FEG INSIGHT

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2013 FEG Investment Forum

Balancing Risk and Return in a Low-Return Environment

KENNETH FRENCH | JOSHUA FRIEDMAN | JAMES RICKARDS | DAVID RUBENSTEIN | BYRON WIEN | JOON YUN, MD, CFA

Fund Evaluation Group®
investment advisors

Your Vision / Our Insight

Balancing Risk and Return in a Low-Return Environment

Fund Evaluation Group, LLC (FEG) held the fifth annual FEG Investment Forum March 19-20 in downtown Cincinnati at the Westin Hotel and the Cincinnati Museum Center at Union Terminal. FEG was privileged to host seven industry leaders, who offered their opinions on the current financial market, portfolio strategy, political policy, private equity, currency issues, credit strategies, and healthcare. More than 400 guests also heard from FEG investment professionals, and attended various breakout sessions and roundtable discussions throughout the forum.

While the following synopses may not reflect the entirety of each session, they attempt to highlight each speaker's primary thoughts and points of discussion.■

David Rubenstein / *Presented on Private Equity, Politics, and Philanthropy*

DAVID RUBENSTEIN
Co-Chief Executive Officer / The Carlyle Group

David Rubenstein began his presentation with politics, stating that the U.S. Congress knows what they need to do, but they unfortunately do not know how to do it. He believes there is a lack of will to collaborate and execute plans, because most politicians are only doing what will increase their chances of re-election. Mr. Rubenstein commented, "Everyone in Congress is much happier after they leave office. The only problem is they spend their lives staying in office." Nowadays, a "good" member of Congress is no longer identified as someone who solves problems or serves our country, but rather someone who has mastered the ability to fundraise.

He stated that there are three main problems that the United States government is currently attempting to modify:

- The debt limit issue
- U.S. government spending
- Sequester

Mr. Rubenstein believes that there is too wide of a divide in the U.S. government for any of these issues to be dealt with in the near future. All three of these issues, however, revolve around revenue generation, which Mr. Rubenstein suggested could come from eliminating four main deductions:

1. State and local income taxes
2. Municipal bonds
3. Charitable deductions
4. Mortgage interest

Mr. Rubenstein posited that at least two of these four avenues would be taken in the near future to produce revenue for the federal government. None of these solutions, however, will fully reverse the financial distress that our country is currently facing. The United States government will continue to have a staggering amount of debt on their books. Yet, Mr. Rubenstein does believe that the U.S. market is in relatively good shape compared to other developed economies due to a rebounding housing market, insourced manufacturing, and the growth impact of the U.S. energy revolution.

Mr. Rubenstein then started into a discussion about the private equity industry, stating that the United States still dominates that business today. Top-quartile private equity firms will consistently outperform the public debt market by 2-12 percentage points, illustrating that public equity is a prolific business. Mr. Rubenstein also believes that many more deals will be consummated in the near term in this low-interest-rate environment, but the United States' global share of GDP has shrunk from 50% to 20%. Therefore, even though the United States should continue to dominate the industry for the next five years, the future trend in private equity is becoming much more global.

Mr. Rubenstein has pledged to donate the majority of his wealth to philanthropic causes, making significant efforts to preserve important artifacts of U.S. history. Mr. Rubenstein believes philanthropy is not just about writing checks. Philanthropic efforts, in his opinion, make you feel much better, as you are helping other people, which should help you live a long and happier life. Mr. Rubenstein also added another motivation: "Who knows? You may even get to heaven a little faster."

Rubenstein Cont.

FEG'S INSIGHT

Mr. Rubenstein provided some entertaining, but sobering commentary on the current state of the U.S. government and its ability – or lack thereof – to address any major issues near term. We would agree, that despite political headwinds, the U.S. is in a healthier economic position than many developed nations and provides a robust set of private investment opportunities, particularly for those that can take advantage of low interest rates. While we would expect a private equity manager to speak positively about the asset class, evidence has shown that well-chosen private investments offer a premium return to public market offerings. We also agree that over the coming decades the U.S. is unlikely to dominate the world economy and that we should seek investments both in the U.S. and globally. We would also like to thank Mr. Rubenstein for sharing his compelling view of the positive impacts of philanthropy at both a societal and personal level.

