{October 15th - October 31st}

THE CONNEX CHRONICLE

An Alternative Reality?

The Culver investment model shows that high allocations to alternatives can be supported through smart risk controls and a sensible approach to liquidity management.

Culver Academies - winner of Institutional Investor's 2010 Small Endowment of the Year award - has become a veritable poster child for the alternatives-dominated endowment model, with more than 75% of the total portfolio allocated to alternative assets like global macro, volatility arbitrage, managed futures, distressed debt, real estate and leveraged buy-outs. Head of Schools John Buxton (JB) along with Investment Committee Chairman Jeff Adams (JA) and Consultant Brian Hunter (BH) sit down with Connex to discuss the benefits and drawbacks of the strategy and the importance of effective risk management.

CX: Even by the standards of the more progressive endowments, you've made a significant allocation to alternatives – around 75% of the total portfolio. Why such a high percentage? In what ways does the alternatives allocation support the financial goals of the academy?

JB: THE ISSUE IS NOT the percentage of alternative investments but the selection of managers who manage risk creatively and successfully in a volatile marketplace and the strategic placement of those managers in a dynamic portfolio model.

JA: THAT'S RIGHT – CULVER is not focused on the percentage of alternatives or any other asset class. Rather, the focus is absolute return and risk control, hence preference for managers (nimble alternative players) who can succeed in what we believe will continue to be highly volatile markets.

BH: I AGREE WITH BOTH John and Jeff. Within the realm of alternatives I would add the following: in a word – prudence. George F. Baker once told me: "Proof of prudence never shows up in a bull market – it shows up in a bear market." In a world where long-only has increasingly become "buy and hope", truly uncorrelated alternatives robustly diversified across both long/short and public/private investments – worldwide – can better cope with flatter, skewed returns distributions where we cannot rely on weak probability for regression to the mean to bail the world – or us – out of disaster.

If you want to realize a return better than most, you need to invest differently than most.

John Buxton

John N. Buxton is the Head of Schools at the Culver Academies. He has spent 42 years in the secondary boarding school business, 15 of them as the Vice Rector for Finance and Operations at St. Paul's School in Concord, N.H. and the last twelve at Culver. He has worked closely with finance and investment committees and has been a close observer of the financial marketplace since 1983.

The core financial goals of Culver are sustainable liquidity and likelihood of supporting and expanding its educational mission. To that end, Culver embraces a realistic view of uncertainty and risk that necessarily require inclusion of a prudent, diversified portfolio of alternatives to engage and benefit from dramatically different and evolving worldwide economic changes and market forces.

CX: Tell us about some of the alternatives you've invested in. What do they do for the portfolio, and in what circumstances would you recommend them to other investors? Are there any alternative investments that you would not recommend?

BH: CULVER IS INVESTED in a wide range of alternatives: event-driven strategies, long/short domestic and international strategies, global macro, managed futures, sovereign debt, credit strategies, distressed, private equity and royalty funds, to name a few.

Dynamically blending assets that are essentially uncorrelated to broad market forces assists Culver's portfolio to capture asymmetric positive returns while attenuating overall negative tail risk.

If true sources of alpha in the strategy are not comprehensible or not likely to be sustainable and the liquidity of the vehicle is not in line with the strategy, we are likely to stay away from the alternative investment.

JA: CULVER HAS A KEEN focus on leverage (we're averse) and liquidity, which makes us reluctant to embrace lock-ups or gating provisions.

" If you want to realize a return better than most, you need to invest differently than most. "

CX: Many endowments – particularly those with large allocations to alternatives – suffered disproportionately during the financial crisis. Culver did comparatively well. To what do you attribute your performance during that period?

JA: THROUGH OUR ADVISOR, Culver has benefited from careful manager selection based on personal knowledge of decision makers and process, ongoing extensive review and evaluation of managers and focus on leverage and liquidity.

BH: CULVER'S PORTFOLIO IS truly diversified and biased to capture asymmetric upside, while minimizing systemic negative tail risk as independent of general market forces as possible. SCA's patented dynamic asset allocation and risk management platform – Quatrain – has been an indispensable tool assisting an engaged Culver investment committee to reach conviction for its gradual, controlled allocation decisions faster and with confidence.

