FEG INSIGHT

2012 FEG Investment Forum
Politics, Policy, and Your Portfolio

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Your Vision / Our Insight

2012 FEG Investment Forum: Politics, Policy, and Your Portfolio

Fund Evaluation Group, LLC (FEG) held the fourth annual FEG Investment Forum the week of March 26 in downtown Cincinnati at the National Underground Railroad Freedom Center and Westin hotel. FEG was fortunate to have 6 excellent speakers offer their perspectives on the elections, political policy, and portfolio strategy and management in the current market landscape. Over 400 guests attended this year and listened to a lineup of prominent guest speakers and FEG investment professionals, as well as attended various breakout sessions throughout the forum.

Following the monumental success of last year's forum review published in the April 2011 *Research Review*, we again provide a summary of the events at the 2012 FEG Investment Forum. While the following synopses may not reflect the entirety of each session, they attempt to highlight each speaker's primary thoughts and points.

We recognize our speakers may have discussed controversial issues, but we believe these issues merit conversation due to their potential market impact. FEG does not support any political party or candidate.

Eric Mindich

Discussed Global Investment Opportunities, the Impact of Politics and Regulations, and the Role of Hedge Funds

MINDICH
CEO / Eton Park Capital Management

Eric Mindich, Chief Executive Officer of Eton Park Capital Management, spoke Wednesday morning at the Westin hotel. Mr. Mindich compared and contrasted last year's market environment to this year's and shared his views on various global price dislocations and resulting investment opportunities. A main focal point of Mr. Mindich's presentation was the ongoing turmoil in the euro zone. Europe as a whole shows signs of strain, most recently in Ireland and the Netherlands, where the political environment is unstable. The capital from the Long Term Refinancing Operations (LTRO) programs, which were enacted to help combat credit contraction in the region, is moving into the sovereign bond market as opposed to the real economy, limiting the programs' success.

Investors should focus on four key themes taking place in Europe:

1. the health of the banks,
2. monetary policy,
3. fiscal austerity, and
4. structural reform.

Mr. Mindich believes that Greece's departure from the euro zone can in fact happen, albeit not anytime soon, and that particular contingency could prove problematic for global financial stability.

Mr. Mindich posited that risks are not limited to the crises in Europe. The latent money that remains in the financial system as a byproduct of global central banks' efforts to fend off recessionary and deflationary pressures has the potential to be challenging for governments to re-absorb. Mr. Mindich expects Federal Reserve Chairman Ben Bernanke "to keep his foot on the gas pedal as long as possible" to combat deflation, which could result in heightened inflation, should a pick-up in the economy occur. Mr. Mindich also believes that the U.S. economy needs further stimulus in the short-term while the government should endorse fiscal austerity programs in the intermediate-to-long term.

Mr. Mindich shared his views on politics and the regulatory environment and in particular what an increase in financial regulation means for hedge funds. Eton Park is of the mindset that the direction of increased regulation is positive for both hedge funds and hedge fund clients. An increase in global regulation and compliance should increase financial transparency for clients while also creating unique investment opportunities for hedge funds.

On the political front, youth unemployment remains a serious issue for many developed countries, particularly the U.S., and this has the potential to result in severe negative social consequences. Younger workers are being forced to move back in with their parents due to excessive student loan debt burdens and bleak job prospects.

While Mr. Mindich stated that there are many risks present in the global economy, he believes there are many opportunities as well. Mr. Mindich expressed optimism for China's future, albeit with the caveat for the possibility of big accidents down the road. Mr. Mindich was also constructive on opportunities in select emerging market countries. He believes gold options are also a good vehicle in which to invest in order to protect against the uncertain market backdrop. Lastly, Mr. Mindich shared his thoughts on the positive outlook for mortgage-related securities.

