Partners Capital Guide to Absolute Return Investing

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In their personal investing, investment professionals generally look for sources of return that are uncorrelated to their business assets, which are usually dominated by equity risk. Classically, Fixed Income securities such as US Treasuries and municipal bonds have played this role. However, in the current environment of historically low interest rates, Absolute Return hedge fund strategies are an attractive alternative. These strategies normally exhibit low correlation to equities with higher potential returns than Fixed Income.

The most efficient allocation to Absolute Return is through top-tier Multi-Strategy managers. Multi-Strategy managers have significant structural advantages compared to funds of hedge funds. We estimate that leading Multi-Strategy funds have a +2-3% per annum advantage over funds of funds or separately managed portfolios of single-strategy funds.[1] In this edition, we share our thesis for Multi-Strategy managers, our investment specification and some insights for your portfolio.

In building your personal account portfolio, it is natural to start with the asset classes with the lowest correlation to the risk in your business. For most investment professionals, this is equity risk. The most common PA portfolio we see among busy investment professionals is the classic "barbell": one part equity (including co-investment and carried interest) and one part cash and municipal bonds. This approach amounts to what we describe as "reckless conservatism," leaving significant long-term capital appreciation on the table.

In the current low interest rate environment, we look for alternative sources of return to fixed income that have similar correlation benefits but higher potential returns. One such alternative is Absolute Return hedge fund strategies. We define Absolute Return hedge funds as those with very low correlations to any market risk, whether it be equity, credit, interest rates, commodities, property or other market risks. The most common Absolute Return hedge funds strategies include equity market neutral, global macro, statistical arbitrage, merger arbitrage, fixed income arbitrage and most so-called "Multi-Strategy" hedge funds. We believe that the most efficient way to allocate to Absolute Return, and the subject of this newsletter, is these Multi-Strategy hedge fund managers.

No definition of an asset class is complete before addressing fees. Absolute Return strategies only rival private equity for having some of the highest fees. Standard terms include a 2% management fee and 20% performance fees with no hurdle, but with a high water mark. As with all asset classes, most asset managers in this asset class do not justify their fees with the true alpha they generate. Many Absolute Return managers use beta to generate their returns and sell it as "alpha." In our screening and due diligence, we seek to flush out the imposters and focus on the handful of Absolute Return managers who have a long demonstrated skill that explains their outperformance.

As shown in Figure 1, Multi-Strategy managers have delivered returns in line with developed market equities over the last ten years with much lower volatility and a beta to equities of 0.30.

[1] Source: Partners Capital analysis. Please refer to Figure 2 for detail.

Figure 1: Asset Class Performance Over Last 10 Years To June 30, 2014 (Sorted By Beta to Equities)

Asset Class	Sub-Strategy	Annual Return	Annual Volatility (Std Deviation)	Sharpe Ratio	Beta to DM Equities
Fixed Income	US Treasuries (Intermediate Duration)	5.4%	5.7%	0.61	-0.13
Fixed Income	Municipal Bonds (Intermediate Duration)	4.9%	3.9%	0.75	-0.01
Inflation-Linked Bonds	TIPS (Intermediate Duration)	5.3%	6.3%	0.52	0.05
Absolute Return	Multi-Strategy Managers	6.5%	5.8%	0.79	0.30
Credit	High Yield Corporate Bonds	9.0%	10.4%	0.68	0.55
Commodities	Diversified Commodities	0.9%	18.0%	NM	0.65
Global Equities	Developed Markets Equities	6.5%	14.1%	0.32	1.00
Real Estate	Global REITs	7.1%	19.3%	0.26	1.20
Global Equities	Emerging Markets Equities	12.1%	23.8%	0.42	1.42

Notes: Sharpe Ratio is calculated using 2% risk-free rate based on actual 3-month LIBOR over last 10 years. Performance based on selected market benchmarks for each asset class as follows: US Treasuries = Barclays US Treasury 5-10 Year Index; Municipal Bonds = Barclays Municipal Bond 7 Year Index; TIPS = Barclays US TIPS Index; Absolute Multi-Strategy Managers = Credit Suisse Multi-Strategy Hedge Fund Index; High Yield Bonds = Barclays US Corporate High Yield Index; Diversified Commodities = Bloomberg Commodity Index; Developed Markets Equities = MSCI World NR LC; Global REITs = MSCI World Real Estate NR LC; Emerging Markets = MSCI Emerging Markets NR USD. It is not possible to invest directly in an index. Past performance is not indicative of future returns. Source: Partners Capital's analysis of asset class performance.

