2013 | Volume 7, Issue 4

K2 Perspective

K2 ADVISORS®

Remember the Rising Sun

How quickly we forget. In the late 1980s the modestly sized island nation of Japan — an archipelago country slightly smaller than the state of California and with a population less than half that of the United States — was on the brink of surpassing America as the world's preeminent economic superpower. Having only emerged from the devastation of World War II less than a generation earlier, by the 1970s Japan had built itself into a manufacturing empire, with corporate giants such as Sony, Toyota, and Nissan turning out innovative electronics and cars that Americans and Europeans alike could not live without, yet seemed to have difficulty producing themselves. Japan's achievement was both applauded and envied by the international community in terms of its audacity and scope. Economists at the time lauded the country as the 'great postwar economic miracle', bookstores were filled with shelf upon shelf of bestsellers proclaiming the superiority of Japanese business models, and students in American high schools were encouraged to learn Japanese as a second language (yours truly included…sadly, as my colleague Toshio Yoshioka can attest, my efforts did not quite pan out).

In addition to unparalleled success in the car industry, Japanese technology rose to the fore as well, with products clearly better than anything else being made in the world at that time. As Apple is to the electronics industry today in terms of innovation and sleek design, so was Japan to the global marketplace in the 1980s. The Japanese manufactured the majority of the world's retail electronics, introducing revolutionary devices such as the VHS recorder and iconic Sony Walkman – a precursor to today's iPad and iPhone as far as consumer love affairs with must-have toys. One could argue the Japanese created the original 'user-friendly and portable' mold from which Steve Jobs and Apple perhaps took inspiration. In addition, the budding American video game industry was quickly overtaken by Japanese powerhouse corporations Nintendo and Sega, and there was even speculation at the time that Sony and Hitachi would eventually acquire American electronic bellwethers Intel and IBM. Indeed, rare was the Syracuse University dorm hall in 1989 that did not possess at least one Nintendo game console in somebody's room, admirably serving as both an altar for late night social gatherings as well as an excellent tool for academic procrastination — Tecmo Bowl in particular.

At the pinnacle of Japanese economic might in the late '80s, and perhaps solidifying the perception in the West that the country's eventual ascendance to the top of the global economic food chain was all but a formality, Japanese business groups acquired the Pebble Beach golf course, New York's Rockefeller Center, and Hollywood's Columbia Pictures – all iconic symbols of American hegemony. In 1990 the U.S. Open golf tournament was actually played at Pebble Beach, the first time ever the prestigious event was held on a foreign-owned golf course (New York Times, 1990). Clearly the new world order had arrived.

(Continued)

Strategy Focus – April 2013

Long Short Equity

April was a month of considerable market turbulence as weaker than expected global economic data seemed poised to challenge the ongoing demand for risk assets and yield. While prices did dip several times over the month, in the end both equities and fixed income again finished higher, as unprecedented levels of global central bank easing and stronger-than-expected corporate earnings buoyed returns.

With this as a backdrop, K2's long short managers collectively posted a modest gain for the month. On a capital weighted basis managers focused on commodities, Asian and healthcare stocks led gains, while equity market neutral and technology centered funds detracted. In aggregate K2's managers were minimally exposed to the top performing S&P sectors for April (Telecom, Utilities and Healthcare), while total net exposure to the bottom three S&P sectors (Energy, Materials, and Technology) was more significant. In technology in particular earnings surprises had the most substantial impact on PnL for several managers, where shorts were more adversely affected than longs. For example, some well-known names in semiconductor and software rallied swiftly over positive surprises or outlooks, catching portfolios wrong footed.

Over the month we observed a shift in manager exposures from defensive to stable growth oriented stocks, specifically a rotation into large capitalization technology companies. Exposure to Asian securities increased as well as investment sentiment in the region improves against central bank monetary easing initiatives. In addition to the well-publicized moves by Japan, Korea, Australia, and India recently cut interest rates as well. On balance there was little change in aggregate net exposure, with roughly half the managers increasing while the other half decreased. Aggregate gross exposures declined by several points.

