Introductory Remarks

Welcome to the latest issue of the premier publication of the Center for Investment and Wealth Management at The Paul Merage School of Business. In this issue we provide both academic insights as well as expert analysis from top investment and wealth managers to explore the implications of the current investment market nervousness. We begin with an overview of current global economic environment and how current trends can help shape investment strategies. Next, Jim Sami and Peter Beer of Payden and Rygel examine the critical challenge in the current rising interest environment concerning how best to position a bond portfolio. Kristoffer Houlihan then discusses the current dynamics of hedge funds and alternatives. An interesting and insightful baseball analogy is drawn for us by Steve Borowski followed by some excellent advice on tax strategies and estate planning in the current environment by Matt Brown. Finally, we provide an interview of our recent Community Programs speaker Harry Markopolos conducted by Merage School FEMBA student, Reynaldo A. Garnica.

We do hope you enjoy this issue and as always, we welcome your comments, feedback and suggestions.

Wishing you a happy holiday season,

Andy Policano
The Current Macroeconomic Environment and Implications for Investing

By: Andrew J Policano Director, Center for Investment and Wealth Management and Dean’s Leadership Circle Professor The Paul Merage School of Business

Currently, the main topic in the media concerns whether the US stock market is in another bubble that will someday, perhaps soon, burst. As Warren Buffet has said many times, there are always issues that are overpriced while others are underpriced and still others are at fair value. Today is no different. Still, most folks today are wary; will there be a repeat of what happened to the stock market during the Great Recession? Although no one really knows whether the market will be higher or lower tomorrow or even in the next few weeks, many analysts believe that the market as a whole will be higher five to ten years from now. The main reasons for a positive outlook are innovation, positive global growth and ample efficiency and cost cutting measures being employed by business broadly.

At the macroeconomic level, the US and global economies remain in a slow growth mode with the more vigorous growth continuing to come from the emerging countries. Of course, to refer to these countries as “emerging” is now a bit of a misnomer.

An MBA's Interview with Harry Markopolos

By: Merage School FEMBA student, Reynaldo A. Garnica

Proving that you cannot judge a book by its cover, the picture of Harry Markopolos on the inside of his book jacket is a black and white photo depicting a cold and serious individual hardened by the industry… the stereotype of a Wall Street guy that does not have the time of day to talk to you. However, nothing could be further from the truth. Upon arriving to the hotel dining area where Harry was having breakfast, I noticed the maize yellow suit with matching tie. Harry was very friendly and candid. In fact, the only thing about him that was black and white was the clarity on his stance with regards to fraudulent accounting practices, the "fraudsters," and how to catch them.

Below is an interview between me and Markopolos before a Community Luncheon program where he was to be the keynote speaker for the Center for Investment and Wealth Management at The Paul Merage School of Business at the University of California, Irvine. For a more in-depth look at the Bernard Madoff case, check out Harry Markopolos’ book “No One Would Listen: A True Financial Thriller.”
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At the macroeconomic level, the US and global economies remain in a slow growth mode with the more vigorous growth continuing to come from the emerging countries. Of course, to refer to these countries as “emerging” is now a bit of a misnomer. More than half the world’s GDP now derives from these economies so many would argue that they have “emerged.” The message for portfolios is that some carefully chosen investments in these higher growth areas of the world are prudent. At the same time, these countries present some risk, which can be a more challenging for individuals in the aging demographic.

The major issue facing the US economy continues to be the burgeoning debt scenario that portends the future. This year the deficit has fallen due to the impact of higher taxes and sequestration. While the lowered deficit has politicians very willing to take credit, the dangers ahead are still very real. Around 2030 the retirement bulge will become an excessive budgetary burden. Both Social Security and Medicare are at risk; in fact, the cash flow into Social Security turns negative within the next five years. The means to deal with the issues are not complex: we must do some combination of lowering spending and entitlements or increasing taxes. A painless way out to ease the situation is to increase tax revenue through expanded growth. Unfortunately, we are likely to be in a slow growth mode in the 2 to 3% range for at least a few more years. Another possible solution is to increase the working population through increased immigration, but this scenario is a political hotbed. Tougher solutions involve addition cuts in spending: sequestration is a start but it alone is not sufficient to cure the ills. The option of cutting entitlements continues to lead to end in a political quandary. In the end, there seems to be little probability that we can escape further tax increases.

Now, before you become totally depressed there are positive signs in the current environment. The US economy is still one of the best places in the world to do business. The Global Innovation Index continues to place the US economy among the top ten countries in the world in terms of the necessary ingredients to spark and capitalize on innovation. In addition new technologies in energy extraction have now resulted in such a large increase in domestic production that the US now exports more energy than it imports. Other good signs are that unemployment is falling, albeit rather slowly, and inflation is still under control.

