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K2 Perspective

K2 ADVISORS®

"You're gonna need a bigger boat…"

Roy Scheider, perf. ***Jaws.*** Dir. Steven Spielberg. Universal Studios, 1975.

It is around this time every year that the inevitable references to Spielberg's classic blockbuster movie proliferate. This coincides with the dog days of summer and Discovery channel's immensely popular Shark Week programming (which likely owes a good portion of its success to the aforementioned film). For me Roy Scheider's infamous *Jaws* line (a brilliant ad lib by the way) allegorically brings to mind the current state of the markets. While risk assets continue to rally, investors — much like their beleaguered counterparts from the fictional island of Amity — remain cautious, and indeed may be looking for a bigger, or at the very least a **better**, boat. Perhaps they seek a craft more suitably constructed to withstand the many macro risks circling just under the deceptively calm market waters — I know I certainly would.

We spoke last month of black swans and happy trees, and the over arching theme was that while the market remains relatively tranquil on the surface, there is an increasing sense of trepidation – or uncertainty – related to potential threats lurking below. Macroeconomic concerns, including geopolitical hot spots, China's status, and whether or not global GDP growth can be sustained, all pose legitimate problems for market stability. Perhaps the most significant and pressing concern today, however, and certainly one the majority of market observers are keenly focused on, is the threat of rising interest rates in the United States…cue the John Williams score. Given the current market environment, particularly as it relates to fixed income securities, rising interest rates could represent a metaphorical Great White macro risk for portfolios not suitably positioned. *You know the thing about a shark, he's got... lifeless eyes, black eyes, like a doll's eye. When he comes at ya, doesn't seem to be livin'. Until he bites ya and those black eyes roll over white…* Indeed, when rising interest rates eventually do bite, some investors eyes may roll over white as well. Fortunately the story does not have to end there, and despite the fact that a rise in rates is seen as an eventual certainty, the potential for portfolios to go the way of the *USS Indianapolis* is not. There does exist a better boat, one constructed not only of equity beta and bond beta, but one built using a good amount of alpha also. I believe this alpha boat may fare quite well in a rising rate environment, perhaps even prospering…and living long as well (mixed movie metaphors).

The Alpha Boat and Rates

As an aside, next summer will mark the 40th anniversary of *Jaws*…40 years! Certainly I cannot be the only one who is made to feel considerably old by that reality. I take comfort in knowing that many of my readers owned Bee Gees records as well (a.k.a vinyl discs for the youngsters)…but I digress.

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Strategy Focus – June 2014

Long Short Equity

US equity markets rose to all-time highs to end the second quarter, supported by generally better US economic data after a severe winter led to economic contraction in the first quarter. Additionally, broadly positive US corporate earnings along with signs of stabilization of economic growth in China provided support to markets. In aggregate K2's long short equity managers captured strong gains in June, with long book alpha continuing to be a significant driver of returns. Healthcare focused managers, activists, and to a lesser extent sector diversified managers outperformed.

Underlying funds that took advantage of the early quarter sector rotation out of biotechnology and higher-momentum technology stocks to increase exposure to their high-conviction longs, especially in growth sectors, benefited in June. Volatility decreased and financial markets refocused on company fundamentals, creating a favorable backdrop for bottom-up stock selection. Healthcare managers benefitted from idiosyncratic events around pipeline approvals and strategic acquisitions. Tax inversion has been a common theme and source of performance in the healthcare space as well. Activists as a group continued to perform well as shareholder and board receptivity improves. Even in view of YTD success a number of activists remain highly optimistic about remaining pipeline of ideas. Other performance drivers included long positions in consumer discretionary, financial services, and in transportation stocks such as airlines, as improving fundamentals and industry consolidation drove margins higher. Energy is also becoming a source of alpha as the theme of GP interests in MLP's continues to be profitable. Exposure to media, particularly broadcasters and cable companies, also contributed as a US Supreme Court ruling benefitted the sector. Short exposure to small capitalization stocks was a broad detractor, as was exposure to refiners following the announcement of new export regulations by the US Department of Commerce. Broad market index hedges also declined.

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In this month's letter I want to highlight the relationship I see between alpha and interest rates, and why in my view a portfolio constructed with alpha components is perhaps the best suited vehicle to withstand the inevitable rate rise when it surfaces. I also want to make several other points with regard to alpha.

