SecondPhase Capital.

secondphasecap.com
quantifyingbehavior.com

**High Net Worth Investor:
Making Your Money Work for You**

INNOVATIONS & INSIGHTS

January 2016

Context

- Stocks got off to a historically bad start this year, in both developed and emerging markets.
- Falling earnings estimates for the U.S. economy, a less accommodative Fed and slowing emerging markets, particularly China, have spooked investors and economic forecasters.
- Bull or bear market, High Net Worth Investors (HNWIs) and their Advisors cannot afford to be complacent.
- Continuing education on new, innovative and alternative ways to address investor financial goals is the intelligent course of action.
- Managers knowledgeable about alternatives, including non-traditional ETFs, can add value to client relationships beyond traditional passive allocations. These advisors are at the vanguard of a new movement in financial services.

Our goal

Affluent and HNWIs invest in order to make their money work for them. With such a wide range of investment products available, allocating capital requires an understanding of alternatives. Our goal with "High Net Worth Investor: Making Your Money Work for You" is to expand upon a previous publication, which offer HNWIs a clearer understanding of a particular breed of alternative investments: quantitative strategies. We will present a handful of alternative strategies that complement each other, or rather, are typically non-correlated, and can be paired together to improve on the risk/reward profile.

Two types of people can benefit from additional education on alternative products: HNWIs, particularly those who maintain self-direction on some portion of their portfolio, and Financial Advisors, because knowing and understanding alternatives on behalf of clients is one area where Advisors can add value to Investors. Venturing deeply into non-traditional waters can be time-consuming and challenging – and most investors have day jobs.

Investors, either directly or through financial advisors, typically have a choice between allocating their money to active managers who bet on select markets in search of out-performance, or passive strategies that attempt to replicate an index via an Exchange Traded Fund (ETF) or mutual fund. Active managers charge higher fees, while passive strategies generally charge bargain basement fees. For those with the appropriate risk tolerance, we advocate both approaches. It makes sense to buy exposure to an index as cheaply as possible while also allocating some capital to more active and alternative strategies in search of out-performance. This is known as the "Core and Explore" or "Core and Satellite" approach. We believe this strategy will increasingly resonate with both Investors and Advisers for two reasons. One, traditional advice regarding passive strategies is available at low cost through ETFs. Two, financial innovators are developing new products designed to behave in ways uncorrelated to traditional indexes – thus offering the potential for a more well-constructed portfolio of intelligently balanced alternative strategies.

What types of investments fall into the satellite, or "explore" portion? This includes things like managed futures – an alternative strategy that can itself compose of trend following, countertrend and volatility based strategies across a range of futures markets. "Explore" strategies can also mean alternative income funds, real estate investments and private angel investments in non-publicly traded

So, where can Financial Advisors add value for clients when gaining exposure to an index can be achieved for less than 15 bps? Family, tax and estate planning are clear value adds. Further, for many investors, a trusted, competent advisor can help clients capture a much greater percentage of the market's return than they would otherwise capture left to their own devices, as many studies show that investors fall prey to their own cognitive behavioural pitfalls, buying or selling at precisely the wrong time. Yet we submit that a further area is fruitful ground for advisors. We believe that adding value means advisors must vet a growing number of non-traditional investments for their clients – many of which can make great options for the "explore" portion of the client's portfolio.

start-ups. Alternative funds that trade liquid, public markets is our focus today.

To summarize, we believe there is a place for low cost passive strategies in an investor's portfolio. We also believe that a broader understanding of the new alternatives available to investors is critical to stay informed – and an advantage for advisors willing to go the extra mile and continually educate themselves on behalf of their clients. It is our belief that these alternative products can be utilized in a range of ways to better round out an investor's portfolio and gain exposure to potentially valuable sources of diversification and return.

For Investors with the appropriate risk tolerance, blending multiple strategies is key

If an investor is diversified across a range of alternative investments, with non-correlated strategies in multiple sleeves, navigating tricky markets becomes easier. In any given year one of those sleeves might not do well, but you likely have less risk in your portfolio.

Alternatives

Our research in 2014 and 2015 revealed that HNWI and Ultra High Net Worth (UHNW) individuals have energized risk appetites as wealth levels have fully recovered in recent years. In fact, the UHNW group are the least conservative, compared to the affluent, and are willing to take risks in an effort to capture outsized returns. So what types of strategies can these investors engage in?