A carefully selected set of monetary and fiscal policies can foster continued moderate growth in the US economy until probably in 2018 or 2019 we reach a point where unemployment falls to acceptable levels. At that time, a solid macroeconomic policy would be to coordinate constrained fiscal spending to control the future debt liability combined with expansionary monetary policy to support continued growth. The future is not as rosy as the high growth periods of the past but is still a healthy atmosphere for a well-designed diverse portfolio.

As the demographics change, the aging population’s appetite for risk also changes. Retired and retiring families tend to change their goal from seeking solid growth to preserving their wealth. Historically, this modification in investment strategy translated into moving a sizeable portion of the portfolio away from equities and into fixed income assets. This movement today would not be wise given the low interest rate environment that is likely to remain until the growth rate of the economy recovers.
The Current Macroeconomic Environment and Implications for Investing

Still, the trend in rates is up; over the next three to five years the term structure will likely shift upward providing the impetus for investors to feel more secure about increasing fixed income positions without a significant fear of capital loss. The tricky question for individual investors is when to start moving in this direction. Too soon and interest rates can still rise significantly; too late and others will already have pushed bond prices up. Here is where a seasoned professional can be very helpful in assessing the investor’s needs and working with familiar markets.

At the macroeconomic level, one of the challenges that aging economies face is that as investors increase their aversion to risk, it can become more difficult to finance entrepreneurial ventures and innovations. Given that a major contributor to growth is innovation, insufficient financial backing for business R&D can lead to a stagnant economy. Above, we mentioned that increasing immigration would be helpful to allow the workforce to grow relative to the retiring population. Another positive aspect of a revised immigration policy would be to lower the age demographic to provide more liquidity from a less risk averse investor base.

Overall, the macroeconomic environment is solid but not vigorous. Developing a winning investment strategy in this environment is no different than any the environment with a few modifications: First, given the shift to emerging markets, identify companies well positioned in these markets. Second, dividend-paying stocks can provide a source of less risky income. Third, a fixed income strategy is tricky in the current environment as most investors are waiting for a rise in interest rates to make a significant move; timing is critical. Finally, the golden rule of investment—diversification—remains the key in any environment. The current scenario is no different.
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Rey – In light of the fraud that happened with Madoff, which was legitimate in the eyes of investors at the time, how should investors vet investment firms to make sure they are truly legitimate and not a scam that was grandfathered into the system?

Harry – Well, I think that small mom and pop investors are better served by investing in “no load” mutual funds.

Rey – No load at all?

Harry – NO LOAD.

Rey – It seems that many of Madoff’s and Petter’s victims were experienced and wealthy investors. How did they, their staff (Lawyers, CPAs, Advisors) and others (IRS, FCC) not see this?

Harry – For big multibillion-dollar frauds to occur, every system of checks and balances in the private sector and in the government sector has to fail first. And it’s due primarily to one factor, lack of professional skepticism. The fraud is obvious if you look at it, analyze it, ask questions, and probe. When most people accept things at face value, they are sheep and as a result they are sheared, fleeced, and taken advantage of. Unfortunately, people say nothing when they hear half-truths or answers that are overly complex. Like empty calories?

Harry – Just like empty calories. You have to insist on them making it understandable to you and if you still don’t understand it, don’t assume that you are stupid, assume that they are crooked and are not telling the truth. Because finance when broken down into its component parts should be understandable by the lay person.

Rey – How does the perpetrator cover all this? How does one keep it from being discovered?

Harry – The frauds themselves are simple in the rear view mirror, but in real time when you are looking at them from the outside, the fraudsters surround themselves with very complex layers of camouflage and concealment. So they have cover stories, which are nothing but a pack of lies and you have to pierce through those and examine them one at a time and do a weight of the evidence analysis and you’ll quickly prove that these guys are fraudsters.

Rey – So investors should look for things that are “too good to be true” or too consistent in terms of returns; that is probably a giveaway of …
Definite giveaway. If it's too smooth, if there is a lack of down months and down years, something is wrong.

So in Madoff’s case, it was particular exclusivity that made it appealing, so if it's so exclusive then maybe it's no good? Because that is how he hooked them in right?

He used a strategy that was successful when you’re dating. Who does everyone like the most in high school? It’s the person that turns you down for the prom. That was his strategy, to appear to be exclusive when it really wasn’t. Anybody could get in because he needed the money, he was desperate for cash.

So underrepresented segments would love to come into the markets. For example, I worked at this company and one of the supervisors, didn’t know English very well, he said he would like to invest, but he was too scared of investments. So they lack certain resources, like the resources aren’t in whatever language that they do speak.

There are resources out there. The government has investor education on their websites. So if you look at FINRA (Financial Industry Regulatory Authority) or the FCC (Federal Communications Commission), you can get access to investor education resources. There is a move afoot to promote financial literacy. Many people in the industry promote sites in different languages and you just need to pay some time and attention and you can find those websites and self-educate. There are books in many languages that you can order on Amazon as well.

So do you think it would be easy to take all the Ponzi schemes that happen in English and translate them to a different language and take advantage of people?

