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K2 Perspective

K2 ADVISORS®

A Finite Mess

"They would have us believe that there is no cause for anxiety, that reserves [of oil] will last thousands of years, and that before they run out science will have produced miracles. Our past history and security have given us the sentimental belief that the things we fear will never really happen – that everything turns out right in the end. But prudent men will reject these tranquilizers and prefer to face facts so that they can plan intelligently…"

Rear Admiral Hyman Rickover (considered the father of the modern nuclear submarine) in a speech to the Minnesota State Medical Association, May 14, 1957

A recent *Financial Times* article reported that several prominent consulting firms, including Towers Watson and Mercer, are placing a greater emphasis on environmental, social and governance (ESG) considerations when evaluating and recommending investment managers. They suggest that sustainability in investing should no longer be a peripheral consideration, but instead should be an integral part of portfolio planning from the beginning. According to the Towers Watson 2014 global investment report, "…such a strategy is vital for asset managers and investors looking to succeed over the long term".

To be sure, as a species we humans have demonstrated a remarkable tendency towards short sighted thinking and behavior. Despite intellectually understanding the potential negative consequences of many of the choices we make, we often seem helpless to the most ignorant of impulsive tendencies. Consider the continued success and profitability of the tobacco industry for example. Despite decades of conclusive scientific and empirical evidence suggesting the severe negative biological impact cigarettes may have on our bodies, humans the world over continue to smoke with reckless abandon. And, while the number of chronic cigarette users has gradually declined in recent years, the rate of decline seems startlingly low when measured against the mountain of negativity associated with the practice. This is really quite vexing when you think about it. Imagine for a moment that some higher intelligent being from another planet were watching our world over the past few centuries. In all likelihood he/she/it would be hard pressed to reconcile many of the irrational decisions we as a species have made for ourselves collectively…never mind the absurdities and follies we as individuals engage in (as an aside, a recent study from the Florida Gulf Coast University in Fort Myers suggests that if there is in fact other intelligent life in the universe then statistically speaking we should have 'made contact' by now.

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Strategy Focus – December 2013

Long Short Equity

Global equity markets recovered from a period of intra-month declines in December to eventually post steady gains for the month, led by performance in the US and Europe while Asia and emerging markets lagged. For the year global stocks finished at-or-near record highs, driven by the release of encouraging economic data including significant expansions in U.S. consumer confidence levels and Euro zone manufacturing activity.

With this as a backdrop K2's long short equity managers ended both the month and the year with strong returns. Based on capital weighted performance the leading sub-strategy in December was healthcare, followed closely by US focused and technology.

As was the case in November, the majority of underlying managers were successful in capturing alpha on both the long and short side of their portfolios. We continue to see improvements in the alpha cycle as earnings growth replaces multiple expansions as the driver of market returns.

Managers kept exposures high initially in December but eventually took advantage of the market rally to capture year-end profits, reducing both net and gross exposure by the end of the month.

In terms of select performance drivers there were a number of single stock events across multiple sectors that contributed to gains. These included rumors of a merger between two large players in the telecommunications space, positive news relating to several internet stocks, as well as successful clinical results for a biotechnology company, which boosted its stock more than 100% over the month. For detractors the most significant losses came from exposures in the technology space and index hedges.

Looking ahead manager focus will be on identifying companies whose earnings may benefit in 2014 from innovation, new product cycles, growing market share, and smart capital allocation.

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The author of the study, mathematician Thomas Hair, said this leaves two possibilities: one, we are alone in the universe, which is presumed to be unlikely; or two, we are deliberately being avoided/ignored by any higher sentient beings. Based on even the most cursory review of human activity over the course of modern history, and assuming that all of our radio and television transmissions over the past 75 years have been broadcast into the vast cosmos – including such programming gems as *Toddlers & Tiara's*, *Jersey Shore* and the *Jerry Springer Show* – then it really would be no surprise at all to think we are being avoided like the Ebola virus).

But we digress. The bottom line is that mankind often fails to recognize the longer-term consequences of its actions, driven by an instinctual and primal compulsion for immediate gratification at the expense of the greater and longer term good. While this compulsive, or 'id-like', tendency is manifest across a broad scope of human activity and interactions, perhaps the one area in which it is most collectively visible is in the way we approach our environment. More specifically, it is our general failure as a species to recognize that many of the natural resources we consume on a daily basis are finite, and that absent a thoughtful approach to managing these finite resources – and as the world's population continues to grow exponentially – we will someday face a critical mismatch between supply and demand.