Absolute Return: Role in the Portfolio

Yale University Chief Investment Officer David Swensen defines Absolute Return as "inefficiency-exploiting marketable securities positions that exhibit little or no correlation to traditional stock and bond investments."[2] Absolute Return funds are distinct from directional hedge fund strategies that have a normative net long exposure to markets. Generally, these are relative value strategies that seek to exploit security mis-pricings without accepting significant net market exposure.

The role of Absolute Return in a diversified portfolio is to provide returns from manager skill (or alpha), with low correlation to equities and other asset classes. Measuring alpha as that portion of historical returns that is not explained by a set of static market exposures, Absolute Return strategies have historically generated some of the highest levels of alpha of any liquid asset class; higher than long/short equities, long-only equities, property, commodities, fixed income and credit asset classes. Since most of the sources of alpha generated from Absolute Return strategies have very low correlation to various market risks, allocations to Absolute Return strategies offer the potential to improve the return of a portfolio at a given level of risk (or reduce the risk required to achieve a given level of return).

[2] David Swensen. Pioneering Portfolio Management. New York: Free Press, 2000 (Revised 2009).

Most Absolute Return strategies involve significant portfolio turnover and thus have poor tax efficiency. For US taxpayers, it is critical to evaluate allocations to this asset class in light of expected after-tax returns. As explained in previous issues of this newsletter, this leads us to allocate to some higher volatility, higher returning Absolute Return strategies in order to deliver meaningful levels of after-tax return. As such, Absolute Return hedge funds do not entirely take the place of our clients' "safety net" allocations, which have historically been satisfied through allocations to government bonds.

Definition of Multi-Strategy Managers and Investment Thesis

In our experience, investors have three primary alternatives for constructing an Absolute Return portfolio:

1) Invest directly in a diversified portfolio of approximately 6 to 10 specialist Absolute Return funds including strategies such as equity market neutral, global macro, statistical arbitrage, merger arbitrage, fixed income arbitrage and managed futures.
2) Allocate to a smaller number of high conviction Multi-Strategy managers (typically 3-5 managers).
3) Allocate to a fund of hedge funds that has a low allocation to more directional strategies.

We believe that the optimal approach to Absolute Return investing is to allocate to a small number of Multi-Strategy managers. This is based on our own long-term experience of investing in the first two alternatives above and monitoring the performance of some of the best hedge funds of funds. We define a Multi-Strategy manager as one that invests across more than one single hedge fund strategy. These strategies and market exposures are combined to produce a stream of returns with generally low correlations to equity and other market returns. Most Multi-Strategy managers do not limit themselves to investing just in Absolute Return strategies, but also invest in directional strategies such as Equity Long/Short, Credit Long/Short and Event Driven strategies (e.g., distressed, spin-outs, restructurings). However, the blend of strategies generally results in low to moderate volatility and correlation to equity markets. By definition, a Multi-Strategy hedge fund is one of the most complex investment strategies to execute. Success requires a deep understanding of multiple asset classes, specialist strategies, integrated portfolio construction and, critically, overall portfolio risk management. Although difficult to execute, we believe that the Multi-Strategy investment model has clear structural advantages over a portfolio of single-strategy hedge funds, primarily explained by the following:

1. Dynamic Capital Allocation: Capital can be allocated nimbly to the best opportunities as market conditions change and as the supply of investment opportunities in any one strategy changes. Compare this to a direct portfolio of multiple funds or a fund of hedge funds. Each could take 6-12 months to reorient its portfolio to an opportunity due to long notice periods for underlying fund redemptions.

2. More Effective Risk Control: Multi-Strategy fund risk is controlled centrally on an hour-by-hour basis. This allows the central capital allocator to eliminate redundant positions or undesired concentration to a single sector or theme. By comparison, the direct portfolio or fund of funds portfolio manager has to rely on monthly exposure reports and still has the response time limitations described above.

3. Lower Fees: Performance fees, which make up as much as half or more of total hedge fund fees, may be netted across strategies in Multi-Strategy funds. Fund of funds and portfolios of single-strategy funds lack this benefit and cannot offset losses in one hedge fund against gains in another. We are quick to add that top-tier Multi-Strategy funds often have the market power based on their superior performance to charge higher fee rates (i.e., above the standard 2% and 20% described above) that may offset much of this fee-netting benefit.

