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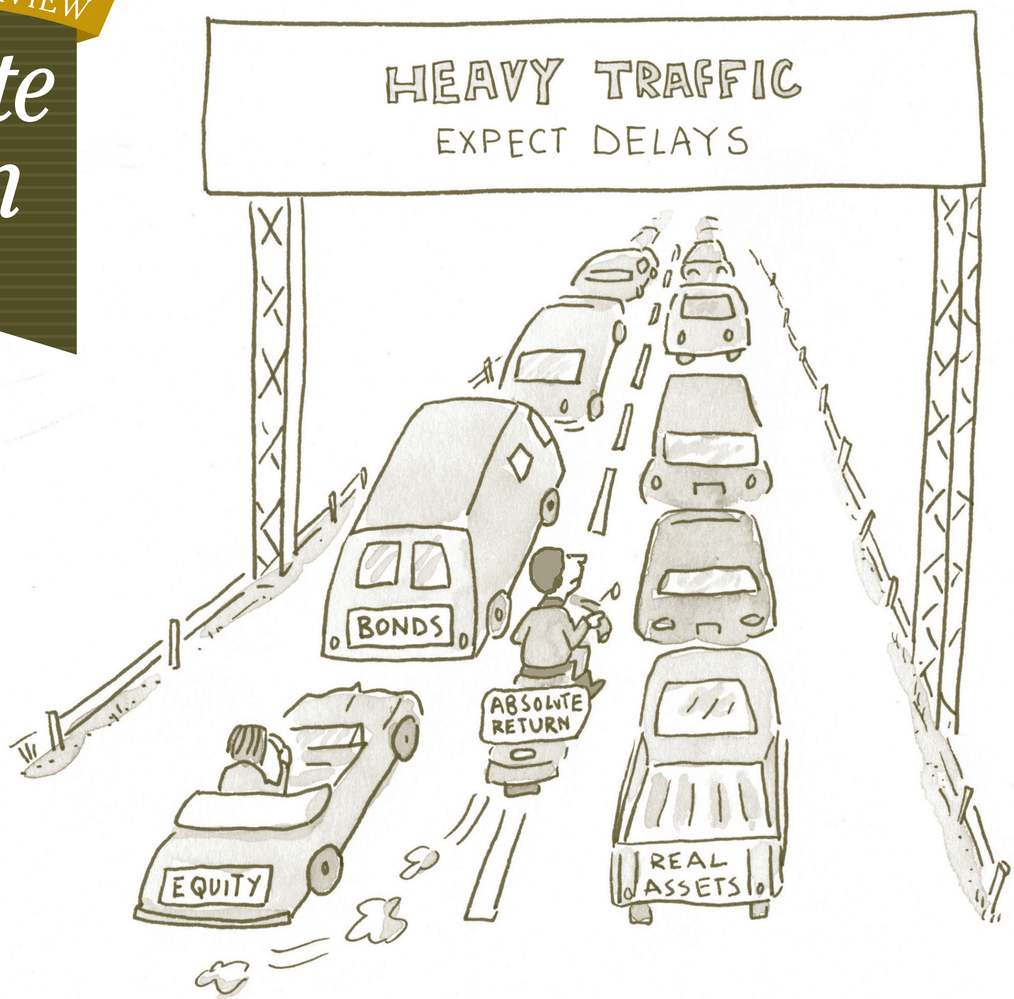
ASSET CLASS OVERVIEW

# *Absolute Return*




We construct our clients' portfolios to consist of a truly diversified mix of assets, such that different investments will benefit in a variety of different scenarios. While we tilt toward our highest conviction outlook, the future is inherently unknowable, and even the best investors' forecasts frequently don't come to pass. Strong bottom-up security selection is critical to our investment process, but macro factors like the strength of the economy, the rate of inflation, and the direction of interest rates can drive markets. We believe constructing a prudent asset allocation that takes a range of outcomes into account is the most effective method for positioning our clients' portfolios to meet their risk-reward objectives.

