{October 1st - October 15th}

THE CONNEX CHRONICLE

Preparing for the Worst; Positioning for the Best

An interview with Jim Hille, CIO, Texas Christian University Endowment, on incorporating "Black Swan" thinking into your asset selection

If a single word were to encapsulate the mood of the current investment climate, it would be "uncertainty." Uncertainty about inflation, uncertainty about the global economic recovery, uncertainty about the geo-political environment, uncertainty about sovereign debt. With the economy lacking a clear direction, what are the implications for investors? How can investors implement "worst case thinking" into their allocation strategy without sacrificing the significant upside that a more vigorous recovery would bring with it?Jim Hille – an investor who has grappled with this question both as CIO of the $100bn Texas Teachers and CIO of the $974m Texas Christian University – shares his perspectives with Connex.

Your keynote address at the December event is about incorporating both best- and worst-case thinking into the asset mix. To start with the negative side … what threats to the economy are currently causing you most concern, and why?

IT SAYS IT all that I am most worried about our own risk free rate – the U.S Treasury Bond. When you begin to have doubts about the viability of your so-called risk free asset (sovereign debt) you are in for a pretty rocky ride. The financing of the U.S. economy through bailouts and deficit spending is on an unsustainable path. In my opinion, the trillion dollar Keynesian-style fiscal spending measures were wasted on transfer payments and pork barrel projects. We now lack the capacity to implement the kind of incentive-oriented policy measures that should have been implemented in the first place. We are in an economic hole that we seemingly cannot get out of; but as

James Hille

James R. Hille was appointed the first Chief Investment Officer of Texas Christian University in May 2006. Formerly he was the Chief Investment Officer of the Teacher Retirement System of Texas, a $100 billion public pension plan. From 1992 to 1995 he managed portfolios for the Employees Retirement System of Texas. From 1990-92 Mr. Hille worked as an assistant to the international portfolio manager at a large family office in Fort Worth while earning an MBA in Finance from TCU. With a BS in engineering from the US Naval Academy class of '83, Mr. Hille served for six years as a Marine Corps officer. He has served as president of the Austin Society of Financial Analysts, and an adjunct finance professor for the University of Texas' McCombs School of Business. Mr. Hille is a Chartered Financial Analyst and a Chartered Alternative Investment Analyst.

they say, the only way to get out of a hole is to first stop digging. We need a credible plan from policy makers for managing our way back to fiscal sanity. Though austerity is needed, it most certainly would be a further drag on growth in the short term. None of this is conducive to generating high growth or returns, and generally means higher than normal volatility.

How do those threats translate into asset choices? What sorts of hedging mechanisms are you currently building into the TCU portfolio?

THE FIRST WAY to hedge against the macro issues we face in the U.S. is to remove the home country bias. Having a truly global focus will provide some level diversification benefit. Growth and returns are likely to be positive somewhere in the world in any given year. Yes, correlations do converge towards 1.0 at maximum times of stress, but most of the time there is a benefit to global diversification. For the other times, we look for low cost long term hedges, also known as tail risk hedges. We also do not allow ourselves to be overly dependent on any asset class to drive our returns. Our asset choices are highly opportunistic. In the current environment this leads us to certain distressed situations, long-short equity, and emerging markets.

Talk to us now about causes for optimism. What gives you most hope about the current investment environment, and how you are positioning to take advantage of that possible upside?

I AM NOT AN extreme contrarian, but a contrarian nonetheless. The malaise that prevails in 2010 owing to the anemic economy and high unemployment will turn to optimism very rapidly and build on itself with the inevitable return of confidence. With so few believing this will occur, as evidenced by a whole host of things like fixed income inflows and low equity volumes, this actually makes me quite optimistic, as a contrarian.

"When you begin to have doubts about the viability of your so-called risk free asset (sovereign debt) you are in for a pretty rocky ride."

You've been CIO of the $1bn Texas Christian University Endowment since May 2006. Prior to that you were CIO of the $100bn Teacher Retirement System of Texas. Talk to us about the differences between the two investment environments: specifically, how easy is it for both major publics and mid-sized endowments to "prepare for the worst and position for the best"? Is size a blessing or a curse?

