Highland Associates, Inc.

Second Quarter 2014

CAPITAL MARKETS QUARTERLY

EVALUATING MANAGERS DURING MARKET EXTREMES

Capital markets have a rhythm over the long-term. They ebb and flow, creating investor sentiment that fluctuates between euphoria and despair. This pattern is one of the key impediments to becoming a successful investor. In order to succeed one must master not only investment knowledge but also investor psychology. Deciphering and filtering large amounts of data in order to make a successful investment is not enough. Investors must also control their emotions which often lead them to poor decisions.

> "EVALUATING MANAGERS AT MARKET EXTREMES SKEWS THE CONCLUSIONS OF A REVIEW AND COULD LEAD INVESTORS TO POOR DECISION MAKING"

Looking at the stock markets today, the S&P 500 and the MSCI All Country World ("ACWI") continue to climb in spite of lukewarm economic data. Through June 30th, the S&P 500 and ACWI are up 7.1% and 6.5%, respectively. This is quite a return when considering the U.S. Gross Domestic Product was reported down 2.9% for the first quarter, which was the first negative quarter since first quarter 2011. The one year returns for the S&P 500 and ACWI were also very robust as these markets gained 19.0% and 18.1%, respectively. This pattern has been in place since the bottom of the market was established in early 2009. While the stock market recovery has allowed investors to regain losses from the financial crisis, the euphoria caused by accelerating markets can create doubt in one's investment philosophy. This can overwhelm an investor's ability to achieve their investment objectives because it can cause them to "chase returns" or "reach for yield" at the exact time in which they should be exhibiting discipline in their investment philosophy/process.

At Highland, our overarching investment philosophy is one rooted in conservatism. We advise our clients to prudently seek return in a manner which protects them during difficult markets (i.e. large market declines). This philosophy leads us to recommend adding managers to a portfolio which exhibit certain characteristics:

- **Downside protection:** losing less than the overall market during large, protracted declines;
- **Emphasis on intrinsic value:** the price of an investment does matter;
- **Lower long-term volatility:** a more consistent return pattern than the overall market (i.e. shorter peaks and troughs); and
- **Long-term time horizon:** longer holding periods allows for an investment thesis to properly play out.

By investing in managers which exhibit these characteristics, we believe that our clients can outperform the overall market over longer periods of time. However, in order to properly execute this philosophy, an investor must remain focused on the long-term and remain patient. The goal of this approach is to enhance our clients' ability to stick with their investment strategies during very difficult markets. Ironically, this investment approach tends to be most difficult to stomach during periods of rapidly appreciating markets as it and these types of managers will tend to underperform. For this reason, this quarter's letter will focus on evaluating managers during euphoric markets and how to determine if your objectives are still being met.

TRADITIONAL EVALUATION METHODOLOGY

The most commonly used method to evaluate managers is to simply compare their historical performance to that of a benchmark index. While many different methods can be used, the most common method is annualized time weighted returns. **Figures 1** and **2** illustrate time weighted returns for two different managers. **Figure 1** is the performance of a U.S. equity manager, and the data in **Figure 2** is for a global manager. Both of the managers are among the top ten managers utilized by Highland clients.

Figure 1

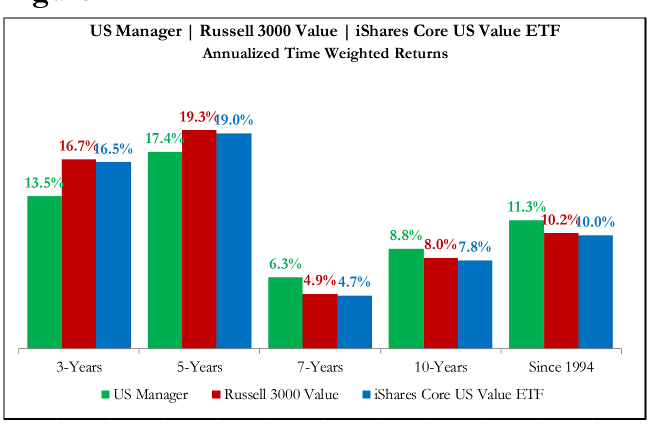
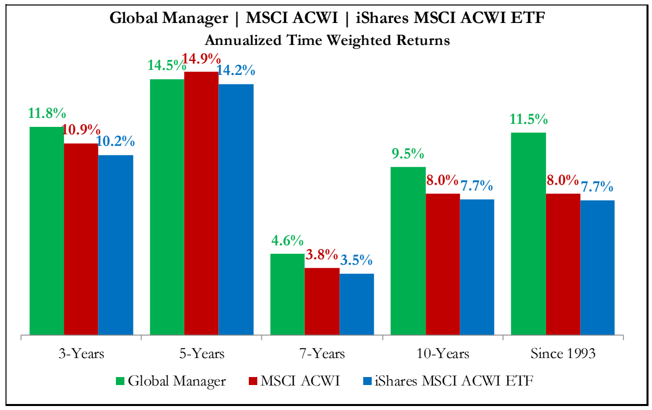