(Continued)

Changing Minds

With the benefit of hindsight we of course know that Japan never quite made it to the top of that global economic heap (though it did come very close), and following its 40-year period of incredible economic growth Japan experienced its own banking and real estate crisis beginning in the early 1990s, the effects of which are still haunting its economy today − a full 23 years later. Essentially Japan has been left mired in a several-decade period of economic stagnation and low-level but persistent deflation. Nominal GDP in 2011 was almost exactly what it was 20 years earlier in 1991, Government debt-to-GDP has grown to roughly 240% over the same period, Japan's trade deficit has trended higher, and interest rates have largely been stuck at the zero bound. What was initially referred to as the nation's 'lost decade' by economists and journalists alike has since morphed into several lost 'decades' for Japan, a trend unfortunately aggravated courtesy of the West's own real estate and banking crisis in 2008.

Still, how quickly we forget. Over the past six years, as the world has collectively muddled (apologies to Bill Gross) its way through the aftermath of the 'Great Recession', the attention − at least in terms of media coverage and academic analysis − has focused squarely on the West and Europe. Naturally, given the origins of the crisis – along with the many precedent setting efforts put forth by both U.S. and European policymakers in an attempt to mitigate its effects – this makes sense. But what of Japan − the nation once poised to lead the world in economic dominance? Why does it feel like Japan is frequently left out of the global conversation − particularly since 2008? This is odd when you consider that, irrespective of its current deflationary malaise, Japan is still the third largest economy after all – not Spain, Portugal, or France…and certainly not Cyprus. Yet, when the CNBC pundits speak of the 'big picture' and 'macro headwinds' and 'global expansion', Japan tends to be overlooked. No doubt China and other emerging markets are important to the story, but certainly so is Japan. It would be naïve to believe that its circumstance over the last two decades has not had a material bearing on global prosperity – at best it has been a neutral factor but not additive, and at worst it has further depressed growth – the latter a more likely reality. Why is this a non-story? Has the global community become so inured to Japan's persistent deflationary slump that it accepts it as status quo? Worse still, have the Japanese themselves come to accept their place at the global table as the world's poster child for 'new normal' muddle through and stagnant economies? As *Financial Times* reporter Taro Aso wrote in an April 18th editorial when describing the current mindset in Japan, 'deflationary expectations are entrenched, discouraging investment in the future and eating away at the economy. Wages, consumption and investments are sluggish...finding our hidden strength and changing our mindset is needed for Japan to regain true competitiveness.'

Changing minds indeed. It is for this reason that the recent paradigm shift in policymaking by new Japanese Prime Minister Shinzo Abe, along with his counterpart at the Japanese central bank Haruhiko Kuroda, is so significant (discussed below).

(Continued)

(Strategy Focus continued)

In terms of alpha capture it was not a particularly strong month as less than half of K2's managers outperformed their net and beta-adjusted exposure benchmarks. Much of the weakness can be attributed to the commodity led sell-off mid-month, most notably related to manager gold exposures.

Looking ahead there has been increased talk that European austerity programs may be overwrought as the European economy continues to struggle. Given this managers have been increasingly exploring value opportunities in the region. Based on the change in tone coming from market pundits and government officials, including the German finance minister, managers anticipate a shift away from the 'austerity-first' focus. The expectation then is that policy changes near-term could have a favorable impact on economic growth.

Specialist Credit

Credit markets posted their strongest month since January 2012, in both the US and in Europe, in large part due to continued central bank rhetoric and action regarding monetary stimulus initiatives. Early in April the Bank of Japan announced a new program of unprecedented easing representing roughly seven trillion Yen of asset purchases per month. This was followed by supportive comments from both the European Central Bank and US Federal Reserve on the continuation of liquidity initiatives.

Global high yield markets were again resilient with indices domestically and across the Atlantic seeing solid gains. Primary market issuance also progressed at a robust pace as demand continued to be bolstered by inflows (particularly in Europe).

For K2's credit managers April was another strong month with all underlying strategy buckets generating gains, led by distressed and structured credit. Managers benefitted from the continued spread tightening and active capital markets which fueled refinancing activity. In a notable trend, many investment grade companies are tapping the debt markets (in both the US and Europe) at record low rates. For example, both AT&T and Microsoft recently raised long-term debt in Euros at yields of approximately 2.5%.

(Continued)

It is not merely that they have sent a strong signal to the world that they are willing to do 'whatever it takes' in terms of monetary and fiscal policy to end 20 years of deflation and zero growth, it is that they have sent a strong signal to perhaps the most important constituents of all – the Japanese citizenry themselves.