Byron Wien / *Presented on the Top Ten Surprises of 2013*

BYRON WIEN
Vice Chairman / Blackstone Advisory Partners LP

Byron Wien was the first speaker at the inaugural FEG Investment Forum in 2009, and received the highest ratings of any speaker since then. Therefore, as FEG was celebrating their fifth Investment Forum, it was only fitting to bring Mr. Wien back to present.

Mr. Wien began his speech by explaining how the United States is in a crisis, and he does not think monetary policy is the way to fix it. It took over 200 years and several major wars for the U.S. to accumulate $6 trillion in government debt. In the last decade, the government's debt burden has increased to $16 trillion, indicating an unstable accumulation of debt despite the fact that we are benefitting from low interest rates. He believes that the proliferation of debt will continue to rise in the near future. In Mr. Wien's opinion, politicians are reactionary. Therefore, they are not innovative or forward-thinking enough to make the powerful decisions that this country needs. Only a crisis, according to Mr. Wien, can force government officials to take the appropriate actions.

Mr. Wien also explained how he believes the tax code was the root of all of our financial problems. "The bottom 50% of the population pays 2.2% of the government's tax revenue and nearly half of Americans pay zero federal income tax; they are getting a free ride." His solution for the debt problem is to generate more revenue by broadening the tax base and completely rewriting the tax code.

Mr. Wien then presented his "Radical Asset Allocation" for institutional investors, which is as follows:

- High Quality Multinational Growth Stocks: 10%
- Emerging Market Equities: 15%
- Hedge Funds: 15%
- Private Equity: 10%
- Real Estate: 15%
- Gold: 5%

Wien Cont.

- Commodities/Natural Resources: 5%
- High Yield Securities: 20%
- Cash: 5%

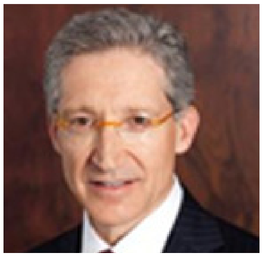
In Mr. Wien's opinion, real estate and distressed debt are the two most attractive asset classes in the current market environment. Gold should be held only as a hedge against financial calamity, not as a strategic commodities position. In today's low-return investment world, Mr. Wien strongly advised against investing in Treasuries. His 2013 outlook is worrisome, mainly because he sees a wave of euphoric, bullish investors in the financial markets today. He believes inflation will be a major issue, which partly will be witnessed in U.S. home prices.

FEG'S INSIGHT

Mr. Wien's "Radical Asset Allocation" for institutional investors follows a diversified construct, with relatively large allocations to areas that FEG favors, such as emerging market equities and hedge funds. Mr. Wien was also optimistic on distressed debt opportunities, which FEG has emphasized over the past three years, particularly in Europe. Mr. Wien's assessment of the current and future obstacles investors face (i.e., an excessive U.S. debt burden, troublesome tax code, etc.) lend themselves to a diversified asset allocation program that differs greatly from the traditional 60/40 portfolio. We believe such allocations must emphasize investments where there is compensation for taking risk, as well as gaining access to skillful managers that can add value through difficult market cycles, key elements of FEG's investment philosophy and approach.

Joshua Friedman

Presented on the History and Culture of Canyon Partners, the Macro Environment, the Technical Environment, Structural Alpha, and Distressed Markets



JOSHUA FRIEDMAN
Founding Partner,
Co-Chairman, Co-CEO /
Canyon Partners LLC

Josh Friedman began his presentation with a brief overview of Canyon Partners. The firm was founded in 1990 and currently has $22.6 billion in assets under management (as of March 31, 2013), most of which is in various hedge funds. The firm was founded under the principles of being honest, working hard, always having a positive attitude, never taking yourself too seriously, and lastly, having a hunger to learn.