CX: How do you manage liquidity at the endowment? Do you do anything differently now in light of the events of the past two years?

BH: LIQUIDITY HAS BEEN managed explicitly for every allocation decision since Culver and SCA began collaboration 9 years ago.

Brian Hunter

Brian Hunter founded Strategic Capital Allocation Group on October 1, 2001.

Mr. Hunter was with Prudential Securities from July, 1999 to September, 2001. Previously he was with Morgan Stanley Dean Witter for four years and Smith Barney for ten years. He has built a unique corporate and institutional consulting practice that concentrates on achieving maximum capability for risk-controlled assets.

The Investment Committee was constantly aware of the portfolio liquidity over this time and has not had to change anything in light of the events of the past two years.

JB: OUR TWO MOST IMPORTANT topics of discussion are liquidity and leverage. We must have significant liquidity in our investments and we want to limit the amount of leverage in the vehicles they and we invest in. The key is managing the risk associated with liquidity. Being a slave to liquidity can compromise your returns as quickly as being ignorant or uninvolved in the discussion will.

CX: What are your goals for the endowment? Are you currently planning any changes to the asset allocation?

JB: WE MUST STAY NIMBLE so we can continue to capture returns on the upside and avoid the troughs on the downside, resulting in a responsible 8% return for the Foundation. To do that, we will continue to assess the prudence of aligning the managers with the knowledge we have of the markets.

JA: OUR GOAL IS 8% over the long haul. Consistent with that, Culver will continue to be willing to sacrifice upside to avoid the full effects of inevitable downdrafts. And we're committed to decisive action to seize opportunities generated by dislocations, leading to our strong inclination to use proven active managers who thrive in rapidly moving and changing markets.

BH: The Culver endowment goals remain consistent with the answer to the first question – solvency, growth and sustainability of the Culver educational mission. Asset allocation changes are ongoing, gradual and dynamic typically in advance of broader market direction.

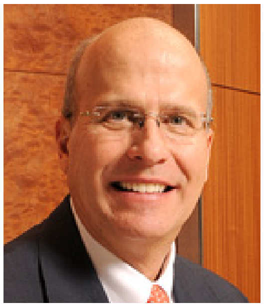
Tactically, Culver is positioned to benefit from deflation, private deleveraging, G-8 economic challenges, emerging market economic ascension and the impact of these forces. Strategically, Culver continues to evolve toward benefit from the ultimate inflationary economic price to be paid for government leverage and resource capacity constraints.

CX: And finally – what are you most looking forward to about the forum?

BH: WE LOOK FORWARD to learning from others to expand our knowledge base.

We hope to share a little of what is possible with an actively engaged, accountable and open-minded investment committee unafraid to take a prudent step down a path not yet trodden by conventional wisdom.

> " The issue is not the percentage of alternative investments but the selection of managers who manage risk creatively and successfully in a volatile marketplace. "



Jeff Adams

Jeff Adams is a founding partner of Balentine in Atlanta, Georgia, and is a member of Balentine's Management Committee and Investment Strategy Team.

Jeff previously served as president and director of Wilmington Trust –Georgia, where he headed the Wealth Advisory / Federal Savings Bank Office. From 1995 until the firm's sale to Wilmington Trust, Jeff was executive vice president and chief operating officer of Balentine & Company. He began his career as an attorney with Alston & Bird, representing public companies and managing the firm's issuer and underwriter finance and regulatory practices. In 1982, he was named a partner in that firm.

Jeff serves in many leadership positions throughout the community. He is a trustee of Young Harris College and chair of the marketing committee. He is also a trustee of The Culver Academies, acting as chair of the finance and investment committee. Jeff was a Morehead Scholar and Phi Beta Kappa at the University of North Carolina – Chapel Hill, where he earned a bachelor's degree in 1973. He later earned a law degree from Yale Law School.

The Midas Effect

Investigating the relationship between CEO stock ownership and performance

What makes a company a good investment prospect? Russell Cleveland – CEO of Renn Capital and Author of Finding Midas – thinks you should look at the leadership. Entrepreneurial CEOs, particularly founders of companies that retain large ownership positions, he argues, tend to outperform other companies in their sectors by a significant margin. Connex sat down with him to discuss the methodology used to identify these companies and to speculate on why stock ownership – as opposed to options – should exert such a powerful influence on performance.