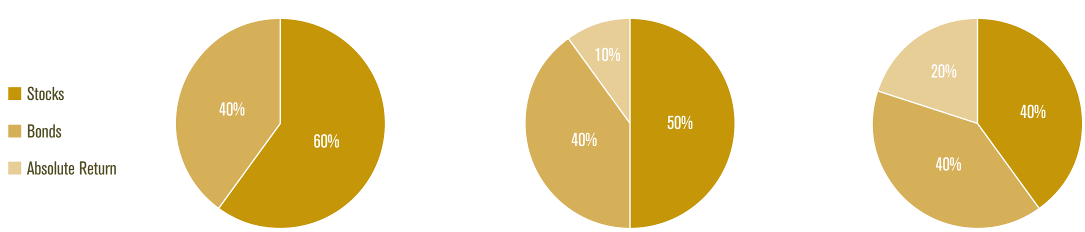
Our asset allocation framework is composed of four distinct categories. The first is Fixed Income; these investments provide capital preservation, limit volatility, hedge against unexpected deflation, and provide dry powder to invest in other assets after they've suffered a downturn. The second category is Equities, typically our clients' largest allocation, which provides long-term capital appreciation and, over longer periods of time, is expected to offer the highest return of the four categories. The third is Real Assets, which also provides long-term total return and is specifically designed to do well in periods of unexpected inflation. The fourth category is Absolute Return; the risk and return of these investments tend to » fall in between those of Equities and Fixed Income, and their main value is that they are uncorrelated to the other three categories, therefore providing good diversification and improving the risk-adjusted return of our clients' overall portfolios.

Across all four categories, the investments we recommend are actively managed by skilled investors with expertise in their approach, and we believe they add value in a variety of market environments. But despite managers' best efforts, macro factors beyond their control can be a significant determinant of performance for the first three categories: the direction of interest rates drives fixed income investments, the direction of global stock markets determines the course for equity investments, and inflation is a major influencer of the performance of real assets.

Absolute return investments are different. Their performance is much less dependent on the direction of equity and fixed income markets and is dictated far more by the strategy they follow and the manager's skill at employing that strategy. There are many types of absolute return strategies, including shorting or other types of hedging; arbitrage[1] strategies, such as merger arbitrage, convertible arbitrage, or closed-end fund arbitrage; and macro strategies that follow trends in the commodities markets or the relative direction of foreign currencies and interest rates. For example, in the classic merger arbitrage strategy, after a merger between two companies is announced, in a stock-for-stock transaction, the two companies' stock prices tend to converge. However, they don't completely converge until after the deal is complete, reflecting the risk that the deal will fall through for reasons such as failure to obtain shareholder or regulatory approval. A merger arbitrage manager buys the stock of the target company and sells short the stock of the acquirer, earning a return when the deal is finalized and the gap between the two closes. Being long one and short the other, it doesn't matter if the market goes up or down in the meantime, just that the gap closes. While this is a simplified explanation and there can be other factors at play, it illustrates how this differentiated strategy can earn a return independent of interest rates or market fluctuations.

Over the last 20 years, merger arbitrage returned 5.8%, fixed income returned 5.1%, and equities returned 7.0%.[2] This is in line with our general expectation that an absolute return investment's performance should fall somewhere in between stocks and bonds (Exhibit 1). »

**EXHIBIT 1** **HYPOTHETICAL RETURNS OF U.S. STOCKS, U.S. BONDS, AND ABSOLUTE RETURN**
JANUARY 1990-DECEMBER 2015




| | 60/40 Stocks & Bonds Portfolio | With 10% Absolute Return Allocation | With 20% Absolute Return Allocation |
|---|---|---|---|
| Annualized Return | 8.1% | 8.4% | 8.4% |
| Annualized Volatility | 9.0% | 8.1% | 7.2% |
| Sharpe Ratio | 0.59 | 0.66 | 0.74 |
| Worst Month | -11.0% | -10.0% | -9.0% |
| Worst Drawdown | -32.5% | -29.3% | -25.9% |

*Source: AQR. Stocks represented by S&P 500 Index total returns, Bonds: Barclays Capital US Aggregate Bond Index total return, Absolute Return: HFRI Fund-Weighted Index. Equities and Bonds are gross of fees, Absolute Return is net of fees. All portfolio statistics calculated using monthly returns from January 1990 to December 2015. Risk-free rate used in Sharpe ratio calculations is the Merrill Lynch 3 Month Treasury Bill Index. Sharpe ratio is calculated as the average annualized excess of cash return divided by volatility. Past performance is not a guarantee of future performance.*