In 2008, financial advisors around the globe learned that they must pay attention to the macroeconomic world. Mr. Friedman has seen deal flow increasing, as aggressive underwriting continues to promote risk taking in the current market environment. Mr. Friedman remains cautious in this time of bullish investing as he points to record low yields, an even bigger debt load than the United States ever imagined, and discouraging demographics as signs of financial distress. Because yields are at 500-year lows, the next asset bubble will be in government and sovereign debt.

Friedman Cont.

Structured alpha is becoming more important in the credit space, with hedge funds having more flexibility to exploit idiosyncratic areas of the markets. Hedge funds have more degrees of freedom when compared to long-only strategies. The goal behind generating structural alpha is not being forced to buy or sell at an inopportune time.

Mr. Friedman then launched into a discussion on the evolution of bankruptcy, explaining that there are significant opportunities in this sector of the financial market, particularly within the European banking sector. Investors also have taken advantage of securitized assets, such as residential mortgage-backed securities, which have run up in price over the past year. Mr. Friedman also believes there are significant opportunities in aircraft and restaurant securitizations, investment-grade special investment vehicles, and collateralized loan obligations vs. traditional high-yield corporate bond investments.

Finally, Mr. Friedman discussed the European distressed environment and the two stages that led to the current turmoil. The first stage (2009-2011) was what unveiled the downward spiral; there was too much capital, too many people, and too many impaired balance sheets for the financial system in Europe to stay afloat. Prices were too low for banks to take capital impairment, which led to macroeconomic uncertainty for two years. Then, the second stage began, which is where we are today. There has been significant improvement in banks' balance sheets and consistent price appreciation, allowing banks to start taking write-downs. Mr. Friedman believes 2013 will be marked by plenty of investment opportunities in Europe as their financial markets continue to heal.

FEG'S INSIGHT

FEG has been an advocate of using credit hedge funds (such as Canyon) for many years due to their ability to invest both long and short, using their expertise to access unique opportunities across a broad universe of credit instruments. The broader mandate of these funds also allows investors to make long-term allocations to credit, as opposed to attempting to time the various segments of the credit markets. FEG has advocated allocating to many of the areas highlighted by Friedman during the past few years, particularly non-agency residential mortgage-backed securities and European distressed investments, to capture unique opportunities within these markets.

Michael Oyster / *Presented on Balancing Risk and Return in a Low-Return Environment*

MICHAEL OYSTER, CFA
Managing Principal and Portfolio Strategist / Fund Evaluation Group, LLC

Michael Oyster presented about how understanding long-term trends can help balance risk and return expectations in today's environment. He reviewed several current trends that we are seeing in the global landscape, which investors need to take into account when making investment decisions.

First, individual empowerment is guiding better-educated citizens around the globe to join an expanding middle class, particularly in emerging market countries. Second, there is a significant diffusion of power among nations happening before our eyes. The United States may be falling from our singular, global leadership to which we have been accustomed to for decades. Third, demographics are changing dramatically as populations in developed countries age, inhibiting economic growth rates. Fourth, there is a large increase in the demand for natural resources, which may impact the balance of power between those countries that are flush with resources and those that are not.

That being said, the rate of real per capita economic growth is slowing at a dramatic rate. Historically, innovations such as running water, electricity, and the internal combustion engine have provided monumental shifts in a society's ability to grow economically. We are seeing fewer similarly important innovations in recent years. Our investment decisions must consider this trend, as we seek opportunities for long-term capital appreciation.