First, as my colleague Tilak Lal pointed out in his *Perspective* from April 2014, alpha is a measurable and tangible market by-product. It is the noise inefficiency residual that shadows the market signal, and it creates a value 'song' that can be captured and appreciated by market participants with discerning ears…and the right equipment.

In this way I like to consider alpha as a viable investment, a security in its own right. We are comfortable with beta as an investment, why not alpha?

As illustrated in Exhibit A, we see that the average for alpha over the past 20 years, as measured by the Hedge Fund Research Index Fund Weighted Composite (HFRI FWC) versus the S&P 500 Index, has been 5.99%.

Exhibit A.

20 Year HFRI FWC Average Alpha is 5.99%

YTD	HFRI FWC Alpha	HFRI FWC Perf
2014	1.58%	3.16%
2013	-0.99%	9.13%
2012	1.22%	6.36%
2011	-5.69%	-5.25%
2010	5.08%	10.25%
2009	12.30%	19.98%
2008	-3.59%	-19.03%
2007	8.26%	9.96%
2006	5.59%	12.89%
2005	7.39%	9.30%
2004	5.33%	9.03%
2003	13.37%	19.55%
2002	6.46%	-1.45%
2001	8.46%	4.62%
2000	10.03%	4.98%
1999	20.85%	31.29%
1998	-7.67%	2.62%
1997	6.74%	16.79%
1996	10.93%	21.10%
1995	10.27%	21.50%
1994	4.47%	4.10%

As of 8/4/14. Source: K2 Advisors, Bloomberg. Please see Important Disclosures and Disclaimers at the end of the presentation, which provide detailed information regarding information presented herein and form an integral part hereof. **Past performance is not a guarantee or indicative of future results.**

The second observation I would like to make relates to alpha and its cyclical nature. For those of you who know me, you no doubt have heard me reference the concept of the 'alpha cycle'. Alpha, like many other aspects of the market, is a cyclical phenomenon that waxes and wanes with macro environments, demographics and investor behaviors. The amount of alpha captured has historically been stronger on average in some regimes, such as periods with higher interest rates (we will show this later), and weaker in other regimes.

In Exhibit B (page 3) we can see the cyclical behavior of alpha graphically displayed.

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Specialist Credit

K2's specialist credit managers delivered strong performance in June, with all underlying funds capturing gains with the exception of one. Credit markets continued to move higher as high yield continued to experience strong inflows and Treasuries remained persistently bid.

The positive performance was broadly dispersed amongst managers and positions, with no meaningful outliers. Long-biased distressed managers had the strongest performance, partly driven by legacy liquidation claims in Lehman and Icelandic banks. Other performance drivers included security selection in high-yield bonds, investment-grade new credit issues, and residential mortgage-backed securities (both in the US and particularly in Spain). Hedges were the one consistent detractor in the period against a backdrop of rising markets. Other detractors included a handful of individual equity short positions, some sovereign bond shorts, and other idiosyncratic positions (e.g. tobacco municipal bonds which traded down on Puerto Rico headlines).

Event Driven

K2's event driven managers captured robust gains in June. A continued uptick in corporate activity, including spinoffs, mergers, and asset divestitures, contributed to performance gains. Corporate tax inversion and REIT conversion strategies have also provided fertile trading opportunities. Of note, since 1942 there have been a total of 41 corporate tax inversions recorded in the US, 11 of which have occurred in the past two years. Detractors tended to be portfolio hedges in the form of broad market index shorts.