Karthik Ramanathan / *Discussed His Experiences at the U.S. Treasury and Funding Challenges for Governments*

RAMANATHAN
Senior Vice President and Director of Bonds / Fidelity Management & Research Company (FMRCo)

Karthik Ramanathan began with a number of facts on the military expenditures of many emerging countries around the globe. China is currently building its naval capabilities due to the importance of the South Sea. India's naval budget increased 75% from a year ago and Russia's grew 60%. Russia's importance centers around the Arctic shipping channel and the amount of natural resources the nation possesses. Brazil is spending $40 billion on naval expenditures to protect their offshore oil basins and given the unstable nature of neighboring countries. Germany is also attempting to build a new submarine fleet at a cost of $90 billion. Mr. Ramanathan used the point to illustrate that the fiscal problems here in the U.S. could have massive national security implications down the road if we lose our global naval dominance. The U.S. currently defends its seas with over 20 submarines, but more spending on entitlement programs means less for defense and military.

Mr. Ramanathan joined the Treasury in the Office of Debt Management in 2005, after a stint at Goldman Sachs. At that time the office had only 6 employees, astounding given the fact that the office was in charge of "setting" the official U.S Treasury curve. This was performed every day by one individual, using a hand calculator. Furthermore, their risk management system was based on a Lotus 1-2-3 spreadsheet, in 2005! The Treasury auction system was based on 40 different underlying systems. Lastly, there was no backup office for disaster recovery and the office didn't even have a budget. Since that time, because of Mr. Ramanathan's efforts, the government finally invested significantly in the necessary technology and infrastructure and now has a sophisticated, state-of-the-art risk management system.

During the summer of 2009, Mr. Ramanathan and William Dudley (then executive vice president of the Markets Group at the New York Fed) began to create a supplementary "soak-up" financing program that would issue roughly $1.5 billion of financing bills. Also at this time, the U.S. was approaching its debt ceiling. Treasury Secretary Henry Paulson killed an idea created by the administration of the Federal Reserve issuing debt, as it would compete with the Treasury's debt and it was unclear if it would be backed by the full faith and credit that Treasuries possess. In September and October, the Fed began to purchase mortgage-backed securities (MBS) to keep rates low. The Treasury was looking at purchasing $1 trillion of mortgages to maintain a 4% mortgage rate. During this time, daisy chain fails began to occur after they had purchased $5 trillion in MBS on October 8 and the Treasury auction system nearly failed. The Treasury dolled out $40 billion and the markets thankfully re-opened. It is worthy of noting that while at the Treasury, Mr. Ramanathan saw two global financial institutions (Fannie Mae and Freddie Mac) put into conservatorship and also attempted to end the TIPS program.

Mr. Ramanathan commended Standard and Poor's for taking a view on the U.S. debt rating and the downgrade from AAA to AA+. While there are $4 trillion in fiscal austerity coming to the U.S. in the form of tax increases and lower spending, the debt ceiling will still need to be raised around election time this year. He did present some optimism during his speech. He believes the U.S. dollar will rally over the next 18 to 24 months and that the USD-euro exchange rate will likely devalue to below 1.00. Also, he believes that Japan needs to aggressively act on their exchange rate relative to the U.S. dollar and a 1% inflation target. He has been surprised by the enormous capital flows into bonds and thinks that emerging market debt might hit a tough patch soon, but believes that bonds will outperform equities, which will be flat. Finally, going forward he stated that the fiscal situation and its resolution will continue to dominate politics.

James Grant & Jeffrey Gundlach / *Discussed U.S. Debt Dynamics and Investment Strategies*

GRANT

Founder and Editor / *Grant's Interest Rate Observer*

GUNDLACH

CEO and CIO, Principal, and Co-Founder / DoubleLine Capital LP

Jeffrey Gundlach, Chief Executive Officer, Chief Investment Officer, and Co-Founder of DoubleLine Capital and Jim Grant, Editor of *Grant's Interest Rate Observer*, shared their thoughts on the desirable qualities of safe haven assets, risks inherent in the financial system, debt dynamics, and investment opportunities. Mr. Grant explained that in today's environment, "super safe" Treasury securities, which are designed to offer a risk-free return, actually exhibit return-free risk. He then discussed how in 1981, interest rates were at secular highs, yet nobody wanted to own Treasuries. Paradoxically, interest rates today are at secular lows and everybody wants to own Treasuries. Mr. Grant believes that many of the assets that are deemed "risky" by market participants are actually safer than risk-free assets.