Yes, that does happen… Really good Ponzi schemes get copied, globally, by bad guys because they want to take a successful model, copy the marketing documents, convert it to a different language and start marketing. Because if it worked in Canada, it should work in the United States, and if it worked in the United States, it should work in Russia too.

Right, and who’s responsible for bringing awareness to these communities, the government or the people themselves… or is it just buyers beware?

It's always buyers beware… no one cares about you like you do. The government has resources available to you. The private sector does too if you take advantage of them. But in the end, it’s all on you. You have to engage in a period of self-study. Do your own due diligence and research to make the right decisions. Otherwise you’re going to be roadkill in the highway of life.

Are there any tips that you have for new people coming into the industry and starting to build their business?

Yes, there is a glaring need for investor education. I would offer investor education. Offer quality products at the lowest possible cost. Disclose your fees. Make sure your interests are aligned with your investors. And over time you will do well.

Once somebody starts a Ponzi scheme, is there a successful way to get out? Or if they were successful, I guess we wouldn't know, right?

By definition, during a Ponzi scheme… there is NO actual investing taking place. There is no product or investing activity being provided to the customer. You are just recycling new victims’ money and you’re paying the old victims with it. And you’re always scrambling for new money investors to come into the scheme… because Ponzi schemes are a cash-devouring beast… always in need of ever increasing amounts of cash. There is no actual investing taking place in a Ponzi scheme so there is no possible happy ending for a Ponzi investor.

This one is a tax question. Some investors did receive payouts from Madoff’s and other scams… once the government enforces claw backs (recovers the payouts), does the investor get to re-state their past income since it really wasn’t earned income?
It depends on what nation that investor resides. In the United States, investors are allowed to file amended tax returns and claim refunds for the amount of tax that they paid for income that wasn’t really income. That was their lifesaver and a godsend to many investors who had lost everything. So at least they were able to get their tax refunded which provided a small measure of comfort to help them get by.

It made the system a little bit fair… no?

It was one of those rare examples when the IRS showed that they had a heart.

For the unsuccessful investors, the ones that came out, is that the only recourse they had? Being able to claim some taxes?

No, there are three levels of recourse. One is file amended tax returns to get a refund on the income taxes you paid on income you had never really earned. Recourse number two is the criminal recourse, where the government can put fraudsters in prison. So we’ve had thirteen people charged in the Madoff case. Several have pleaded guilty. Five are going to trial next week. And then there is the civil recourse which is what most investors can take advantage of, where you can sue the people that put you into Madoff… and if those firms have deep pockets, like the big banks did, they’ll probably make you whole. You’re not going to get any of your fake returns given to you by the banks, but you would get the initial money that you invested returned to you. However, if you went into a small closely held firm that did not have deep pockets, you’re forced to sue them as individuals and their assets probably aren’t enough for you to recover an equal percentage of what you put in… in which case you’re probably a big victim and you’re not going to get much money back.

And I assume it’s the same case if you recommended me to Madoff… your pockets wouldn’t be as deep and you probably got taken as well, right?

Yes, yes.

And the last question… These schemers obviously have intelligence and skills to pull these schemes, is it regulations within the legitimate world or something else that prevents them from applying themselves to a legitimate business and being successful by making an honest living?

It’s always easier to make a living by being crooked rather than by being honest because the profit margins are always going to be higher since every dollar of sales turns into a dollar of profit. Fraud is the highest profit margin activity any business can engage in. Real businesses have Cost of Goods Sold. They have to pay their employees. They have to pay for goods and services from their vendors. They have to pay income taxes and sales taxes. A fraudster doesn’t have to worry about any of those expenses. Every dollar of revenue turns into a dollar of net income.

How about regulations… do you think they could make regulations to get to a business quicker so that you don’t have to do it the illegal way? Is there anything that you could see changing?

No. With Ponzi schemes they are such an illegal entity… so they do not register with the Securities and Exchange Commission (SEC) as an investment advisor. As a result they are off the government’s radar screen. So you can see the issue… the first time the government finds out about them is when the Ponzi operator fails to make payments to existing victims and then they call up the SEC and say, “this firm didn’t pay me the money they owed me,” and that is the first the SEC finds out about them. So they are totally off the radar screen. That is the first time the FBI finds out about them as well.

Because with Madoff, you had said something, but nobody took it seriously until his kids reported themselves, right?

Yes.

Did that upset you?
In conclusion, based on my interview with Harry Markopolos and his keynote address, you should not judge a book by its cover. Pick it up, open the pages, and if there is fraud involved you should be able to see it by doing your own due diligence.
Tax Strategies and Estate Planning in the Above Environment

By: Matt Brown of Brown and Streza LLP

Estate Tax Planning During Economic Uncertainty

Estate planning is only partially about getting the money to the kids. It is also about getting the kids ready for the money and about fulfilling philanthropic goals.

But to the extent you are focused on minimizing estate taxes when transferring wealth, now is the time to take action. Interest rates are low, and many estate tax planning strategies work best with low interest rates. Taking action now allows you to lock those rates in and capture any appreciation outside of your taxable estate, avoiding estate taxes for generations.