SIZE IS INDEED a blessing and a curse, at both ends of the spectrum. You just learn to exploit your advantages to offset your disadvantages. With $100 billion, you have negotiating power, economies of scale, while lacking nimble, opportunistic capacity. You also have managers pounding on your door for your capital. At $1 billion, we get much less attention, and there is less research bandwidth, but we can be extraordinarily opportunistic, comparatively. And as a smaller fund, every single investment decision "moves the needle" either in terms of return, or risk, or probably both. This can cut both ways, but if we are thoughtful about it, it usually means we are able to be positioned how we want to be most of the time. For the $100 billion fund it often can take years to get positioned how you want, and by the end of that time, the return opportunity ship might have sailed.

What are you most looking forward to about the forum? Which other sessions are you interested in attending?

DR. PETERSON'S TALK about managing emotion in the investment process looks to be particularly interesting. I'm always especially interested in different perspectives on asset allocation and risk management and there is an abundance of this at this forum that I look forward to.

A Flood of Income?

Cashflow Generation and the Problem with Municipal Bonds

Amidst fear of problems in the municipal fixed income space, many investors are exploring alternative asset classes capable of generating high-yield fixed income-style returns, minus credit risk. Connex sat down with Dennis Gibb, founder and principal of Sweetwater Investments, to get his diagnosis on the US economy, the health of the municipal bond market, and alternative strategies to deliver income.

Dennis, thanks for joining us today. Tell us: how do you think the economy has changed since 2008? What are the implications for capital raising and investing?

THE MESSAGE OF the 2008 financial crisis is that Wall Street – as we knew it – no longer exists. I often ask people if they know what the largest independent investment banking company is in the United States. It isn't Goldman Sachs, it isn't Morgan Stanley, it isn't Merrill Lynch or Lehman Brothers. They've all been subsumed by someone or changed their status to a commercial bank or gone out of business. The only real investment bank – that isn't part of a commercial bank – is Lazard, which most people haven't heard of.

And it's pretty clear that the commercial banks aren't really lending money. The Fed has pumped one and a half trillion dollars into the economy by purchases of mortgage-backed securities, and about a trillion of that is still sitting on the balance sheet of the Fed in deposits by commercial banks. In other words, what we have going on now is a balance sheet recession rather than an inflationary recession. Balance sheets are stretched and they need to be made whole again before the economy can get on its feet. That takes time. And balance sheets are stretched for corporations and states alike.

This isn't only a problem for the United States, by the way. Look at the UK. Look at France, where there is finally talk of reducing pension benefits after years and years of expansion. When debt servicing gets to be 40% of national income, economies inevitably start to slow down – and many developed economies are heading in that direction.

Dennis R Gibb

During his 30 year career in the investment industry, Dennis Gibb has been involved in every type of market condition and industry change. He began his career working for H. Ross Perot, was a retail broker at Dean Witter, and has held senior positions both at Morgan Stanley and Bear Stearns. In addition to his retail experience, Dennis has also been an institutional fixed income salesman, a compliance officer, an investment banker, and an assistant office manager.

Dennis is the principal shareholder of Sweetwater Investments a registered investment advisor since planning their lives and managing their financial affairs to accomplish their goals.

Dennis has frequently testified before both the Congressional House and Senate on investment-related matters as well as to the Securities and Exchange Commission. He has been a guest commentator on CNBC and hosted a radio show with 9 million listeners.

You're pretty bearish on municipal bonds. What are the specific problems facing the municipal bond market at the moment?

WELL … PEOPLE OFTEN ASK me if I think there's going to be another crisis, and if so where it will come from. My response is: look for the thing that's had the longest time without a crisis. We in the United States had never seen a systematic decline in real estate for 70 years … until now. What hasn't gone down for 70 years? Well, it's municipal bonds. There were massive defaults on muni bonds in the 1930s. And municipal bonds are looking shaky now for a couple of different reasons. The first thing to be aware of is that many states and municipalities are using municipal bonds to fund pension obligations and entitlements. That becomes structural debt and it doesn't go away. The overall cost structure of the municipality or the state increases, and it becomes harder and harder for them to dig themselves out of the hole.

