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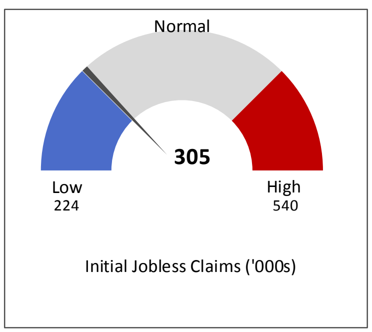
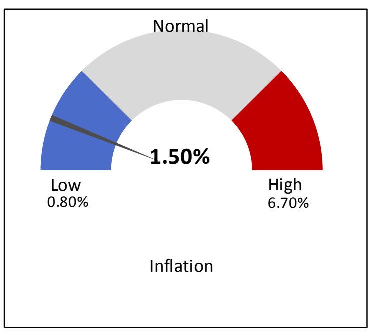
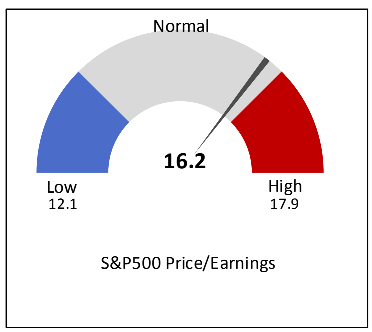
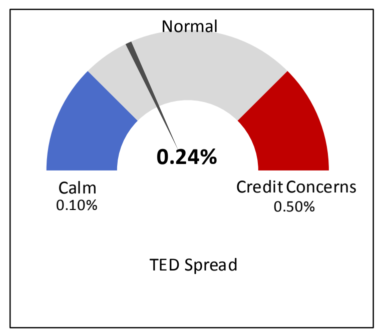
Market Digest

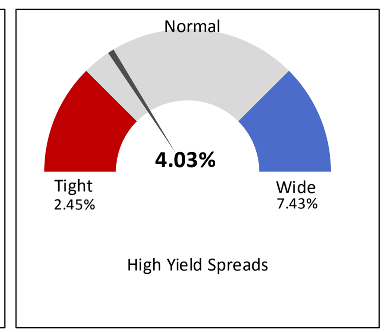
Third Quarter 2013











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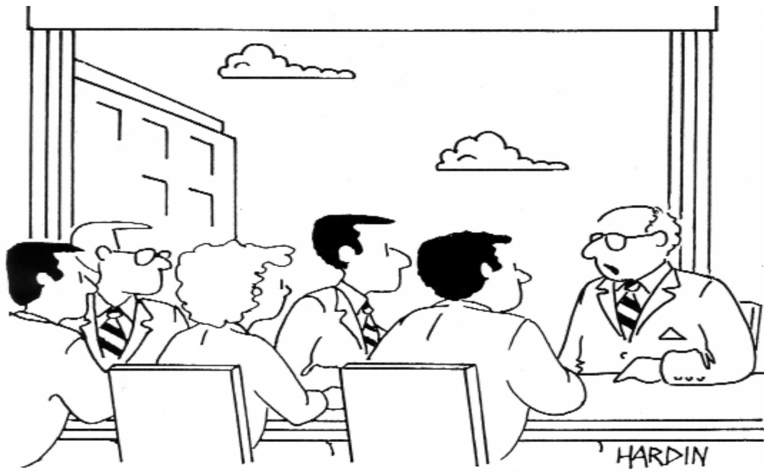
Review of Liquid Portfolio Alternatives



"We've considered every potential risk except the risks of avoiding all risk."

Source: Patrick Hardin. Reprinted with permission, cartoonstock.com

Overview

Many of our clients are already familiar with the use of alternative or specialty strategies as a way to enhance returns, gain exposure to returns uncorrelated to traditional stocks and bonds, or to act as a diversifier to reduce overall portfolio risk within their portfolios. Historically, exposure to these specialized strategies could only be obtained via private partnerships whose high investment minimums, illiquid terms and specific net worth requirements made them inaccessible to smaller investors. In recent years, there has been a huge rise in the availability of alternative mutual funds, exchange traded funds and investment trusts, all of which purport to offer the benefits of the private alternative strategies, but with low investment minimums, daily liquidity and no (dis)qualification criteria.

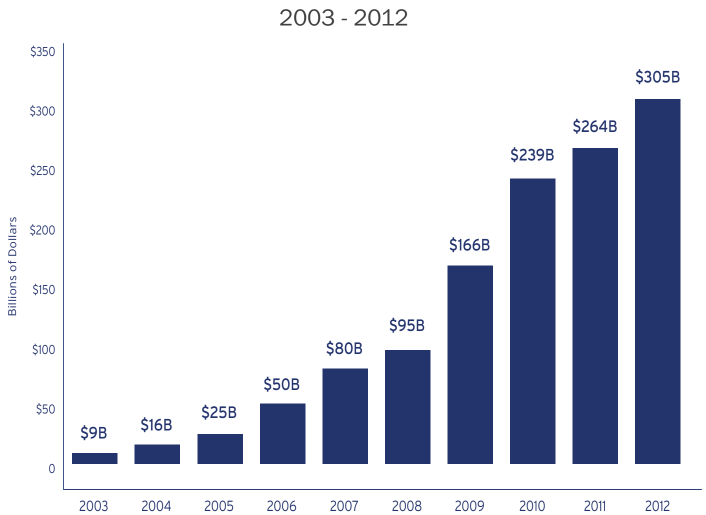
Although liquid alternative vehicles have been around for some years, interest in them has grown since the 2008 financial crisis. Investors noted that portfolios containing alternatives held up better than those containing traditional investments alone. Initially, investment managers resisted calls for liquid versions of their existing hedge funds. They expressed concern that the requirement for daily liquidity would severely compromise the investment strategy, and in any case, their institutional clients, who often did not have immediate liquidity requirements, would not be interested.

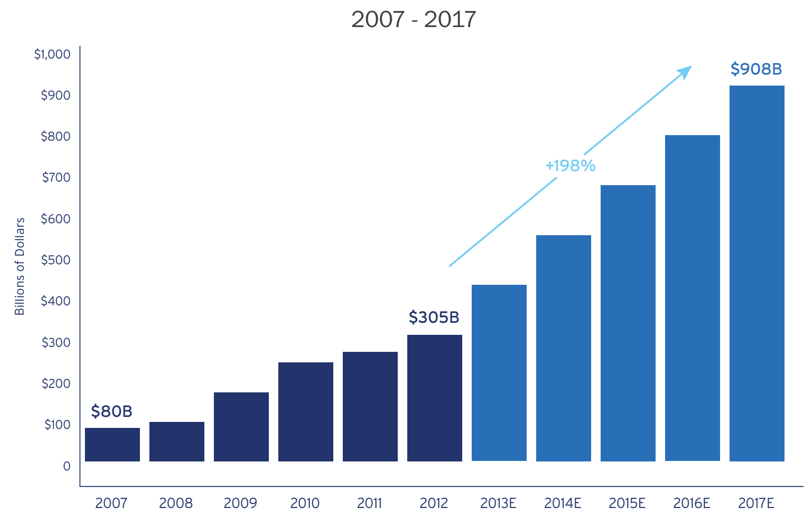
Attitudes have changed as a result of the financial crisis. Institutional investors who were heavily allocated to hedge funds and private equity funds found themselves in a liquidity crunch when they could no longer access the frozen credit markets. Others found themselves gated, or locked into illiquid vehicles, by managers unable to meet redemption demands. These experiences caused institutional investors to rethink their approach to liquidity. Around the same time, a number of successful hedge fund managers, notably AQR Capital Management, decided that certain strategies, such as equity long/short, global macro and managed futures, could easily be offered in mutual fund format without sacrificing or compromising the benefits. Once the likes of AQR got into the game, it was difficult to argue that alternative mutual funds were only offered by inferior or less successful managers.

Thus, in the same way that portfolio construction and risk management tools are no longer the exclusive preserve of large institutions, investors, both large and small, now have access to a growing array of liquid alternatives. The explosive growth of this category is captured in Chart 1 on the following page, which shows that the market for liquid alternative funds grew from $9 billion in 2003 to $80 billon in 2007 to $305 billion in 2012, and is forecast to triple again to $908 billion by 2017.