Your investment strategy places a great deal of emphasis on investing in companies led by entrepreneurial CEOs, who own a significant portion of the equity. Why this particular approach?

THE RETURNS FROM investing in companies led by entrepreneurial management, (i.e., founder-owners), has been significantly better than the return on any known market index. For the past 5 years, of all public US-traded companies with CEOs that have greater than 10% ownership, the return was 332% versus 18% for the best performing US average, the Russell 2000. For a 10 year period, the return of CEO-owned companies was 183% versus 44% for the Russell 2000. The ten-year averages were lower due to two bear markets.

"...companies with CEOs that have greater than 10% ownership, the return was 332% versus 18%..."

One good illustration of this concept is Steve Jobs, CEO of Apple, Inc. When Jobs returned in 1997 after a number of years under "professional management" the stock was $3 per share. Recently, the stock hit $300 per share or nearly 100 times higher. This occurred in one of the worst stock markets on record. If you look at the history of the US you will find that superior growth is directly related to leadership at the top. This is true of large companies as well as small ones.

Russell Cleveland

Russell Cleveland is the principal founder and the majority shareholder of RENN Capital Group, Inc. RENN provides capital to emerging publicly owned companies. Russell is a Chartered Financial Analyst who has specialized in investing in emerging growth companies for over 40 years. Mr. Cleveland is a graduate of the University of Pennsylvania, Wharton School of Finance and Commerce.

He has served as President of the Dallas Association of Investment Analysts and his background includes executive positions with major southwest regional brokerage firms. For over 10 years, he was a contributing editor of Texas Business Magazine where he analyzed investment trends. Russell Cleveland is a coauthor of the book Money Grows in Texas and the SMI course Being Financially Independent. He is working on several other books, including The Investors Garden and The 10 Principles of Business Success. He has contributed and has been quoted in a number of national publications including The Wall Street Journal, Barron's, Equities Magazine and Business Week. Russell has appeared numerous times on CNBC (the international market News channel), as a commentator reviewing small-cap companies.

"No equity portfolio will be immune to a market crash such as occurred in 2008-2009. However, these types of entrepreneurial companies seem to recover faster."

In what ways do entrepreneurial CEOs (founder-owners) contribute to the growth of a company's stock price?

FOUNDER-OWNERS USUALLY have a clear vision of growth and are able to have their organizations get behind this vision. I am speaking of the leadership of Sam Walter at Wal-Mart, Ray Kroc at McDonalds, Howard Schultz at Starbucks, Herb Kelleher at Southwest Airlines, Warren Buffett at Berkshire Hathaway and Bill Gates at Microsoft as a small illustration. Due to the rapid growth of these companies, superior gains are reflected in the stock price.

What are the risks associated with your investment strategy?

THERE ARE MARKET RISKS in any equity portfolio. No equity portfolio will be immune to a market crash such as occurred in 2008-2009. However, these types of entrepreneurial companies seem to recover faster. The key to this strategy is to think long-term and, of course, have a diversified portfolio. Because the leadership has so much at stake, the risk reward is more favorable. One of the myths is that entrepreneur leadership is more risky. The facts over a very long period of time show that nothing could be further from the truth.

What criteria do you use for identifying appropriate companies?

WE USE A DISCIPLINED check list with four main criteria:

a) CEO and management are significant shareholders. They must be owners as opposed to receiving stock options. Most would be thought of as founder-owners.
b) CEOs have a clear vision for future growth.
c) Company must be profitable now and have a successful record of profitability.
d) Company must be selling at reasonable prices.

Worldwide entrepreneurial activity is concentrated currently in the United States and Asia with China being the largest area. We concentrate only in companies traded on national US Exchanges but that includes many foreign stocks listed in the US.

What kind of investor would stand to benefit from your strategy?

WE BELIEVE EVERY long-term investor should consider Entrepreneur CEO Investing (founder-owners) as an asset class and have both large and small companies in this area. I believe the two important questions today are: "How does a portfolio manager achieve long-term performance in a short-term world and how does one achieve growth while at the same time manage risk?" We believe that every investor should have 5-10% in this asset class.

"Founder-owners usually have a clear vision of growth and are able to have their organizations get behind this vision."