Also – not all municipal bonds are created equal. You find out about weakness when a crisis occurs. For example, there were a couple of bonds in New Orleans that lots of people thought were terrific, but with the BP oil spill and the subsequent moratorium on drilling, the traffic over some of those toll roads has collapses, and there's no money to pay the bonds. You have the city of Harrisburg in Pennsylvania, which has a waste incinerator … it hasn't met standards and there's a ton of debt against the thing that the city doesn't want to pay.

So there are things that can go wrong. And investors need to know that – whereas a state can't technically go bankrupt – a municipality can. The law surrounding municipal bankruptcies is pretty obscure and there are few people who know what their rights are.

"...investors are looking for novel ways to generate high fixed-income style returns that may not be achievable through traditional avenues."

You've pioneered a fixed income-like asset class that generates cashflow in a novel way. Can you explain how the asset class works? What are the benefits for investors?

WE DESIGNED INCOME Flood to provide regular, high-yield fixed income-like returns on a superior risk-adjusted basis. It's designed to deliver 8-15% annual return net of fees and expenses. Essentially it works in the following ways: first we invest in a laddered portfolio of 1 to 4 year Treasuries that provide liquidity, low credit risk, and income. No portfolio of 1 to 4 year Treasuries has had a negative return since 1900. The fund then sells exchange-listed European-style put and call options on the S&P 500 index in combinations that have a 98.1% probability of expiring worthless, thereby creating a flood of income. It provides monthly liquidity with no lock up period or limits on the withdrawal of funds … and one of the things that's nice about it is the fact that risk is managed very transparently. You know when the risk is going on and when it's coming off, and the amount that is at stake at any one period.

In the environment we're in, I think investors are looking for novel ways to generate high fixed-income style returns that may not be achievable through traditional avenues.

Dennis Gibb will be conducting meetings in Dallas this December at the Strategic Investment Executive Forum.

De-Risking or Re-Risking?

An interview with Kevin Zhu from Ontario Teachers on the suitability of Risk Parity as an investment paradigm

In recent years the risk parity approach to asset allocation – in which each asset class contributes an equal amount of risk to the portfolio – has grown in popularity. But how does the risk parity compare with other asset allocation strategies, like the GMO valuation-based approach? $96bn Ontario Teachers is in a unique position to compare the two approaches, having performed a number of important studies on the suitability of various allocation models to different overall investment strategies. Kevin Zhu, who has spearheaded a number of these studies, sat down with Connex to discuss Ontario Teachers' approach to asset allocation

For the benefit of those new to the concept, what is risk parity? What is the objective of the risk parity approach to asset allocation?

TO USE SIMPLE, non-technical language: to use risk parity is to construct a portfolio in which each asset class has an equal *risk* contribution. In other words, you're focusing not on the capital allocation but on the risk allocation.

In your view, how effective is risk parity compared with other allocation strategies, like GMO's valuation-based approach? How does the suitability of allocation model vary between different categories of investors?

WE JUST HAD an internal debate about the risk parity and valuation-based approaches. There's no conclusion about which approach is right or wrong, and both approaches have their pros and cons. The philosophies underlying the two approaches, however, are very different. Risk parity is only focused on the risk of the portfolio – which means you don't take any views on the return. The key assumption is that the risk is both easier and more important to forecast than the return, and all of the focus is placed on the risk.

Kevin Zhu

Kevin Zhu is the Portfolio Manager of Strategy & Economics within the Asset Mix & Risk at the Ontario Teachers' Pension Plan. His key areas of focus are: 1) Provide long-term macroeconomic and capital market research to support the Plan's strategic asset allocation decision; 2) Research various investment strategies to improve the Plan's strategic asset allocation process as well as risk management process for Plan's pension liabilities, and 3) Develop and maintain the Plan's internal asset model as a critical tool for the ALM studies.

Prior to joining the Ontario Teachers' Pension Plan, Kevin was the Senior Economist at the Bank of Canada where he was a key contributor to developing the bank's new policy model and conducting the quarterly projection of the Canadian economy. He has a Master of Economics from Carleton University in Ottawa, and he is a CFA charterholder.

The valuation-based approach – as the name suggests – is much more focused on the other side of the equation, which is the return. The key assumption in this methodology is that most asset classes have a mean-reverting characteristic over the long term. In other words: prices will rise, reach an over-valuation, but over the long term they will tend to return to a fair value. GMO's approach is more return-focused and the risk parity approach is more risk focused.