Review of Liquid Portfolio Alternatives

Chart 1. Growth of Liquid Alternatives - Mutual Fund & Exchange Traded Fund Assets





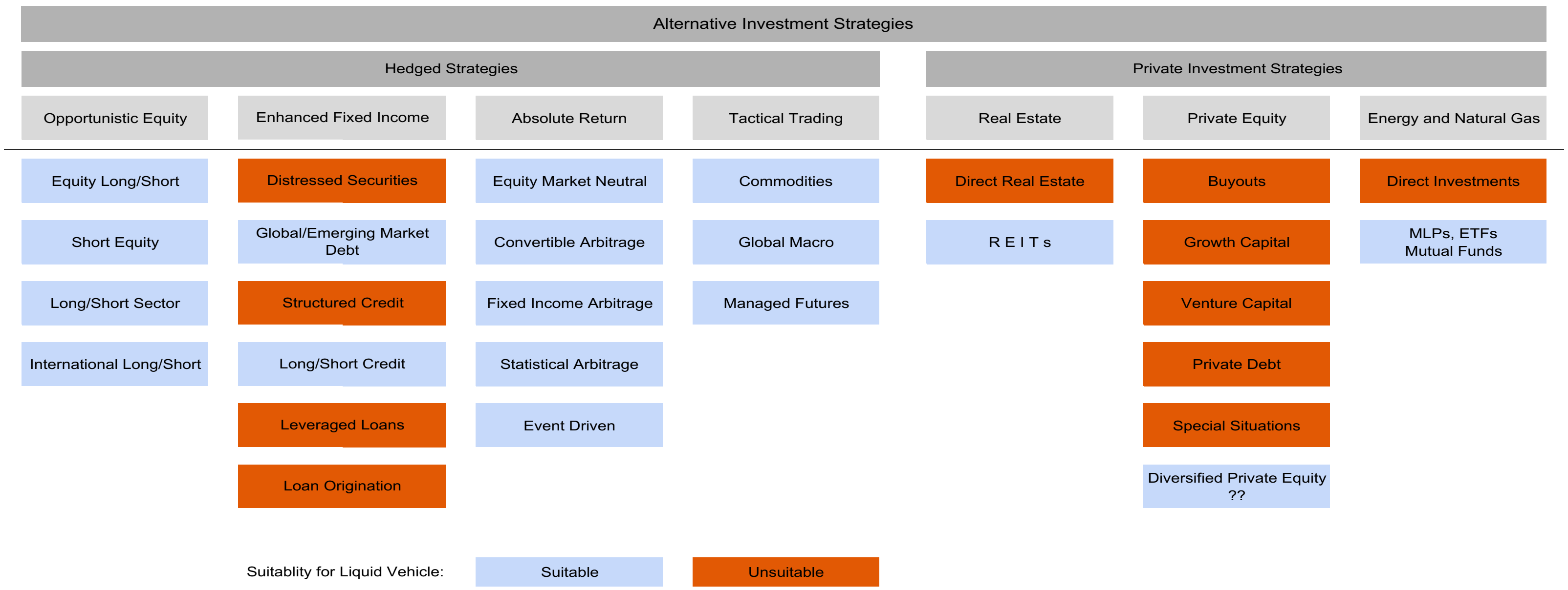
Source: Rise of Liquid Alternatives, Citi Prime Finance, May 2013

In the following pages, we will analyze the case for using alternatives, compare the performance of liquid and illiquid strategies, identify which strategies are appropriate for use in liquid format, and conclude with some ideas for building a portfolio including liquid alternative products. Let us start by looking at the current universe of alternative strategies in Chart 2 on the following page. Strategies colored light blue are either suitable for, or already available in, mutual fund format, while those colored orange are either unsuitable for, or currently unavailable in, liquid format.

Other than highly illiquid or long-lived strategies such as distressed investing or direct investments in real estate, timber or energy infrastructure projects, we see that a large number of alternative strategies can be adapted for a liquid vehicle. Until recently, private equity was the only category where no liquid options were offered. (We don't consider funds such as the ALPS Red Rock Listed Private Equity Fund or Vista Listed Private Equity Fund as true PE funds, since they invest in the stocks of publicly traded PE companies.)

However, within the past few months, the largest and most successful private equity firms including Apollo, Blackstone, Carlyle and KKR have all filed plans to launch a variety of alternative funds and the first private equity fund will be offered by Carlyle. Until we see how this category develops, we put a question mark against its suitability for a liquid offering format in Chart 2 and we will focus mostly on liquid hedge fund strategies in the discussion that follows.

Chart 2. Alternative Investment Strategies



Source: Evolution of Alternatives, Hatteras Funds, Oct 2011

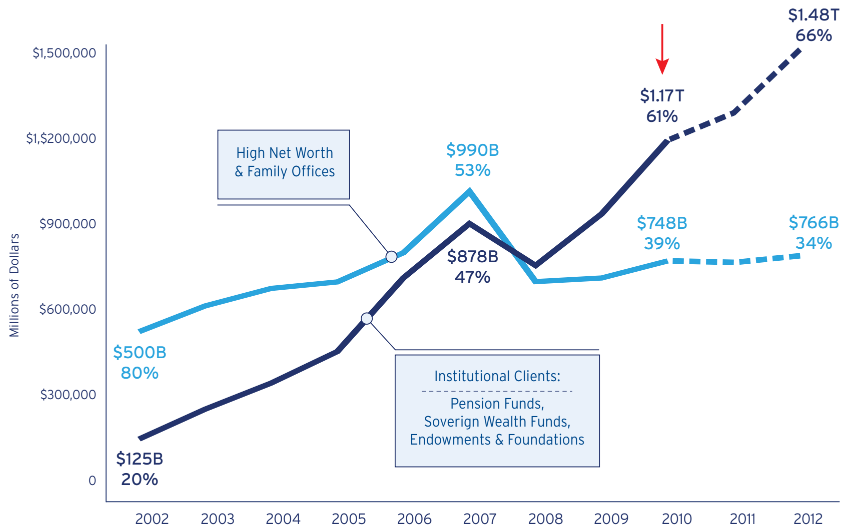
The entry of the top tier hedge funds and private equity firms into the liquid market is a game-changer for the alternatives business. These firms have traditionally ignored the retail market and only dealt with large institutions and the wealthiest family investors who meet their steep minimums. You might then ask, why their new interest in retail investors? As we discuss below, the answer is a combination of supply and demand factors.

Trends Driving the Market for Liquid Alternatives

Going back to the early days of hedge funds, most hedge funds were designed for return enhancement and wealthy families or family offices accounted for the vast majority of hedge fund assets (Chart 3). The publication of Pioneering Portfolio Management by David Swensen of the Yale Endowment in 2000 marked a major inflection point for the business. Prompted by Swensen's descriptions of how the Yale Endowment captured outsized returns by investing in private equity, hedge funds and other illiquid investments, a great many pension plans and endowments jumped on the alternatives band wagon. Today, the market for alternative investments is dominated by large institutions and pension plans, foundations and endowments are the biggest market for hedge fund and private equity investments (Chart 3). In the process, the investment focus has shifted from return enhancement to capital preservation and risk reduction.

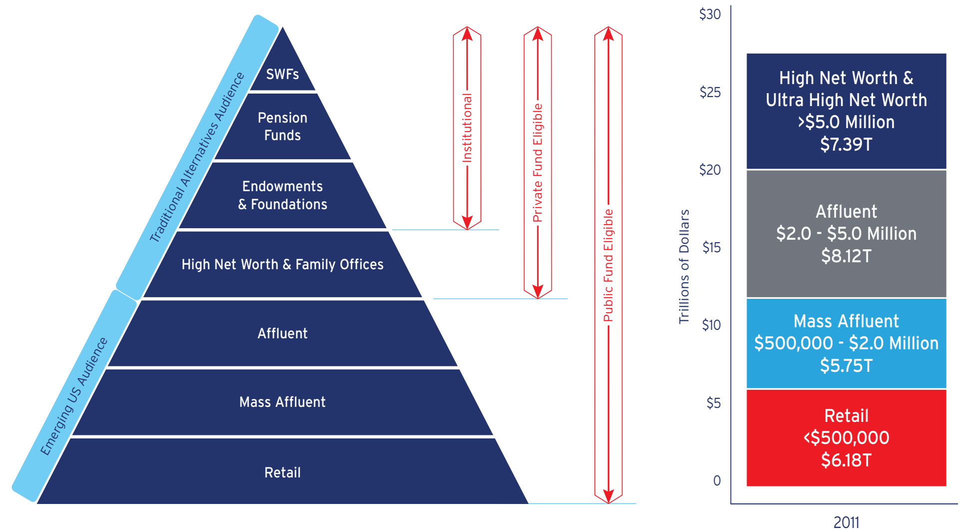
Review of Liquid Portfolio Alternatives

Chart 3. Hedge Fund Assets by Investor Type



Source: Rise of Liquid Alternatives, Citi Prime Finance, May 2013

Chart 4. Expansion of Market for Alternative Solutions



Source: Rise of Liquid Alternatives, Citi Prime Finance, May 2013

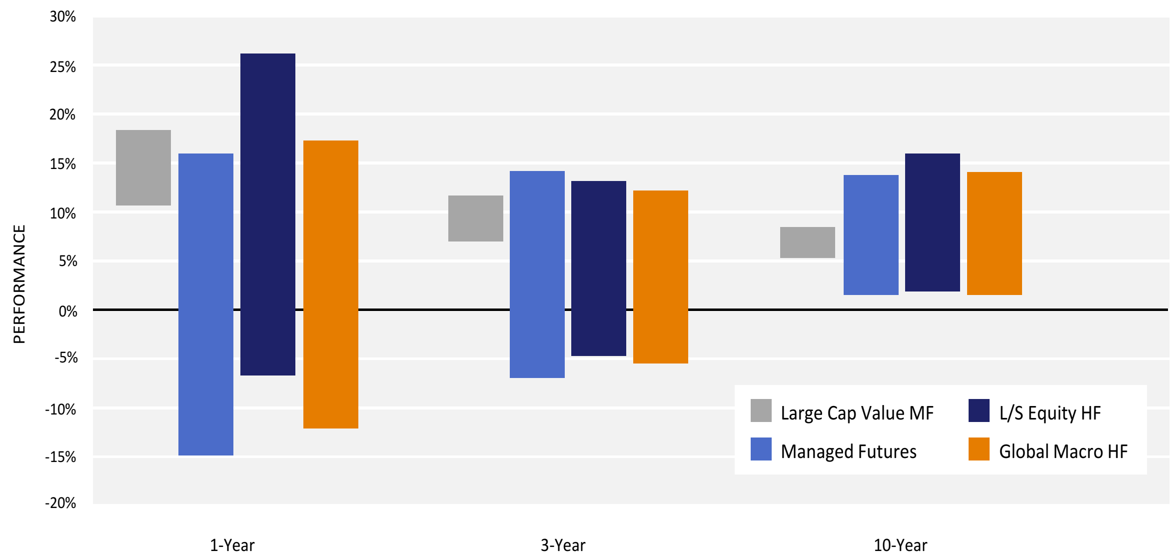
Also, more and more companies are doing away with pension plans and replacing them with 401k plans. As they see their traditional customer base declining, hedge funds and private equity firms are eyeing the huge untapped pools of money held by retail investors and 401k plans (Chart 4) and know that the only way to access these reserves is through mutual funds or ETFs. Thus, Apollo, Blackstone, Carlyle and KKR have all announced plans for retail funds, signaling that liquid alternatives are now part of the investment mainstream.