The estate tax exemption is now $5,250,000 per person ($10,500,000 per married couple). The IRS takes 40% of the value of wealth transfers exceeding that amount. The tax is due within 9 months of death, and the IRS only deals in cash.

Effective estate tax planning rests on three key concepts: valuation, arbitrage, and tax burn. This entails a combination of valuation discounts, low interest rate loans, and shifting income tax liability on transferred assets to burn through Mom & Dad’s taxable estate.

There is a fourth element: time. Estate tax planning techniques are most effective when given time to age. But given the connection of the estate tax to death, many are tempted to delay serious planning until it is too late.

Many people don’t want to use their exemption today because they fear the loss of control and access to funds that may accompany such a transfer. But estate tax planning must consider the future value of an estate, not just the present value. Thoughtful estate planning allows clients to engage in long-term, proactive estate tax avoidance while retaining control and access to funds, often without using any of the precious estate tax exemption amount.

Every Estate Planning Transaction Should Involve an Irrevocable Trust

Before we talk taxes and economics, it is important to note that **every estate planning transaction should involve an irrevocable trust.** In a quest for perceived simplicity, many clients, and even some estate planning attorneys, skip this step.

But funding an irrevocable trust is a once-in-a-lifetime opportunity. Once assets have left your balance sheet and landed on the balance sheet of your children, they are potentially subject to estate tax, creditors of your children (i.e. a future ex-spouse), and predators looking to take advantage of your children (using them to provide a personal guaranty in a questionable investment; manipulative caregivers; pool boy; yoga instructor – you get the picture).

It is sometimes possible to use asset protection techniques to protect inheritance received outside of an irrevocable trust. But the effectiveness of some of these techniques is questionable, and most are quite expensive.

Irrevocable trusts allow you to make your children’s inheritance divorce-proof, creditor-proof, and predator-proof, and avoid estate taxes for generations.

Intra-Family Loans

For those nervous about the personal economic risk of transferring significant wealth to children (I know you love your children, but I also know you love yourself more), low interest rate loans may be particularly important.

Every month, the IRS publishes interest rates that apply to intra-family transactions (the "Applicable Federal Rate" or "AFR"). These rates are lower than rates that are commercially available, so the kids can borrow at cheap rates from the Bank of Mom & Dad.
Tax Strategies and Estate Planning in the Above Environment

The October 2012 AFR is 0.32% for short-term loans (0-3 year term), 1.93% for mid-term loans (4-9 year term), and 3.50% for long-term loans (9+ year term). These rates assume annual compounding.

If you lend $1 Million to a child’s irrevocable trust at 1.93% and the money grows by 10%, the trust will have earned $100,000 in the first year yet only owes you $19,300 in interest. That is a net wealth transfer of $80,700 without using any of your $5.25 Million exemption.

Example:

- Consider a loan of $1 Million to a child’s trust
- If the money grows by 10%, the child’s trust will earn $100,000 in the first year and only owe $19,300 in interest (assuming a 9 year loan in October 2013)
- The additional growth of $80,700 is a tax-free gift to the trust

Selling the Family Business

The Bank of Mom & Dad can also sell-finance the sale of the family business to a trust for the benefit of the children. Just imagine the wealth transfer possibilities of allowing the children to buy a family business growing in value at 20% per year but only paying a 1.93% interest rate. If the business is worth $10 Million, that cheap financing provides a tax-free wealth transfer of $1,807,000 to the children in just a single year ($2 Million of growth less $193,000 interest payment!).

Mom & Dad still own a promissory note for $10 Million at 1.93% interest. The minimum they must receive in any year is the interest payment of $193,000. They can receive that payment in a single year is $10 Million. They have transferred significant wealth yet retained a healthy net worth as well.

Selling to a Trust for Mom & Dad

Maybe you aren’t content with the retained income stream from an intra-family loan or the installment sale of the family business. You appreciate the retained promissory note, but what if you need the gifted asset back? It sure would be nice if you could access it – just in case.

Never fear. You can sell the family business (or other assets) to a special type of irrevocable trust for the benefit of Mom & Dad (that’s you). If properly structured, the trust assets are excluded from your estate and immune from most creditors and predators.

Other Considerations

The concepts noted above can be combined with other planning techniques to create even more leverage. For example, many structures offer valuation discounts. It may be possible to sell the $10 Million family business to a child’s trust for $7 Million, a 30% discount. Alternatively, one type of irrevocable trust, called a grantor trust, allows for Mom & Dad to retain the obligation to pay income taxes on the trust income even though the cash flow from the transferred assets stays with the trust outside of your taxable estate.

This allows the trust to enjoy an income-tax-free rate of return. On Mom & Dad’s side of the equation, their estate is being whittled away by income taxes that somebody must pay – it is ideal to pay that income tax out of assets that will otherwise be subject to estate tax.

