



## K2 Perspective

### Happy Little Trees and Black Swans

*Note: The author for this month's K2 Perspective is Brooks Ritchey, SVP, Director of Investment Solutions, K2 Advisors.*

This past July 4th would have been American painter Robert “Bob” Ross’s 71st birthday. Ross was best known for his art instruction television program *The Joy of Painting*, a show that ran for more than a decade on public broadcasting channels in the U.S. and Canada in the late 1980s and 1990s. Through the years Ross’s show developed a bit of a cult following – particularly on college campuses across America – due to the inimitable nature of his presentation. When he spoke Ross projected an incredibly laid-back, positive and pleasant demeanor. His cadence was casual, calm, and soothing; in many ways almost hypnotic. Ross was well known for his use of quirky and amusing catch phrases that reflected his eternally optimistic nature. When painting landscapes, for example, he would refer to “happy little trees” living in his world. When brush strokes went awry he would say “we don’t have mistakes here, we just have happy accidents”. Before his death in 1995 Ross was asked about his perpetually positive attitude. “That’s why I paint”, he said. “It’s because I can create the kind of world that I want, making it as happy as I want it to be.”

For market participants it has no doubt been a happy world of late, as major indices continue to advance relentlessly day after day, cheered and cajoled forward by the rear guard of central bankers proudly sponsoring the onward March.

**This seemingly perpetual market optimism is of course a bit worrisome to the risk manager in me, as I am sure it is worrisome to many other market observers as well. Indeed, as we have watched over the past 8+ years the Federal Reserve and other central banks around the world attempt to paint their own happy worlds by artificially stimulating economic growth through monetary intervention and liquidity injections — largely to no avail despite the run up in global stock markets — we are naturally skeptical.**

Instead of pessimism, however, it seems the markets have taken a page from the Bob Ross book of philosophy, hoping for “happy trees” to continue blossoming. We have a feeling Janet Yellen is doing the same.

Alternatively there is another tome that often comes to mind at times like these, author Nassim Nicholas Taleb’s masterful *The Black Swan* (2007). In it he wrote of certain kinds of rare and unpredictable events (outliers) that result in extreme outcomes — the proverbial ‘Black Swan’ events. Taleb also highlighted the human tendency to find simplistic explanations for these events retrospectively. This theory has since become known as the black swan theory. According to the author a so-called ‘black swan’ is an event with the following three attributes:

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### Strategy Focus – May 2014

#### Long Short Equity

In May, global stock markets rose, supported by generally better economic data and market expectations that the European Central Bank (ECB) would ease its monetary policy in the near term. Emerging-market equities, in broad terms, outperformed US and European equities during the month. US economic data released in May remained generally positive, similar to data released in April, suggesting that the impact of unusually cold weather during the first quarter was over. Both manufacturing and non-manufacturing activity for April continued to improve, indicating a strong economic start to the second quarter.

Against this backdrop K2’s long short equity managers generated strong aggregate performance, largely outperforming broad equity markets on both a net adjusted and absolute basis. Growth stocks had improved performance as many investors seemed attracted to lower valuations and re-entered the space. The technology- and health care-focused managers experienced meaningful rebounds in their higher quality growth-oriented holdings, and they were not as challenged by their short portfolios against a market rally. The recovery in technology, led by a rotation into Internet names, was more widespread than in health care, in which stock appreciation often seemed tied to deal activity and pipeline approvals. 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. Detracting from performance were broad market index hedges, as well as single-name shorts in sectors such as energy, consumer staples and utilities.

By month-end we saw several managers rebuilding some of the gross exposure that they had taken down in April. Overall there has been a refreshing of portfolios with several new themes and positions getting sized up during the month.

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First, it is an outlier, as it lies outside the realm of regular expectations, because nothing in the past can convincingly point to its possibility. Second, it carries an extreme 'impact'. Third, in spite of its outlier status, human nature makes us concoct explanations for its occurrence after the fact, making it seem explainable and predictable.