Passing the Spigot

So what of this recent regime shift in Japan? In perhaps one of the boldest moves in recent financial and monetary policy history, at least since the U.S. Federal Reserve crafted entire semesters worth of MBA curricula following the collapse of Lehman Brothers in the fall of 2008, Japan has gone 'all-in' on neo-Keynesian economic theory, implementing what some market pundits have described as the 'shock and awe' of quantitative easing initiatives. The liquidity hose that began its deluge in the U.S. in 2008, then moved across the Atlantic to Europe in 2009 and 2010, is now aimed squarely and with full force on the Japanese archipelago (perhaps having sprinkled Asia along the way). Dubbed 'Abenomics' by the press, Japan's new initiatives reflect a radical overhaul of its policymaking, defined by the prime minister as a three-arrow plan: more-credible fiscal plans, aggressive monetary easing, and a growth strategy based on structural reform. The Bank of Japan ('BOJ') has said it intends to double its monetary base in two years, and is targeting an inflation rate of 2% or higher before tapering. In addition, the government identified several fiscal/structural priorities, including deregulation (with a focus on the labor market, energy sector and healthcare), reforming the corporate tax regime, and trade liberalization. In the energy sector, for example, the plan is to split the generating divisions from the transmission divisions of utility companies, therefore allowing competition in retail sales of electricity.

Ultimately the intent of the program is to create an upward and reinforcing spiral of sorts, a self-sustaining cycle where a surge in stock market prices benefits domestic investors, who then are more likely to spend (economists call this the wealth effect), and thus this increased spending may revive corporations, leading to higher investments in new plants and R&D, higher wages and salaries, and so on and so forth – a virtuous harmony. So the question then is will this aggressive experiment work?

Will It Work?

While there are opinions on both sides as to the effectiveness and potential of the program, one thing everyone appears to agree on is that the magnitude of the measure is unprecedented in terms of recent Japanese history. It is as if Abe-san and Kuroda-san had decided that if they were going down, it would not be without a significant fight. Indeed, given what they inherited when they took office, what other choice did they really have? At this point in the game structural reform without accompanying stimulus would be like weeding, cultivating, and sowing a badly overgrown, dried and dormant garden without adding copious amounts of water and fertilizer as well. It simply would not work. Since the bubble burst in the 90s the BOJ had for the most part attempted to leave efforts to jump-start the Japanese economy to fiscal authorities (legislature), asking them to act with more effective measures to fight the crisis and stimulate growth.

(Continued)

(Strategy Focus continued)

Some managers saw losses on their sovereign shorts as yields continued to fall to recent lows; both Italian and Spanish 10-year government debt is now trading below 4%. In the structured credit markets managers benefitted from across the board strength and good liquidity. Some managers continue to opportunistically sell low yielding RMBS paper, while maintaining sub-prime paper (which could benefit from additional housing appreciation) and also adding CMBS and niche-ABS (e.g. student loans). Freddie Mac recently announced it will be selling some of its non-agency assets (securities and whole loans). Given the strong housing trends and normal run-off of non-agency securities overall, this could prove to be an opportunistic sale that is accomplished without pressuring existing secondary pricing levels.

Looking ahead distressed managers may be exploring more equity situations given the somewhat limited amount of traditional distressed bonds.

Event Driven

K2's event driven managers posted a very strong April with all approved funds generating gains. Managers benefited from both market strength and idiosyncratic events, with gains driven by long positions in credit and special situation equities, restructurings, capital structure arbitrage, some distressed corporate credit positions and to a lesser degree from merger arbitrage. Generally single name shorts and portfolio index hedges tended to detract. Gross and net exposure for managers was broadly unchanged from the previous month.

Merger activity was resilient in April with $169 billion of newly announced transaction volume. Of note, the busiest sector so far this year with respect to M&A has been telecommunications, as spectrum acquisition has been a major unifying theme for a broad range of companies. Notable announced and developing situations recently have included Vivendi, Clearwire, Dish, Sprint, Virgin, Verizon, Vodafone, and MetroPCS. Other active sectors included healthcare, where Thermo-Fisher Scientific announced a $16 billion offer for Life Technologies, and in Europe Elan announced the rejection of an increased takeover offer from Royalty Pharma.

(Continued)

The end result was a badly overgrown and weed choked garden, with a 200%+ debt to GDP ratio and zero cumulative growth. The question remains however, is anything too late? Has the garden progressed past the point of return, such that the soil is better suited to asphalt than agriculture? Only time will tell.