Start Now

Irrespective of the planning approach you take, the most important step is to start now. Even a modest amount of estate tax planning can go a long way if allowed time to work. The longer you delay the more complicated and expensive your planning will be when you finally get around to it. So starting early allows you to spend less on the IRS and less on attorneys – that is a double win.

Endnotes

i. There are numerous exceptions, including spousal support, child support, criminal restitution, and certain bankruptcy exceptions, but an irrevocable trust created by a third party provides exceptional asset protection to the beneficiaries of that trust.
Bond Strategies for Rising Rate Environments

By: Jim Sarni and Peter Beer of Payden and Rygel

Whither Bonds? The Role for Fixed Income in Portfolios in a Rising Interest Rate Environment

The yield on the 10-year US Treasury rose more than 1.3% over the summer of 2013. The prospects of returning to higher yields too quickly have many fixed-income investors worried. Inquiring minds want to know: how can we adjust portfolios for this rising rate environment?

It is important to put the recent increase in interest rates in a broader context. For the past 3 years, interest rates declined and now hover near historic lows. In 2012, the yield on the 10-year Treasury note averaged 1.8%, the lowest in half of a century. While future increases in interest rates are highly likely, the magnitude and timing of the potential rate rises are key considerations. If history is any guide, we should welcome an adjustment to 3-4% yields. Such an adjustment moves yields closer to more "normal" levels (See Chart Below).

However, a move back toward mid-single digit interest rates is not necessarily the next step on the way to dramatically higher, double digit interest rates (think late 1970s, early 1980s). Structural factors like the disconnect between growing investor demand for income and the shrinking supply of income generating investments is a force helping keep interest rates low. Especially in the safest asset classes (e.g. US Treasuries), demand has pushed yields to levels unacceptable for many income oriented investors.
Bond Strategies for Rising Rate Environments

In this unprecedented environment, there remain ample opportunities in bonds. That said, lower current yields and up-trending interest rates require different strategies than those that worked in the past. Traditional fixed-income strategies such as shortening the maturity of bond holdings and remaining income focused have generated declining income over the last several years. But alternative strategies do exist.

By keeping moderate duration exposure, extending investment horizons beyond yesterday’s preferred credit sectors, and expanding traditional fixed-income portfolios to include high dividend paying stocks, fixed-income investors can position portfolios more opportunistically.

Alternative Bond Strategies

First, as interest rates rise and the yield curve begins to steepen, accepted wisdom suggests investors should shorten duration, and thereby reduce duration (the price sensitivity of a bond—longer duration means the price fluctuates more as the yield moves up and down). By reducing maturity, the thinking goes, investors avoid large potential price shocks in their bond portfolio.

In today’s bond market, with the Federal Reserve intent on keeping short-term interest rates at or near 0% for the near future, shortening maturity in isolation results in little or no income. For investors who depend upon income, yields of 0.50% or less are often times insufficient to meet expenses. However, with the yield difference between 2-year and 10-year Treasury notes currently close to 2.5%, up from 1.3% in early 2013, investors may be rewarded for laddering maturities out to 4-5 years despite the eventual risk of rising rates.

Another strategy for bond investors to consider today is broadening investments to lower rated (a.k.a. “below investment grade”) credit sectors. While departing from the world of investment grade credit may be slightly uncomfortable for some, moving down the yield curve affords investors both potentially improved yield/total return and lower bond price sensitivity to changes in interest rates (see table below).

### Below Investment Grade performs well versus Investment Grade in a rising rate environment

<table>
<thead>
<tr>
<th>12-Month Ending</th>
<th>10-Year Treasury Starting Yield</th>
<th>10-Year Treasury Yield Move</th>
<th>US Treasuries Total Return</th>
<th>Investment-Grade Corporates Total Return</th>
<th>Below Investment-Grade Corporates Total Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sep-97</td>
<td>7.42%</td>
<td>+220bps</td>
<td>-1.06%</td>
<td>0.20%</td>
<td>5.97%</td>
</tr>
<tr>
<td>Feb-98</td>
<td>8.15%</td>
<td>+117bps</td>
<td>3.04%</td>
<td>4.73%</td>
<td>7.32%</td>
</tr>
<tr>
<td>Dec-94</td>
<td>5.78%</td>
<td>+204bps</td>
<td>-3.35%</td>
<td>-3.34%</td>
<td>-1.57%</td>
</tr>
<tr>
<td>Dec-93</td>
<td>4.66%</td>
<td>+170bps</td>
<td>-2.38%</td>
<td>-1.66%</td>
<td>3.38%</td>
</tr>
<tr>
<td>May-04</td>
<td>3.37%</td>
<td>+130bps</td>
<td>-2.47%</td>
<td>-0.47%</td>
<td>13.23%</td>
</tr>
<tr>
<td>Jun-06</td>
<td>3.91%</td>
<td>+120bps</td>
<td>-1.66%</td>
<td>0.27%</td>
<td>4.64%</td>
</tr>
</tbody>
</table>

While a lower credit rating is not necessarily synonymous with lower quality, such investments typically require thorough company research but we believe that investors can be rewarded for doing their homework in today’s low yield environment. By sifting through the universe of below investment grade corporate bonds, emerging market bonds, and the like, investors can find securities that perform relatively well in rising interest rate environments. Investments in below investment grade securities benefit from improving economic growth and rising inflation expectations which are two of the conditions that can trigger rising interest rates. In summary, this strategy is an effective way to better optimize the tradeoff between principal protection and income generation.