Managed Futures are one such alternative strategy that tends to behave differently than equity markets and have been utilized by institutional investors for decades. Managed Futures funds tend to have low to negative correlations to equities products and are thus worthy of investigation. The strategies attempt to identify and capitalize on market trends by investing in futures, options and other contracts tied to various markets including currencies, commodities and interest rates. These strategies often shine in extreme market environments, such as falling oil prices and a surging U.S. dollar – as the trend-following approaches behind the strategies go short as well as long.

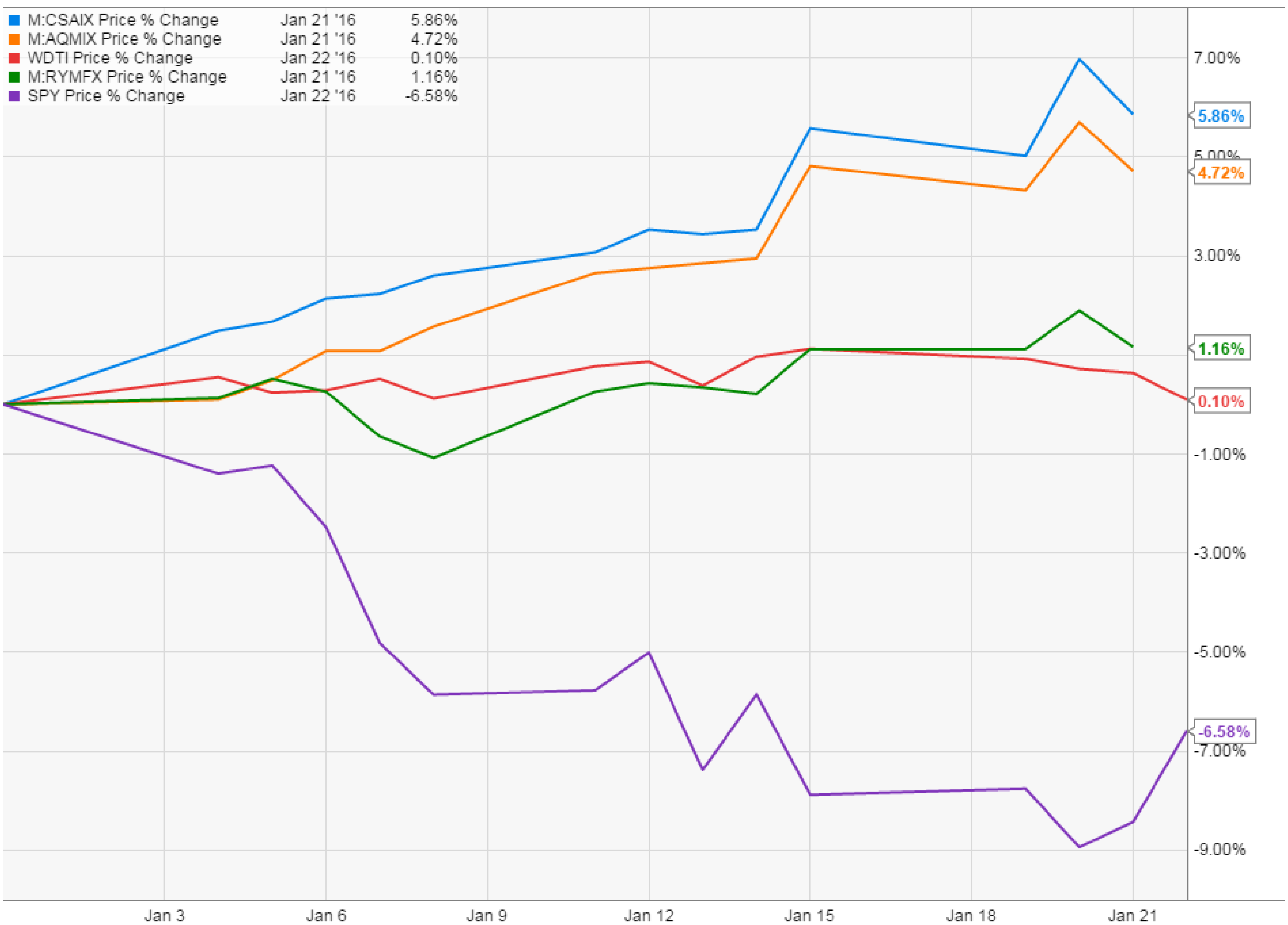
Select Managed Futures strategies such as the AQR Managed Futures Strategy fund (AQMIX) and Credit Suisse Managed Futures Strategy (CSAIX) have posted gains of 4.72% and 5.86%, respectively, year to date, while broad equity benchmarks such as the SPY have fallen more than 6%. Managed Futures have outperformed almost all of the 'more than 90' fund categories tracked by Morningstar this year.