Certainly from the world's perspective – and a view that K2 naturally shares – the hope of course is that the effort does work. A resurgent Japanese economy, particularly one driven by Japanese consumers, could be the critical piece missing from the global growth puzzle. In this way there is a great deal riding on its potential success, not only for the 128 million residents of Japan, but also for the hundreds of millions in the U.S. and Europe whose own governments have attempted several similar attempts at QE to stimulate economic growth – the true efficacy of which is still unknown. While short term stability has been achieved in the euro zone and in the U.S. – most notably in the real estate market – longer term the real impact of the Fed and ECB's liquidity programs is unknown. In this way perhaps the Japanese effort may serve as the ultimate model in neo-Keynesian policy experimentation, from which the world can observe and take notes as to how to proceed against their domestic economic challenges. Japan is a large and advanced economy which has been grinding through the aftermath of its own banking and financial crisis for much longer than either the U.S. or Europe. It has control over its currency, and its citizens' demand for government bonds is deep enough that it has simultaneously the highest debt to GDP ratio in the world and the lowest interest rates (which is really quite astonishing). In effect what Kuroda-san and Abe-san are providing may serve as either the ultimate road map for the West out of years of bubble-induced economic stagnation, or it may serve as a cautionary tale. Only time will tell.

Thus far Abe-san's promise of economic revival has already created a budding optimism in urban areas like Tokyo, where the stock market has rallied and restaurants seem more crowded than they were during years in which many people resigned themselves to Japan's fading prospects. The new, if fragile, hopefulness has been boosted by rising corporate profits, as a weakening yen has brought desperately needed relief to badly shaken electronics corporations and other exporters struggling to compete with Chinese and Korean rivals. Japan grew at a 3.5% pace in the first quarter of 2013, and the Nikkei Index had risen 70% from November of 2012 through May 17th 2013. In other words the weaker yen already delivered a major tailwind to Japanese markets, as the currency dropped 30% against the dollar and China's Yuan since August, and 37% against the Euro, through May.

With regard to the longer term outcome we of course do not know. What is known is that this is a serious and radical economic move and one that needs to be recognized for its far reaching implications. From this point forward there is no turning back. When the full story of this latest effort from Japan to reinvigorate its economy can someday be observed from a historical perspective, perhaps its significance in the grand scheme will be greater than even the most forward of thinkers today can appreciate. The sun does rise in the east, and if Abe-san's grand program works as intended – and as we certainly remember from the 1980s – what a glorious and bright sun it can be.

Michael J. Kelly, CAIA
mkelly@k2advisors.com
(203) 504-1429

(Strategy Focus continued)

Elsewhere JAB confirmed its agreement to a cash offer for DE Master Blenders, and Glencore's offer for Xstrata received anti-trust approval from China. Lastly, activist hedge funds have increasingly begun to pressure targeted companies to engage in further corporate actions to unlock additional value for shareholders.

Commodities

Commodities maintained their dislocation from equities in April as concerns around global growth pressured prices across the complex. Weaker than expected macroeconomic data, including US ISM declines and weakness in Chinese 1Q13 GDP, weighed on market sentiment and resulted in material declines across a broad swath of global commodity indices. Against this backdrop K2's managers performed very well over the month, in aggregate generating modest gains against a substantial market headwind. Several underlying energy funds in particular did quite well, capturing profits from tactical trades in natural gas and the tightening of the differential between WTI and Brent crude oil.

For the broader markets the headline news related to gold prices which suffered their biggest two-day fall in thirty years, collapsing 15% by mid-month. The combination of hawkish FOMC minutes and noise surrounding the potential for Cyprus to sell its gold reserves may have aggravated an already weak market. Base metals declined as well, based on weaker demand data. In energy oil prices capitulated below long term trading ranges and tracked with other cyclical commodities. A raft of disappointing data and geopolitical factors pressured net oil length during a seasonally weak period, including a slowdown in Chinese demand. Lastly, agriculture predominantly traded sideways for the month. The USDA made smaller downward revisions to US demand than implied by the March stocks report, leaving US corn and soybean ending inventory below consensus expectations. Conversely, the USDA raised global corn and soybean ending stocks above consensus on higher production and lower consumption.