As the middle class grows throughout emerging market countries, innovations once enjoyed in the developed world will begin to proliferate throughout the emerging and frontier markets. Productivity will begin to increase, which will serve as a much needed catalyst for economic growth, and the diffusion of power will shift slightly away from the developed countries and into emerging markets. According to Mr. Oyster, a significant allocation to emerging and frontier markets should prove beneficial in the long term. To help reduce risk and benefit from long-term global trends, investors should "flatten" their portfolios and reduce their allocations to financial assets (stocks and bonds) in favor of real assets and diversifying strategies.

Joon Yun / *Presented on Healthcare and Healthcare Investing in the 21st Century*

JOON YUN, MD, CFA
President / Palo Alto Investors

Joon Yun provided a unique twist to close the FEG Investment Forum, as he highlighted the healthcare industry and an interesting outlook on the future of medical innovations. Dr. Yun began his speech by stating his investment philosophy revolves around thinking big and investing in unconventional ideas that nobody thinks are possible.

The problem with people (and investors) is that they are a "camera" the first 12 years of their lives, learning continuously as they encounter new ideas and ways of thinking. Then after puberty, people become a "projector," stating their beliefs and trying to influence others, rather than focusing on the aspect of learning. After the age of 20, we begin to aim too low and become close-minded. Instead of aiming to grow at 10x, we are aiming to grow at 1.2x, which is unfortunately how the human brain is programmed to think after the age of 20.

Rising healthcare costs are occurring due to the population constantly aging. Therefore, many pension funds are losing value, as medical innovations have caused people to live longer and more prosperous lives. Fortunately, Dr. Yun provided a new philosophy that makes healthcare "the solution, not the problem." Pension funds can invest in healthcare as a natural hedge against increasing healthcare costs and rising life expectancy. There are plenty of interesting and unconventional healthcare innovations today that investors can seize as ideal opportunities. For example, aging is a programmed trait in humans and human cells, but perhaps a different approach to treating aging symptoms can program aging out of humans and human cells. There is research already eliciting that this may be an option in the future.

Dr. Yun concluded his presentation by giving the attendees some tips for how to be healthier and more productive:

1. Avoid stressful people
2. Eat low-stress food that is not processed
3. Exercise and take improvisation classes to keep your body and mind fresh
4. Always be funny and laugh, as having a positive attitude is more important than you could imagine
5. Aim high and practice your compound thinking

FEG'S INSIGHT

Dr. Yun brings a unique, non-conformist perspective to healthcare investing, which allows Palo Alto to truly differentiate their investment ideas. This viewpoint allows them to be early investors in emerging trends and companies that are positioned to benefit from compound, non-linear growth, and also creates the opportunity for outsized (think 10x) returns. We also believe Palo Alto exemplifies an approach where active management can truly add value.

The characteristics of this approach include:

- Focusing on less efficient areas of the market (micro/small-cap, biotechnology) where expertise is a requisite,
- Concentrating their portfolio on a select number of their best ideas,
- Willingness to be contrarian, and
- Employing a long-term perspective.

Kenneth French / *Presented on Equilibrium Markets and the Importance of Passive Investing*

KENNETH FRENCH
Professor of Finance / Tuck School of Business / Dartmouth College

Ken French began his presentation by stating that he is happy our current market is efficient, and that some skilled stock pickers can outperform the market at any given time. Dr. French argued, however, that few investment professionals in the industry consistently outperform the market. He indicated that, overall, people should expect to trail the market when they invest their capital in an active strategy. Over the long-term, passive investors that achieve market returns outperform the aggregate of active investors for the following reasons:

Active investing is handicapped due to fees.

- Dr. French illustrated this point by discussing how passive investors pay approximately 20 basis points for exposure to the financial markets while active investors pay close to 100 basis points. Therefore, passive investors' average return is 80 basis points higher year after year.

Identifying superior strategies or managers is difficult.

- The most skilled managers would limit access to their scarce capital, which is their abilities, in order to preserve their advantage.
- When these managers do actually successfully predict the financial markets, investors are charged higher fees, making them more difficult to access and increasing the hurdle rate required for outperformance.