Mr. Gundlach shared his view that physical currency should be held by investors, both as a deflation hedge and a hedge against exogenous shocks. With interest rates on savings and money market accounts at record lows, the opportunity cost of the more typical interest-bearing qualities of those accounts is virtually non-existent. One particular reason that Mr. Gundlach believes that physical currency is prudent to own is for protection against event risk, illustrated by the fact that nobody truly knows the size of the derivatives market, as professional guesstimates range from $600 trillion to $1 quadrillion. The $400 trillion spread between estimates is reflective of the uncertainty of that area of the market and systemic risk posed if that market were to face structural issues.

Mr. Grant and Mr. Gundlach highlighted many of the key risks present in the global economy, focusing much of their attention on excessive debt burdens, excessively accommodative central bank policies, and labor force imbalances. Mr. Grant shared his concerns with the Federal Reserve's heavy influence on interest rates, drawing a parallel of their actions to wearing "interest rate goggles" (in a joking reference to "beer goggles" – where one has a distorted perception of another's attractiveness due to the excessive consumption of alcohol) that has resulted in an unclear understanding of the natural level of interest rates. Mr. Grant expressed displeasure with the leveraged nature of the Federal Reserve's balance sheet, of which is over $3 trillion in size. Mr. Grant acknowledged that the Federal Reserve has the tools necessary to drain this liquidity, yet he fears that they lack the judgment as to the appropriate time to reign in their accommodative policies.

Mr. Gundlach's primary concerns in the marketplace, in addition to the instability of the massive derivatives market (highlighted above), were related to unusually low labor force participation rates for young adults (and conversely unusually high participation rates for those around the retirement age), as well as the sheer size of outstanding student loan debt. Labor force participation rates for younger workers, such as those between the ages of 25 and 34, are at historic lows, while participation rates for workers near and at their retirement ages remains highly elevated. As such, younger adults, strapped with student loan debt and other liabilities, are finding it difficult to find work and many have resorted to altering their living arrangements. This dynamic is adding to the already existent structural issues plaguing the U.S. economy. Student loan debt, which goes hand in hand with the youth unemployment/solvency issues, has officially surpassed credit card debt and today stands at over $1 trillion. This excessive debt burden, coupled with a weak labor market, has been a driving force behind the Occupy Wall Street movement and he believes this group of young voters has the potential to threaten President Obama's reelection chances in November.

Despite the myriad of current issues and future obstacles, Messrs. Grant and Gundlach have found pockets of optimism in certain areas of the market. Mr. Grant and the team at *Grant's Interest Rate Observer* remain optimistic on single family housing in certain areas of the country. Mr. Grant also expressed his liking for gold and the equities of gold mining companies. Gold, as Mr. Grant described, yields nothing, but can provide a hedge against monetary instability, as well as the haphazard behavior of global central banks.

Mr. Gundlach, while shunning short-to-intermediate Treasury securities, as well as long-term TIPS and money market funds, is favoring non-agency mortgage-backed securities. These securities were priced at absurdly low levels during the height of the credit crisis and remain dislocated today. If investors are looking for avenues to protect their wealth against extreme events, such as the decline and fall of the derivatives market, Mr. Gundlach favors gemstones, such as rubies, physical currency, and to a lesser extent, gold. Mr. Gundlach stressed, however, that investors would be wise to not put all of their eggs in one basket and should focus on diversifying their portfolio while building hedges against both inflation and deflation.