Contact us for more info about Managed Futures Products

To illustrate the point:

The Chart below plots several Managed Future products against the SPY (S&P 500).

- Credit Suisse Managed Futures Strategy Fund (CSAIX)
- AQR Managed Futures Strategy Fund (AQMIX)
- WisdomTree Managed Futures Strategy (WDTI)
- Rydex Managed Futures (RYMFX)



Source: Ycharts

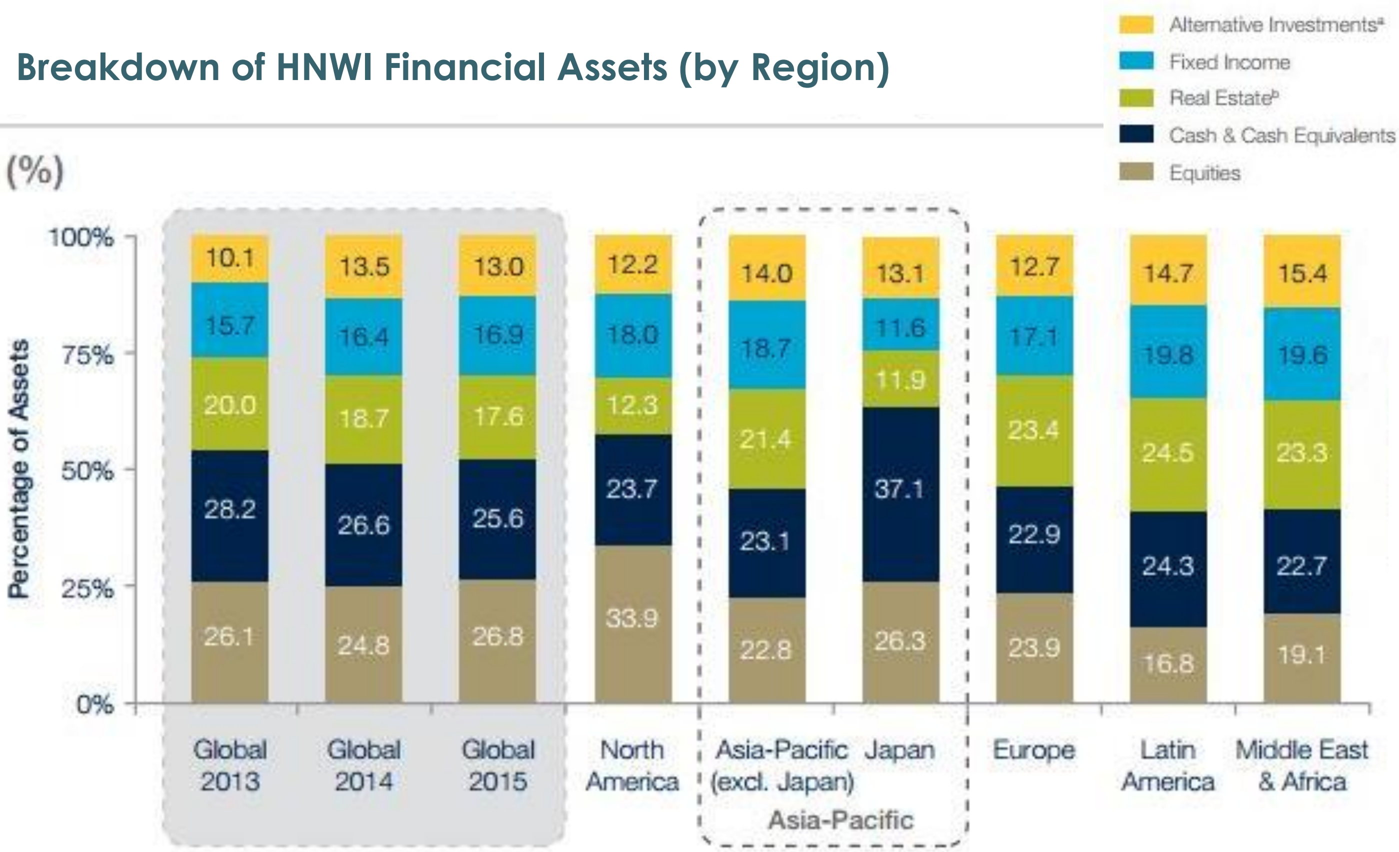
To dive deeper, [Click Here](#) (Morningstar's Managed Futures database)