Figure 2

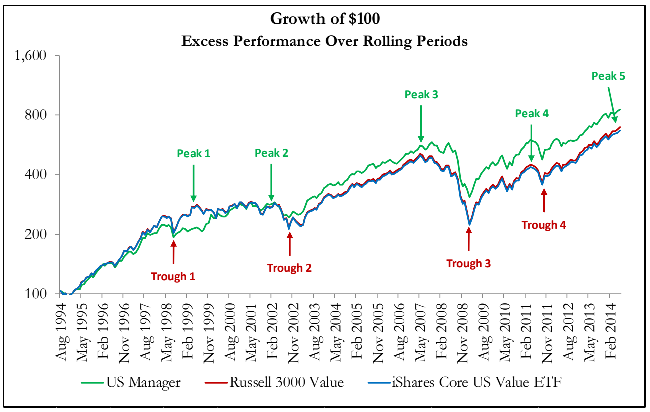


In order to evaluate the success of a manager, an investor must first define/understand what they mean by success. Many investors simply define success as a manager outperforming their respective benchmark. Using this measure of success, it appears that the U.S. manager has been struggling to achieve success over the past five-years and the global manager appears to be falling short over the past five-years. Based upon this analysis, an investor might be tempted to terminate these managers in search of managers that have provided above benchmark returns.

At Highland, we believe that success is defined by an investor's ability to achieve their long-term investment objectives. Ultimately it is not only the return, but how you achieve the return that determines success, i.e. outperforming the benchmark over the long-term (minimum of 5 year rolling periods) in a manner that protects capital during difficult markets and exhibits an overall volatility lower than the benchmark. The traditional type of analysis ultimately fails to determine success for two reasons. First, only one aspect of success (return) is being examined. Second, it suffers from a major flaw: **endpoint sensitivity**.

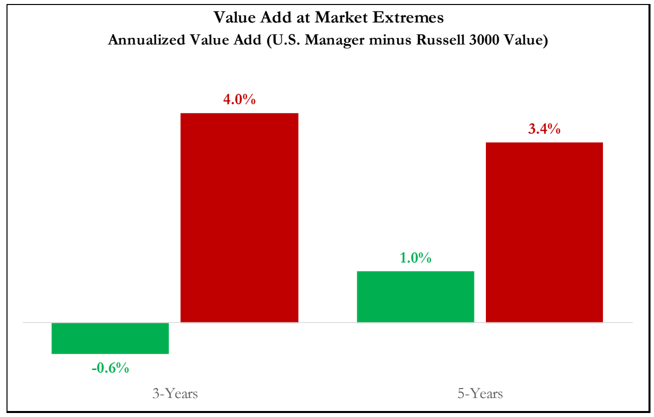
End point sensitivity is a phenomenon which occurs when the conclusions of an analysis can be significantly changed by changing the ending data point (the ending date in this example). Highland's investment philosophy employs strategies which seek to protect capital during difficult equity markets. This means that the managers in the portfolio tend to have less downside risk and lower overall volatility. Conversely, they tend to perform less well, on a relative basis, in big up markets. Therefore, this type of strategy often suffers severe endpoint sensitivity during market extremes. Since August 1994, there have been five market peaks and four market troughs (see **Figure 3**).