4. Portfolio Managers are 100% dedicated to investing: PMs in single-strategy funds often have distractions away from research and trading as they devote time to meeting clients, dealing with firm management issues, regulators, recruiting and other activities. PMs in Multi-Strategy funds are generally completely shielded from these activities by the firm's functional heads.

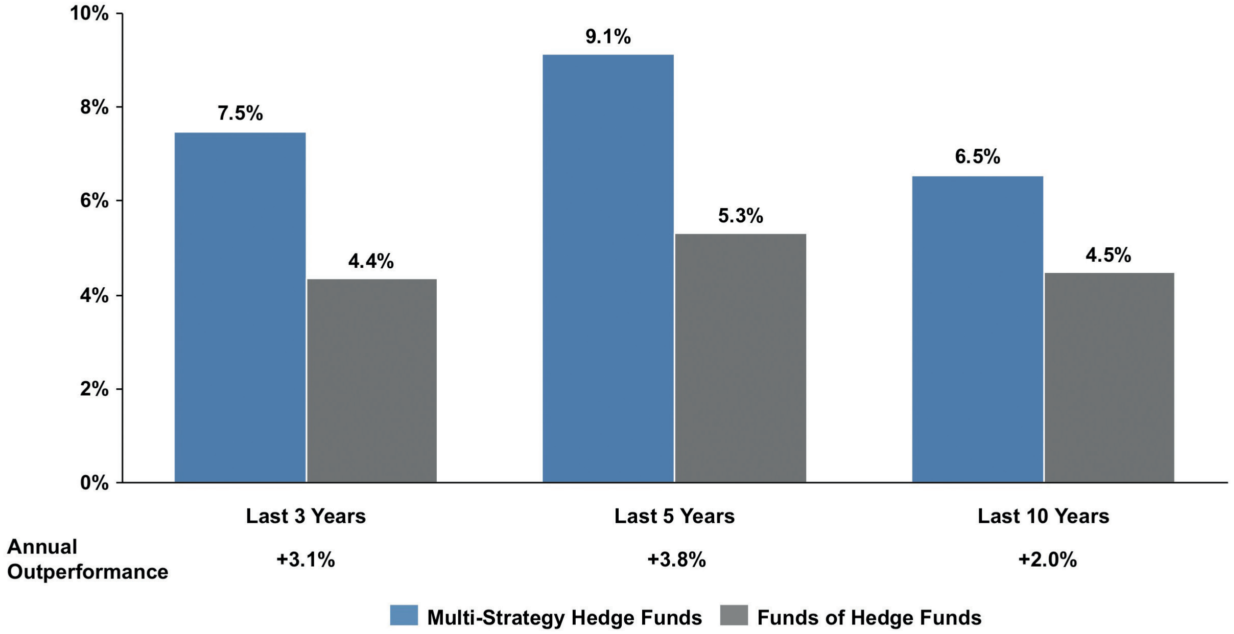
5. Attract Top Talent: The top tier Multi-Strategy firms leverage their financial firepower, institutional brand and infrastructure to attract and retain great investment talent. These funds have significant resources dedicated to recruiting exceptional investors. Some of the best young talent is drawn to these firms in order to "make their names" in the hedge fund world. In our experience, the investment staff at top Multi-Strategy firms is on par with the best single-strategy managers we know.

Before we abandon the first option of building a direct portfolio of specialist Absolute Return funds, we note that the best portfolios from our experience have comprised a blend of two to three Multi-Strategy funds as the core with a small number of high conviction specialists. These specialist managers usually occupy a structurally attractive niche, not simply a cyclical opportunity that can be easily exploited by a Multi-Strategy manager. Examples include fixed income arbitrage, catastrophe reinsurance managers, and sector and regional specialist equity market neutral investors.

Historical Performance of Multi-Strategy Managers

These structural advantages of Multi-Strategy firms are evident in the segment's performance track record. As shown in Figure 2, Multi-Strategy hedge funds have outperformed funds of hedge funds soundly over the last three, five and ten years. The historical level of outperformance is consistent with our own estimate of a 2-3% annual return advantage in favor of Multi-Strategy funds. The volatility and beta to equities was similar between the categories over each time period, so the outperformance of Multi-Strategy funds is not simply attributable to greater market risk.

