



NEPC, LLC

To: State of Rhode Island Investment Commission

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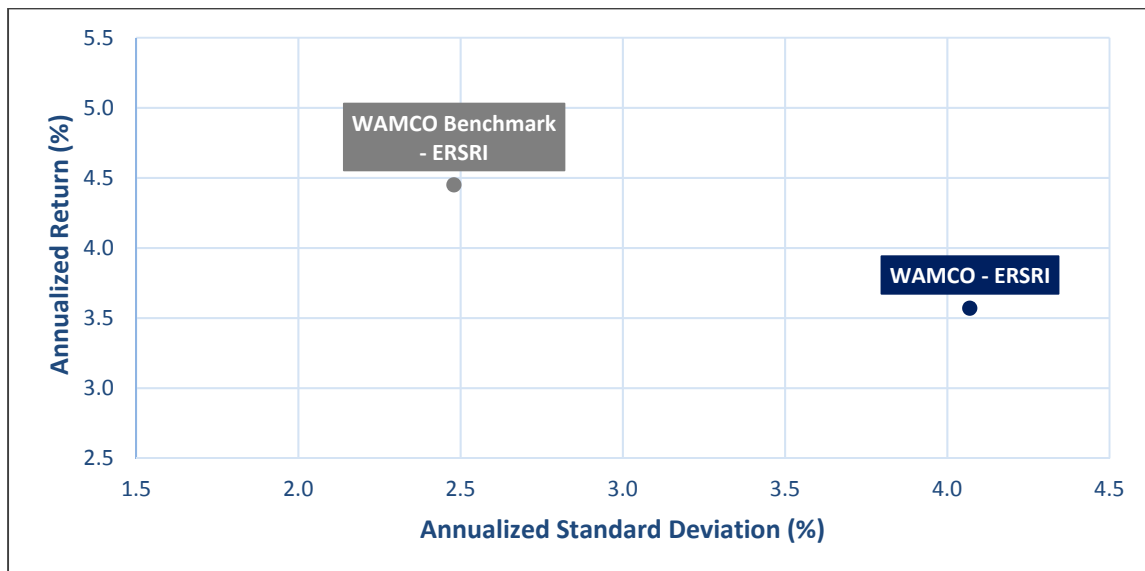
Subject: Western Asset Management Review & Recommendation

Executive Summary

Western Asset Management Company (“WAMCO”) currently manages approximately \$173 million on behalf of the System as part of the Liquid Credit mandate. The WAMCO portfolio was originally funded in April, 2013 and was subject to custom guidelines related to duration and sector allocations. As part of our review of the System’s investment manager roster, NEPC highlighted WAMCO as an area of focus to better understand its underperformance over the past 5 years. As part of our review and consistent with the messaging provided to the Investment Commission over the past few months, NEPC recommends considering options for replacing WAMCO.

Summary of Review

As part of our review, NEPC identified multiple drivers that we believe contributed to WAMCO lagging its benchmark over the trailing 5-year period, net of fees. The most significant driver is related to WAMCO’s credit selection in the Industrial sector, with Energy being a key detractor. Poor credit selection within the sector has weighed on longer-term performance. Interestingly, WAMCO’s underperformance over that timeframe also came with higher volatility. Despite a strong environment within credit sector over the past 3 years, WAMCO has not benefitted from the higher risk profile compared to that of the benchmark.



*Performance is net of fees and as of June 30, 2018

**WAMCO’s benchmark is 30% BofA 1-3 BB-B HY/70% CS LLI



To better understand WAMCO’s capabilities and performance across both the high yield and bank loan sectors, NEPC reviewed the performance of the firm’s composite strategies to a universe of their respective peers. WAMCO’s High Yield composite ranks in the 72nd percentile of the eVestment US High Yield universe over the trailing 5-year period. While WAMCO’s Bank Loan composite ranks in the 93rd percentile of the eVestment U.S. Floating Rate BL universe.

<u>High Yield</u>	<u>3-year</u>	<u>Rank</u>	<u>5-year</u>	<u>Rank</u>	<u>10-year</u>	<u>Rank</u>
WAMCO US High Yield	4.92	54	4.95	72	7.92	43
BB US Corp. High Yield 2% Cap	5.54	31	5.52	42	8.23	26
<i>eVestment US High Yield Fixed</i>	<i>5.07</i>		<i>5.35</i>		<i>7.78</i>	

<u>Bank Loans</u>	<u>3-year</u>	<u>Rank</u>	<u>5-year</u>	<u>Rank</u>	<u>10-year</u>	<u>Rank</u>
WAMCO US Bank Loan	3.67	89	3.60	93	5.24	62
S&P/LSTA Leveraged Loan Index	4.21	66	4.00	75	5.19	64
<i>eVestment US Floating-Rate BL</i>	<i>4.45</i>		<i>4.43</i>		<i>5.53</i>	

*Composite performance is gross of fees and as of June 30, 2018

Despite disappointing longer-term performance, WAMCO has rebounded over the trailing 1-year period ended August 31, 2018 due in large part to its overweight to CCC’s relative to the custom benchmark. However, security selection over that period has not been a positive contributor to relative performance. For the 2018 calendar year-to-date period (ended 8/31/18), the preliminary portfolio return is in line with the benchmark (+6 bps, gross of fees) with the positive impact of the CCC overweight being mostly offset by negative security selection.

Recommendation

NEPC recommends that the Investment Commission consider alternative options for WAMCO in light of its long-term performance struggles. NEPC believes WAMCO, as a firm, has strong capabilities in multi-sector credit strategies for mandates that include larger allocations to the securitized sector and non-US markets, but has faced headwinds in managing the System’s U.S. focused, customized Liquid Credit mandate.