As we mentioned, financial advisers and individual investors are keen to get access to tools that can help them manage portfolio risk or enhance returns in the same way as large institutional investors. At the same time, institutions who were squeezed during the financial crisis are rethinking their approach to liquidity, and either scaling back their overall allocation to illiquid alternatives or becoming more open to using liquid solutions for some portion of their allocation.

Why are these trends of interest to us? Although our clients have the ability to invest in private alternatives, they may be reluctant to do so, or precluded from doing so, for any number of reasons. Some are owners or principals of private businesses and much of their net worth is tied to an illiquid holding. For others, the high investment minimums on individual strategies make it difficult to assemble a properly diversified portfolio. Others have multiple accounts, not all of which meet the required investment minimums. Many are reluctant to invest in partnerships that generate K-1s and require tax filing extensions. And finally,

Chart 5. Performance Dispersion of 1st Quartile vs 4th Quartile Managers

As of Dec 2012



Source: All Managers Are Not Created Equal, Altegris Advisors, July 2013

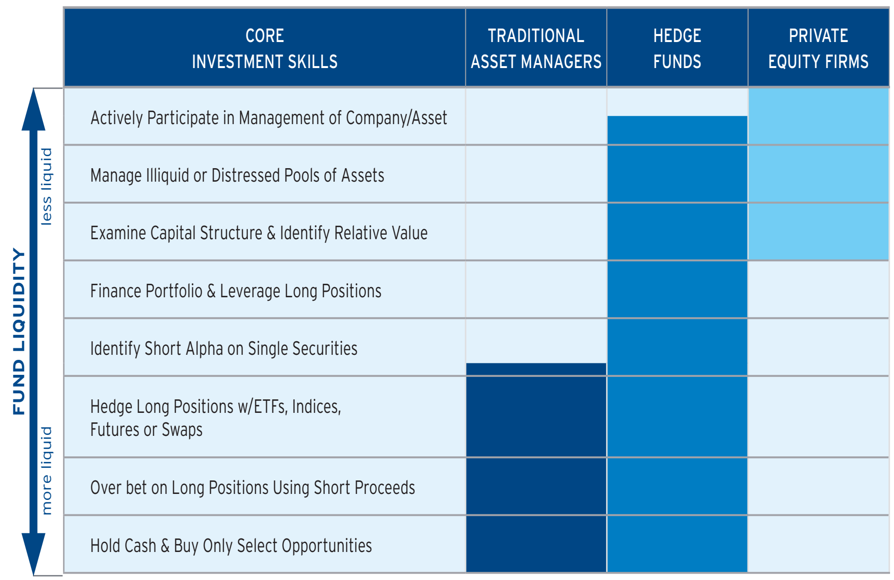
many are participants in IRAs and 401k plans where the investment choices are very limited. For all these groups, tools to help enhance potential returns or manage risk more effectively will be a welcome development and help to narrow the gap between how their smaller and larger accounts are managed and how they perform.

Manager Skill

Why are investors so keen to get access to hedge funds and private equity? A big reason is manager skill. Chart 5 above compares the performance dispersion between first quartile (top) and fourth quartile (bottom) managers for different investment classes. The performance gap between a top quartile and bottom quartile traditional equity manager is considerably smaller than for managers of alternative strategies. Performance for the equity manager is largely driven by efficient markets and it is difficult for any individual manager to have unique insights about a given stock. Conversely, performance for alternative investments is more dependent on manager skill and market inefficiency. Hence, the performance differential between a top quartile and bottom quartile manager in these categories is much broader. When it comes to alternatives, history shows that investors are amply rewarded for investing with top quartile or top decile managers.

The skill requirements are also markedly different for a traditional asset manager versus a hedge fund manager or a private equity manager. Compared to the more limited range used by traditional asset managers, hedge fund managers have a much broader range of tools to master and deploy. (Although Chart 6 suggests that private equity managers operate with a limited toolbox, many techniques such as shorting and hedging cannot be used in the same way by PE managers.)

Chart 6. Core Skills for Traditional Asset Managers, Hedge Funds & Private Equity Firms



Source: Rise of Liquid Alternatives, Citi Prime Finance, May 2013

Value-added of Alternatives

The average hedge fund lost 21.4% in 2008. While better than the 37% loss for the S&P 500 index, this was a far cry from the promise of absolute returns. Subsequently, hedge funds returns have lagged the broad rise in equity markets.

Thus, it is reasonable to ask: have hedge funds lived up to their promise? Are they worth the extra fees? To answer these questions, let’s first look at the recent performance for various hedge fund strategies:

Chart 7. Hedge Fund Performance vs S&P 500, 2009-2012

	Up Market		Down Market	
Strategy	Avg Return	Capture	Avg Return	Capture
Equity Hedge	2.1%	54.0%	-2.1%	48.0%
Event Driven	1.8%	46.0%	-1.0%	23.0%
Global Macro	0.6%	14.0%	-0.6%	13.0%
Relative Value	1.4%	36.0%	0.0%	0.0%
Short Bias	-3.4%	-88.0%	2.9%	-64.0%
Systematic	0.3%	8.0%	-0.4%	10.0%
Distressed	1.7%	45.0%	-0.7%	15.0%
Merger Arbitrage	0.7%	19.0%	-0.2%	4.0%
Convertible Arbitrage	2.2%	58.0%	-0.4%	10.0%
Market Neutral	0.5%	12.0%	-0.6%	14.0%
HFRI Composite	**1.6%**	**41.0%**	**-1.3%**	**29.0%**
S&P 500 Index	**3.8%**		**-4.5%**	

Source: Prime Brokerage Perspectives, J.P. Morgan, 2Q 2013

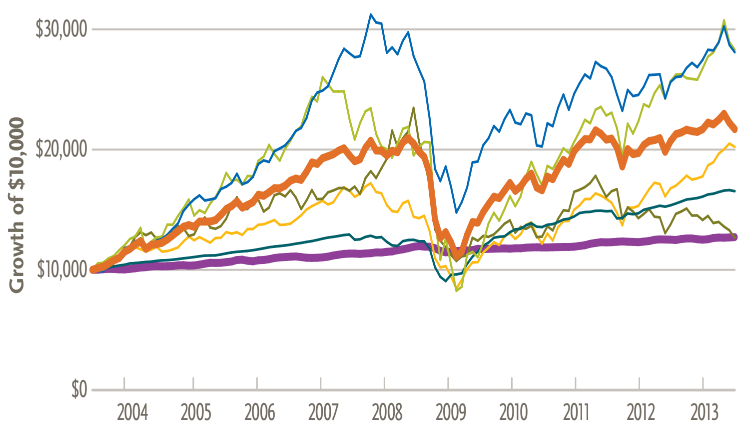
We see that from 2009 through 2012, the average hedge fund captured 41% of the upside of the S&P 500 index and 29% of the downside. Certain strategies such as convertible arbitrage and distressed investing captured far more on the upside than the downside. Some such as global macro and market neutral were more balanced in their upside and downside capture. Investors are happy to pay a premium for an asymmetric return profile that both captures more of the upside and protects on the downside.

Review of Liquid Portfolio Alternatives

For another check on the potential value-added from alternative investments, we turn to a Nuveen study that analyzed the performance of various investment categories over the last ten years, a period that encompassed good and bad markets. The study showed that a diversified mix of alternative strategies helped to both smooth out portfolio returns as well as to reduce overall portfolio volatility.

