Profiles

Consultant Finds Success In Customization For Nonprofits' Varied Philosophies, Biases

BY COLIN RAJALA | AUGUST 13, 2015

Truly understanding the investment philosophies and biases of the staff and board members involved in decision making at foundations and endowments is a key component to structuring a customized investment strategy that provides a framework for outperformance while taking into consideration an institution's needs, according to Pavilion Advisory Group Consultant Antonio DiCosola.

To create a customized program, Pavilion works with clients to develop an investment philosophy and model multiple asset allocations to determine the best fit for the portfolio over a long-term horizon, according to DiCosola.

Antonio DiCosola

"When we are hired by a new client, oftentimes we are not coming into an optimal portfolio. When we are brought on, we know where clients are coming from and, generally speaking, they want change. They weren't happy with their portfolio before and they have hired us for our advice and recommendations. During the process, we take a collaborative approach, with open, healthy dialogue about what works and doesn't. We go through a step-by-step process with the goal of trying to add the most value to the portfolio upfront, and make refinements over time," he said.

Building On An Investment Philosophy

Pavilion's step-by-step process to create and implement a customized strategy begins with meeting key members of the staff and board or committee members that are involved with portfolio decisions to get their views on the markets, the portfolio, what has or has not been successful within it and their general viewpoints on investing.

DiCosola noted that understanding a client's general investment philosophy helps the consulting firm avoid bringing unfavorable investment ideas or strategies to the table when it comes time to determine and implement an asset allocation.

A client's investment philosophy is shaped by inherent biases the staff or committee members may have, which DiCosola says is inevitable. When delving into staff or committee members' biases, which includes confirmation bias, negativity bias and loss aversion bias, Pavilion makes sure to be very clear in letting a client know what biases they agree with and which ones they do not, DiCosola said.

"We want to pick our clients' brains to see if they have a perspective on active versus passive investing, a preference of reducing downside risk or capturing upside and whether they want to be opportunistic within the portfolio," DiCosola said.

Beyond a client's biases and investment philosophy, Pavilion wants to understand the organization's liquidity profile, cash flow needs, risk tolerance and constraints, among other factors, as they play a strong role in influencing the asset allocation models that are recommended.

Understanding a client's portfolio and their investment philosophies allows Pavilion to develop or revise an investment policy statement, to document a timeline of investment program decisions, detail governance issues and provide benchmarks and guidelines for evaluating the investment program.

Asset Allocation Modeling

After meeting with a client and understanding their view on the current portfolio, broader investment themes and the restraints and needs, the firm begins asset allocation modeling to ultimately determine the best way to add value without impacting the corpus or triggering any risk, liquidity or cash flow issues.

"Getting the asset allocation right will make the biggest impact on a client's portfolio," DiCosola said. "Asset allocation is number one in terms of driving value and you can't create an appropriate asset allocation without knowing a client's constraints and objectives."

The asset allocation modeling process features a variety of techniques and mathematical models utilized by Pavilion, including mean variance optimization.

After modeling different asset allocations, Pavilion analyzes insights from its global macro research team and in-house economists, playing out different stress scenarios and showing how the portfolio should react during specific economic environments, which provides a perspective of the impact on the long-term performance of the portfolio, DiCosola said.

Asset allocation modeling and stress testing different hypothetical portfolios allows Pavilion to provide a good view on the downside risk that's inherent in the asset allocation, while providing another opportunity to have important discussions with the key decision-makers, he said.

"I think that liquidity and risk tolerances are driving forces into what types of asset allocation models we present," DiCosola said. "…At the end of the day, selecting the right asset allocation is more of an art than a science."

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Within higher-risk asset classes, the firm prefers to have target asset allocations with bands closer to the target.

For opportunistic asset classes, which include emerging markets equity and hedge funds, the firm typically has a floor for the range that stays at 0% and a cap that is fairly tight above the range, according to DiCosola.

"We like when our clients are more tactical," DiCosola said. "This gives us the ability to scour the market for opportunistic investments, and take action based off higher conviction ideas."

Structuring the Portfolio

Within each investment program the firm develops and implements, they look to diversify the portfolio across asset classes, styles and investment managers.

The firm also offers a variety of customization capabilities within a client's portfolio, including liquid real assets, multi-manager strategies and global developed markets socially responsible investing strategies.

In the current market environment where forward price-to-earnings multiples "look fairly valued to a little stretched," the firm tends to favor portfolios that include hedge funds and select private assets, DiCosola said.

The firm, which has $60 billion in assets under advisement and approximately $621 million in assets under management as of Jan. 31, 2015, looks to alternative and private assets to "stomach" headwinds for the fixed-income market as it is in a low-yield environment that has the potential for rising interest rates, according to DiCosola.

Because of the low level of fixed-income yields, foundations and endowments are looking at unconstrained fixed-income strategies, but DiCosola has found some problems with recommending the strategies to clients because no two are the same, making it difficult to understand what risks are being taken to generate returns. He also noted that there are concerns with paying higher fees for a product that has pretty low return expectations, noting that you could pay 30 to 50 basis points for a core-plus mandate, while you might pay 60 to 90 basis points for an unconstrained mandate.

He noted that given the current environment, the firm tends to "max-out" clients' alternative and private asset allocations in the 20% range.

While the firm advocates for alternatives in clients' portfolios, they understand that some foundations and endowments take a cautious approach, prompting the firm to make sure the clients understand their use in a portfolio. DiCosola noted that for clients that need or want more liquidity within their portfolios, the firm shies away from private equity, private real estate and even some hedge fund strategies.

Liquidity may also be a concern for some clients, as trying to reach the expected return target is a significant barrier for nonprofits today, DiCosola said. To maintain a portfolio's corpus, an organization has to accommodate for the spending rate, which may be in the 5% range, plus a percentage for fees and operations, as well as 2% for inflation, according to DiCosola.

He noted that it is tough to keep pace with an 8% return target given the current market environment with fixed-income yields squarely in the 2% range.

"Unless equity markets take off, it will be difficult to hit return targets," DiCosola said. "To combat that, we are looking at a couple of things, lowering expectations, and looking at hedge fund allocations that may be able to achieve a 6% to 8% return range with a lower risk profile."

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Selecting Managers

Investment managers looking to become part of Pavilion clients' customized investment programs will find their initial point of entry in the firm's proprietary investment manager database, MGR-IQ (https://app.pavilioncorp.com/next).

The firm takes a detailed analysis of the firms in the database, selecting approximately 10 to 15 managers or strategies that meet the firm's quantitative and qualitative factors, before isolating a list of finalist candidates to recommend to a client.

The firm's quantitative screens pay close attention to performance and risk measures versus the benchmark, peer group samples, sector and regional weights, market capitalization, historical asset levels and valuation metrics that include dividend yield, price-to-earnings ratios, price-to-book ratios and return on equity.

On the qualitative side, Pavilion looks at a firm's philosophy, culture, compensation, processes, team structure, history of the firm and product as well as general information from discussions that the manager has with Pavilion's research team, analysts and consultants.

Pavilion clients who access the database can also ask the firm's consultants and research analysts for an in-depth and independent opinion on specific managers and strategies.

To get on the firm's radar an investment manager ultimately has to show and communicate they have a reputable and differentiable process, while having a proven track record for the space they are invested in and "doing what they are supposed to be doing—adding value to the portfolio," DiCosola said.