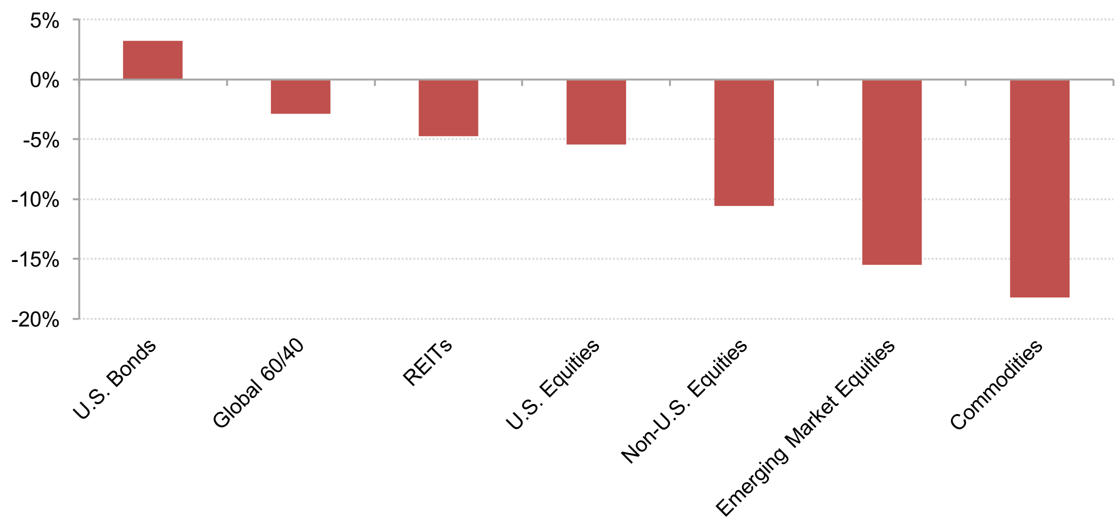
Volatility Spike

November 18, 2015

The third quarter was a tumultuous period that ended with global equities falling 9.5% to end down 7.0% for the year to date. The hardest hit categories, emerging equities and commodities, fell more than twice that. It was a difficult market environment for many active strategies, as well as for broad asset class diversification and our risk-driven approach to asset allocation. Broad asset categories are shown below in **Exhibit 1**.

Exhibit 1: Broad Asset Categories*



* Please see the last page for important disclosures regarding the information presented herein.

The third quarter saw a return to a level of volatility and violent price movements experienced only in market crises. The trigger this time was China's decision in mid-August to devalue the yuan, which in turn furthered concerns about the health of the Chinese economy and possible spillover effects to the global economy. Fears of a global slowdown played out across asset markets and were fueled further when the Fed weeks later decided to postpone its long-awaited rate increase. The S&P 500 was down 11% in the space of a week, then staged a partial recovery through month's end, followed by a decline in September of 2.5%.

As the market began its precipitous decline, an important barometer of risk, the VIX index, more than tripled and remained elevated for the remainder of the quarter.[1] The VIX, which reflects the price that market participants are paying for downside protection, is a well-known fear index—and for good reason. The chance of significant future loss in broad equities is much higher when the VIX is elevated.

We have long used the VIX as one among an array of risk indicators. It's a telling relationship though by no means one-sided. When the VIX is high, it's not just that the downside is far more pronounced—so too is the upside. The key insight is that the upside historically has not been sufficient to compensate for the greater downside. So when the VIX is high, equities broadly are not only riskier but also less attractive from a risk-reward perspective. In times of turbulence, we therefore take a more cautious stance in terms of macro exposures. This is consistent with our mandate and focus on capital protection and, furthermore, better positions us to take advantage of potential dislocations.

This quarter we again took protective action as market risks became elevated in August and September. Given the pace of the decline our measured approach only partially protected capital during this period. In October markets rebounded strongly and recovered most of the losses sustained over the prior six weeks.

We are well aware that our strategy does not perform well in V-shaped market recoveries, and we have experienced it a number of times before. We also know that sudden market implosions and recoveries of this magnitude are rare. Since 1990, when the VIX was first published (and not including 2008 where our ability to preserve capital worked extremely well) the S&P 500 has declined by 11% or more in a week only four times (in 1998, 2001, 2002, and 2011). Importantly, these cases all occurred at very high levels of the VIX, averaging over 30. The difference in August was that the VIX before the large decline was very low at only 13. Since 1990, the worst weekly S&P 500 decline with the VIX anywhere below 20 was -6.5% (VIX at 18, 2010). Fully aware that this could happen, however unlikely, we have always managed our exposures to remain in a controlled range.

Protecting capital while also pursuing returns is a serious and difficult task. Our strategy over the long term has been effective in avoiding large drawdowns while keeping us invested in benign markets. We pay a "price of insurance" from time to time but the benefits have been well in excess of those costs. Regarding our general strategy, we believe we are in an environment of heightened uncertainty and greater propensity for dislocation, and we believe it is crucial to preserve flexibility to take advantage of the opportunities that are likely to arise. We are underweight in exposure to global equities. Given recent events, many segments of the capital markets have come under pressure. We believe the opportunity set has improved significantly in select areas, and we are playing offense selectively.

[1] The VIX index rose from 13 at the start of August (08/03/2015) to 40 in just three weeks (08/24/2015).

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Definitions for Exhibit 1 are as follows:

Asset Class	Index
U.S. Equities	Russell 3000 Total Return Index
Non-U.S. Equities	MSCI ACWI ex-U.S, (Net Dividend) Index
Emerging Market Equities	MSCI Daily TR Net Emerging Markets USD Index
U.S. Bonds	Merrill Lynch U.S. Treasury 5-7 Year Index
REITs	FTSE NAREIT Composite TR Index
Commodities	S&P GSCI Reduced Energy Official Close TR Index
Global 60/40	Represents a portfolio with 60% invested in the MSCI ACWI (Net Dividend) and 40% invested in the Merrill Lynch 5-7 Year U.S. Treasury Index