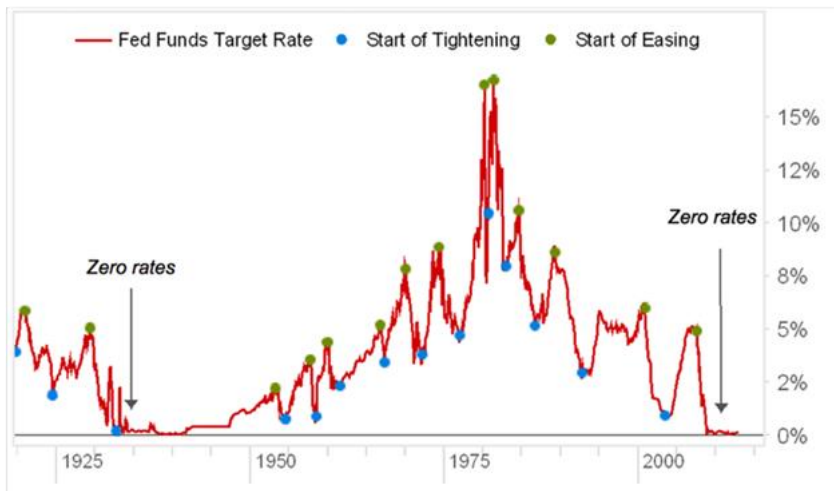
**This is where the trouble lies for me intellectually. If by its implicit nature a black swan event cannot be forecast in advance, and its existence will only be recognized and dissected after the fact, what then are we to make of any obvious and unsettling data points or empirical observations?**

All things being equal, these would suggest to a reasonable person that some sort of calamitous event may be lurking just beyond the bend in the river...perhaps obscured by the many "happy trees" growing in the equity markets. But if so-called black swans by their nature are not envisaged in advance...what then? Shudder the thought.

While there are many sources of data that one could observe that I would define as "unsettling", for the purpose of this month's letter I will focus on three: the Fed Funds Target Rate, the velocity of money, and the S&P 500 Index.

First, we will take a look at the Fed Funds Target Rate. Since the crisis began in 2008 and the threat of severe deflationary pressures loomed over the global economic landscape, the Federal Reserve responded forcefully by slashing rates to almost unprecedented levels (save for the early 1930s...hmmmm) as illustrated in Exhibit A.

**Exhibit A.**



Source: Bloomberg. Mauldin Economics.

We do not arrogantly presume to know better than the Federal Reserve what was the best course of action post-2008. From their perspective – and tasked with the mandate of promoting a healthy economy – one could say they had little choice than to act in the way they did. Critics of the central bank's efforts, however, have described the programs as 'pushing on a string'; a metaphor (often

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**Specialist Credit**

A healthy tailwind pushed credit markets higher in May, as high yield continued to experience strong inflows and Treasuries remained persistently bid. In aggregate K2's specialist credit managers captured steady gains over the month, led by distressed managers. Long short credit managers tended to lag, while long-biased funds with increased exposure to longer duration assets generally outperformed. Performance drivers were broad-based and included security selection in European and North American bonds and equities, notably in health care and biotechnology, high-yield bonds, investment-grade new credit issues and residential mortgage-backed securities. Among the detractors from performance were a handful of individual short positions, as well as market index and interest rate hedges.

**Event Driven**

K2's event driven managers had a strong month, with all funds in the strategy capturing gains. Positive performance drivers included M&A transactions and asset divestiture-related trades (particularly in the food services and telecommunications sectors), and special situations equity. Portfolio hedges in the form of broad market index shorts and futures weighed on performance.

Of note, there continues to be a lot of complex corporate activity in the marketplace, which has created many opportunities for managers. Significant consolidation in the Telecom and Pharmaceutical industries has recently carried over into the food sector. Tax inversions continue to drive consolidation in the Pharmaceutical sector.

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attributed to economist John Maynard Keynes) intended to describe the futility of monetary policy in the context of stimulating economic growth. This is because, as a function of monetary policy being asymmetric, it is easier for the Federal Reserve to slow an expansion rather than stimulate one.

**In other words money can easily be pulled from central banks (and hence borrowers) during economic growth, thereby slowing expansion, but it cannot easily be pushed to borrowers if there is no demand. And so we have the string. Rates can be raised (pulled) to dampen growth, but lowering them to stimulate an economy becomes less effective as the zero bound limit is approached (and in this case essentially reached).**

To better understand this dynamic it is helpful to explore the relationship between money supply and GDP. As defined by noted economist Irving Fisher, GDP is equal to money times its turnover or velocity ( $\text{Nominal GDP} = M \cdot V$ ). In economic circles this formula is defined as the ‘equation of exchange’. For the rest of us it is defined as ‘something we have never heard of or have quickly erased from the memory banks following the Econ 101 final exam in December of 1989’, or something like that. In either case, for the purpose of trying to understand the Fed’s aim with regard to priming the liquidity pumps, it may be helpful to examine this dynamic further.

If we deconstruct the formula  $M$  (or  $M2$  in the charts below) is considered the entirety of money supply in circulation. It is comprised of the monetary base (currency plus reserves) times the money multiplier. The Federal Reserve controls the monetary base, while the multiplier is determined by the depository institutions and non-bank public. In simpler terms the entirety of money in circulation is a multiple of how much the Fed is pushing times how much is actually being used.