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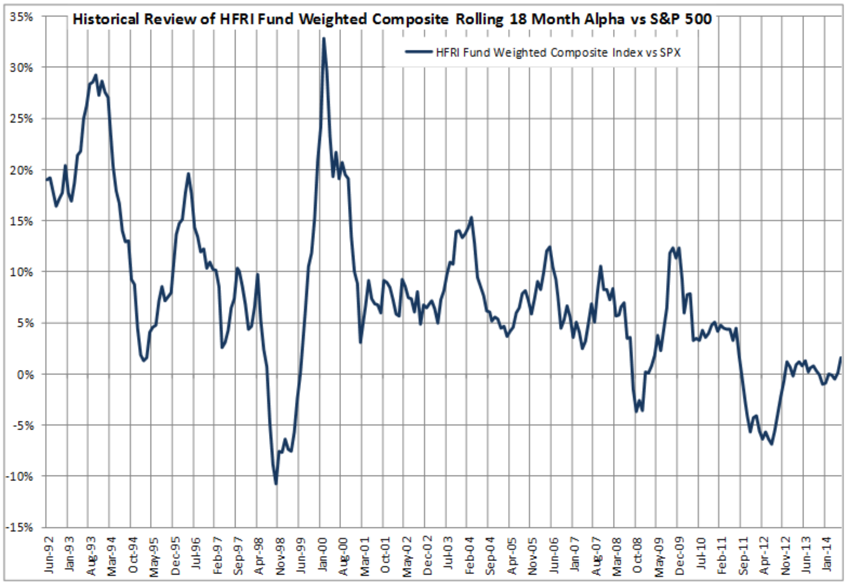
Exhibit B.



Source: K2 Advisors, Bloomberg. Data: July 1991- June 2014. Please see Important Disclosures and Disclaimers at the end of the presentation, which provide detailed information regarding information presented herein and form an integral part hereof. **Past performance is not a guarantee or indicative of future results.**

The last point I would like to make relates to alpha and the strong relationship I observe it having with interest rates.

First and foremost, we should note that most financial market observers believe the US Federal Reserve will start to hike interest rates at some point in the not too distant future, perhaps as early as the second half of 2015. Fixed income has enjoyed a bull market rally spanning close to thirty years now, give or take a few outliers here and there such as 1994. Interest rates have steadily declined from the mid-teens in the late 1970s to single digits today. This inexorable decline and associated increase in bond prices has protected investors against rate and duration risk for an extended period. But it seems inevitable that this long-term trend of lower rates and higher bond prices will reverse, and not preparing for this shift appropriately will leave some boats taking on substantial water.

Given this, we see many institutions seeking to mitigate these risks by looking to alternative strategies, like hedge funds, where customized portfolios can be structured that seek to soften interest rate and duration exposure.

These fixed income 'surrogates' if you will can be particularly attractive in a rising rate environment because they can be structured to both provide protection and gain from rising rates.

In my view when interest rates go up bonds will naturally suffer some, equities will probably do okay, but the real strength will be in alpha generating strategies like hedge funds. Statistical analysis of the historical relationship between interest rates and alpha support this. In Exhibit C (page 4) we have created a Factor Response Curve that illustrates the historic relationship between HFRI FWI alpha levels and US 5-year Treasury yield levels.

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Global Macro

On average K2's global macro managers were flat to slightly positive in June. In terms of positive performance managers benefited from exposure to peripheral European bonds, which rallied on robust investor demand for new issues and continued accommodative monetary policy by the ECB. Exposure to US and European equities was also beneficial as equity markets advanced amid lower volatility. However, sectarian violence in Iraq added to geopolitical concerns, even as the crisis in Ukraine continued. Currency movements posed challenges to the systematic macro strategies, particularly short positions in the Korean Won and the Canadian Dollar, although long positions in currencies such as the British Pound and the Chinese Yuan posted gains.

Commodities

K2's commodity managers were in aggregate slightly positive in June. Marginal performance reflected the largely offsetting impacts of events such as a drought in Brazil, an expected record crop output in the US, and a rally in nickel prices in an otherwise muted base metals market. Further, political events such as the crises in Ukraine and Iraq added to the challenges faced by discretionary commodity managers. In terms of performance drivers energy tended to be a significant contributor for several managers amid strong crude oil price performance during first half of the month, followed by the platinum group metals and agriculture.