Saving the Proverbial Forest and the Trees

Individually humans have made great strides in taking a more thoughtful approach to resource conservation. For example, recycling initiatives have gained significant traction throughout developed economies, and in the case of some emerging markets the actual industry of recycling (separating materials, smelting, filtering, etc.) is becoming a substantial driver of economic growth. The issue then is not so much about changing individuals' behavior as it is about changing corporate behavior. Prompting corporate change, however, has never been easy, and is made more difficult by the inherent nature of the economic system in which the world conducts business. Capitalism, for all of its wonderful attributes, as a model has never been good at addressing long-term issues. It is not good at recognizing the tragedy of the commons, e.g., overfishing, collective soil erosion, air contamination, etc. The finiteness of natural resources is simply ignored in a traditional capitalist model, and pricing is based entirely on short-term supply and demand. More generally, because of the use of very high discount rates, modern capitalism attributes no material cost to damage that occurs far into the future. For all intents and purposes our grandchildren and the problems they may face due to a warming planet and/or resource shortages have no material present value to the standard capitalist approach. In a way it is as if capitalism's effectiveness moves along a spectrum of time, brilliant at the short end but lost, irrelevant, and perhaps even dangerous at the very long end. Indeed, the argument can be made that this inherent flaw in the capitalist approach is what led to the 2008 credit crisis in the first place, one of the greatest economic disasters of modern times (and one from which we are still recovering).

In more recent years, however, it seems global industry is paying more attention to these slow-burning problems that potentially threaten future economic growth and viability.

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These opportunities may be present outside of the US, where valuations are still relatively low, earnings expectations are improving; and where economies are earlier in the recovery process than in the US. While equity market return expectations are moderate for 2014, long short equity managers should have a more fertile investing environment where they can seek to profit both long and short.

Specialist Credit

In general credit markets were quiet over the month, characterized by low trading volumes and limited volatility associated with the holiday period. The JP Morgan Global High-Yield Index returned 0.66% and the spread over Treasuries tightened by 24 basis points to 459. The yield on the 10-year Treasury increased 26 basis points with an overall return of -2.02% for the month.

K2's credit managers captured steady gains against this backdrop with all sub-strategies posting gains, led by multi-strategy, structured credit, and distressed. Specific performance drivers included exposures to corporate securities, corporate structured credit, distressed debt, and special situations. Select detractors included liquidation claims, real estate, as well as shorts and some negative carry exposure.

Of note from a macro perspective, US interest rates witnessed the biggest annual change in yields since 2009, with the US 10-year treasury yield ending 2013 at 3.03%, up from 1.76% to begin the year.

Event Driven

K2's event driven managers finished the year strong in December to complete what was a robust 2013 in terms of performance gains for the strategy, this despite M&A activity remaining well below historic highs. All underlying managers were positive for the month. Select performance drivers in December included special situations, capital structure arbitrage, equities, currencies, and M&A. Portfolio hedges such as S&P put options and futures tended to detract, as did some single position losses and commodities exposure. Significant M&A activity over the month included transactions between Kroger/Harris Teeter, NYSE/Intercontinental Exchange, CapitalSource/PacWest, Salix/Santarus, Koch/Molex, and Thermo Fisher/Life Technologies.

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This is not to suggest that collectively corporations are progressing towards a more heightened state of enlightenment, or recognizing on principle alone the inherent moral value of conservation and responsible resource utilization. Not quite. Instead it seems a more intelligent application of the core principles of capitalism is driving this trend, a recognition of the economic benefit to thinking about planetary sustainability. In other words it is motivated primarily by profit and self-preservation, and for that reason we are most optimistic about its potential for long-term success.

UN PRI

An example of this paradigm shift in thinking can be observed in recent initiatives to promote more globally responsible investing. For example, the United Nations Principles for Responsible Investment ("PRI") is a United Nations-backed initiative comprised of a network of international investors that have committed to a set of voluntary guidelines intended to address ESG issues. As of December 2013 over 1,240 investment institutions, of which K2 is one, have become signatories, with aggregate assets under management of approximately US$ 35 trillion. A full list of current signatories can be found at www.unpri.org/signatories.