**Since the recession in 2008, the monetary base has surged an astonishing 70% according to the Fed’s own statistical analysis, and with the announcement at its latest meeting that it is committed to holding short term rates at effectively zero for the foreseeable future we can expect this trend to continue. Concurrently, while the monetary base has exploded over the last six years, we observe that the money multiplier has continued to decline. So while base amounts of money in the system swell exponentially, real circulation has collapsed.**

The other part of the equation relates to monetary velocity, and in my view this is the critical component. Essentially, monetary velocity measures (intuitively) how fast money changes hands, providing a gauge of economic vitality. Concurrent to the exponential increase in base supply, the velocity of money has plunged since 2008, and now stands at a five decade low (Exhibit B.)

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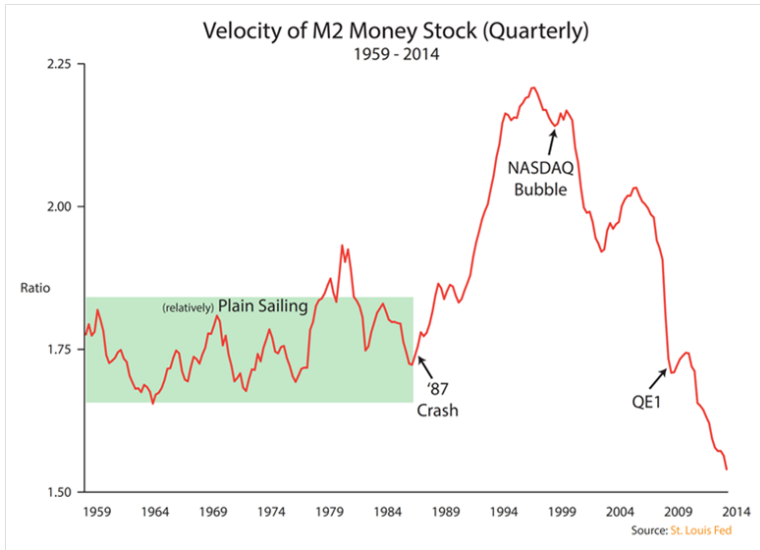
## Global Macro

In aggregate, led by the systematic strategies, K2’s global macro managers performed strongly in May. Fixed income and equities generally contributed to positive performance, while commodities and currency positions tended to detract. Positive performance in fixed income was driven by long positions in long-term rates such as in the United States, Australia and Europe. Additionally, short-term fixed income positioning in eurodollars and euribor were contributors. Positive performance in equities was driven by long positioning in the United States and Europe. Commodities performance was hampered by agriculturals, and soft and base metals. Negative performance in currencies was driven by long positioning in the euro, British pound, Swiss franc and New Zealand dollar.

## Commodities

K2’s commodity managers captured solid gains in aggregate over the month, with positive performance generally attributed to longs in industrial metals, precious metals and energy, as well as from shorts in agriculture and softs. Precious metal trades tended to detract.

**Exhibit B.**

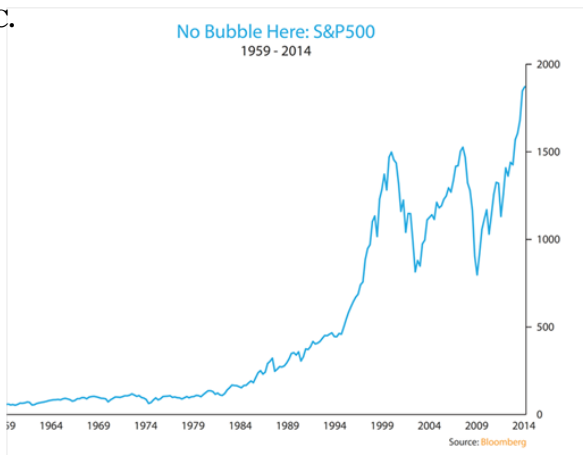


Source: St Louis Fed, Mauldin Economics.

In basic terms when velocity declines sharply – even as supply is being introduced at historically unprecedented levels – then one could make the inference that the added liquidity is having little effect on engendering economic activity.

There can be little doubt that Janet Yellen (and Ben Bernanke before her) and their colleagues at the Federal Reserve are fully and completely aware of this dynamic, and of the criticisms their policies have solicited – and yet they push ahead. Clearly the Fed recognizes that the QE efforts to date have failed to spur economic activity adequately, as the stimulus cannot force banks to increase their loan and investment activity. As the money velocity data indicates, these new liquidity flows are simply remaining idle in places like bank reserves. Yellen understands this, but it seems she would prefer to deal with any potential future problem as long as deflation is avoided. As such, the Fed is committed to flooding the system with liquidity indefinitely, come hell or high water (no pun intended), and plans to worry about potential consequences (hyper-inflation anyone?) later. The point is that every action taken by the central banks since September 15th, 2008, has been starkly inflationary. Starkly inflationary. Yet the inflation has not yet made itself known — save for perhaps the equity markets (Exhibit C).