Figure 3



To illustrate the effect of endpoint sensitivity, we examined the trailing annualized time weighted returns at each of the market extremes. **Figure 4** shows the average value add (U.S. Manager minus the benchmark) at the market peaks (green bars) and the market troughs (red bars). The value add is measured by looking at the difference between the U.S. manager and the benchmark at the market extremes. The average differential is then calculated based on the type of extreme (either peak or trough). Looking at **Figure 4**, during the equity market peaks, the U.S. manager has trailed the benchmark by 60 basis points annualized over the trailing three-year return. By contrast, the U.S. manager has outperformed by 400 basis points annualized over the trailing three-years at market troughs. The endpoint sensitivity for Highland's conservative investment philosophy is evident in the large differential between the two market extremes. This analysis also validates that the U.S. manager is producing the sought after return pattern. Currently, the U.S. stock market is near an all-time high and more likely closer to a peak than not. This is exactly the time in which this strategy typically struggles to keep up. The fact that the market is near a peak skews the conclusion reached in **Figure 1**.

Figure 4

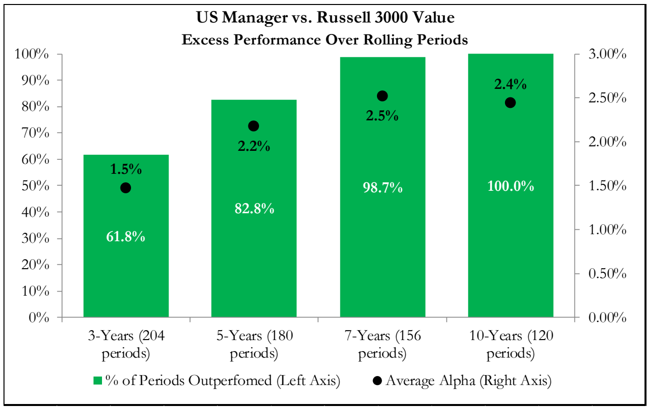


HIGHLAND'S EVALUATION METHODOLOGY

In order to minimize potentially erroneous conclusions caused by endpoint sensitivity, Highland employs additional analyses to evaluate manager success. The first is to consider rolling periods of compound returns (i.e. how consistent are a manager's returns over longer periods of time). This type of analysis examines the entirety of a manager's return stream to determine their probability of success. In addition, we examine a manager's rolling excess performance over the benchmark to ensure consistency. By combining these two methods, we believe that we have a more predictable method of assessing whether a manager has the ability to add value. **Figure 5** illustrates the U.S. manager's results based on this methodology. The results show that the manager has the ability to consistently outperform the benchmark, especially when examining longer time horizons (i.e.

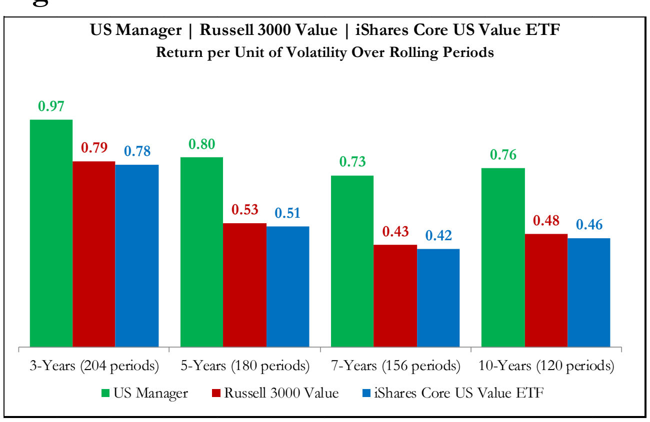
outperforming 100% of ten-year periods). This also shows how the results in **Figure 1** are more driven by the extreme market environment and less by the manager's ability to outperform.

Figure 5



While the results in **Figure 5** better account for endpoint sensitivity, they still only capture one aspect of success (return). To evaluate the risk aspect, Highland examines volatility and risk-adjusted returns to ensure a manager is providing the return profile required by our investment philosophy. There are numerous methods that can be used to evaluate risk-adjusted returns, and Highland uses most of them to analyze success. **Figure 6** is one example, which examines return per unit of volatility over rolling periods (to eliminate endpoint sensitivity).

Figure 6



Each of the methods used to evaluate success have their own set of pros and cons; therefore, one method cannot be used in isolation to properly judge a manager. Instead, Highland utilizes all of the methods discussed in order to determine if objectives are being met. This allows us to temper our emotions at market extremes and maintain sound judgment when it is the most difficult. We are then able to focus on the long-term and put our clients in a position to achieve their investment objectives.