A third way that fixed-income investors can navigate a rising interest rate environment is by investing in high dividend paying stocks. Investors in high dividend paying stocks can reap the benefits of relatively stable—and possibly growing—dividend payments while potentially enjoying inflation protection and upside price potential. This is possible because investors are “owners” in the business rather than creditors and share in any inflation-generated increases in revenues and earnings.

High dividend paying stocks offer another potential benefit. Not only have high dividend paying stocks performed well in rising rate environments, generating positive returns in seven such periods since 1948, high dividend stocks have outperformed the broad stock market in five of seven rising rate environments. It is quite possible that the future may be like the past.
Surveying the factors that drive interest rates, we see that while the recent period has witnessed a steep increase in yields, higher yields also create opportunity. Moderate inflation and steadily recovering economic growth should gradually nudge Treasury yields moderately higher over the next couple of years. Obviously, yields on non-Treasury securities would also ratchet up accordingly. However, as mentioned earlier, we believe that the prospect of returning to the high single digit and even double digit yields of the 1980s and 1990s remains unlikely.

Despite three years of low interest rates, the bond market is not dead as some suggest. As yields move higher, investors can profit by resisting the temptation to rely exclusively on short-term Treasuries. Maintaining the appropriate duration exposure in bond portfolios, pursuing lower credit-rated securities and migrating into high dividend-paying stocks offer life rather than death in bonds.
Democratization of Hedge Funds and Alternatives

By: Kristoffer Houlihan of Armilla Partners

The democratization of alternatives and hedge fund in particular has given rise to two important trends; 1) greater utilization of HFs by private clients and family offices; 2) increased attention to smaller / emerging manager hedge funds. Here are some thoughts for private clients and family offices as they go enter the hedge fund investment space, and some practical considerations when evaluating an emerging manager.

Risk Management must be at the core.

Many believe the causes that contributed to the financial crises from 2007 to 2009 will carry on in future years. But, without a doubt, one key factor has led to the endless amounts of financial failures at every level: the lack of effective risk management.

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Baseball, Active Management and the Willingness to be Wrong

By: Steve Borowski of Aristotle Capital

For what seems to be twenty years now, we’ve heard this steady mantra that active equity management, especially in the domestic large cap space, has not added value when compared to passive alternatives. I understand the frustration. As one who has spent the better part of the last thirty years attempting to build a case for active management (and earning ample gray hair in the process), the fact is, it’s true. Most managers have not earned their keep once you factor in expenses and other opportunity costs. You hear of companies not earning their cost of capital. The same is true of many managers. Most don’t earn their relative cost of capital either.

You’re probably wondering what this has to do with baseball. I have season tickets to the California Angels (I refuse to call them the Los Angeles Angels of Anaheim, but that’s another story). We sit just behind the visitors’ dugout. I love baseball. Always have. When I can, I’m the guy who gets there hours early to take in batting practice (those are the games my wife doesn’t attend), You pay attention to the pre-game activities, the ground crew, the perfectly manicured field, the interaction between the players and fans, and the coaches.

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Democratization of Hedge Funds and Alternatives

By: Kristoffer Houlihan of Armilla Partners

The democratization of alternatives and hedge fund in particular has given rise to two important trends; 1) greater utilization of HFs by private clients and family offices; 2) increased attention to smaller / emerging manager hedge funds. Here are some thoughts for private clients and family offices as they go enter the hedge fund investment space, and some practical considerations when evaluating an emerging manager.

Risk Management must be at the core.

Many believe the causes that contributed to the financial crises from 2007 to 2009 will carry on in future years. But, without a doubt, one key factor has led to the endless amounts of financial failures at every level: the lack of effective risk management.

For the purposes of clarity and simplicity, let’s focus the private client discussion on Family Offices where the data and examples are more accessible. Since the financial meltdown, trillions of dollars of wealth have been lost all over the world. According to a 2009 Wharton Global Family Alliance report, 15% of 167 family offices worldwide posted positive returns in the second half of 2008 and first half of 2009. This is quite remarkable given the high level of difficulty of recovery. However, with about 4,000 family offices in the United States alone, the majority were not an exception to these financial catastrophes. Lack of effective risk management has led to significant declines in family offices. Only a few managed to utilize adequate risk controls in order to mitigate financial losses.

