Allium
FINANCIAL ADVISORS

Long/Short Equity Discussion
May 2017

Why Long/Short Equity?

Hedge funds have significantly underperformed the U.S. stock market throughout the current bull market. Several factors contribute to their headwind, which we will present in this discussion. This could all be changing, perhaps setting the stage for a comeback. But first, what is the long-term role of long/short equity in a portfolio?

Diversification

- Long/short equity strategies are less constrained and offer a more opportunistic approach to generating return than traditional equity investing/long-only strategies
- Short selling[1] provides a differentiated return source

Risk Reduction

- The vast majority of long/short equity funds have lower volatility relative to stock market indices
- Lower volatility comes from multiple sources:
  - **Flexibility:** active risk management, hedging in periods of stress
  - **Shorting:** short selling typically reduces risk of long positions
  - **Net exposure:** typically less than 100% (whereas a long-only fund would have net exposure of 100%)

[1] Short selling is the sale of a security that the seller has borrowed. Short selling is motivated by the belief that a security's price will decline, enabling it to be bought back at a lower price to make a profit.

Hedge Fund Performance relative to S&P 500 since January, 1997

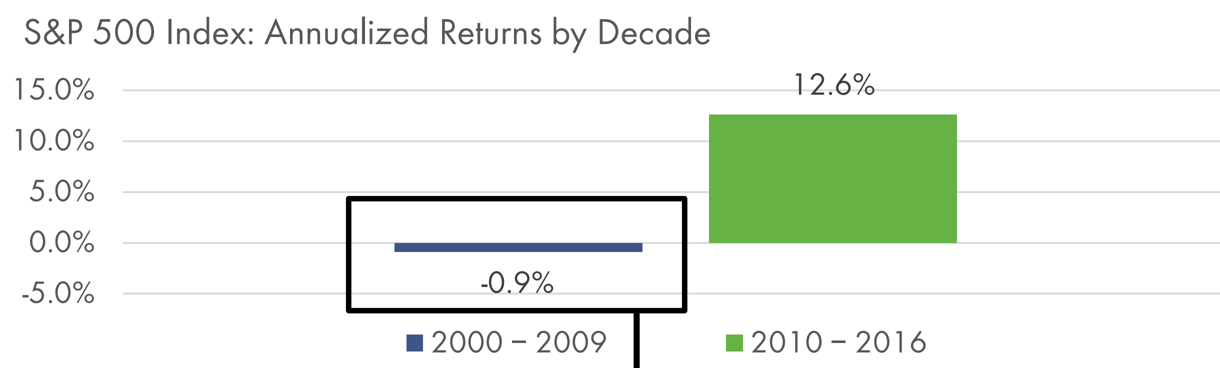
- Why are hedge funds lagging by a larger margin during the current bull market vs. previous bull markets?
- Is this permanent or a temporary phenomenon?
- If temporary, what will cause it to change?

Benchmark	Bull Market (1/97 – 8/00)	Bear Market (9/00 – 9/02)	Bull Market (10/02 – 10/07)	Bear Market (11/07 – 2/09)	Bull Market (3/09 – 3/17)	Entire period (1/97 – 3/17)
S&P 500	+116.1%	-44.7%	+108.4%	-50.9%	+281.8%	+366.0%
HFRI Fund of Funds	+48.6%	+0.1%	+59.8%	-21.9%	+33.6%	+147.9%
HFRI Equity Hedge	+135.3%	-10.3%	+85.2%	-30.6%	+75.9%	+377.3%

Market Capture vs. S&P 500	Bull Market	Bear Market	Bull Market	Bear Market	Bull Market	Entire Period
HFRI Fund of Funds	41.9%	-0.2%	55.2%	43.0%	11.9%	40.4%
HFRI Equity Hedge	116.5%	23.0%	78.6%	60.1%	26.9%	103.1%

Source: HFRI, Morningstar

An attractive alternative to traditional equity



Long/short equity funds outperformed the equity markets with less risk from 2000 – 2009

The outperformance was generated by:

- Alpha (a measure of performance on a risk-adjusted basis) – through stock selection and sector positioning

- Dynamic Beta: (beta is a measure of the volatility, or systematic risk, of a portfolio in comparison to the market as a whole) – the ability to increase and decrease risk based on market conditions

2000 – 2009 Data	Annualized Return	Annualized Volatility
S&P 500 Index	-0.9%	16.2%
MSCI All Country World Index	-0.5%	15.6%
HFRI Equity Hedge	**+5.4%**	**9.2%**
Suisse L/S Equity	**+5.6%**	**8.8%**
HFRI Strategic	**+3.6%**	**8.0%**

Source: HFRI, Morningstar

Why are hedge funds lagging by a larger margin during the current bull market vs. previous bull markets?