**Exhibit C.**



Source: Bloomberg, Mauldin Economics.

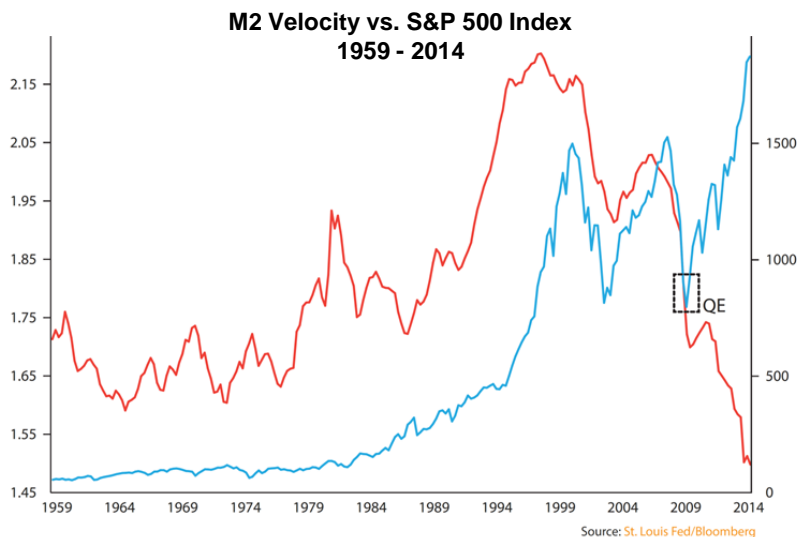
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Indeed, Ben Bernanke made no secret about his intent to inflate risky asset prices. Recall that following QE 2 Bernanke said in no uncertain terms that one of the primary goals of the program was to inflate the stock market. In a November 2010 Washington Post article he is quoted as follows: “Stock prices rose and long-term interest rates fell when investors began to anticipate the most recent action. Easier financial conditions will promote economic growth. ... And high stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion.”

Empirically we can see that the measures taken by the Federal Reserve since the recession have fueled appreciation in the stock market, so from that perspective one could deem the programs a success. But has the economic growth for the country followed suit? Not so much...

It should be noted that equity gains fueled in part by government stimuli can be erased as quickly as they are created. The liquidity operations that have produced the huge spike in money supply since 2008 have also created massive structural imbalances in my opinion (Exhibit D.)

#### Exhibit D.



Source: St Louis Fed, Mauldin Economics.

While it bothers me to suggest it, I do not believe divergences like the one illustrated in the above chart can be repaired quietly over time. I believe they revert suddenly, and usually for entirely obvious reasons that absolutely nobody saw as potential catalysts at the time. Black swans?? Happy trees! Happy trees!

There are those that argue that should we see signs of a turn in velocity, inflationary pressures will be right behind. In addition, given the low base from which that velocity will bounce and the sheer weight of additional money now in the system, those pressures will be of the kind that may lead to hyper-inflation.

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**According to ornithologists, black swans utter a whistle, especially when disturbed while breeding and nesting. Based on the above observations, I believe it is fair to say that we've heard a few whistles of late in terms of the recent run in global markets. While we can't predict a black swan event, perhaps we can at least listen for one, and build our portfolios accordingly. Although black swans cannot be seen, portfolio robustness can be tested against the potential for distress. If there ever were a time in recent history to consider doing so, may I humbly suggest now is that time.**

I will close with a few words of personal wisdom...or words of something anyway. Take from them what you like...

- Goldilocks environment? We know how that story ended...
- Crowded Trigger Syndrome. Many investors saying they "have their finger on the 'sell' trigger". Does this mean many will be staying at the party too late?
- Grey swans can attack as well. Don't have to be black swans.
- The key to painting ( and other arts and crafts) is to "know when the masterpiece is done". Don't over paint if the proportion of happy trees is just right. Let the paint/oil dry and prepare for the next masterpiece (capital preservation).
- Hedge when you can; not when you have to.
- Trees don't grow to the sky; even happy ones.
- Bottom line. Continue to draw happy trees but don't over crowd the painting.

Sincerely,

**Your Vix adjusted worry wart Brooks Ritchey**

## 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 USDIX 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 passsthroughs), 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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