Figure 2: Performance of Multi-Strategy Hedge Funds vs. Funds of Funds (As of June 30, 2014)



Source: Credit Suisse and Hedge Fund Research. Multi-Strategy Hedge Fund performance is based on the Credit Suisse Multi-Strategy Hedge Fund Index. Fund of Hedge Funds performance based on HFRI Fund of Funds Composite, estimated gross of 1% annual fund of funds fee layer. It is not possible to invest directly in an index. Past performance is not indicative of future returns

Note that we add 1% back to the reported annual performance of the funds of funds as investors with sufficient wealth can build their own diversified hedge fund portfolio without paying fund of funds fees. Net of fees, the Multi-Strategy fund outperformance is even more significant. Of course, this performance data is at the index level and is a proxy for performance of the average Multi-Strategy manager. We believe that astute selection of Multi-Strategy managers can lead to even stronger results.

There are Multiple Strategies to Multi-Strategy Investing

There is such a vast universe of Multi-Strategy hedge funds that it helps to group these different funds to find those with the highest propensity for persistent outperformance going forward. Of the three approaches we describe below, we prefer Integrated Multi-Strategy Firms and Funds of Traders, rather than the Core/Satellite approach which tends to have too much exposure to a single strategy. However, there are strong firms competing in each sector that are highly investible.

1. **The Fund of Traders** model allocates risk dynamically across a group of talented traders, rather than conventional hedge fund strategies. In this Fund of Traders approach, the talent of the individual traders is critical. Funds of Traders need a platform and brand that will attract and retain PM talent. Individual traders focus on their "book" and tend to operate in siloes with little or no input from other traders. They are similar to investment bank prop desk traders who may execute a single strategy or trade a single asset class. They will be tightly risk-managed from the center with stop loss triggers and VAR limits. Traders are primarily compensated based on their individual performance and will be allocated a larger or smaller share of the total fund risk budget based their individual performance. Examples of the Fund of Traders model include Millennium, Hutchin Hill, Moore, Visium Global and Brevan Howard.
2. **Integrated Multi-Strategy Firms** are large institutional hedge fund firms that are truly diversified across multiple hedge fund strategies. They are distinct from Funds of Traders, which may have most of their risk in one asset class (e.g.,

Visium Global with over half of their risk allocated to equity-related trading strategies), and Core/Satellite Firms, which have significant exposure to a single strategy (e.g., Whitebox in credit). Management is seeking to build a world-class financial institution characterized by recruitment of top investment talent, appropriate incentives, institutional processes and tight regulatory and legal controls. The senior capital allocators may or may not be portfolio managers (PMs) themselves. These firms tend to grow PM talent internally and focus on mentoring and developing their strategy expertise in-house. The capital allocation process tends to be collaborative. Capital moves incrementally across strategies given the firms' broad, diversified nature. Major swings in exposure are relatively rare. The most senior PMs and executives will be compensated based on overall fund performance. Examples of Integrated Multi-Strategy Firms include D.E. Shaw, Citadel, AQR, Och-Ziff, BlueCrest, Bridgewater, HBK and Davidson Kempner.

3. Finally, **Core/Satellite** funds have a core strategy that reflects their heritage (e.g., equity long/short or fixed income macro) and have started to add other strategies as they grow. Often this is done as they reach capacity limits in their core strategy. These funds have the ambition of becoming Integrated Multi-Strategy firms but have not achieved the depth across strategies or the scale of those institutions. The primary risk with Core/Satellite funds is that they are not sufficiently diversified and they may not have proven their ability to generate alpha in the satellite strategies outside of the core. However, the best of these managers will go on to become great Integrated Multi-Strategy Firms as they deepen their capabilities and institutionalize. Examples of Core/Satellite funds include Silverpoint, Pine River, Whitebox and Farallon.

While these groupings are useful for sorting through the vast universe of Multi-Strategy managers, we again stress that there are good and bad hedge funds in each group and included in the examples provided above. The key message of this newsletter about the relative attractiveness of Multi-Strategy hedge funds is only useful if the manager selection is effective.

Key "Watch-Outs" When Selecting Multi-Strategy Managers

There is a sizeable "graveyard" of failed Multi-Strategy hedge funds. Famous examples include Sowood, which collapsed in 2007 due to leveraged positions in corporate loans; Peloton, which was forced to liquidate in 2008 when it was unable to meet margin calls on mortgage-backed securities; and SAC, which returned money to investors in 2014 after extensive insider trading investigations by the SEC. These and other case studies have armed us with valuable learning to inform our Multi-Strategy manager screening, due diligence and monitoring. We evaluate Multi-Strategy managers just as we would evaluate any business. We look for talented, motivated management teams with a defensible competitive edge in executing their strategy.