Michael Oyster

Presented on Politics, Policy, and Your Portfolio

OYSTER
Managing Principal,
Portfolio Strategist /
Fund Evaluation Group, LLC

Mike Oyster, Managing Principal and Portfolio Strategist at FEG, presented on politics, policy, and investor portfolios. Mr. Oyster began the presentation by describing the characteristics of former PIMCO portfolio manager Paul McCulley's theory on the constant battle of democracy and capitalism. Democracy is defined as one person/one vote, or "we the people," whereas capitalism is defined as one dollar/one vote, or "we the markets." Mr. Oyster explained the qualities associated with bull and bear markets in democracy and capitalism, which can largely be defined as pro-consumer and pro-markets, respectively. A historical example of a bull market in democracy took place in the late 1970s as efforts began to de-regulate our society. Thus, the 1980s and 1990s witnessed a bull market in capitalism.

Today, Mr. Oyster believes the current environment is most likely reflective of a bull market in democracy, which can be extrapolated from the myriad of financial legislation (new regulations) that has been passed in recent years. In this type of environment, real assets should perform well. Investors should seek to "flatten" investment portfolios by relying on all asset strategies for total return. For equity, FEG's current focus is on private equity, venture capital, hedged equity, and emerging markets. For fixed income, investors should attempt to build a yield advantage while paying attention to active management. Specifically, global bonds and emerging market debt remain attractive areas in which to invest. In the real assets space, commodities are attractive to help protect against unexpected inflation. Master Limited Partnerships and mineral rights also present opportunities. Lastly, in the diversifying strategies space, FEG is focusing efforts on pharmaceutical royalties, as well as global macro hedge funds.

T. Boone Pickens / *Discussed Energy Policy*

PICKENS

Oil and Gas Entrepreneur / Energy Expert

T. Boone Pickens began his session by answering questions prepared by Jenny Strasburg (of the *Wall Street Journal*), as well as forum attendees. Mr. Pickens remains active and is regularly flying across the country to share his thoughts on energy policy with the goal of ending the U.S.'s dependency on OPEC oil and to support American products. Two-thirds of oil consumed in the U.S. is imported from foreign sources and this creates a large national security issue in his mind. Mr. Pickens explained that the U.S. has the cheapest energy in the world, as elicited by natural gas spot prices of $2/mcfe in the U.S., while China's spot is at $16/mcfe and Europe's is $13/mcfe. He suggested that the U.S. needs to take full advantage of this disparity.

Mr. Pickens also examined the U.S.'s dependency on OPEC oil. He commented on a Saudi rig recently moved back into an oil field found in the late 1930s. OPEC stated Saudi Arabia wanted to produce another 100,000 barrels a day, but Mr. Pickens recognized it as the Saudis running out of oil and having no more relatively attractive drilling and production sites. Additionally, individuals talk of production costs for Saudi oil being at $5/barrel, which in fact is true; however, in reality they need to charge approximately $98/barrel or the Saudi royal family would be overthrown.

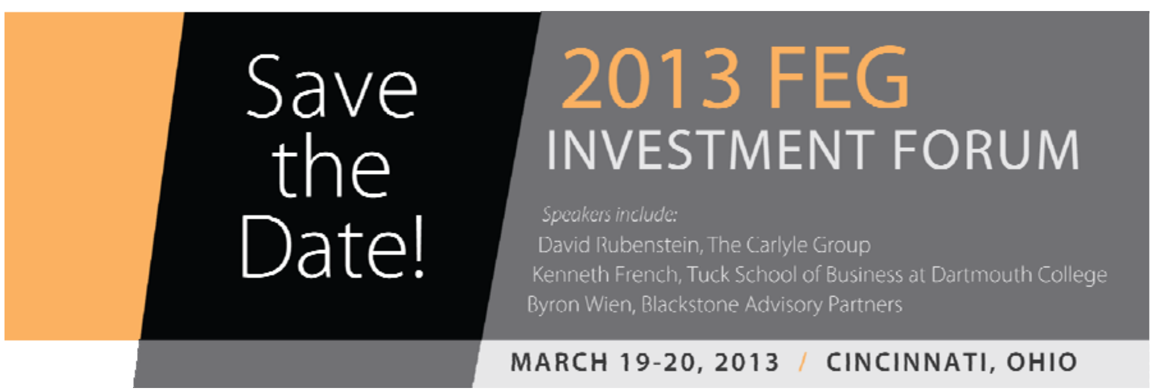
Mr. Pickens discussed his thoughts on the lack of leadership in the U.S., especially in Washington. He continues to work on the Pickens Plan and has gotten Pilot Oil gas stations to agree to building 450 liquid natural gas stations, as the stations need to be built before the equipment can follow. He spoke of the momentous environmental impact of switching all 18-wheelers onto natural gas versus diesel fuel. Furthermore, if the U.S. wants to reduce or eliminate dependency on foreign oil, it must start with transportation. Mr. Pickens understands that the U.S. liquid natural gas consumer is on the rise, albeit at the margin, but until consumers demand these types of vehicles, the car manufacturers won't produce them for U.S. consumption. Anecdotally, in Paris, a consumer can choose from over 50 vehicles running on natural gas, of which many are produced by U.S. domiciled auto manufacturers.