How the Wealthy Are Putting their Money to Work

A recent survey by Capgemini and RBC Wealth Management shows the breakdown of High Net Worth Individual's financial assets. HNWIs' asset allocations typically include:

- Equities – 33.9%
- Cash & cash equivalents – 23.7%
- Real Estate – 12.3%
- Fixed Income – 18%
- Alternative Investments – 12.2%

Breakdown of HNWI Financial Assets (by Region)

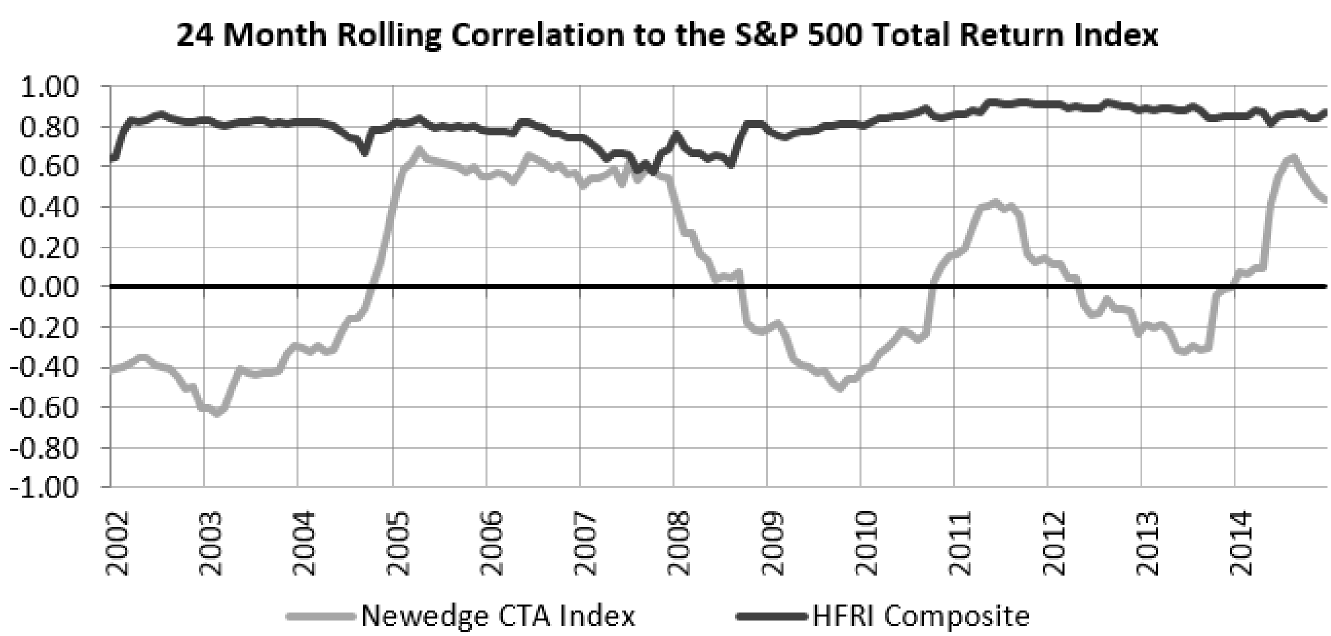


Capgemini and RBC Wealth Management Global HNW Insights Survey, 2013, 2014, 2015

Does Blending Managed Futures with Alternative L/S Equity Strategies Work?

Correlation is one of the most widely used statistics in all of investment management, and, like all things "market", the measures fluctuate through time. While never a constant certainty, correlation measures are one of the best tools we have to measure the potential diversification benefits of a security or asset class, as well as how persistent the measures are across time.