A simple calculation shows that a portfolio of 65% bonds and 35% stocks would have produced a return of 5.8%, the same as merger arbitrage, so one might question the rationale for investing in merger arbitrage when the same return can be produced with stocks and bonds. This is a nuanced point. First, while the return was in between, the manner in which it was generated was different, meaning that an investor who had an allocation to merger arbitrage in addition to equities and fixed income had a smoother ride than one who did not, due to the benefits of diversification. Second, a portfolio of only stocks and bonds may not produce the same return in the future. With interest rates near all-time lows, similar performance from bonds will be difficult to achieve, and forward-looking equity returns are difficult to predict. But we can presume that corporate mergers and acquisitions will persist, meaning that we should expect to earn a return on merger arbitrage strategies in the future that will have little dependence on interest rates or the broad stock market.

Until the last five to 10 years, absolute return strategies were offered almost exclusively via hedge funds (though, importantly, not all hedge funds offer absolute return strategies). Hedge funds are very flexible vehicles and provide access to the greatest range of absolute return strategies. Many talented investors prefer to manage hedge funds—not only for their flexibility but also because their fees are typically high. In addition to high fees, most hedge funds come with other downsides, including a lack of transparency and regulatory limitations on who can and cannot invest.

More recently, many mutual fund managers have been offering absolute return strategies, a phenomenon many in the industry refer to as liquid alternatives. (For more information about liquid alternatives, please refer to "A Brief Review of the Liquid Alternatives Universe" from our Winter 2014 issue of INVESTED.) Mutual funds frequently provide greater transparency and lower fees, as well as significantly more regulatory oversight. However, because of the Investment Company Act of 1940, mutual funds are much more limited in the investment strategies they are able to employ and, because of their lower fees, they do not always attract the most talented managers. Cognizant of these issues, we recommend absolute return investments to our clients in both mutual funds and hedge funds, attempting to balance the pros and cons of each.

When determining how much of a client's portfolio should be in absolute return investments, there is no single right answer or formula to solve. Many factors must be considered, among them accreditation, which dictates the types of investments available; time horizon, which affects how impactful a portfolio-level drawdown might be; and risk tolerance, including how the investor might behave in the midst of a large drawdown and whether he or she would be susceptible to selling at just the wrong time. When building an asset allocation for our clients, in addition to doing in-depth analysis of investment options, we work with them to understand their individual goals and behaviors in order to determine the optimal mix. Absolute return investments are typically an important ingredient for success. ■

1 *Investopedia defines arbitrage as "the simultaneous purchase and sale of an asset to profit from a difference in the price. It is a trade that profits by exploiting the price differences of identical or similar financial instruments on different markets or in different forms." "Arbitrage," Investopedia, accessed November 13, 2017, https://www.investopedia.com/terms/a/arbitrage.asp.*

2 *As of September 30, 2017. Merger arbitrage strategies are the HFRI ED Merger Arbitrage Index, fixed income is the Barclays Aggregate Bond Index, and equities are the S&P 500 Index.*

Index Descriptions

- The Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency). Provided the necessary inclusion rules are met, U.S. Aggregate-eligible securities also contribute to the multi-currency Global Aggregate Index and the U.S. Universal Index, which includes high-yield and emerging markets debt.
- HFRI Event-Driven Merger Arbitrage Index: Merger Arbitrage strategies that employ an investment process primarily focused on opportunities in equity and equity-related instruments of companies that are currently engaged in a corporate transaction. Merger Arbitrage involves primarily announced transactions, typically with limited or no exposure to situations that pre- or postdate or situations in which no formal announcement is expected to occur. Opportunities are frequently presented in cross-border, collared, and international transactions that incorporate multiple geographic regulatory institutions and that typically involve minimal exposure to corporate credits. Merger arbitrage strategies typically have over 75% of positions in announced transactions over a given market cycle.
- The HFRI Fund-Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager funds that report to HFR Database. Constituent funds report monthly, net of all fees performance in U.S. dollars and have a minimum of $50 million under management or a 12-month track record of active performance. The HFRI Fund-Weighted Composite Index does not include Funds of Hedge Funds.
- The S&P 500® Index is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 7.8 trillion benchmarked to the index, with index assets comprising approximately USD 2.2 trillion of this total. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.