Chart 8. Blending Alternatives Creates Smoother Performance

Growth of $10,000 Investment, July 1, 2013 - June 30, 2013



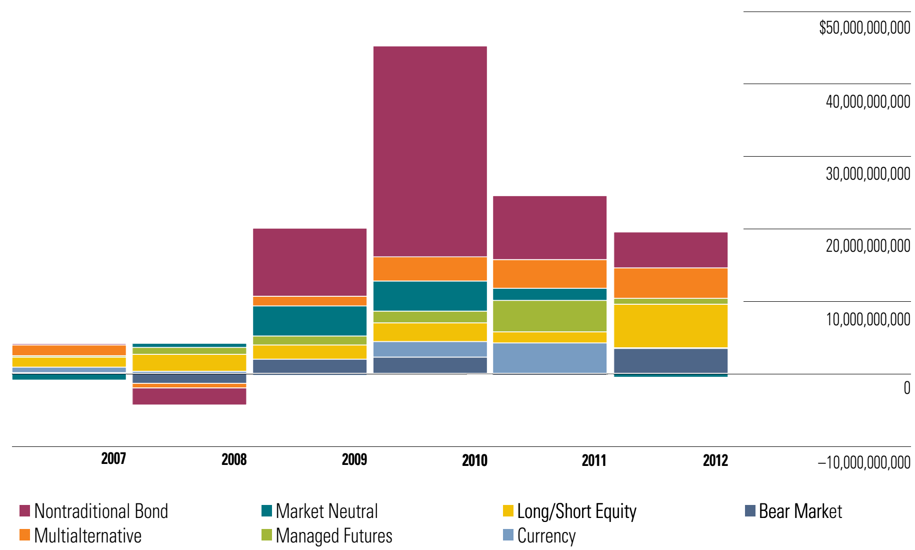
	Ending Value	Return	Risk
REITs	$28,300	10.96%	25.75%
Infrastructure	$28,096	10.88%	16.24%
Alternatives Blend*	**$21,697**	**8.05%**	**14.64%**
U.S. Equities	$20,225	7.30%	14.58%
Senior Loans	$16,539	5.16%	7.50%
Inflation	**$12,720**	**2.43%**	**1.53%**
Commodities	$12,662	2.39%	18.21%

Source: Rethinking Risk and Return, Nuveen Investments, July 2013

Strategies Suitable for Liquid Offerings

Having established that alternative investments are generally a good idea, and that making them more accessible extends these benefits to more investors, let's next look at which alternative strategies are most suitable for use in liquid format. Since 2007, the largest dollar flows into alternative mutual funds have been directed into non-traditional bond funds, with smaller allocations to long/short equity, equity market neutral, multi-alternative and managed futures strategies:

Chart 9. Alternative Mutual Fund Flows



Source: 2012 Alternative Investment Survey, Morningstar, June 2013

These categories share some common characteristics that make them suitable for deployment in a mutual fund or exchange traded fund. All are strategies that utilize highly liquid instruments such as listed equities, bonds, options and

Chart 10. Historical Index Performance

		2007	2008	2009	2010	2011	2012	2013
Equities								
Equity Long/Short	HFRI Equity Hedged	10.5%	-26.7%	24.6%	10.5%	-8.4%	7.4%	9.1%
Equity Market Neutral	HFRI Equity Market Neutral	5.3%	-5.9%	1.4%	2.9%	-2.1%	3.0%	3.7%
Fixed Income								
Non-Traditional Bond	HFRI Relative Value Total	8.9%	-18.0%	25.8%	11.4%	0.2%	10.6%	4.7%
Convertibles	HFRI Convertible Arbitrage	5.3%	-33.7%	60.2%	13.4%	-5.2%	8.6%	6.2%
Alternative								
Global Macro	HFRI Macro	4.8%	11.1%	4.3%	8.1%	-4.6%	-0.1%	-2.0%
Managed Futures	HFRI Systematic Diversified	10.3%	18.1%	-1.7%	9.8%	-3.5%	-2.5%	-3.7%
Multi-Alternative	HFRI FOF Diversified	9.7%	-20.9%	11.5%	5.5%	-5.0%	4.8%	4.8%
Benchmarks								
Equities	S&P 500 Index	5.5%	-37.0%	26.5%	15.1%	2.1%	16.0%	19.8%

Source: Bloomberg, HFRI. 2013 Data through 9/30/2013

futures. Hence, they are a good starting point for building out an alternatives allocation. Let's review these strategies, plus some others not mentioned above, starting with a summary of how each strategy has performed relative to the broad market benchmarks since the start of the financial crisis (see Chart 10).

Global Macro Funds: By definition, global macro managers invest opportunistically across any combination of asset classes based on their specific outlook or idiosyncratic view of the world. This flexibility means that global macro strategies tend to have low correlations to traditional assets classes, and it enabled global macro managers to preserve capital during the financial downturn. The full benefits of an allocation to global macro may only be realized over longer holding periods, and investors should be prepared for periods of mediocre or negative returns in shorter time frames.

Managed Futures Funds: Managed futures trade highly liquid commodities, currencies and futures using quantitative algorithms based either on trend following or fundamental analysis. They offer the tantalizing prospect of returns that are positively correlated with rising markets and negatively correlated with falling markets. Strong performance during the financial crisis sparked considerable interest in the category, which waned as the category underperformed relative to strong equity markets in the following years. As with global macro, it is important to remember that the diversification benefits will be realized over longer holding periods and investors should be prepared for underperformance or negative returns over short time frames.

Equity Long/Short: Given continuing concerns about downside protection, we expect continued interest in the use of long/short strategies to diversify and hedge long-only exposure; however, investors should be prepared that the short allocation may cause the strategy to underperform in strong equity markets.

Review of Liquid Portfolio Alternatives

Equity Market Neutral: This strategy is designed to neutralize market risk by trading pairs of related stocks. Ideally, the shorted stock will go down in value and the long position will increase in value, generating positive returns from both bets. The strategy tends to underperform in rising markets, and will do badly in markets that are highly correlated or which trade on macro or psychological factors (eg risk on, risk off), rather than fundamentals.

Convertible Arbitrage: Another market neutral investment strategy, it involves buying a company's convertible bonds and simultaneously selling short the common stock to profit from any pricing discrepancies between the convertible bond and the stock. Convertible bonds are considered a hybrid security. They carry a lower yield than a straight bond but can be converted to the underlying common stock at a discount to market value. If the stock price rises, the manager can convert the bond into stock at the pre-set discount price and then sell the stock at current market value, locking in a profit. If the stock price falls, the short stock position will benefit and although the convertible bond will decline in price, it will fall less than the equity.

Non-Traditional Bond: Managers in this category use various descriptions to identify their approach, including absolute return or unconstrained bond. In anticipation of rising rates, nearly all the funds in this category have very short durations, but with rates so low, they are struggling to generate acceptable returns and many have taken on credit exposure as a way to boost returns. While we are more comfortable with credit risk than interest rate risk, we point out that the performance of bond funds with a higher credit component may be closer correlated to riskier assets such as equities and high yield bonds and the expected diversification benefits may not be realized.

Multi-Alternative: The multi-alternative category encompasses a broad range of strategies that are overseen by a single manager or multiple managers. According to Morningstar, this is the fastest growing category of alternative funds as they provide an easy way for investors to fill out their alternatives allocation. While similar to fund-of-funds in their diversification and approach, multi-alternative funds differ in one important respect – in the mutual fund structure, there is no additional layer of fees at the fund-of-funds level.

Due Diligence & Risk Management

Performing due diligence on private alternative investments is challenging, due to the lack of transparency and absence of regulatory oversight. In theory, the task of reviewing liquid alternatives should be easier, since these managers are regulated and there is greater transparency into their strategy and holdings. In practice, the task is complicated by the lack of long-term performance data, although in some cases, the new mutual fund mirrors the manager's flagship private strategy.

In the absence of detailed quantitative data, our due diligence partners place great emphasis on qualitative factors such as the manager's overall tenure and reputation; infrastructure and platform, and the counterparties engaged for prime brokerage, auditing and legal services to the fund.

Performance of Liquid Alternatives

One of the early knocks against liquid alternatives was the assertion that liquid alternatives were inferior to private alternatives because of the trade-offs required to package these strategies into a mutual fund wrapper. A study by Cliffwater Research indicates that the average performance differential between private alternatives and public alternatives is around 1%, and considerably lower for strategies such as managed futures and global macro (Chart 11).

The Cliffwater study concluded that the 1% performance differential was a reasonable trade-off for enhanced liquidity, and similar to the price difference

Chart 11. Performance Differential - Private vs Liquid Alternatives
April 2003 - March 2013

	Average Return	Alpha	Median Return
All Strategies	**0.98%**	**0.97%**	**0.86%**
Equity Long/Short	1.07%	0.96%	0.52%
Credit	0.95%	1.06%	0.71%
Market Neutral	2.24%	2.15%	0.94%
Multi-Strategy	0.61%	1.32%	2.18%
Managed Futures	0.48%	-0.24%	0.42%
Global Macro	0.22%	1.49%	0.86%
Event Driven	2.26%	1.65%	1.60%

Source: Performance of Private versus Liquid Alternatives, Cliffwater Research, June 2013

between comparable publicly traded bonds and private market bonds. So the question for readers is whether they are prepared to pay 1% for the opportunity to invest in strategies that can potentially reduce portfolio risk and deliver returns in ways that may not be currently available to them for size, or other, reasons. Given this choice, we believe investors will opt to include liquid alternatives in their portfolio mix and view the performance trade-off as the cost of entry into a market that would otherwise be closed to them.

Fees

Closely related to performance is the more contentious issue of fees and value for money. Hedge fund managers have access to tools and techniques such as short selling and leveraging that traditional equity or bond managers may not be able to access readily for practical or regulatory reasons, or perhaps use as effectively. Plus, we note that hedge fund managers may be operating in less liquid markets. Hence they may have a higher cost structure than traditional managers and it is not unreasonable for them to charge higher fees for this reason.

In addition to annual management fees, hedge funds (and private equity firms) also take a share of the performance they generate, typically 20%. It is argued that these firms employ the best minds in the business, and that by taking a share of the performance fees, their interests and those of their investors are aligned. Performance fees cannot be taken on mutual funds, and until recently, this was a significant deterrent to managers contemplating launching a mutual fund vehicle. With some of the trends we outlined earlier, this is less of a deterrent.