The chart below shows the 24 month rolling correlation between hedge funds and the S&P 500 as well as managed futures and the S&P. Clearly there are varying periods of positive correlation that occur between the HFRI Composite and the S&P 500, but it is also clear that there is potential diversification when introducing managed futures to the equation.



Source: http://www.acorn.ca/2015/02/13/dancing-with-bears/

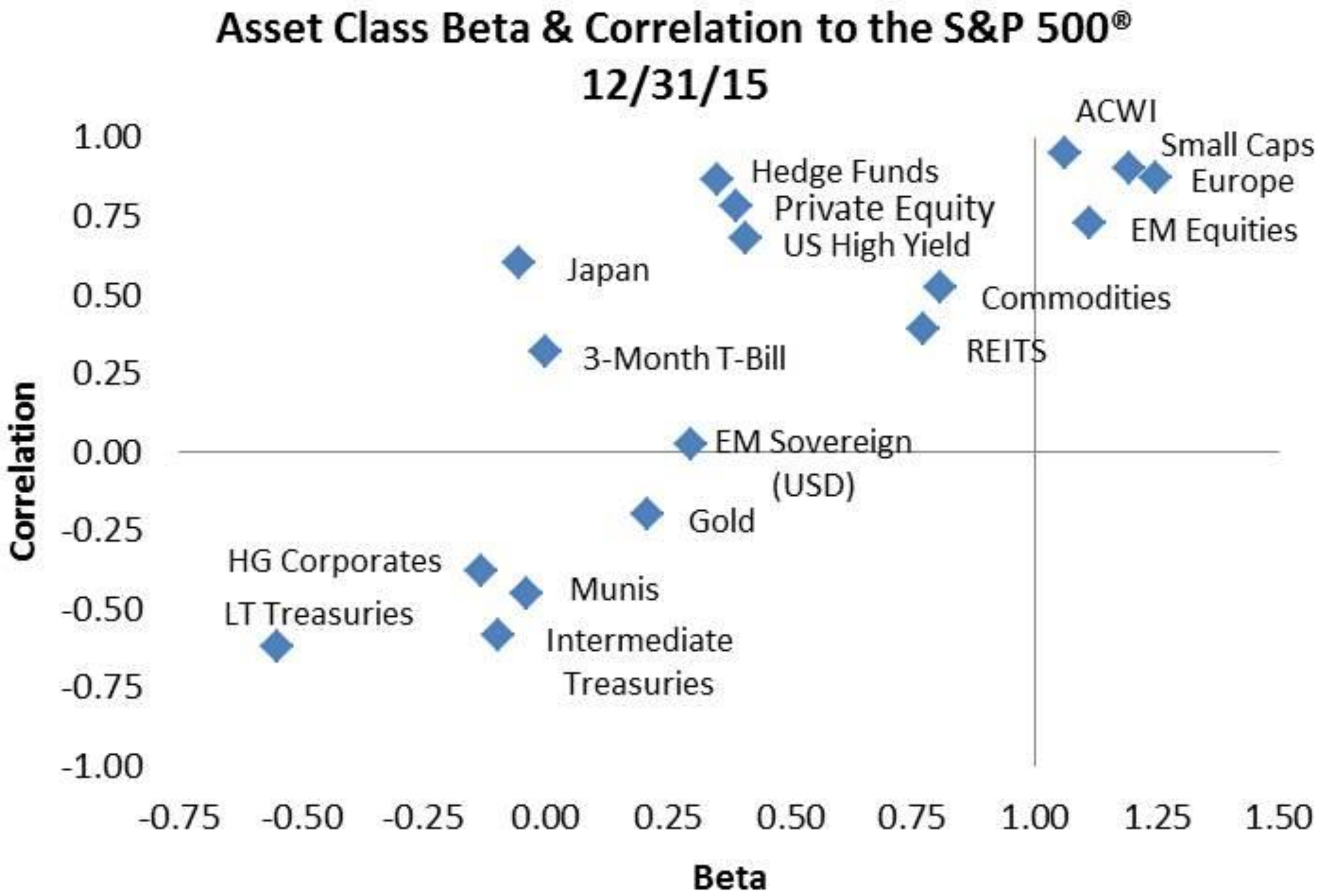
Diversification, sometimes referred to as the only "free lunch", has long been recognized as an important goal when designing an investment portfolio. Indeed, according to the Morningstar/Barron's ninth annual Alternative Investment Survey, almost two-thirds of advisors who responded said they plan to allocate more than 11% of their portfolios to alternatives in the next five years; just 40% said so last year. The vast majority, 73%, said they use alternatives to diversify their portfolios with assets that have a low correlation to the market.