- Too many hedge managers were in the market following the last bull market
- Overcrowding in specific stocks
- Monetary stimulus / low interest rates
    - Driving investors out the risk curve in search of yield
    - Rationalizing higher equity prices
    - Extremely difficult for short sellers
        - Monetary stimulus has kept bad companies on life support
        - It has also fueled Merger and Acquisition activity
        - Borrowing costs to short stocks have been very high, in part due to overcrowding

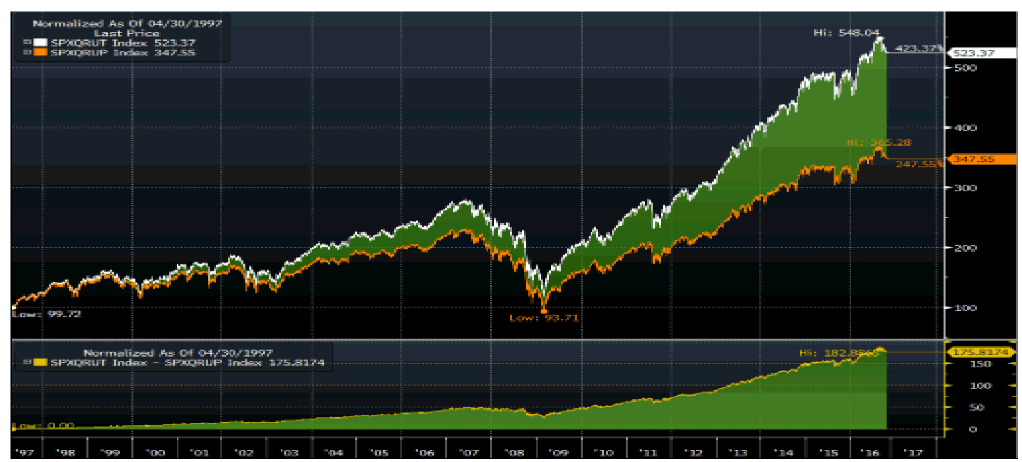
Is this permanent or a temporary phenomenon?

We believe the current investment environment is temporary and we're starting to see change. After 2008, periods of high returns have been during periods of Fed stimulus.

Source: FRED, Federal Reserve Bank of St. Louis

Lower interest rates have led investors to increase risk in order to achieve return. This is evident as low quality stocks have outperformed high quality stocks by the largest margin since the indices were created in 1997.

These factors have fueled the second longest bull market in history and an extremely tough period of relative performance for hedge funds.

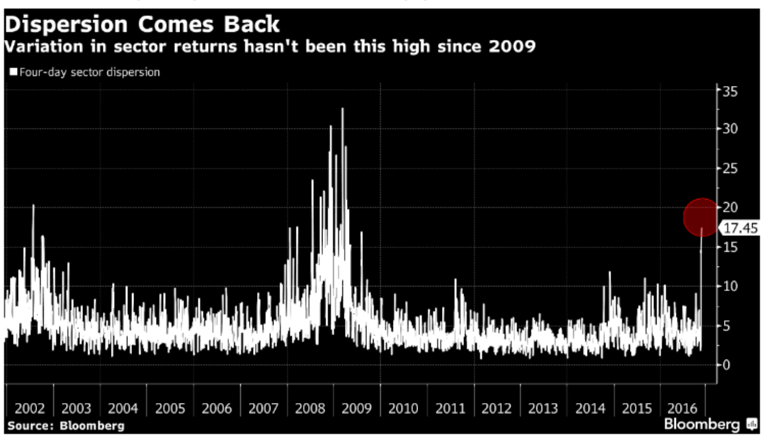


Source: Bloomberg

Are hedge strategies turning the corner?

1. There is less competition – According to HFR, the number of Hedge Funds declined in 4Q15, 1Q16, and 2Q16
2. We are currently experiencing second longest bull market in history (20 year chart):

3. Dispersion is returning (variation in sector returns hasn't been this high since 2009) and correlation between U.S. large company stocks is disappearing.



Source: Bloomberg

Source: Bloomberg

4. Changing political landscape

These four factors are creating incredible opportunities for active managers, but especially for smaller, more flexible long/short managers.