Investors in traditional mutual funds are conditioned to examining fund expenses. Portfolio returns are driven by asset allocation and fees are a crucial element of long-term portfolio returns. Fees for alternative funds should be looked at differently. Where performance fees are paid, they drive up the fund's expense ratio, so the higher expense ratio can reflect better performance, and the investor is better off on an after-fee basis.

Review of Liquid Alternatives Market

Although liquid alternatives have gained popularity mainly since the 2008 financial crisis, many of these strategies have been available as mutual funds for considerably longer periods. Here are launch dates for mutual funds in various alternative categories:

Chart 12. Alternative Mutual Fund Launches

Investment Category	Launch of First Mutual Fund
Long-Short Equity	January 1978
Market Neutral	February 1989
Non-Traditional Bond	Febuary 1996
Multi-Alternative	January 2001
Managed Futures	April 2007

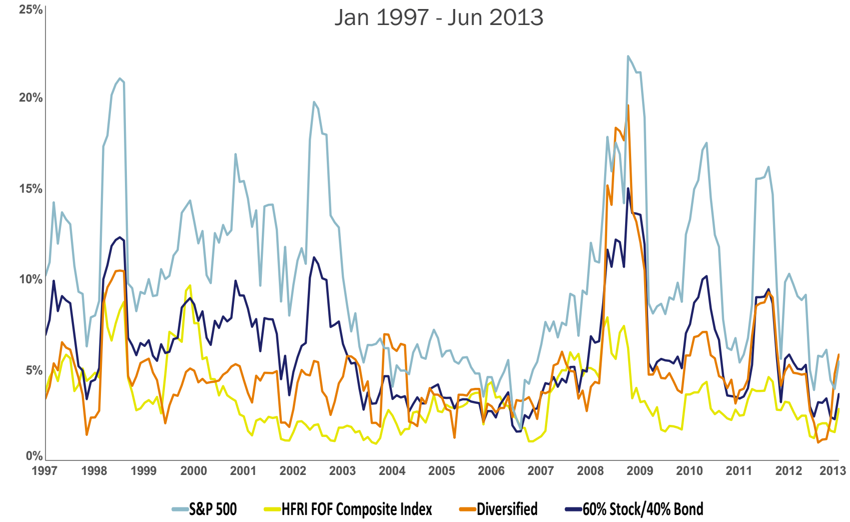
Source: Alternative Strategy Mutual Funds, Fortigent, October 2013

Review of Liquid Portfolio Alternatives

With more and more liquid alternatives expected to come to market, it is prudent to examine whether liquid alternatives provide comparable diversification and risk reduction benefits to private alternatives. For proof, we look to a pioneering study by Research Affiliates, an early proponent of this investing category. Since this study was completed before the 2008 financial crisis, we extended the data period to 2013 to check if its original conclusions are still valid.

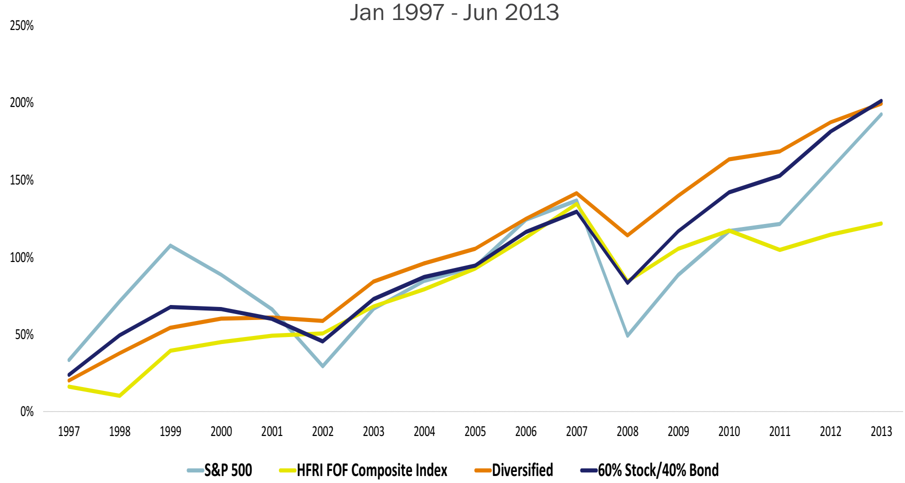
Our results are presented in charts 13 and 14, which compare the cumulative returns and annual volatility of a fully diversified portfolio comprising 1/3 stocks, 1/3 bonds and 1/3 alternatives to the corresponding return and volatility data for each of the S&P 500 index, HFRI hedge fund of funds index and a simple 60% stock/40% bond mix. We have included the latter data point as we are often asked if investors would have been better off in a 60/40 portfolio. Using the above data points, we see that over this sixteen-year period, the broadly diversified portfolio using alternatives provided better risk adjusted returns (higher Sharpe Ratio) than a 60/40 blend or an all-equity or all-hedge fund allocation:

Chart 14. Comparative Asset Volatility
Jan 1997 - Jun 2013



Source: Bloomberg, HFRI, Altegris

Chart 13. Cumulative Asset Returns
Jan 1997 - Jun 2013



Source: Bloomberg, HFRI, Altegris

Chart 15. Risk/Return Comparison

(Jan 1997 - Jun 2013)		Annualized Return	Annualized Volatility	Cumulative Sharpe Ratio
Diversified	1/3 each Stocks/Bonds/Hedge Funds	6.76%	8.59%	0.4799
60/40 Blend	60% S&P 500 + 40% Barclays Aggregate	6.73%	9.71%	0.4216
Stocks	S&P500 Index	6.73%	16.10%	0.2536
Bonds	Barclays Aggregate	5.84%	3.53%	0.9064
Hedge Funds	HFRI Index	4.96%	6.13%	0.3789

Source: Bloomberg, HFRI, Altegris

Review of Liquid Portfolio Alternatives

Hence, we conclude that a well-diversified mix of liquid alternatives helped to smooth out portfolio returns and reduce portfolio risk over a period that was arguably one of the most difficult investing environments in recent years. Although Chart 15 shows that bonds had the best risk-adjusted returns over this period, bear in mind that they benefited from a 30-year cycle of low interest rates and an environment where investors sought refuge in US Treasurys and the highest quality bonds. Looking ahead, we expect the outlook for bonds will be less favorable once the Federal Reserve scales back its bond purchase programs and interest rates begin to normalize.

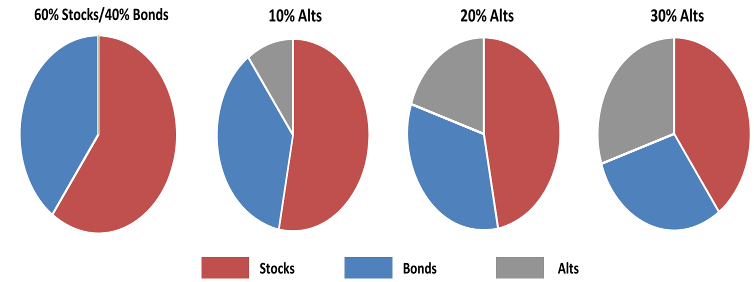
Portfolio Implementation

Now that we have established the benefits of liquid alternatives, let us look at how this approach might be implemented within portfolios. A critical question is how much of an allocation is required to have an appreciable impact on the portfolio. A recent study by Merrill Lynch looked at the impact on long-term portfolio risk and return from the addition of alternative mutual funds, beginning with a simple 60/40 portfolio and adding successively higher amounts of alternatives to the portfolio. Compared to the simple 60/40 portfolio, a 20% allocation to alternatives brought a 0.18% reduction in expected return and a 1.45% drop in expected risk, while a 30% allocation provided a 0.27% reduction in expected return and 2.04% drop in expected risk (Chart 16). Although the expected return goes down as the proportion of alternatives rises, this is offset by a greater reduction in the expected risk of the portfolio; hence, the study concluded that liquid alternatives appreciably improve the overall risk/return profile.

Based on this and other research, it appears that the optimal allocation to alternatives is in the range of 20% to 30% of the total portfolio value. And how should we allocate among various alternative strategies to construct a portfolio that maximizes the benefit of adding alternatives? Chart 17 shows that market neutral and managed futures strategies are the best portfolio diversifiers and

Chart 16. Cumulative Asset Returns

Jan 1997 - Jun 2013

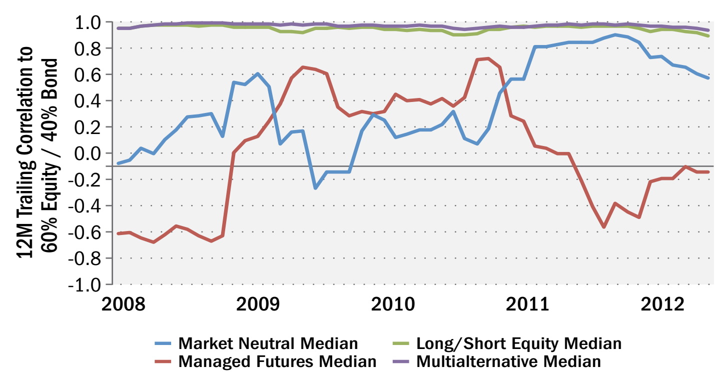


Expected Return	7.82%	7.73%	7.64%	7.55%
Expected Risk	11.87%	11.11%	10.43%	9.83%

Source: Non-Traditional Mutual Funds and Portfolio Strategy, Merrill Lynch CIO Reports, April 2013

that the return and correlation profiles for other strategies such as equity long/short, multi-strategy and fund-of-funds are more closely tied to traditional equity and bond returns. And despite the high correlations, an equity long/short allocation will reduce overall equity risk via the short component of the portfolio,

Chart 17. Correlations to Traditional 60/40 Bond Portfolio



Source: Non-Traditional Mutual Funds and Portfolio Strategy, Merrill Lynch CIO Reports, April 2013 while diversified or multi-alternative strategies can provide exposure to other sources of return beyond equities and bonds.