The "Desirability Dilemma"

When – and how – should pension funds make the transition to LDI?

LDI has grown in popularity in recent years, as concerns around interest rates and longevity improvements have focused attention on the liability stream. But when should pension funds make the transition to a liability-driven investing model, and how should they execute? We speak to Bob Connolly from NV Energy, recent recipient of the Plan Sponsor of the Year Award, about rebalancing the portfolio and timing the transition.

Liability Driven Investing has grown in popularity in recent years. What do you think is behind this growth, and what were your reasons for making the transition at NV Energy?

ONE OF THE MAJOR reasons that LDI strategies are increasing in popularity is because of the Pension Protection Act of 2006 (PPA) and FAS 158. These newly adopted pieces of legislation require mark-to-market accounting and annual funding requirements for under-funded plans. Therefore, although investing heavily in equities might have a higher expected return over a longer time horizon, the downside is funded status volatility. De-risking the plan with an LDI strategy helps to minimize the large capital calls and other penalties that come with funded status volatility. NV Energy has elected to implement an LDI-like strategy for these very reasons. We hope that assets and liabilities will move up and down together so

that NV Energy can maintain a desirable funded status while avoiding large unplanned capital calls.

What are the specific features of the LDI strategy you've introduced? How has your asset allocation changed?

NV ENERGY HAS elected to move from a traditional 60% Equity/40% Fixed Income asset allocation to a 70% Fixed Income/30% Equity asset allocation. By increasing the fixed income percentage, we are targeting a higher interest rate hedge ratio so that small changes in the discount rate for plan liabilities does not affect the funded status as much as before. The fixed income allocation is being invested to benchmark against the Barclay's Long Gov/Credit index to lengthen the duration of plan assets.

What have been some of the challenges you've encountered during the implementation process? What advice would you give to a plan sponsor who was considering making this sort of asset allocation transition?

Bob Connolly

Bob Connolly is currently the Principal, Benefits at Las Vegas based NV Energy. His most recent accomplishment was being awarded Corporate Plan Sponsor of the Year in 2010 by the PLAN SPONSOR organization for his creative management of both the assets and liabilities of the company's pension plans. Bob has over twenty-five years experience in the design and funding of defined benefit, defined contribution and retiree medical plans at major electric, telecommunication and natural gas utilities. Bob has an MBA in Finance from University of Southern California and a B.A. from Dickinson College. He resides in Las Vegas with his wife and two girls.

ONE OF THE MAJOR challenges to implementing an LDI strategy is keeping the expected return of plan assets at a desirable level while the plan is still less than 100% funded. Currently, interest rates are at a historic low. A lower expected return increases the pension cost and potentially increases the required contributions. Our response to these challenges has been to make the transition over a longer time horizon (18 month long transition). By making the transition to long duration over an 18 month period, we have been able to take advantage of the higher equity returns in 2009 and early 2010 while increasing our fixed income exposure over that period of time.

All pension related reporting must also change to measure movement of both asset & liabilities together and to focus on funded status (/volatility) as the new risk metric.

Many commentators on LDI have spoken of the “desirability dilemma”: namely that LDI is most attractive to investors when it’s least appropriate for them, and vice versa. Was this an issue you encountered at NV Energy, and if so how did you get around it?

THE DESIRABILITY DILEMMA is real. Plan sponsors want to be riding the waves of high equity returns of a bull-market, but also want the safety and lower volatility of investing in fixed income when markets turn south. Selecting an investment strategy should be a risk budgeting decision based on the plan sponsors ability to withstand volatility. Often times, plan sponsors tend to think they are more risk tolerant when equities are doing well, but realize they are more risk adverse during fat-tail events.

To overcome this dilemma, NV Energy has attempted to maintain a long-term perspective and avoid allowing our risk tolerance to waver with the market.

And finally Bob – what part of the forum are you most looking forward to?

I AM PARTICULARLY looking forward to the panel moderated by Robert Ball on the topic “The New Risk Management,” with Brett Hammond from TIAA-CREF, Jon Shear from the University of Utah and Dennis Wilber from the Visiting Nurse Service of New York. It will be instructive to see how they’re managing risk reporting and risk measurement in this new environment.

Toby Donovan, Program Director, Connex International
Tel: 646 502 8873
Email: tdonovan@theconnexgroup.com