As a steward of client assets, K2 has always sought to invest responsibly and with integrity, while seeking to maximize financial returns against an established risk tolerance framework. While there are clear positive moral and ethical implications for becoming a PRI signatory, K2's motivation relates to the firm's fiduciary responsibility and desire to best protect and promote the economic interests of clients. There is increasing evidence that ESG issues can be material to performance of portfolios, particularly over the long term. As such, K2 believes recognizing the importance of socially responsible investing – which could lead to a more complete understanding of a range of material issues that may have an impact on the risk and opportunity set to which K2's portfolios are exposed – is ultimately the intelligent thing to do from an investment management standpoint.

Why Environmental Externalities Matter

A recent study[1] commissioned by the PRI attempted to analyze the financial implications and true costs of unsustainable natural resource use and pollution of the environment. The study characterized these costs as "external" in that most companies in the world do not pay for the environmental damage caused by their activity, hence they are largely "external" to financial accounts – and more importantly not measured by capital markets. Without adequate information about these "externalities", markets have failed to accurately account for the dependence of businesses on ecosystem services such as a stable climate or access to water.

External costs can eventually affect equity valuations because they lead to a more uncertain, rapidly-changing economic environment and greater systemic risks. For institutional investors – whose highly-diversified portfolios are often exposed to a broad range of global capital markets – these costs are unavoidable, as they come back into the portfolio as insurance premiums, taxes, inflated input prices, and physical costs associated with disasters.

1. UNEP Finance Initiative – Universal Ownership: Why environmental externalities matter to institutional investors.

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Deal activity in 2014 started off strongly with some large deals including Suntory's $16 billion acquisition of the spirits make Beam and a $61 billion offer for Time Warner cable by Charter Communications. Deal activity started strong in the new year, and we remain very positive on event driven strategies and expect the opportunity set to expand into 2014.

Global Macro

K2's global macro managers also finished the month and the year with very strong returns, with discretionary and systematic underlying funds capturing gains in aggregate over both periods. In terms of performance drivers the continued rally in developed market equities against a backdrop of easy central bank policies buoyed performance for several managers, as did the resolution of the US debt ceiling and strong employment numbers in the US. The Japanese reflation theme also contributed as the Nikkei 225 Index (JPY) rallied and the Japanese Yen weakened versus the US Dollar. Lastly, Fed tapering in December at consensus levels helped to sustain market trends, supporting both discretionary and systematic strategies.

Commodities

In aggregate K2's currently approved commodity managers finished the year strong with a positive December. The month was generally free of macro and regulatory headline news and there was a nice dispersion of returns across the complex, an indication that fundamentals were perhaps driving prices. Broadly speaking energy commodities posted gains led by Crude Oil & Natural Gas, while Metals were mixed as Gold & Silver declined; agricultural commodity declines were led by Wheat & Sugar, while Cotton gained.

Over the quarter macro and regulatory headwinds significantly challenged discretionary commodity managers, making it difficult to capture non-directional gains. For example the conflict in Syria paralyzed the oil market for several weeks; the LME launched a consultation on a proposal designed to cut warehouse queues, triggering uncertainty about the price impact on metals; the CFTC continued its never-ending debate about position limits;

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These costs may also reduce future cash flows and dividends, damage the profitability of other portfolio companies, adversely affect other assets, and ultimately bring down overall market returns.

The reported findings of the study – of course reflecting a fair amount of uncertainty and margin of error inherent in estimates of externalities – were nonetheless compelling. In short, the value of global environmental externalities is high and increasing, and the unaccounted costs associated with threats to the finite stock of natural capital are quite high.

According to the report, global environmental external costs caused by human business activity amounted to an estimated US$ 6.6 trillion in 2008. For context, this estimate suggests that external costs that year were 20% larger than the roughly US$ 5.4 trillion decline in pension fund assets resulting from the global financial crisis over the same period (source BCG).