To help pull all of this together, let's look at how we can build out a representative alternatives allocation for our various investor profiles using some of these solutions. Keep in mind that these categories can be filled with a combination of private and liquid vehicles, as appropriate. As we show below, replacing a portion of the traditional equity and bond exposure with alternatives can also help to help manage risk on that side of the portfolio.

Chart 18. Representative Portfolio Allocations

	Conservative	Moderate	Growth	Aggressive	Comments
Traditional Portion of Portfolio:					
Equity Long/Short	**2.0%**	**5.0%**	**4.0%**	**2.0%**	*Fund from Large Cap Equity Allocation*
Convertible Arbitrage	**2.0%**	**2.0%**	**2.0%**	**2.0%**	*Fund from Fixed Income Allocation*
Non-Traditional Bond	**2.0%**	**2.0%**	**2.0%**	**2.0%**	*Fund from Fixed Income Allocation*
Alternatives Allocation:					
Global Macro	**5.0%**	**3.7%**	**3.5%**	**3.5%**	
Managed Futures	**3.0%**	**2.5%**	**2.0%**	**2.0%**	
Market Neutral	**6.0%**	**2.5%**	**2.0%**	**2.0%**	
Multi-Alternative	**6.0%**	**6.0%**	**6.0%**	**6.0%**	
Private Equity	**1.5%**	**6.0%**	**7.0%**	**7.0%**	
	21.5%	**20.7%**	**20.5%**	**20.5%**	

Source: HPM Partners 2013 Strategic Allocation Targets

Conclusions

1. Liquid alternatives are an increasingly common and accepted feature of the investment landscape, with a growing proliferation of offerings from the more established and reputable hedge funds and private equity firms.

2. Though they can comfortably meet the minimums to invest through private vehicles, institutional investors now place a premium on liquidity and accessibility. As such, they are receptive to using liquid alternatives in categories where there is no performance trade-off.

3. Not all alternative strategies are suitable for use in a liquid vehicle, nor can all liquid alternatives deliver comparable returns to their private counterparts.

4. This is still a developing category. The newer funds lack a long-term track record and have not been tested in adverse market conditions. For these reasons, it may be prudent to work with established managers who already have a track record managing comparable investments in the private market.

5. The decision to invest in private funds or public funds is not a binary decision. Where illiquid strategies are the better option, they should be used. Where viable liquid options are available, they can help to alleviate some of the illiquidity associated with hedge funds and private equity investments.

6. It is important to use a diversified mix of strategies and to maintain exposure for sufficient time to allow these strategies to perform their designated role within the portfolio. Consider allocations to these categories are strategic, rather than tactical, investments.

7. We regularly highlight the importance of diversification as a critical tool for controlling portfolio risk. It is also an effective counterpoint to the unpredictability and mean reversion tendency of portfolio returns. These points are amply demonstrated in the chart below, which shows the overall randomness of returns for hedge fund strategies over extended time periods.

Review of Liquid Portfolio Alternatives

Chart 19. Annual Returns of Hedge Fund Strategies by Style

1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Special Situations 27.83	Special Situations 21.94	Sector Long/Short 14.45	Sector Long/Short 68.38	Short 19.09	Distressed 12.39	Short 25.50	Sector Long/Short 25.22	Distressed 14.12	Non-US Long/Short 17.86	Special Situations 13.90	Macro 16.48	Short 23.55	Convertible Arbitrage 41.21	Merger Arbitrage 21.60	Distressed 1.51	Distressed 15.95
Sector Long/Short 23.89	Sector Long/Short 20.28	US/Global Long/Short 14.12	Non US Long/Short 45.18	Merger Arbitrage 17.66	Special Situations 10.04	FX 12.19	Distressed 22.01	Special Situations 11.22	Sector Long/Short 9.14	Sector Long/Short 13.80	Special Situations 12.28	FX 8.49	Merger Arbitrage 27.17	Special Situations 14.19	Equity Mrkt Neutral -0.35	FX 13.35
Fixed Income 23.05	US/Global Long/Short 19.92	Equity Mrkt Neutral 11.78	US/Global Long/Short 44.61	Special Situations 13.53	Fixed Income 8.94	Managed Futures 10.23	Special Situations 21.54	Fixed Income 10.38	Macro 8.96	Convertible Arbitrage 13.73	Merger Arbitrage 11.94	Managed Futures 6.14	Special Situations 25.42	Fixed Income 13.82	Convertible Arbitrage -1.89	Fixed Income 13.05
Non-US Long/Short 22.71	Multi Arbitrage 19.24	Managed Futures 10.06	Special Situations 32.66	Sector Long/Short 13.21	Short 8.64	Convertible Arbitrage 7.36	Non-US Long/Short 20.96	Non-US Long/Short 9.17	Fixed Income 8.49	Distressed 13.33	Non-US Long/Short 11.89	Macro 3.41	US/Global Long/Short 25.17	US/Global Long/Short 11.97	Fixed Income -2.49	Merger Arbitrage 11.66
US/Global Long/Short 21.86	Non-US Long/Short 17.43	Merger Arbitrage 9.92	Macro 26.40	Equity Mrkt Neutral 13.09	Convertible Arbitrage 7.98	Fixed Income 6.99	US/Global Long/Short 20.89	US/Global Long/Short 8.30	US/Global Long/Short 7.41	Non-US Long/Short 12.67	Managed Futures 10.87	Equity Mrkt Neutral -3.82	Fixed Income 24.02	Sector Long/Short 11.72	Macro -2.60	Non-US Long/Short 9.20
Merger Arbitrage 20.85	Managed Futures 16.14	Special Situations 5.88	Convertible Arbitrage 21.82	Multi Arbitrage 12.01	Managed Futures 7.27	Macro 5.90	Macro 18.43	Merger Arbitrage 7.42	Distressed 6.94	US/Global Long/Short 11.99	US/Global Long/Short 10.66	Multi Arbitrage -8.10	Non US Long/Short 22.64	Convertible Arbitrage 10.16	Multi Arbitrage -3.27	Convertible Arbitrage 8.52
Distressed 20.43	Distressed 15.92	Macro 5.60	Merger Arbitrage 20.84	Managed Futures 11.24	Non-US Long/Short 7.13	Distressed 5.79	Convertible Arbitrage 15.42	Sector Long/Short 7.26	Special Situations 6.89	Fixed Income 11.99	Sector Long/Short 10.48	Merger Arbitrage -10.82	Sector Long/Short 20.53	Equity Mrkt Neutral 9.01	US/Global Long/Short -4.48	Special Situations 8.03
Multi Arbitrage 18.75	Merger Arbitrage 15.79	FX 5.50	Multi Arbitrage 18.96	US/Global Long/Short 10.90	Multi Arbitrage 6.92	Multi Arbitrage 4.91	Fixed Income 15.24	Managed Futures 6.43	Managed Futures 6.08	Merger Arbitrage 11.60	Short 10.46	Distressed -14.92	Distressed 18.60	Macro 9.00	Merger Arbitrage -5.43	Equity Mrkt Neutral 6.94
Macro 18.35	Fixed Income 15.15	Convertible Arbitrage 4.32	Distressed 17.30	Convertible Arbitrage 9.79	Equity Mrkt Neutral 6.33	Equity Mrkt Neutral 3.98	Managed Futures 14.91	Multi Arbitrage 6.29	Equity Mrkt Neutral 5.91	Multi Arbitrage 10.89	Distressed 8.38	Fixed Income -15.33	Macro 18.54	Non US Long/Short 8.52	Sector Long/Short -5.51	Sector Long/Short 5.91
Convertible Arbitrage 17.19	Macro 14.99	Multi Arbitrage 4.27	Fixed Income 16.82	Macro 6.39	Macro 5.82	Non-US Long/Short 1.70	Merger Arbitrage 12.56	Macro 5.58	Multi Arbitrage 5.32	Equity Mrkt Neutral 9.36	Equity Mrkt Neutral 7.88	US/Global Long/Short -17.99	Multi Arbitrage 14.77	Managed Futures 8.52	Managed Futures -6.30	US/Global Long/Short 5.23
Equity Mrkt Neutral 17.07	Convertible Arbitrage 14.77	Distressed -1.75	Equity Mrkt Neutral 15.73	Distressed 5.89	US/Global Long/Short 5.56	Merger Arbitrage 1.24	Multi Arbitrage 12.16	Convertible Arbitrage 5.16	Merger Arbitrage 3.04	Managed Futures 8.77	Multi Arbitrage 7.60	Non-US Long/Short -18.50	Equity Mrkt Neutral 11.79	Distressed 8.37	Special Situations -6.52	Multi Arbitrage 1.95
Managed Futures 16.54	FX 13.85	Short -3.67	Managed Futures 11.82	Fixed Income 5.51	FX 5.15	Special Situations -1.20	FX 8.37	Equity Mrkt Neutral 3.88	Short 2.82	Macro 6.80	Fixed Income 6.69	Special Situations -18.87	FX 5.86	FX 8.37	FX -9.73	Managed Futures 1.90
FX 14.04	Equity Mrkt Neutral 13.81	Non US Long/Short -3.84	FX 4.77	FX 5.05	Merger Arbitrage 3.61	US/Global Long/Short -2.49	Equity Mrkt Neutral 6.73	FX -0.83	Convertible Arbitrage 2.55	FX 3.46	FX 2.94	Sector Long/Short -22.12	Managed Futures 4.44	Multi Arbitrage 5.18	Non US Long/Short -11.62	Macro 1.49
Short 0.05	Short 8.02	Fixed Income -4.40	Short -14.82	Non-US Long/Short 0.92	Sector Long/Short 3.51	Sector Long/Short -3.56	Short -12.08	Short -6.64	FX 1.16	Short -5.52	Convertible Arbitrage 2.28	Convertible Arbitrage -31.02	Short -23.43	Short -10.28	Short -12.41	Short -10.74

