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Montana moves cautiously on diversifying strategies

The board allowed investment staff to begin building out a 0-4% allocation to diversifying strategies, starting with an internally-managed long-duration Treasuries strategy

Dietrich Knauth | 06 Mar 2018

The **Montana Board of Investments** is proceeding slowly with a new allocation to diversifying strategies, moving forward only after a close board vote and a cautious initial allocation of 0-4% of the overall portfolio.

The board updated its asset allocation targets for the \$11.3bn *Consolidated Asset Pension Pool* in November, including a brand-new target for diversifying strategies. The asset class includes a potentially wide mix of public markets investments that seek to provide downside protection while maintaining liquidity and providing a better return than just holding onto cash.

Creating a new asset class was necessary, according to CIO **Joe Cullen**, to allow the state pension funds to take advantage of multi-asset strategies and other investments that otherwise would not fit within the state's asset allocation structure.

"There's no place for them in our current portfolio," Cullen said at the fund's February meeting. "The opportunity set for diversifying strategies is larger than what we collectively utilize across the other asset classes."

The November approval did not allow any investments in the new asset category right away, but the board gave the green light at its February meeting, after debating and approving investment policy statements for the asset class. Although two board members ultimately voted against moving ahead with the new asset class, the decision clears Montana's investment staff to begin allocating to diversifying strategies, starting with an internally-managed strategy focused on long duration U.S. Treasuries.

In the near-term, Montana is also considering multi-asset strategies and strategies that focus on equities, ETFs, commodities, currencies, preferred stocks, convertible bonds, fixed income, and cash equivalents. Convertible bonds, preferred stocks, and emerging market debt are three types of investments that otherwise would not fit neatly into Montana's public equity or fixed income portfolios, and the diversifying strategies allocation allows Montana to dip a toe into those waters without carving out a dedicated portion of its portfolio to any particular strategy, Cullen said.

Cullen also expressed interest in strategies that mix equities and bonds, and can be flexible in the particular mix of assets within the strategies, but noted that those types of investments would not be appropriately benchmarked against either equity or fixed income.

Careful first steps

Board members pushed back against several aspects of Cullen's proposal, questioning why the allocation was necessary, whether the 0-4% target range was enough to provide meaningful downside protection, and whether the initial long-duration Treasuries strategy would be better placed within the state's fixed-income portfolio.

Cullen largely answered by saying those initial steps were meant to provide a deliberative introduction to the new asset class, and that over time, he would like to see a larger and more complex allocation to diversifying strategies.

"One reason that I proposed, and the board approved in November, 0-4% in this asset class, is to be incremental, do certain things, provide communication on what's going on and how that performs and if things are acting as suggested, then there's reason to grow it over time," Cullen said. "I would support a much higher weight there, but I've been asked to be incremental and move forward slowly."

Starting small also allows Montana to gain experience with asset types and strategies that it doesn't currently use, like emerging market debt, and put those lessons to use during future asset allocation cycles.

"Over time we might say, you know, we should really introduce more emerging market debt into our portfolio, more non-US bonds," Cullen said, "So that discussion may not have immediate impact, but it's an investment that we're making that could impact the asset allocation going forward."

Cullen said that the asset class would not include anything that was illiquid, overly complex, or had nontransparent fees or opaque underlying investments. Cullen distinguished the new asset class from hedge funds, which the board had previously rejected, on those grounds.

The consultant pitch

Montana's investment consultant, **RVK**, said it that diversifying strategies could be a good addition to the portfolio. RVK's **Jim Voytko** compared it to discussions in recent years over adding real estate and hedge funds to the state's investment portfolio, calling each one a "messy opportunity" that required board approval. The board decided to add real estate, but not hedge funds, and in retrospect, the decision to pass on hedge funds was probably the right call, Voytko said.

"Now you have another messy opportunity on your hands," Voytko said. "It's reflective of the struggle that every institutional investor is having right now, trying to figure out - more equity is not going to help me. It's going to add to my risk, and equities have had this huge run. It sounds like a very reasonable thing to do with a small part of your portfolio."

Under the approved plan, Montana's investment staff plans to implement a long-duration U.S. Treasury Portfolio in the first month, then continue to research and consider investing in a few multi-asset class strategies and single-asset class strategies over the next two to six months. After six months, Montana plans to work with RVK to broaden the scope of strategies that may be included in the diversifying strategies asset class.

The asset class will be benchmarked to the *Bloomberg Barclays US Intermediate Treasury Index*, the same benchmark that Montana uses for its U.S. Treasury/Agency Fixed Income Asset Class.

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