(Continued)

(Strategy Focus continued)

Global Macro

K2's global macro managers generated significant returns in April — both discretionary and systematic. Gains were largely attributable to positions in equities and currencies, while some fixed income trades contributed marginally as well. A sharp divergence in commodities versus equities benefited certain positional trades also, as gold posted the sharpest two-day decline in 30 years while the S&P 500 Index touched an intra-month record high.

In terms of other performance drivers the short Japanese Yen and long Nikkei Index continue to dominate manager positioning over the month. With the Yen crossing the key ¥100 level versus the Dollar, managers believe further depreciation in the currency will progress much faster and expect it may reach ¥125 in the next several months. Managers also remained generally bullish on markets and were positioned for equities to continue to rally as they did. A big tail risk in the form of Italy's hung parliament was reduced and the large global monetary stimulus provided by the BOJ, Fed, and the BOE further enhanced confidence.

In emerging markets managers continued to be long the Chinese Yuan. Although the currency briefly fell against the Dollar late in the month when initiatives by the Chinese foreign-exchange regulator (SAFE) were thought to be an impediment to further appreciation, its rise continued when the new measures were understood to be stabilizing to Yuan volatility and not controls. In other emerging markets traders benefitted from a strengthening of higher-yielding currencies such as the Mexican peso, while short South African rand positions detracted for several managers.

Given the sell-off in commodities short positions in metals like gold and copper were of course profitable, although results from other parts of the complex were mixed.

All data in this document sourced from Bloomberg unless otherwise referenced.

Index Definitions

LIBOR: London-Interbank Offered Rate - The fixing is conducted each day at 11am (London time). The rate is an average derived from the quotations provided by the banks determined by the British Bankers' Association. The top and bottom quartile is eliminated and an average of the remaining quotations calculated to arrive at fixing. BBA USD Libor is calculated on an ACT/360 basis and for value two business days after the fixing.

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.

S&P Consumer Discretionary Sector: A capitalization-weighted index that encompasses those industries that tend to be the most sensitive to economic cycles. It includes automotive, household durable goods, textiles & apparel, leisure equipment, hotels, restaurants, other leisure facilities, media production & services and consumer retailing.

S&P Energy Sector: This S&P/TSX Capped Energy Trust Index is a subset of the broad-based S&P/TSX Income Trust Index. It is a sector-based index comprised of income trusts which are classified in the Energy sector of the Global Industry Classification Standard (GICS®). Individual constituent Energy income trusts will have their relative weights capped at 25%. The Toronto Stock Exchange (TSX) serves as the distributor of both real-time and historical data for this index.

Dow Jones UBS Commodity Index: The index is composed of futures contracts on 19 physical commodities. It reflects the return on fully collateralized futures positions. Components are weighted according the amount of trading activity in a given contract family.

STOXX Europe 600 Index: The Dow Jones STOXX (Return) Index is a broad based capitalization-weighted index of European stocks which duplicate the Dow Jones Global Index Europe index. The index was developed with a base value of 100 as of December 31, 1991.

Russell 2000 Index: The Russell 2000 Index is comprised of the smallest 2000 companies in the Russell 3000 Index, representing approximately 8% of the Russell 3000 total market capitalization.

Nikkei 225 Index: The Nikkei-225 Stock Average is a price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange.

Hang Seng (Hong Kong) Index: The Hang Seng Index is a free-float capitalization-weighted index of selection of companies from the Stock Exchange of Hong Kong. The components of the index are divided into four subindexes: Commerce and Industry, Finance, Utilities, and Properties.

Dow Jones Industrial Average: The Dow Jones Industrial Average is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry.

High Yield CDX: Credit default swap index.

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.

Volatility of VIX 30-day: This index is calculated as the 30-day rolling standard deviation of the CBOE VIX Index. The VIX Index measures the implied volatility of options on the S&P 500.

iTraxx Main Index: iTraxx (Bloomberg code 'ITRX') is the brand name for the family of credit default swap index products covering regions of Europe, Australia, Japan and non-Japan Asia. They form a large sector of the overall credit derivative market. The indices are constructed on a set of rules with the overriding criterion being that of liquidity of the underlying Credit Default Swaps (CDS).

300 Atlantic Street 12th floor | Stamford, CT 06901 | (203) 348-5252 | k2advisors.com

A Franklin Templeton Investments company

K2 ADVISORS®