Source: Investment Facts, Lazard Asset Management, 2013

Third Quarter Performance Summary

Asset Class	Benchmark	3Q13 Return	YTD Return	Performance Summary
Cash	*Citi 3-month T-bill*	0.01%	0.04%	Cash yields will continue to remain low for the foreseeable future.
Domestic Gov't / Agency	*BC U.S. Gov't & Related 5-7*	0.40%	-0.83%	Fed's surprise Sep 18 announcement to delay tapering lowered interest and led to a rally in Treasurys at the shorter end of the yield curve. The appointment of Yellen to succeed Bernanke raised expectations that rates will remain low for longer.
Domestic Tax-Exempt	*BC Municipal Bond 5-Year*	0.87%	-0.03%	September was the first positive month for municipal markets since April. Intermediate and short-term municipals have benefited from Fed decision to delay tapering. The condition of state/municipal finances remain a concern; following Detroit's bankruptcy filing, attention is now focused on Puerto Rico.
TIPS	*BC TIPS*	0.70%	-6.74%	TIPS rallied on the Fed announcement putting tapering on hold; however, with inflation expectations still muted and interest rates expected to remain low for some time to come, the outlook for TIPS remains unfavorable.
Investment-Grade Debt	*BC Inv. Grade Intermediate*	0.57%	-1.89%	New IG issuance of $141 billion came just shy of the $143 billion all-time record in May 2008 as investors took advantage of lower rates ahead of Fed decision on tapering. Verizon's $49 billion mega-deal was heavily oversubscribed.
High-Yield Debt	*BC High-Yield Intermediate*	2.44%	3.91%	The sector rebounded in Q3 and retraced Q2 losses. Bank loans saw record inflows in July/Aug. High yield new issuance hit new highs in Q3, with strong demand from buyers seeking income.
Global Bonds	*Citi World Gov't Bond Index (Hedged)*	2.84%	-2.94%	The Fed announcement to delay tapering set of a rally in global bond markets and helped them to recover some of the ground lost in the Q2 sell-off; however, the category is still in negative territory year to date.
Emerging-Markets Debt	*Morningstar EM Composite Bond Index*	0.87%	-5.40%	Following the Q2 sell-off, emerging markets debt saw a small turnaround in Q3, with returns boosted by the weaker USD. Despite attractive valuations, favorable debt-to-GDP comparisons and higher economic growth prospects, emerging markets have experienced significant outflows from investors.

Source: Bloomberg; Data as of 9/30/13.

Third Quarter Performance Summary (Continued)

Asset Class	Benchmark	3Q13 Return	YTD Return	Performance Summary
Large-Cap Equity	*S&P 500*	4.67%	19.79%	Despite concerns about an end to tapering and wrangling over the debt ceiling, large-cap stocks posted strong returns in Q3. Performance was boosted by continued improvement in corporate earnings, employment growth and retail sales.
Small/Mid-Cap Equity	*Russell 2000*	8.83%	27.68%	Small-cap stocks enjoyed another strong quarter in Q3. Investors remained willing to look beyond near term political and economic issues and focus on longer term growth opportunities. In a sign of increasing risk appetite, micro cap stocks performed particularly well.
International Equity	*MSCI EAFE*	10.55%	16.77%	European markets led a global rally, on hopes that the Eurozone was poised to come out of recession International small cap outperformed large cap; both benefited from USD weakness.
Emerging-Markets Equity	*MSCI EM*	5.67%	-4.20%	A strong third quarter for emerging market equities helped to reverse some of the losses from the Q2 sell-off. China is showing signs of stabilization, while India and Brazil continue to struggle with weak currencies, rising inflation and slowing growth.
Real Estate	*DJ Composite REIT Index*	-3.26%	-1.03%	Despite a continued economic recovery and improving market for real estate, Q3 was the second consecutive quarter of negative returns for the REIT sector. Higher borrowing costs following the mid-year rise in interest rates were a major factor contributing to the sector's weak returns.
Commodities	*DJ UBS Commodity Index*	1.37%	-8.60%	The environment remains challenging for commodities. Broadly speaking, supplies are plentiful, while demand remains sluggish to weak. This situation is expected to persist in the near term.
Private Equity	*S&P Listed Private Equity*	11.83%	28.89%	Strong deal flow, robust transaction activity and strong equity markets all combined to give a strong boost to the share prices of private equity firms in Q3.
Hedge Funds	*HFRX Global Hedge Fund Index*	0.86%	4.29%	Although their performance has lagged the broader equity and fixed income markets, hedge fund assets grew by $23 billion to a record $2.5 trillion in Q3, driven by investors' desire for access to strategies to help them cope with an increasingly uncertain and complex financial landscape.

Source: Bloomberg; Data as of 9/30/13.

Third Quarter Market Summary

						Annualized			
		1Q13	2Q13	3Q13	YTD	1-Year	3-Year	5-Year	10-Year
US Equity Benchmarks	**Price**								
Dow Jones Industrial	15,129.67	11.93%	2.91%	1.66%	17.63%	14.92%	14.94%	9.10%	7.74%
Nasdaq Index Composite	3,771.48	8.51%	4.52%	10.16%	26.12%	23.10%	18.29%	11.61%	8.95%
S&P 500	1,681.55	10.60%	2.91%	4.67%	19.79%	19.01%	16.26%	8.13%	7.57%
Russell 1000 (Large Cap)	939.50	10.96%	2.67%	5.36%	20.78%	20.66%	16.64%	8.38%	7.97%
Russell 1000 Growth	785.46	9.55%	2.06%	7.28%	20.87%	19.09%	16.94%	9.12%	7.82%
Russell 1000 Value	848.24	12.31%	3.23%	3.44%	20.50%	22.00%	16.26%	7.56%	7.97%
Russell Mid Cap	1,381.83	12.96%	2.26%	6.76%	24.39%	27.99%	17.55%	9.82%	10.74%
Russell Mid Cap Growth	625.87	11.51%	2.87%	8.08%	25.41%	27.48%	17.65%	9.47%	10.12%
Russell Mid Cap Value	1,398.60	14.21%	1.74%	5.32%	23.05%	27.96%	17.32%	10.06%	10.88%
Russell 2000 (Small Cap)	1,073.79	12.39%	3.08%	8.83%	27.68%	29.64%	18.30%	10.61%	9.62%
Russell 2000 Growth	637.16	13.21%	3.73%	11.16%	32.47%	32.80%	19.98%	11.35%	9.83%
Russell 2000 Value	1,371.33	11.63%	2.47%	6.47%	23.07%	26.49%	16.57%	9.80%	9.25%
S&P GICS Sectors	**Weight**								
Consumer Discretionary	9.6%	12.15%	6.81%	7.06%	29.12%	31.81%	24.13%	18.39%	9.79%
Consumer Staple	11.5%	14.58%	0.50%	0.07%	16.08%	13.28%	15.86%	11.92%	9.89%
Energy Sector	11.4%	10.17%	-0.37%	4.57%	15.42%	11.65%	15.38%	1.08%	14.15%
Financials	14.6%	11.42%	7.25%	2.37%	22.93%	29.60%	13.58%	1.44%	-0.12%
Health Care	13.0%	15.81%	3.84%	6.35%	28.45%	27.79%	20.95%	13.40%	8.18%
Industrials	10.5%	10.67%	2.81%	7.93%	23.92%	27.94%	16.69%	8.86%	8.71%
Information Technology	19.4%	4.59%	1.68%	5.87%	13.39%	7.11%	13.70%	9.00%	7.13%
Materials	3.5%	4.79%	-1.80%	9.47%	13.50%	16.19%	11.92%	2.73%	9.41%
Telecommunication Services	3.0%	9.46%	1.00%	-4.28%	5.69%	-0.42%	12.56%	8.34%	8.93%
Utilities	3.6%	13.02%	-2.73%	1.51%	10.13%	7.44%	10.58%	3.35%	9.76%
Global Equity Benchmarks	**Price**								
MSCI World Index	1,543.67	7.92%	0.83%	7.52%	17.89%	20.37%	12.59%	5.16%	8.33%
MSCI AC World x-USA	382.07	6.62%	-0.22%	7.31%	14.96%	17.88%	10.92%	4.66%	8.57%
MSCI EAFE	1,818.23	5.34%	-0.77%	10.55%	16.77%	23.38%	9.18%	2.40%	8.76%
MSCI EAFE Growth	1,386.03	6.88%	-1.02%	9.37%	17.00%	22.75%	9.40%	2.34%	8.62%
MSCI EAFE Value	2,918.89	3.78%	-0.49%	11.74%	16.51%	24.01%	8.90%	2.41%	8.82%
MSCI Emerging Markets	987.46	-1.90%	-7.76%	5.67%	-4.20%	1.04%	0.01%	1.14%	13.21%
MSCI BRIC	274.60	-3.01%	-9.74%	8.56%	-4.91%	0.77%	-4.28%	-3.87%	13.03%
Nikkei 225	14,455.80	19.67%	10.98%	4.91%	41.13%	67.02%	17.84%	3.38%	5.14%