Mr. Pickens continues to run BP Capital, which invests in energy and energy-related companies. Further, he spoke of his experiences with hydraulic fracturing or "fracking." Mr. Pickens witnessed his first frack in 1953 and has fracked nearly 3,000 wells in his life, having never seen a job that has either gotten away from him or pierced an aquifer. When completing the wellbore, 8 and 5/8" concrete is used to insulate the pipe from acquifers. He believes that fracking has no detrimental consequences to the environment and it can be done nearly risk-free given today's technology and improvements made in engineering.

Mr. Pickens spoke briefly on alternative energy, but explained that natural gas prices need to hit $6/mcfe in order for wind power generation to become economical and effective at the margin. He also recently tried to incorporate his transportation policy in the new transportation bill in Washington; however, politicians told him that 18-wheelers and cross-country shipping and transport were not germane to the bill. Mr. Pickens also believes we should capture Canadian oil and supports the Keystone pipeline. Lastly, he explained that investors should remain patient when investing in natural gas at these prices and supply levels. A great metric to watch is the oil rig count. He believes natural gas pricing will remain low for a while, but investors need to be mindful that $2 natural gas is something like $8 oil. By 2015, he sees natural gas hitting $6, though other pundits state this as more towards 2035. He also sees Japanese liquid natural gas hitting $20 at some point in the future.

Conclusion

Given the upcoming November elections, the speakers focused on the political landscape, the implications of potential policy changes, and how investors should position their portfolios given today's uncertain and potentially low returning environment. FEG presented clients with industry leaders to better explain and clarify the most poignant topics investors face today. We hope that our clients and forum attendees benefitted from the speakers' insightful comments and opinions, and they can look to FEG to incorporate thoughts discussed at the 2012 Forum into their investment strategies.



2012 Pre-Conference Workshops

Socially Responsible Investing (SRI): Execution, Timothy O'Donnell – FEG, *Senior Vice President*

The discussion provided an overview of FEG's solution for embracing the unique opportunities in socially responsible and ESG (environmental, social, and governance) investing.

Hedge Funds 101, Gregory Dowling – FEG, *Managing Principal / Director of Hedged Strategies*

The session was used to provide attendees with a brief history on the hedge fund industry, the various strategies that hedge funds employ, as well as how hedge funds could be incorporated into a portfolio.

Private Capital Funds, Susan Fasig – FEG, *Managing Principal / Director of Private Capital*

Ms. Fasig discussed the opportunities that illiquid investments can provide, as well as FEG's solutions for clients seeking to embrace the opportunities present in private capital investments.

Non-Discretionary vs. Discretionary Services, Gary Price – FEG, *Managing Principal / Head of FEG Managed Portfolios*, Matthew Veith – FEG, *Vice President*

Messrs. Price and Veith compared and contrasted non-discretionary vs. discretionary investment approaches and discussed the benefits and considerations of adopting these investment approaches.