PASSIVE INVESTMENT STRATEGIES

The active versus passive debate continues in the investment world. While more and more investors are allocating to passive strategies, Highland maintains that those who can select superior active managers are rewarded over time and have the ability to build a portfolio that is more efficient than the overall market.

There are two very important facts about passive investing that should be discussed before one can form a meaningful conclusion from the debate. First, passive strategies are not costless. There are management fees and expenses just like active strategies. While the management fee is typically lower than those of active managers, the degree in which they are lower depends on the passive strategy utilized. For example, large cap U.S. equity can be very inexpensive, but global equity can be two to three times more expensive than large cap U.S. equity. This means that investors should take into consideration the cost of the passive strategy before deciding that an active manager's fee is too high. For example, an investor may be concerned about paying 80 basis points for an active global equity manager. By contrast, the total expenses for the iShares MSCI ACWI Exchange Traded Fund (ETF) is 34 basis points, making the cost of active management 46 basis points (not 80 basis points).

> "HIGHLAND BELIEVES THAT ACTIVE MANAGEMENT IS SUPERIOR TO A PASSIVE STRATEGY BECAUSE OF THE PRUDENCE PRACTICED BY THE MANAGERS AND THE RESULTS OBSERVED IN OUR EVALUATION PROCESS."

Second, passive benchmarks are constructed to mimic the returns of market indices. The methodology of the construction is vital to understanding the returns that will be produced by a passive strategy. The S&P 500 and ACWI are market capitalization weighted indices. This means that the constituents of the indices are weighted based on their respective market capitalization. While this may seem harmless, the two factors that drive the weighting are number of shares outstanding and market price. Therefore, the largest companies in the indices are the names that have the best performing stock price. This makes a passive strategy act like a momentum based strategy, which is the opposite of Highland's overall strategy. By converting to a passive strategy, our clients would convert their conservative equity investment strategies that are based on intrinsic value to ones that are based on the collective opinion/impulses of the marketplace and doing so in a manner that locks in a below market return. Highland believes that active management is superior to a passive strategy because of the prudence practiced by the managers and the results observed in our evaluation process.

DEFLATION/CRISIS HEDGING
⇩ UNDERWEIGHT

For the year, deflation/crisis hedging strategies (mainly high quality fixed income) have rebounded from a difficult 2013, gaining 3.9% year-to-date (as measured by the Barclay's Capital U.S. Aggregate Bond Index – "Aggregate"). Many forecasted continued difficulties in the bond markets for 2014 due to the Federal Reserve's reduction of quantitative easing (a.k.a. taper). A forecast of rising rates (thus declining bond markets) makes sense given this Federal Reserve action, but the opposite has occurred. The yield on the Aggregate has declined from 2.5% at the end of 2013 to 2.2% at June 30th. Several factors have led to this decline. As mentioned earlier, news regarding the health of the U.S. economy has been very tepid and many investors have been responding to this news. Second, the supply of U.S. Treasuries has been declining at the same time the Federal Reserve has been cutting its purchasing program. Year-to-date, the net debt issuance of the U.S. Treasury is $201.2 billion, which is $137.0 billion less than the same period last year. This reduction in supply combined with increased demand has created a declining rate environment for the first half of the year.

Over the long-term, today's low yield environment can be detrimental to fixed income investors in several ways. First, a rising yield environment can put downward pressure on prices causing negative returns in the short run. Second, the nature of fixed income investing is that you eventually earn the yield you purchase, so low yield environments begot low return environments in the future. For these reasons, Highland continues to recommend an underweight to these types of investments.