Furthermore, many family offices had large investments in illiquid assets, which contributed to significant losses. Without much liquidity, it was much more difficult to bounce back during early years of recovery. In times of less certainty and greater volatility, family offices can employ proper risk management and well-coordinated advisory processes to best preserve assets. Also, by looking at the investment world today, there are still many risk management flaws in even the most sophisticated investment institutions from which family offices can learn, exemplified by the bankruptcy of MF Global and the $6 billion in losses at JP Morgan.

Risk Framework

For effective risk management to be employed by Family offices, a suitable framework needs to be in place. Key examples of necessary components for a robust family office risk management program include risk metrics (risk, performance and attribution capabilities), a database and IT infrastructure, and a seamless network between risk management and all other functions of the family office such as technology, legal matters and accounting.

A key consideration for a family office is to seek guidance for developing and building its own framework for risk analytics and management. On the other hand, the family office can just utilize its close relationship with an independent risk management advisor to its advantage, especially when the advisory firm has great experience.

Necessities for Effective Risk Management:

- Strategic approach to investment risk management – a family office must define its investment objectives and associated risk specifications before creating its risk management framework.
- Appropriate framework of risk — a key component for risk analytics and management. A family office must be able to have access to firm-wide positions across different asset classes in order to have a better grasp of its total risk exposure. A better grasp of a family office’s risk profile allows for greater alignment between investment objectives and actual performance.
- Risk guidelines and governance — key components in developing and maintaining a comprehensive and successful risk management program.
Important of independence — an independent risk management advisor should not be involved in the investment selection process for the family office due to conflict of interests and decisions. A truly independent risk management advisor can provide greater insight into a family office’s risk and investment management processes.

Investing in Emerging Managers? Focus on Operational Risk

The Need for Operational Risk Management

Over the years, there has been heightened market volatility, rapid and unstable macroeconomic conditions and subpar performances across the hedge fund space. As more regulations are set in place, hedge funds find it increasingly difficult to comply with such rules.

Most Hedge Fund managers from their inception have paid little attention to implementing institutional quality operations both internally and externally. This needs to change as investors now expect this component of a hedge fund’s business to be of the highest quality. Simply put, emerging managers should not attract capital without the right infrastructure and operations partners.

Even before the financial failures from 2007 to 2009, there have been well-documented instances of poor operational risk management. According to a CAPCO study on 100 hedge fund failures over a span of 20 years, 50% of hedge fund failures were solely due to mismanaged operational risk. Many portfolio managers and investors tend to overlook operational risk and place too much emphasis on other risks such as market and credit risks, when, in fact, operational risk influences all other risk factors. Therefore, lack of operational risk can amplify the effects of market, liquidity, and credit risk.

KEY CONSIDERATIONS

Investors need to question whether an emerging manager can acquire the necessary assets that will support institutional quality operational systems. These systems come with relatively costly staff, compliance and legal consultants, and accounting and order processes. Therefore, it is imperative that emerging managers build great relationships with experienced advisors, who may have insight on ways to establish an institutional-quality firm and robust operational risk management program. The ability to attract more investors becomes less difficult if these emerging managers understand the true importance of operational risk.

The positives for investors are that even though emerging managers have fewer resources than larger, more experienced firms, they are in better position to quickly implement nimble solutions. Investors should look to see how managers are adopting new technology, qualified personnel, and a implementing a risk culture that fosters an effective operational infrastructure. Investors are attracted to the nimbleness of emerging managers and their proven ability to produce higher returns.

BEST PRACTICES

Investors should ask and look for the following from their hedge fund managers:

- Do they have an institutional quality Prime Broker?
- Do they have an independent Administrator?
- Do they have an independent Auditor?
- Has the manager implemented quality controls and processes to manage their business?
- Can a manager demonstrate their operational capabilities and infrastructure as being an ‘Alpha’ contributor?
- Investors must conduct forensic levels of due diligence on any hedge fund manager.
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Baseball is one of the few major sports with an elaborate minor league system. Getting drafted by a major league ball club is one thing. Getting to the major leagues, let alone staying for any reasonable period of time, is something entirely different. (Believe me, I know.) Many a fresh faced 18-year-old high school phenom turns into a not so fresh faced 28-year-old journeyman after spending ten years of his life toiling away in locales such as Peoria, Quad Cities and Bakersfield. Hundreds of minor league ballplayers lose their jobs every year. Most assimilate into society, but some, a lucky few who are well liked by the right people but not quite considered major league player material, are kept on board as coaches to spend the next ten (or twenty) years of their lives working in small Midwestern towns, giving instruction to the next generation of fresh faced 18-year-olds. If they’re fortunate enough, some day they may have a crack at coaching at the major league level. Next time you’re at a big league game, take a look at the coaches. They’re the ones with skin that has seen way too much sun and wearing uniforms designed to fit athletes decades younger (which begs the question, what other sport has coaches dressed the same as the players?)