Link to full Barons article.

The chart on the next page shows asset class correlation to equities measured against sensitivity to equity movement (beta). An asset class might have a high correlation to equities, meaning that its returns move in tandem with equity returns, but might have a low beta, which suggests that the movements although aligned are muted relative to equity returns.

Of course, the relationships shown in the chart and depicted in the schematic are dynamic, and must be monitored through time (an area a Financial Advisor can add value for Investor clients). Whether one is examining stocks, bonds, hedge funds, private equity, venture capital, or non-US stocks and bonds; the important consideration is not what box to fill in within an allocation table, rather it is what sensitivity one wants to exploit and what is the most cost effective way to gain that sensitivity.

Source: "Asset Allocation 2.0" – Richard Bernstein of Richard Bernstein Advisors



Source: Richard Bernstein Advisors LLC, Standard and Poor's, HFRI, Cambridge Associates, MSCI, BofA Merrill Lynch, Bloomberg Finance L.P.

.

Summary

Markets periodically experience 30 – 50% losses when major bear markets take hold of an asset class. At Second Phase Capital, we don't want our clients, which include our own families, to experience the worst of these extreme events. That's why we employ systematic solutions which adapt in real time to material changes and diversify across a range of time series - including both long and short positions. While these methods won't work all of the time in all market environments, we believe we can deliver positive performance during directional market trends while minimizing draw-downs during major bear markets.

To summarize, stock markets are increasingly efficient. Should self-directed High Net Worth investors and Financial Advisors spend time researching the best long only mutual funds, the majority of which can't beat a passive, inexpensive index ETF? Or should they adopt a two-pronged approach: First, plan to allocate a portion of investment capital towards low-cost ETF products that get exposure to areas of the market where efficiencies are highest; and second, look for managers in the alternative space who have unique products that can be combined into a superior suite of "explore" sleeves – which may allow the investors to earn higher returns in inefficient corners of the investment opportunity set, thereby injecting their portfolios with additional sources of returns, while also adding valuable diversification to the broader portfolio.

For additional insights, call 404.918.7219 or visit secondphasecapital.com

About Us

Second Phase Capital is a boutique asset manager offering institutional quality alternative strategies to investment advisors and High Net Worth Individuals. Today, the firm combines its quantitatively constructed momentum models with that of other world-class investment managers to offer a family of alternative strategies including long/short equity, managed futures and interest rate products.

SecondPhase Capital.

Disclaimer

Information used in this report may be gathered from various sources believed to be reliable but are not guaranteed as to accuracy or completeness. The information in this report is not intended to be, and shall not constitute, an offer to sell or a solicitation of an offer to buy any security or investment product or service. The information in this report is subject to change without notice, and Second Phase Capital LLC assumes no responsibility to update the information contained in this report.

Index Descriptions:

While we believe this data to be accurate we make no such guarantee. Data is subject to revision at any time. Anyone interested in further details is free to consult each such sponsor's or originator's website. The past performance of an index is not a guarantee of future results.

Hedge Fund Index: HFRI Fund Weighted Composite Index. The HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager funds that report to the HFR (Hedge Fund Research) database. Constituent funds report monthly net-of-all-fees performance in USD and have a minimum of $50 million under management or a twelve (12)-month track record of active performance. The Index includes both domestic (US) and offshore funds, and does not include any funds of funds.

SG CTA Index (formerly Newedge CTA Index) The SG CTA Index provides the market with a reliable daily performance benchmark of major commodity trading advisors (CTAs). The SG CTA Index calculates the daily rate of return for a pool of CTAs selected from the larger managers that are open to new investment. Selection of the pool of qualified CTAs used in construction of the Index will be conducted annually, with re-balancing on January 1st of each year. A committee of industry professionals has been established to monitor the methodology of the index on a regular basis. The SG CTA Index will allow market participants and institutional investors to:

- Measure aggregate CTA performance on a day-to-day basis;
- Track the performance of a CTA (or a pool of CTAs) against the market; and
  Assess the performance of Managed Futures Funds against an index with the same accuracy as is already possible for other asset classes.