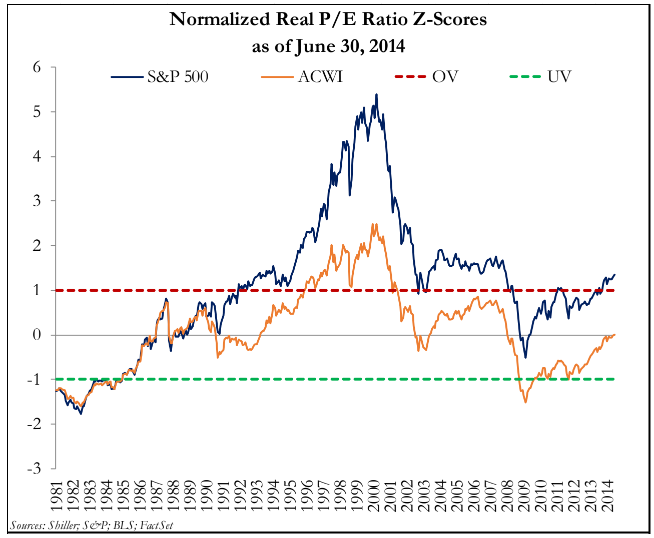
GROWTH STRATEGIES
⇔ NEUTRAL

As discussed in the introduction, growth strategies (i.e. public and private equity) have continued to advance. This advance has been going strong (with only a few setbacks) since the bottom of the market in March 2009. Over this time, the S&P 500 and ACWI have gained an impressive 224.4% and 187.5%, respectively. While this has been a good result for investors, it is important to understand that these returns are in the past and Highland is looking forward to determine our clients' positioning.

Our investment philosophy is a conservative one that is grounded on intrinsic value. Therefore, we look and fundamentals to determine our forward expectations. For equities, this means we examine dividends, earnings, and price to determine our expectations for future returns. Looking at earnings, the last ten-years have produced a compound annual growth rate of 6.3% per year, which is 140 basis points above the long-term growth rate of 4.9%. Over the past five-years, companies have reported 20.0% annualized earnings per share growth, while sales have only grown at a 2.4% annualized rate. This points to expense reduction as the driving force behind earnings expansion.

While earnings have been growing at a rapid rate, the price of equities has been growing at a more accelerated rate. This has put upward pressure on most valuation metrics. **Figure 7** shows the movement of the cyclically adjusted price earnings multiple for both the S&P 500 and the ACWI. While this is only one valuation metric that is utilized by Highland, it is one that provides good insight on broad market valuation. This chart shows the z-scores (or how many standard deviations away from the mean the current figure is), illustrating that the U.S. market looks over-valued (over one standard deviation above its mean) while the ACWI appears fairly valued.

Figure 7



The earnings and valuation picture of the overall market points to some headwinds for equity markets going forward. These headwinds don't necessarily have to manifest themselves anytime soon, but over the course of the next five to ten-years could make returns in the equity markets more difficult than the previous five.

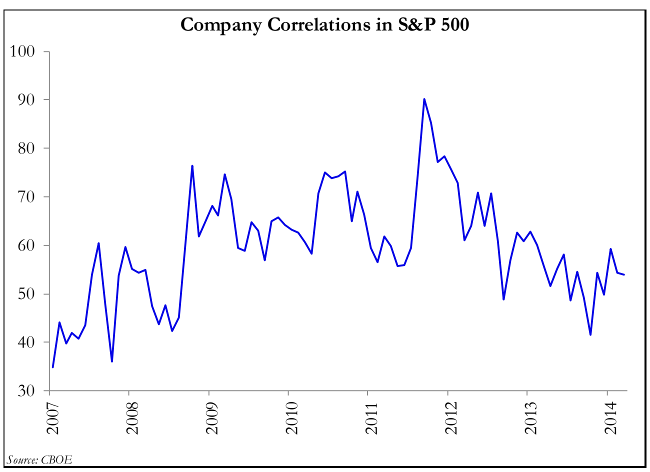
These fundamentals obviously are at the aggregate market level and don't show the true story at the individual company level. **That is one of the reasons that Highland prefers active management, so that individual managers can focus on valuation and produce a portfolio that is more attractive (over the long-term) than the broad market.** For this reason, Highland continues to maintain a target weight to growth strategies.

VOLATILITY CONTROLLED GROWTH STRATEGIES
⇧ OVERWEIGHT

Highland recommends the use of volatility controlled growth strategies by clients to lower the overall volatility of their portfolio. We also seek investments that have the ability to achieve equity like returns over the long-term. There are several types of strategies we have used in this portion of a client's portfolio, including credit-oriented fixed income, convertible securities, hedge funds, or liquid alternative strategies. Given the current low yield environment, Highland doesn't believe the opportunity set for fixed income based strategies is attractive for a volatility controlled growth strategy (i.e. hedged equity).