FEG Overview & Due Diligence, Scott Harsh – FEG, *Managing Principal, President and Chief Executive Officer*, Christopher Meyer – FEG, *Managing Principal / Chief Investment Officer*

Messrs. Harsh and Meyer provided attendees with an overview of FEG, the firm's ongoing strategy, as well as FEG's investment philosophy.

Retirement Readiness: Does Your 403(b) Plan Measure Up?, Bill Hummel – FEG, *Managing Principal*

This session reviewed the background of the 403(b) plan industry and reviewed new regulations, new risks, and steps plan sponsors can take to fulfill their fiduciary responsibilities.

FEG Managed Portfolios, Gary Price – FEG, *Managing Principal / Head of FEG Managed Portfolios*, Michael Oyster – FEG, *Managing Principal / Portfolio Strategist*

Messrs. Price and Oyster reviewed FEG's Managed Portfolios discretionary portfolio solution and reviewed the investment philosophy, objectives of the portfolios, the investment process, and the portfolio construction process. Performance and current positioning of the portfolios were also reviewed.

FEG Investment Philosophy and Research Update, Christopher Meyer – FEG, *Managing Principal / Chief Investment Officer*

This session provided attendees with an overview of FEG's investment philosophy and research process, in addition to an overview of the depth of the firm's research staff and capabilities.

Hedge Funds: Update and Outlook, Alan Lenahan – FEG, *Managing Principal / Director of Hedged Strategies*

Mr. Lenahan provided an update on FEG's proprietary hedge fund investment solutions, in addition to an overview of investment objectives, recent performance and positioning, and an outlook for hedge fund strategies.

FEG's Endowment Alliance Program, William Goslee – FEG, *Managing Principal / Head of Sales and Marketing*

Mr. Goslee outlined the growing opportunity for financial advisors with endowments and foundations and described how FEG can help support financial advisors through the Endowment Alliance Program.

2012 Education Sessions

Outlook for Real Estate: The Long and Winding Road to Recovery, Christian Busken – FEG, *Senior Vice President / Director of Real Assets*, Russ Bernard – Westport Capital Partners, LLC, *Managing Principal*, Steven Orbuch – Och-Ziff Real Estate (OZRE), *Founder and President*, David Sherman – Metropolitan Real Estate Equity Management, LLC, *President, Chief Investment Officer, and Co-Founder*

Panelists described the current distress in real estate, what the road to recovery could potentially look like, and how investors can take advantage of the opportunities inherent in the various subsectors of the real estate market.

Behavioral Finance: How to Succeed Despite Yourself, Greg Houser – FEG, *Vice President*, Russell Fuller – Fuller & Thaler Asset Management, Inc., *Chief Investment Officer*

Messrs. Houser and Fuller described common behavioral biases that affect investment decisions, as well as how understanding the investment decision making process can help counterbalance these biases.

Risk-Based Approach to Portfolio Construction, Christopher Meyer – FEG, *Managing Principal / Chief Investment Officer*, Nolan Bean – FEG, *Managing Principal*

Messrs. Meyer and Bean outlined various techniques that institutions can employ to help increase the probability of meeting long-term investment objectives in the midst of a low return environment. They discussed the tradeoffs in balancing short-term market risk with long-term shortfall risk and structuring portfolios based on the primary sources of risk.

Assessing the European Investment Landscape, Keith Berlin – FEG, *Senior Vice President / Director of Global Fixed Income and Credit*, Maria Boyazny – MB Global Partners, LLC, *Founder and Chief Executive Officer*, John Hock – Altrinsic Global Advisors, LLC, *Founder, Chief Investment Officer*, Victor Khosla – Strategic Value Partners, *Founder, Chief Investment Officer, and Senior Managing Director*

Thought leaders in the fixed income and equity markets assessed the current European investment landscape and explored how investors can consider allocating assets to best take advantage of the dislocations caused by recent turmoil in the euro zone.

About the Authors

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