What does life in baseball have to do with investment management? More than you think. Investment manager selection reminds me of baseball manager selection in decades past. In baseball, a middle-aged career guy is fired as manager of the Cubs because he isn’t getting the job done. (Sorry Chicago, but no one seems to be able to get the job done. Then again, everyone has a bad century now and then.) Weeks later he’s recycled by someone else because he has new, fresh ideas and what it takes to lead his next employer to the World Series. He’s the same guy, for cryin’ out loud. Same managerial experience, same decision-making process, and ultimately, same result.

No different with investment managers. For years you couldn’t open an industry publication without reading of a particular manager being fired from some fund for performance-related issues, and then in the next column read of the same manager being hired elsewhere to manage the same strategy for someone else. It’s uncanny. Nothing has changed. It’s the same people managing the same strategy for what is now expected to be a different result. It’s a big zero-sum game. In baseball, as with investment management, the same managerial experience, the same decision-making process along with the same staff will lead, ultimately, to the same result. The manager is the same. The process is the same. Only the uniform is different.
Manager selection, whether in baseball or investment management, is not an easy task. With investment management, although there are large, established firms out there who consistently do a good job, they are the minority. I have always believed that, with many if not most firms, once you reach some level of success, whether that is determined by assets under management, revenues or the amount of money the key people are making, whether intentional or not, something changes. That something is that many previously successful firms cease to play the game to win. They now play the game to not lose. The name of the game is not to do what’s in the client’s best interest (provide alpha) but do what’s in your best interest. Namely, protect the revenue stream of the business. Don’t get fired. How do you do that? Don’t take chances. Don’t make mistakes. Play defense. Not offense. Gravitate to the mean.

Most investment firms work in an institutional environment where they’re typically one of several managers employed. Let’s take a situation where a manager is one of five working with a large pension fund. While the implied goal is to rank among the top of your peers, the unstated or unintended goal (depending on your level of cynicism) of too many managers in this business is to finish...third. Why third? Because it’s unlikely you’ll be fired. You would love to be number one or two, but that implies somehow sticking your neck out and taking on what may be perceived as additional risk. Managers need to do something different to add value. You can’t look like everyone else. If you differ from everyone else and you’re right, great! What if you’re wrong? That’s the problem. You could be that fourth or fifth manager. Can’t go there. That flies in the face of rule number one—don’t get fired. If you linger among the cellar dwellers for some uncomfortable period of time, you could lose the relationship and its accompanying revenue stream. Plan sponsors may consider replacing one manager out of five. Maybe two. But three? Unlikely. Hence, the unwritten incentive is to finish in the middle of the pack. You’ve bought yourself some time. You’ve protected the revenue stream for the time being. Most importantly, you’ve protected your paycheck. Is the client happy? No. Are they unhappy enough to fire you? Probably not. At least not now.

Need some evidence? In 2006, K.J. Martijn Cremers and Antti Petajisto of the Yale School of Management introduced the concept of “Active Share.” Professors Cremers and Petajisto studied a large cross section of mutual funds over time and asked the simple question: Which ones added value, which ones didn’t? The findings were quite telling. Newer, younger, more entrepreneurial funds, those with no other choice but to succeed or perish, had a higher component of something called Active Share. Active Share can be loosely defined as that portion of your portfolio that deviates from the underlying index with which it’s being compared. An interesting trend began to emerge. Along with performance success came a growth of assets under management. The more successful the fund became, the more assets under management grew, the more revenues increased, the more of a franchise the manager had to protect. As assets, revenues and incomes grew, that portion of the portfolio attributed as Active Share did not. In fact, it shrank.

Those same portfolio managers who added meaningful value early on were now playing defense. Not offense. They too were not playing the game to win. Rather not to lose. As they succeeded there was an inverse relationship to assets under management and a high Active Share. Portfolios they managed began to look more and more like the index they were compared to. Intentionally or not, they became a closet index fund.

Is this entirely the fault of self-interested portfolio managers? Not necessarily. There’s plenty of blame to go around. The plan sponsor and some in the consultant community play a role here too. Countless times have I been in prospect presentations or consultant meetings where you’re repeatedly asked why you don’t look like everyone else. How can you own a particular security your peers don’t own? Why don’t you have industry or sector allocations that look like everyone else’s? If a plan sponsor or consultant is hostile to a manager who doesn’t look like everyone else, that would imply they’re favorably predisposed to managers who do. It’s a vicious cycle. Success begets success. Unfortunately, so does failure. Hence, the tendency is to retain managers who are predisposed to mediocrity. The inclination is to retain managers who, ultimately, perform like the index. Managers who look like everyone else perform like everyone else.

Investment managers need to think outside of the box to add value. So do plan sponsors. So do consultants. There are active managers who add consistent value in a transparent, liquid and cost-effective manner. You just need to look a little harder to find them. Loading up on alternatives is not the answer to all your problems.

In portfolio management, as in baseball, it is helpful to think for yourself and be different. You can’t be fearful of criticism and, occasionally, failure. Many times you need to be willing to be wrong in order to be right.

As of this writing, the Angels are off to one of their worst starts in team history. But the grass is just as green, the uniforms are just as crisp, and the hot dogs are just as good.