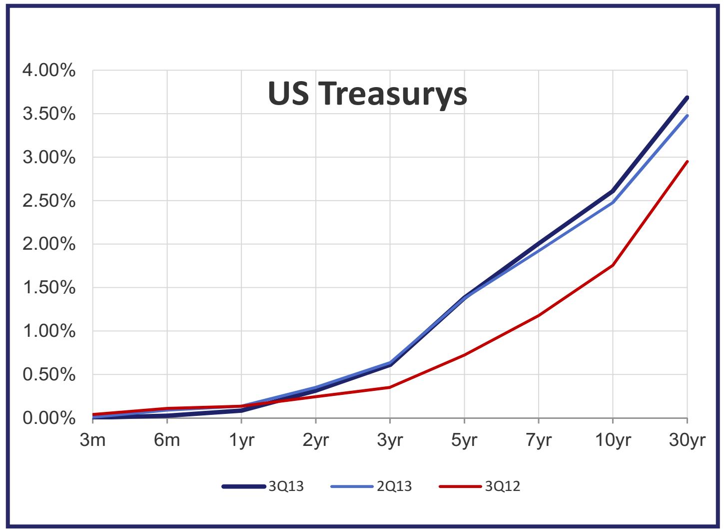
Global Equity Valuation Summary

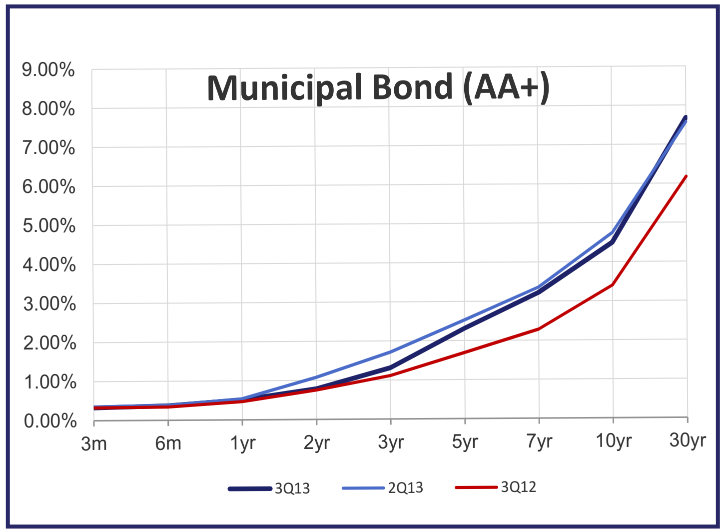
Benchmarks	2Q13	3Q13	QoQ
S&P 500			
Price	1,615.0	1,681.6	66.6
Trailing P/E	15.6	16.2	0.6
Est P/E	14.6	15.3	0.6
Trailing 12m Earnings	103.5	103.9	0.4
Est Forward 12m Earnings	110.3	110.2	-0.1
Implied 1yr Earnings Growth	6.5%	6.0%	-0.5%
Russell Mid Cap			
Price	1,299.4	1,381.8	82.5
Trailing P/E	19.4	20.7	1.2
Est P/E	17.2	18.4	1.2
Trailing 12m Earnings	66.9	66.9	0.0
Est Forward 12m Earnings	75.6	75.1	-0.6
Implied 1yr Earnings Growth	13.0%	12.2%	-0.8%
Russell 2000			
Price	989.8	1,073.8	83.9
Trailing P/E	37.5	39.6	2.1
Est P/E	24.1	27.1	3.0
Trailing 12m Earnings	26.4	27.1	0.7
Est Forward 12m Earnings	41.1	39.7	-1.4
Implied 1yr Earnings Growth	55.7%	46.2%	-9.5%
MSCI EAFE			
Price	1,656.0	1,818.2	162.2
Trailing P/E	15.8	16.4	0.6
Est P/E	12.3	13.1	0.9
Trailing 12m Earnings	103.7	111.1	7.4
Est Forward 12m Earnings	133.7	138.5	4.8
Implied 1yr Earnings Growth	28.9%	24.7%	-4.2%
MSCI Emerging Markets			
Price	941.9	987.5	45.5
Trailing P/E	11.8	12.0	0.2
Est P/E	9.5	10.0	0.5
Trailing 12m Earnings	79.8	82.5	2.6
Est Forward 12m Earnings	99.2	98.6	-0.6
Implied 1yr Earnings Growth	24.3%	19.6%	-4.7%

Source: Bloomberg; Data as of 9/30/13.

Third Quarter Market Summary (Continued)

						Annualized			
		1Q13	2Q13	3Q13	YTD	1-Year	3-Year	5-Year	10-Year
Interest Rates	**Yield**								
Prime Rate	3.25	0.00	0.00	0.00	0.00	0.00	0.00	-1.75	-0.75
3m Treasury Bill	0.01	-0.01	-0.01	-0.01	-0.04	-0.08	-0.15	-1.65	-0.93
US LIBOR 3m	0.25	-0.02	-0.02	-0.02	-0.06	-0.11	-0.04	-2.54	-0.91
US Treasury 3m	0.02	-0.02	-0.02	-0.02	-0.03	-0.07	-0.14	-1.66	-0.93
US Treasury 10yr	2.64	0.14	0.14	0.14	0.86	1.00	0.11	-1.35	-1.32
US Treasury 30yr	3.68	0.21	0.21	0.21	0.73	0.86	0.00	-0.84	-1.20
Fixed Income									
Citi 3-month T-bill		0.02%	0.02%	0.01%	0.04%	0.07%	0.08%	0.15%	1.61%
BC U.S. Gov't & Related 5-7		0.14%	-1.37%	0.40%	-0.83%	-0.80%	1.75%	3.52%	3.76%
BC Municipal Bond 5-Year		0.84%	-1.71%	0.87%	-0.03%	-0.24%	2.71%	4.90%	3.85%
BC TIPS		-0.36%	-7.05%	0.70%	-6.74%	-6.10%	4.02%	5.31%	5.23%
BC Investment Grade Intermediate		-0.12%	-2.32%	0.57%	-1.89%	-1.68%	2.86%	5.41%	4.59%
BC High Yield Intermediate		2.90%	-1.43%	2.44%	3.91%	7.16%	9.01%	12.94%	8.55%
Citi World Gov't Bond Index		-2.78%	-2.97%	2.84%	-2.94%	-4.60%	1.02%	3.59%	4.79%
Morningstar EM Composite Bond Index		-1.23%	-5.28%	0.87%	-5.40%	-1.94%	3.89%	8.07%	8.32%
Real Estate	**Price**								
Dow Jones Composite REIT Inde	202.96	7.84%	-4.73%	-3.26%	-1.03%	0.39%	6.93%	1.16%	2.99%
FTSE EPRA/NAREIT Europe	1,538.69	0.09%	0.60%	6.21%	6.46%	13.92%	9.15%	4.44%	7.63%
Commodities	**Weight**								
DJ UBS Commodity Index		-1.15%	-9.46%	1.37%	-8.60%	-14.85%	-3.24%	-11.50%	0.50%
Energy	21.0%	7.09%	-8.51%	1.96%	0.73%	-6.16%	-5.97%	-26.22%	-8.55%
Agriculturals	33.0%	-3.18%	-4.49%	-1.80%	-9.94%	-18.48%	0.24%	-5.65%	0.88%
Livestock	6.7%	-6.45%	2.18%	2.75%	-1.89%	1.27%	-2.04%	-8.27%	-6.67%
Softs	8.3%	-3.22%	-8.44%	0.83%	-10.56%	-18.93%	-6.40%	-0.82%	-2.23%
Industrial Metals	20.2%	-7.86%	-10.40%	1.44%	-13.91%	-17.66%	-9.67%	-9.34%	7.06%
Precious Metals	10.8%	-5.48%	-25.51%	6.70%	-23.29%	-29.39%	-0.05%	5.87%	11.32%
Private Equity / Hedge Funds	**Price**								
S&P Listed Private Equity Index	190.88	13.63%	0.60%	11.83%	28.89%	36.00%	16.29%	4.80%	N/A
HFRX Global Hedge Fund Index	1197.61	3.13%	0.03%	0.86%	4.29%	5.06%	0.52%	-1.86%	1.09%
Currencies	**Price**								
ICE Dollar Index	80.22	4.05%	0.17%	-3.41%	0.57%	0.50%	0.63%	2.08%	-1.45%
Euro / US Dollar	1.35	-2.86%	1.51%	3.54%	2.53%	4.96%	-0.26%	-3.05%	1.50%
Pound / US Dollar	1.62	-6.53%	0.13%	6.37%	-0.42%	0.35%	0.99%	-4.10%	-0.26%





Municipal bond yields are shown on a comparable, adjusted basis using a 35% tax rate.

Source: Bloomberg; Data as of 9/30/13.

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