Dr. French then stated that institutional investors historically relied on exploiting the misinformed individual investors. Dr. French indicated the strategy was easier in 1980, when every $1 that was invested by an institution was matched by $1 invested by an individual investor. In 2007, that ratio tilted to nearly 4:1 in favor of institutional investors, proving that there is much more skillful competition in the marketplace for institutional investors.

Dr. French also stated that determining, with statistical certainty, whether an active manager truly was skillful (as opposed to lucky) is extremely difficult. To infer consistent equity premiums of 6% with 20% volatility would require 400 years of data and historical returns to statistically verify skillful alpha generation. Moreover, with the same volatility of 20% and 5% alpha, we could not identify that a manager is skilled unless we have 64 years of performance data.

Dr. French concluded his speech by stating active investors believe they can succeed in the marketplace due to three primary reasons:

- Confusion: Investors read and believe financial press, which has historically motivated them to make bad decisions.
- Overconfidence: There is an abundance of information and noise to interpret and analyze, and investors are too confident in their abilities.
- Belief of Superior Skill: Most believe they have above average skill, yet Dr. French's research indicates only 2-3% of active managers truly have superior skills, which makes identifying them difficult in a financial world full of noise.

French Cont.

FEG'S INSIGHT

Dr. French highlighted several investment themes that influence FEG's investment approach. We believe investors should dedicate their resources wisely. In many areas of the market, where the opportunity for outperformance is limited, using a passive/structured approach to efficiently and inexpensively access the market is the wisest option. These approaches may not always follow cap-weighted indices, but may be structured with specific biases or more thoughtful means of gaining market exposure.

Furthermore, we emphasize gaining access to the most skillful managers with unique capabilities to add value through strategies that do not simply result in a representation of the market. Identifying these skillful managers is multifaceted. Statistically speaking, in order to ascertain skill in a manager based solely on performance measures, one would require a performance history greater than that manager's career. This illustrates the importance of taking a holistic view of a manager, and why five of our six tenets of investment manager research are qualitative in nature. Lastly, investors should heed Dr. French's points to be cognizant of their natural disposition to be overconfident and must sift through the market noise. Achieving strong long-term performance often requires a willingness to diverge from the consensus.

James Rickards / *Presented on Currency Wars and the Future of the International Monetary System*

JAMES RICKARDS
Partner / JAC Capital Advisors

James Rickards shared his thoughts on the international monetary system and the "currency wars" that seem to consistently dominate its landscape. The definition of a currency war is "the devaluation of one country's currency against that of another, in order to increase exports and economic growth." Typically, currency wars occur when there is not enough organic economic growth in a particular country; this forces them to boost growth by artificially creating a weaker currency.

Mr. Rickards then highlighted the three main currency wars that have occurred throughout the world over the past 100 years. Currency War I lasted from 1921 through 1936 and began with massive war reparations and Weimar hyperinflation. It also included episodes of French devaluation and the gold exchange standard in 1925, Federal Reserve monetary mismanagement, devaluation in England in 1931, and the U.S. dollar losing value in 1933 through the executive order to confiscate gold at $20 per ounce and re-sell it at $35 per ounce. Currency War I saw sequential beggar-thy-neighbor devaluations, hyperinflation, and countries moving off of the classical gold standard and onto the gold exchange standard in order to increase competitiveness versus trading partners. Mr. Rickards also explained that President Franklin Roosevelt manipulated the price of gold by resetting its price through executive order. The collapse seen during the Great Depression included many parallels to the Credit Crisis of 2007-2009.

Rickards Cont.

Currency War II took place from 1967-1987, when the U.K. had a massive overhang of sterling claims from World War II and the U.S. was running a policy of "Guns and Butter" in 1965. The Bretton Woods system, implemented in 1944, began to break down in 1967, initiating a progression of events. President Richard Nixon took the U.S. off the gold exchange standard in 1971, which quickly led to inflation, recession, and oil shocks from 1973-1979. The U.S. dollar was in serious jeopardy of crashing, which brought significant concern to the United States. Federal Reserve Chairman Paul Volker and President Ronald Reagan helped implement a "King Dollar" policy from 1980-1984, which included raising interest rates in order to stifle inflation. After this policy was put into place, the United States saw remarkable cumulative real GDP growth of 16% from 1983-1986. Currency War II ended with the Plaza Accord in 1985 and Louvre Accord in 1987.