Both approaches are one-sided. We believe the optimal strategy is somewhere in the middle. You should combine your skill for forecasting the return with your skill for forecasting volatility, and in the end you come up with the Sharpe Ratio, which is the risk-adjusted return. That should be your focus.

Is it possible to combine elements of the two approaches in a single strategy? What principles are currently informing OTPP's approach to asset allocation?

WE ACTUALLY TAKE a value-based approach at the moment. Because we are long-term investors, we try to form our view in terms of growth, inflation – you know, general economic trends – and then tie that view to basic fundamentals that drive the asset price. We believe that we need to carefully assess the value of different asset classes at different points in time, acknowledging that each asset is mean-reverting in the long-term, but volatile in the short term. So yes, at a policy level we're still using a valuation-based approach, but given what happened in the crisis we're also focusing on short-term risk management. We actually do believe that the optimal approach is to combine the basic concept in the risk parity approach with our current approach, which is valuation-based.

"We strongly believe that economic performance will be divided between the developed markets and emerging markets."

Alternatives play an important role within your asset allocation strategy: OTPP is currently the world's largest investor in insurance-linked securities, for example. What advice would you give to investors about incorporating unconventional asset classes into their portfolios?

IN TERMS OF picking different asset classes, the fundamental question you want to be asking is: what is the objective? From OTPP's perspective, when we think about the asset mix, what we're really thinking about is what will serve our pension liabilities in the best way. What asset classes reflect the risks facing our liabilities? For example, our liabilities are exposed to real interest rate risk and inflation risk, both of which need to be reflected in the asset mix. As long as we know the final objective, that will determine the most effective mix of asset classes.

The "New" Risk Management

One of the most eagerly-awaited panel discussions at the 6th Strategic Investments Forum will be on new approaches to risk management: a timely issue. Moderated by Robert Ball of the $5bn Joint Industry Board of the Electrical Industry, the panel features Brett Hammond, Chief Investment Strategist of TIAA-CREF, Jon Shear, Chief Investment Officer of University of Utah, Dennis Wilber, Director of Investments at the Visiting Nurse Service of New York, and Robert Bernstein, Co-Founder of the family office Prism Partners. The panel will uncover new strategies relating to risk metrics, risk reporting, and portfolio construction.

What do you think are the most significant threats to investors in the current economic environment? How do those threats translate into hedging mechanisms and asset choices?

YOU ASKED THE question at the right moment – we're currently in the middle of doing risk analysis for the board. We strongly believe that economic performance will be divided between the developed markets and emerging markets, and we see a continuing decoupling between the two regions: ie, the developed world isn't going to perform fantastically over the next 3-5 years. A couple of different reasons – some fundamental, some structural – are behind that: private sector deleveraging, a weak banking sector, and sovereign debt issues, to name a few. The debt problems facing the developed world also place limitations on the ability of governments to stimulate their economies fiscally, and that could result in anemic growth in the mid-term.

But the emerging markets don't seem to have the same problems, and we consequently expect more and more investment capital to flow into these markets. Rebalancing in favor of emerging markets, in our view, should be a priority for investors with a significant home-bias.

Finally: what are you most looking forward to about the event?

I'M VERY INTERESTED in being exposed to new ideas about strategic asset allocation – at Ontario Teachers, we're always on the look-out for innovative new approaches

About Connex International Executive Forums

At its core Connex has created a broad network of experts, each of whom contributes their unique perspective and knowledge to the group as a whole. The Connex network acts as an objective, proactive filter to distinguish what is important from what's not, avoiding wasted effort and saving members time and money. Whether you are already one of the world's largest companies or simply aspire to be, you tap into a robust process that's already in motion.. For more information, please visit http://www.theconnexgroup.com

About the Strategic Investment Forum 2010

Now in its sixth successful year, the Strategic Investments Forum is a series of peer-to-peer discussions, roundtables and think-tanks – designed by members of our esteemed advisory committee – who are seeking a better way to access truly independent research and information that allows them to make more informed investment decisions. With the exception of a handful of a keynote speakers, access to the sessions is strictly limited to plan sponsors, foundations and endowments, and family offices.

This year's event will be taking place at the Ritz Carlton, Dallas, from December 5th - 7th. If you would like to be considered for attendance, please contact:

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