Highland does believe that today's equity markets could provide hedge funds and liquid alternatives with opportunities to add value to a portfolio. **Figure 8** shows the correlations of the companies in the S&P 500. Correlations peaked in late 2011 at close to 90%, which makes it difficult for stock pickers and long/short managers to add value since most stocks are moving together. Since then, correlations have been moving lower and can provide opportunities going forward. For this reason, combined with the level of public equity markets, Highland recommends an overweight to these types of strategies.

Figure 8

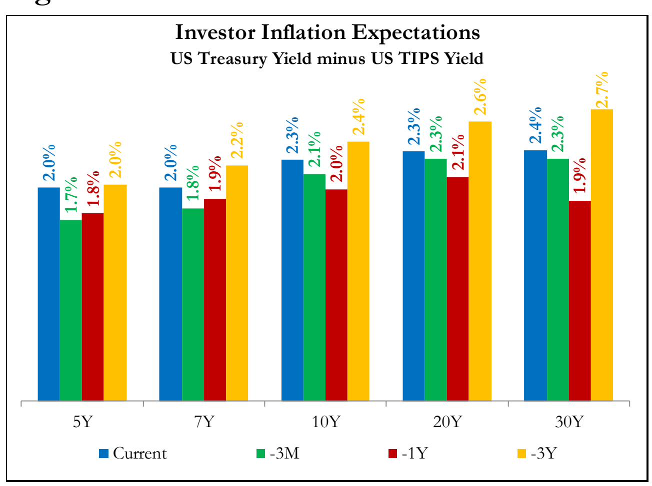


INFLATION SENSITIVE
⇔ NEUTRAL

Highland believes that inflation sensitive strategies are essential to most portfolios because inflation is a major risk to them. For example, an individual saving for a child's college education has the objective to grow to an amount to cover the cost of education. The key to this objective is that the cost is constantly changing based on the annual change in college costs (i.e. education inflation). If the individual saves a large amount of money, but fails to keep up with inflation, then the objective is not met. This same example can be applied to pensions, endowments, operating companies, etc. The issue is that most invest in financial assets that are inversely related to inflation; therefore, their portfolio will struggle to keep up with their liability. For this reason, Highland recommends a strategic allocation to assets that are positively correlated to inflation.

As for today's inflation environment, it is low and has been that way since the financial crisis. The levels of accommodative monetary policy have been historic because of both the level and the methods (i.e. quantitative easing). While inflation has yet to manifest itself, any miscalculation by central banks could lead to rising inflation. Most investors do not see inflation as a major threat, as inflation expectations based on the market (nominal U.S. Treasury yields minus U.S. Treasury Inflation Protected Securities yields) are low (see **Figure 9**).

Figure 9



These low expectations show that the market isn't looking for inflation to pick up. While Highland doesn't know exactly when inflation will rise, we feel that the possibility is growing. Therefore, we continue to recommend a target weighting in these types of assets.

CONCLUSION

Conservative investment strategies can be beneficial for investors. They allow investors to stay calm and stick to their investment philosophy when markets are experiencing large corrections, which put an investor in the position to achieve their investment objectives over the long-term. On the other hand, these types of strategies struggle to keep up with markets during long, protracted upswings, which could cause an investor to question the validity of a conservative strategy. It is important to understand that traditional evaluation tools at market extremes (i.e. peaks and troughs) often skew the appearance of success or failure. For this reason, Highland utilizes evaluation metrics that limit endpoint sensitivity. Therefore, investors can limit their emotions and make decisions in a manner that is prudent and most beneficial for their portfolio.

HIGHLAND'S CURRENT POSITIONING

⇩ DEFLATION/CRISIS HEDGES

⬄ GROWTH

⇧ VOL. CONTROLLED GROWTH

⬄ INFLATION SENSITIVE

About Our Firm: Highland Associates, Inc. is an independent institutional investment advisor headquartered in Birmingham, Alabama. Highland was founded specifically to help develop, implement and maintain investment management programs for not-for-profit institutions. We serve a national client base of institutional investors including not-for-profit healthcare organizations, foundations, endowments, pensions, and a select group of high-net worth individuals. As of June 30, 2014, we serve as investment consultant on approximately $19.5 billion in assets. With every engagement, our goal is the same: to protect our clients' assets while prudently growing their portfolios over time. Please visit our website at www.highlandassoc.com to learn more about our firm.