Using Long/Short Equity to manage risk: the impact of market exposure

Portfolio	A	B	Long Only
Gross Long	150% (using leverage to purchase 50% more stock)	75%	100%
Gross Short	(-100%)	(-25%)	0%
Net Market Exposure	50%	50%	100%
Gross Exposure	250%	100%	100%
If the stock market is down 10%	**Portfolio A Results**	**Portfolio B Results**	**Long Only Results**
Longs down 10%	(+150% x -10%) +	(+75% x -10%) +	(+100% x -10%) =
Shorts down 20%	(-100% x -20%) =	(-25% x -20%) =	

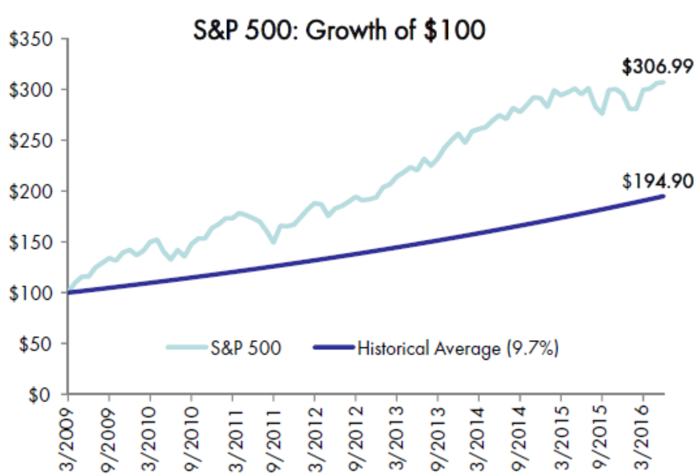
Up 5.0%

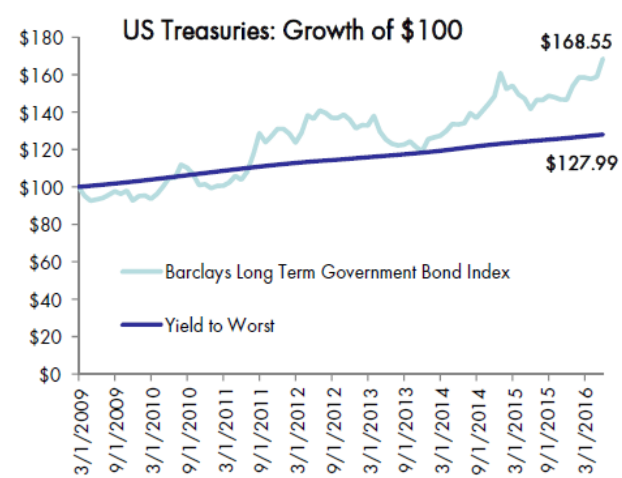
Down 2.5%

Down 10.0%

Conclusion

- Due to unprecedented Central Bank stimulus, stocks, bonds and real estate have significantly outperformed hedge funds.
- We are starting to see a change in the investment environment:
  - Interest rates are rising
  - President-elect Donald Trump's pro-American business / tough on trade stance can create opportunities to pick winning and losing companies
  - Already seeing increased dispersion and decreased correlation among U.S. stocks
- By design, long/short equity hedge funds are expected to underperform during bull markets and outperform during flat or bear markets
- While it is impossible to predict market turns, we feel that the next 8 years will be very different than the past 8 years…and that what outperformed in the past likely won't in the future, particularly given that the two best performing asset classes have over earned their historical and expected averages.





Source: Morningstar Direct

- We feel that now is an opportune time to reduce risk in portfolios and to add capital to underperforming asset classes – specifically hedged funds.

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Past performance does not guarantee future results.

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Index Descriptions:
Index performance does not reflect the deduction of transaction costs, management fees, or other costs, which would reduce returns. An index is an unmanaged, broad-based index and investing in the Fund is not similar to investing in an index. References to market or composite indexes, benchmarks, or other measures of relative market performance over a specified period of time are provided for your information only and do not imply that a Fund will achieve similar returns, volatility, or other results. An investor cannot invest directly in an index.

- The S&P 500 Index is an unmanaged index of 500 widely held common stocks.
- The Russell 2000 Index measures the performance of the small cap segment of the U.S. equity universe.
- The HFRI Fund of Funds Composite Index is a multi-manager diversified portfolio.
- The Barclay US Aggregate Index measures the investment grade, US dollar-denominated, fixed-rate taxable bond market it includes Treasuries, government-related and corporate securities, MBS, ABS, and CMBS.
- The HFRI Equity Hedge (Total) Index consists of hedge fund managers that maintain positions both long and short primarily in equity and equity derivative securities.
- The HFRI Monthly Indices (HFRI) are equally weighted performance indexes, utilized by numerous hedge fund managers as a benchmark for their own hedge funds.