Learning from these case studies has driven us to the following additional key criteria in selecting Multi-Strategy managers:

- **Large fund size:** In our view, size is actually a good thing in this strategy. Small Multi-Strategy firms fail to attract top talent and cannot afford institutional risk management infrastructure. It is not unusual to see strong $10 billion Multi-Strategy funds, but they still must manifest strong discipline around fund raising. If AUM has grown meaningfully, we must see evidence that alpha has been sustained at the current fund size. The best Multi-Strategy funds tend to be large and closed to new capital.
- **Spinouts from other great Multi-Strategy firms:** These do not automatically succeed. In fact, the failure rate is very high. There is a natural barrier to entry in this hedge fund strategy where, to be successful, the fund must migrate from a single-strategy fund into others, gradually over long periods of time. We much prefer to invest in the veteran funds when we can pry open access.
- **Great veteran Multi-Strategy Firms can fail:** Many will remember the story of Amaranth, one of the largest hedge fund blow-ups in history. Nick Maounis, who established his reputation as a convertible bond trader at Paloma Partners in the 1990s, founded Amaranth in 2000 in the multi-strategy mold of Paloma.[3] The firm collapsed in 2006 when bets on natural gas prices made by energy trader Brian Hunter led to $6.6 billion in losses. At the time of the implosion, Hunter controlled over 50% of the fund's capital.[4] Amaranth is a cautionary tale about hubris, leverage and ineffective risk management.

[3] "Billions in Losses Dim a Star Manager's Glow." The New York Times. September 20, 2006.

[4] "Amaranth's $6.6 Billion Slide Began With Trader's Bid to Quit." Bloomberg. December 6, 2006.

- **Risk management is paramount:** We look for clearly defined controls on risk (stop losses, maximum exposures, individual trader portfolio sizing, etc.). Risk management decision-making should be separate from the portfolio management team. We look for a minimum of five years of track record running their Multi-Strategy fund to prove out their risk management systems, ideally having been through a crisis. A risk-focused culture is critical.
- **High volatility may be better than low volatility.** For most US taxpayers, earning a 5% pre-tax return, only to give back more than 40% of the gains in taxes, is not worth the effort or risk associated with investing in hedge funds. To the extent that higher volatility translates into higher expected returns, we prefer those Multi-Strategy funds for our US taxpaying clients. Such managers typically target net pre-tax returns of 8-10%, generating 4-6% after-tax returns, with annual standard deviations expected to be around 10%. This higher volatility may mean that there is more beta in the mix, but as long as the correlation to equity risk remains low to moderate, we find these strategies to be highly accretive to overall portfolio risk-adjusted after tax returns.

Allocating to Absolute Return Multi-Strategy Managers in Your Personal Account

Overall Absolute Return portfolio construction involved the right mix, number and sizing of the portfolio. As with any asset class strategy, we look to diversify the sources of alpha. Ideally the individual multi-strategy funds' returns will not be correlated with one another. The choice of each additional multi-strategy managers should optimally have different underlying strategy mixes or sources of alpha. We clearly want to avoid creating a portfolio of 2-3 managers who all do the same thing, where the combined performance is not materially differentiated from the performance of the individual funds.

The right number of Multi-Strategy managers for your portfolio will depend on your portfolio size, your target allocation to Absolute Return strategies and access to high quality managers. We design a typical allocation around a core of 2-3 Multi-Strategy managers. These positions may be sized at as much as 3-6% of the overall portfolio in light of their underlying strategy diversification. We complement the Multi-Strategy core with smaller opportunistic allocations to niche strategies that are not well represented (e.g. healthcare equity market neutral, catastrophe reinsurance, etc.).

For taxable investors, we must highlight that classically Absolute Return hedge fund strategies are among the least tax efficient of any asset class, depending upon your tax jurisdiction. For US taxpayers, there is little in the form of long term capital gains as most underlying strategies trade heavily. For US investors, the optimal vehicle in which to hold your Absolute Return allocation is a tax-advantaged account, such as a Private Placement Life Insurance (PPLI) policies.[5]

[5] Please consult with your independent tax advisor to determine the tax treatment of your investments. Partners Capital does not provide tax advice and circumstances may vary by investor.

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