference indices and determine what is the percentage of active share management (i.e. the profile that veers from being purely passive or "index hugging.") They measure returns, R^2, alpha measurements, and beta values.

5) **RISK PERFORMANCE** - The risk team focuses on the volatility measures and tries to determine the potential drawdown risk. They also try to determine whether the portfolio is currently built for through-a-full-economic-cycle holding period.

6) **FIXED INCOME ANALYSIS** - Fixed income is compared to relevant FI benchmarks, e.g. Barclays Global Aggregate. They also measure the US Treasury composition, corporate debt, other categories, as well as the maturity buckets, interest rate duration, and credit rating duration.

7) **SUMMARY OF OBSERVATIONS** - They then provide a summary of observations.

8) **RECOMMENDED ACTIONS** – Are informed by a thorough 4 to 5-page analysis.

Another OCIO might perform an evaluation as follows:

1) **HOLDINGS PROJECTED BACKWARDS** – They create a look-alike portfolio of your actual holdings. They assume monthly rebalancing and do a 30-year lookback, showing semi-annual returns. They benchmark to a balanced long-term portfolio, a) US equity bias and 2) ACWI focused. They track return performance over time against purchasing power goals.

2) **INCREMENTAL RISK v. VOLATILITY OF RETURNS** - This is a graphic representation of a NACUBO-cohort median portfolio adjusted for your organization's size as well as a cohort of the OCIO's own clients, also adjusted for size.

3) **TABLE OF ASSET CLASS ALLOCATION** – They provide an asset class allocation grid which identifies 3 main categories (with sub-categories):

   (a) Global Equity (US/Intl-EM), Alternatives (PE/HF/Comm./RE) and Fixed Income (Core/Opportunistic/TIPS/Cash.) They provide 4 additional columns;
   (b) Policy Goal percentages by both categories and sub-categories), Min-Max range per the 3 major categories of assets,
   (c) detailed Active Target (current),
   (d) your own organization's current allocations, and
   (e) planned goals to reach over the next 6 mos. to 12 mos. Horizon.
   They are especially mindful of harvesting the illiquidity of alts as well as the volatility dampening nature of hedge fund holdings for a through the cycle resiliency of the portfolio.

4) **RISK ANALYSIS** - They perform a thorough returns-based style analysis as well as a holdings-based style analysis. They are especially mindful that using multiple managers sometimes obscures the combined risks if the portfolio information is not timely, consistent, and properly aggregated.

5) **"ACTIVE RISK" ANALYSIS** - This is the risk segment of an investment portfolio that results due to active management decisions made by portfolio managers. This measure will also capture the impact of "market timing" decisions made by the managers. So, the active risk is the annualized standard deviation of the monthly difference between the portfolio return and the benchmark return. Active risk is typically a long-only measure.

6) **DETAILED ANALYSIS** of the drivers of specific risk. This is often stock specific risk and could be related to stock size, especially if you have a small cap manger in your stable of managers.

7) **STYLE MAPPING OVER TIME** - This provides insight into how a manager may be adjusting its factors over time and perhaps moving from growth to value, etc. as market condition require. Classification of portfolios by size, value, growth orientation, etc.

8) **SUMMARY** - A final two paragraphs on the importance of evaluating both the risk and fee budgets on active managers, most specifically on those managers who have demonstrated adding value through their security selection.

Personally, we find the second approach provides a more robust analysis. It covers full, multiple economic cycle time horizons and includes a realistic rebalancing impact. Moreover, the same team performs the investment and risk analysis and so there is no "handoff" between internal teams that could create gaps in the analysis.

Want to learn more? Please contact Chris Cutler or Tom Donahoe.