The study also suggests that these costs will continue to rise, projected to be roughly US$ 28 trillion in 2050, equating to nearly 18% of projected global GDP. This is significant in that these externalities represent the depreciation of natural capital, and reflect the true global cost of ecosystem maintenance failure. As such, we believe it is reasonable to seek to maintain ecosystems, such that price stability, business continuity, and current levels of economic activity are sustained for the future. Traditional measures of economic value, such as GDP, often treat resources as current income instead of capital depreciation, and therefore do not fully account for the effects of current consumption on future capital. If natural capital is not maintained, over time it will eventually undermine economic growth.

We Can Work it Out

As we highlighted at the start of this letter recognizing the limits of our global supply of natural resources has been talked about in academic circles for generations. The difference today is that it seems there is a real intellectual discourse – and in some instances action – taking place in the world of business regarding this inevitable challenge. The bottom line is that there is very little about the resource limitation problem that we cannot resolve. Humans possess the brain power, *Jersey Shore* notwithstanding, and the inventiveness. What may have been lacking up until this point has been the motivation. Our hope is that initiatives like the PRI will augment this ambition.

To be clear there are some nearly infinite resources: the sun's energy and the water in the oceans for instance. On the other hand we also have some critically finite resources, such as oil, metals and arable land (which is a very long and interesting topic possibly suitable for a later *Perspective*). Assuming we take a more sensible far-sighted approach to their use, the gap between today – when we live beyond a sustainable level – and say 200 years from now when we may have developed the necessary technologies to allow us to attain true long-term balance, could be bridged.

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The Federal Reserve considered imposing a new capital surcharge on Wall Street banks that own oil pipelines, metals warehouses and other lucrative physical commodity assets; and finally, the negotiations with Iran about a limitation of their nuclear activities in exchange for specific, limited sanctions relief triggered a back-and-forth about future oil supply.

Index Definitions

T-bills: A short-term debt obligation backed by the U.S. government with a maturity of less than one year. T-bills are sold in denominations of $1,000 up to a maximum purchase of $5 million and commonly have maturities of one month (four weeks), three months (13 weeks) or six months (26 weeks).

S&P 500 Index: Standard and Poor's 500 Index is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Swiss Re Cat Bond Index: The Swiss Re Cat Bond Total Return Index tracks the total rate of return for all outstanding USD denominated cat bonds. The index is based on Swiss Re pricing indications only.

ML High Yield BB Index: The ML benchmark index for BB-rated high yield corporate bonds.

The BofA Merrill Lynch US Floating-Rate Asset-Backed Index: is a statistical composite tracking the overall performance of the US floating-rate asset-backed securities (ABS) market over time. The index includes US dollar-denominated ABS having a floating coupon, a minimum amount outstanding of $25 million and an investment grade credit rating of BBB or higher.

BarCap U.S. Inflation Linked Bonds over 5 Year TR.: A part of the Barclays Capital family of global inflation-linked bond indices, the Barclays Capital US Government Inflation-linked bond index (US TIPS) measures the performance of the TIPS market. TIPS form the largest component of the Barclays Capital Global Inflation-Linked Bond Index. Inflation-linked indices include only capital indexed bonds with a remaining maturity of one year or more.

US Treasury Bill 90-Day On-The-Run Yield: Measured in percentage yield, this is the interest yield payable per year on the most liquid U.S. 3 month Treasury Bill.

The Dollar ("DXY") Index: indicates the general international value of the USD. The USDX does this by averaging the exchange rates between the USD and 6 major world currencies. The FINEX computes this by using the rates supplied by some 500 banks.

The Eurekahedge ILS Advisers Index: is an equally weighted index of hedge funds that explicitly allocate to insurance linked investments and have at least 70% of their portfolio invested in non-life risk.

HFRI Fund of Funds Composite Index: Funds of Funds invest with multiple managers through funds or managed accounts. The strategy designs a diversified portfolio of managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager. The Fund of Funds manager has discretion in choosing which strategies to invest in for the portfolio. A manager may allocate funds to numerous managers within a single strategy, or with numerous managers in multiple strategies.

BarCap U.S. Agg TR Unhedged USD: The U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS sectors.

BarCap U.S. Long Treasury TR Index Unhedged USD: The Barclays US Treasury bond index is part of Barclays Capital global family of government bonds indices. The index measures the performance of the US Treasury bond market, one of the largest and most liquid government bond markets in the world. Using market capitalization weighting and a standard rule-based inclusion methodology; the index accurately reflects the performance and characteristics of the Treasury market and provides a basis for customized indices.

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