Currency War III began in 2010 after the world saw a significant warning from Japan's "Lost Decade" of 2000-2009 and the collapse of Long Term Capital Management in 1998. The prelude included Glass-Steagall reforms, Swaps Repeal, VAR, and Basel III provisions. During Currency War III, the Chinese export model met the U.S. consumption model, creating various battles on currency exchange rates. It was also a time period marked by debt, depression, and deleveraging throughout the international monetary system. Currency War III is still taking place, with the next big step possibly coming from President Obama's administration. President Obama has stated that he wants to double exports in his next term, and the only way Mr. Rickards believes he can do that is by trashing the dollar in the process.

The root of all currency wars, explained Mr. Rickards, is debt, deleveraging, and deflation in a country's fiscal policy. Fiscal policy is driven by the calculation of GDP. The U.S. government is propping up GDP by spending and is looking to increase net exports through the devaluation of the dollar against other major currencies. Net exports are the genesis of currency wars and Mr. Rickards believes the United States is heading down a road that points directly at increasing the severity of Currency War III.

The main driver of a currency war, however, is monetary policy, with the aim of each country to eliminate inflation and deflation. Mr. Rickards explained that economist Milton Friedman argued for constant money velocity. From 1950-1980 this was mostly true, which led the United States monetary system to success. The money velocity rate has since collapsed, causing our country to launch quantitative easing (QE) measures and initiatives to keep interest rates low in order to spur economic growth. Mr. Rickards expects QE to continue at least until 2015, which will keep the U.S. dollar artificially cheap compared to other currencies around the world.

Mr. Rickards also explained that the Fed has limited effectiveness because capital markets are highly complex, adaptive, and highly connected. A big looming question is: how close is the international monetary system to being in critical state? According to Mr. Rickards, the system is way too densely connected and immensely interconnected for the Federal Reserve to ever make the right decision.

Rickards Cont.

When the current form of international monetary policy collapses in three to five years, he predicts there will be four potential outcomes:

Multiple reserve currencies will form, but will be too unstable for long-term reform.

A global reserve currency will be created, with "power elite" countries having control over special drawing rights issued by the International Monetary Fund (IMF).

The U.S. will be forced to move back to the gold standard after fiat currencies collapse, which would require coordination from several countries.

Mr. Rickards expects a fourth outcome will take place: chaos, in which denial, delay, and confusion will fully encompass the international monetary system as it tries to stay afloat.

FEG'S INSIGHT

Mr. Rickards's speech emphasized the fragility of the current monetary system, particularly relating to monetary policy programs enacted and expanded by the G-3 countries since the onslaught of the 2008/2009 crisis. The various policy responses that have taken hold over the past half decade have come in many forms, with most following a path of central bank balance sheet expansions, and in turn, volatile exchange rates. A key pillar of FEG's investment approach is the broad diversification of key risk exposures, of which currency risk is an important component. Through manager and strategy diversification, investors have the potential to not only weather any future currency storms, but also capitalize on associated dislocations.

Conclusion

Given the current low-growth, low-yielding environment, investors are being forced to take a new approach to asset allocation and long-term planning. Therefore, the speakers focused on long-term macroeconomic trends, asset allocation tips for success, and industry-specific focus topics. We believe the forum attendees benefitted from the speakers' insightful comments and opinions, and know that they can look to FEG to incorporate these thoughts into their investment strategies.

Save the Date!

2014 FEG INVESTMENT FORUM

Speakers will be announced soon.

SEPTEMBER 23–24, 2014
CINCINNATI, OHIO

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