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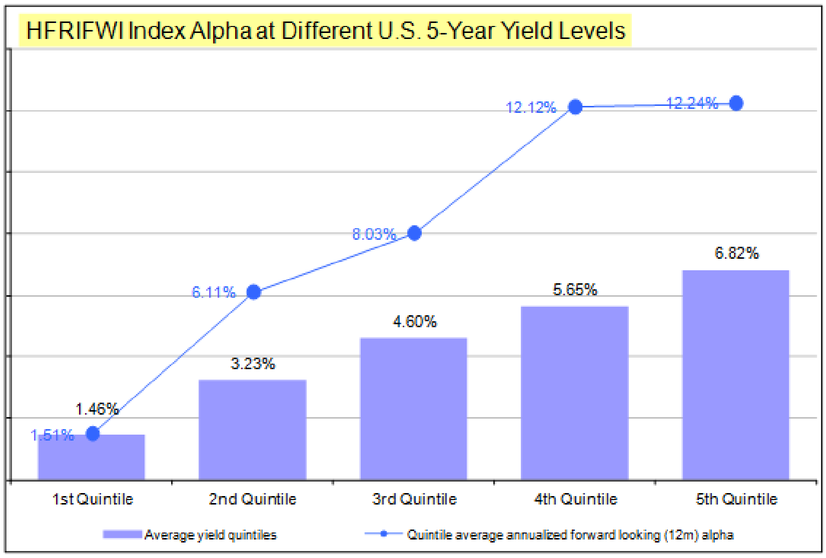
As you can see when interest rate level averages over the last 23 years have been at their lowest, represented by the first quintile bar on the left, average alpha levels have also been at their lowest.

But as we move from lower yield levels to higher average levels across the five quintiles, we see a corresponding rise in average alpha as well.

Exhibit C.



Source: Source: K2, Bloomberg. Date: January 1991 - June 2014. Calculations are based on monthly returns. Please see Important Disclosures and Disclaimers at the end of the presentation, which provide detailed information regarding information presented herein and form an integral part hereof. **Past performance is not a guarantee or indicative of future results.**

Clearly higher nominal yields of US government bonds, such as five-year Treasuries, have on average historically corresponded with increased average annualized hedge fund alpha capture as well. In my experience the vast majority of hedge funds are defensive with respect to interest rate risk, while some macro managers see it as a speculative opportunity.

Conceptually I find that the relationship between rising rates and the associated increase in the level of alpha capture to be quite intuitive. Imagine if you will a street with several homes on it, all built by the same contractor and hence all the same value. The occupants of these homes, particularly in a very low rate environment, may represent a broad range of economic backgrounds. Some may be relatively wealthy, some may be middle-class, and others may represent the lower-end of the income scale. When interest rates are low the ratio of income to monthly payments is manageable for all. For the wealthy families it is likely not even recognized economically, while for the lower income group it may represent a significant component of their economic circumstance, but it is sustainable in the current environment. As rates rise however, the lower income families will feel increased pressure, and some may eventually be forced to sell their homes for non-rational economic reasons. Alternatively, the wealthy families will not feel added economic pressure from the rise in rates, and they may in some instances benefit from personal investments and savings that potentially gain from increased yields.

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Outlook

We believe the second half of 2014 could be more interesting than the first, as markets work through uncertainties and if global growth trajectories improve and divergences materialize in central bank policy expectations. The somewhat uneven path of the US recovery thus far in 2014 remained a problem for central banks globally, as many had hoped the US rate normalization would be further along and that the US dollar would be higher. The lack of a rise in US rates has been the source of some idiosyncratic market activity in recent months, and we believe this environment could persist for some time. The strong results from equity markets over the second quarter have been encouraging to us. Investors have rightly cheered their gains, but in our view the time for caution is just when things appear to look best. Market volatility has declined to significantly low levels, which we believe may signal storms ahead. In addition, we remain vigilant with regard to high yield corporate debt, as the market reconsiders the current low yields relative to historic levels. Events in Iraq, Ukraine and, recently, Israel still warrant close attention, in our view, as more downside volatility could be triggered given the impact the regional strife may have on global energy prices and investor sentiment. Managers will be paying close attention to developments in Asia and the Middle East regions. The Fed again pledged that it would continue with its bond purchase taper while maintaining an accommodative stance with regard to rates. We anticipate the central bank's policies will remain supportive for risk assets for the foreseeable future.

A similar dynamic occurs for companies and countries when rates rise. The result is a pressure on profit margins, and the variances in profit margin pressures are reflected in the variance in security performance. The inefficiencies created by these variances promote alpha.

In closing, the implication of rising rates for individual and institutional portfolios, particularly for fixed-income investments, could be troublesome as they will be confronted with either diminishing returns with small losses or potentially significant losses – depending upon the magnitude and velocity of the rate rise.

We believe an alpha boat is the best option available to hedge against the eventual attack.

Sincerely,

Your Vix adjusted worry wart

Brooks Ritchey

SVP, Director of Investment Solutions, K2 Advisors

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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