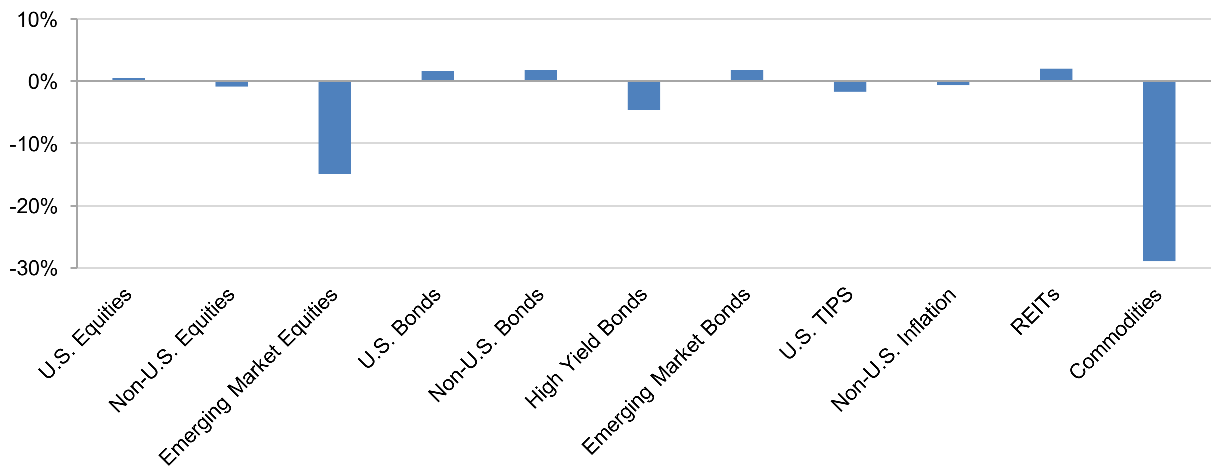
Portfolio Management in Volatile Times

February 16, 2016

The year 2015 was a perilous period for investing. Global equities ended down a modest -2.4% but this figure masks dramatic price swings, steep declines in emerging market equities and energy prices, and a marked deterioration in credit markets. It was also a difficult period for investing with a value bias. We will elaborate but suffice it to say that the market conditions of 2015 underscored the importance of maintaining a disciplined approach to risk control and patience in pursuit of return.

Exhibit 1: Broad Asset Class Returns in 2015*



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

That this is an environment of great uncertainty is reinforced time and again as markets gyrate in response to the latest macro data. U.S. economic and corporate health always matters for markets but additional concerns of late center on excess oil supply and the slowing growth (or worse) of the Chinese economy. Oil and China are only somewhat related, though both are contributors to, as well as affected by, the weak global economy. Other factors include attempts at currency devaluation as one country after the next seeks to protect itself at the expense of others. The uncertainty is compounded by rapidly changing interpretations of events such as when markets trade up on announcements of lower interest rates only to reverse when the realization sets in that those lower rates are symptomatic of a weaker than anticipated economy. At each turn, we have witnessed rapid gains, losses or transfers of wealth in the many trillions of dollars.

Our approach to investing in this world remains singularly focused and unchanged: we seek bottom up to make attractive investments with managers and in direct strategies, and top down to maintain global diversification and to control exposure to macro risks. As stewards of significant portions of our own and our investors' capital, we take the subject of risk control seriously and our approach specifically seeks to protect on the downside by modulating the effects of changing risk environments on our investment portfolios.

We are often asked why we are so concerned with volatility management when one can "just ride out the ups and downs in market prices". Our answer to this question is straightforward: When it comes to specific investments where one can possess an edge in handicapping the outcomes, then one should absolutely try to stand one's ground and "ride out" the intervening volatility. But at the macro exposure level—where it's difficult to possess much if any such edge—we think one should be more cautious at times of heightened risk.

We liken it to the contrast between a rollercoaster ride and a bull ride. In a rollercoaster ride, the ups and downs can be quite violent, but the final outcome critically is known in advance: the ride will smooth out and end well. That's why we are willing to go along in the first place. In a bull ride, on the other hand, remaining atop a bucking animal also entails enduring violent moves, but the final outcome is far from certain. Only the skilled can succeed repeatedly, and even for them the end result is not a foregone conclusion.

Because the end is uncertain, we think the bull ride is absolutely the more apt metaphor for investing. By all means try to ride out elevated volatility if you're skilled, but dampen the volatility (ride a tamer animal) if you're not. We know and invest with managers who are good "bull riders" in the specific stocks and other instruments they know well; and we are comfortable with short-term volatility or underperformance on their part. But we know few, if any, managers—certainly not ourselves—who can do this well repeatedly in the macro markets. Accordingly, we proactively manage exposures to broad market risks, and we do so by systematically monitoring and reacting to changing risk and correlation environments. The approach moreover is synergistic. Successful bottom-up investing requires a long-term horizon and managing macro risks helps to provide the staying power needed to do so.

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Definitions for Exhibit 1 are as follows:

Asset Class	Index
U.S. Equities	Russell 3000 Index
Non-U.S. Equities	MSCI EAFE Index*
Emerging Market Equities	MSCI Emerging Markets Index*
U.S. Bonds	Merrill Lynch 7-10yr U.S. Treasury Index
Non-U.S. Bonds	JP Morgan Global Government Bond Ex-US Hedged USD Index
High-Yield Bonds	Merrill Lynch High Yield Bond Master II Index*
Emerging Market Bonds	JP Morgan EMBI+ Emerging Market Bond Index
U.S. TIPS	Barclays U.S. Inflation Protected Securities Index
Non-U.S. Inflation	Barclays World Govt. Ex US Inflation-Linked Bonds Hedged USD Index
REITs	NAREIT Real Estate Investment Trust Index
Commodities	S&P GSCI Reduced Energy Total Return Index