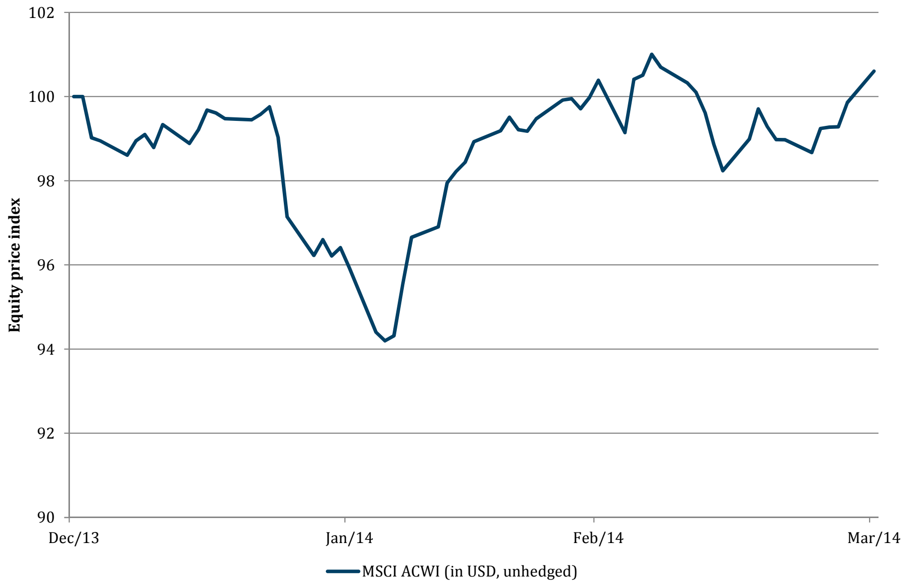
William Blair

March 31, 2014

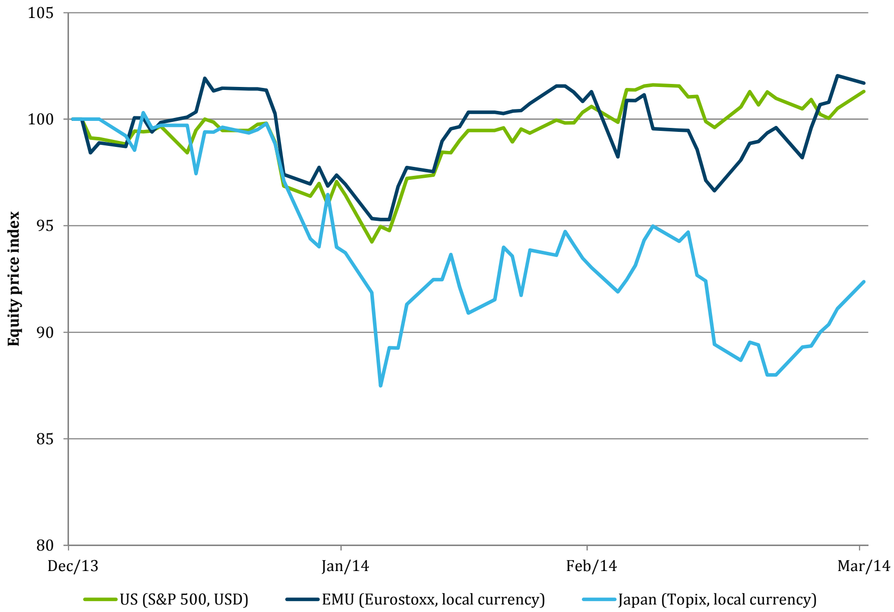
# Dynamic Allocation Strategies Team Investment Letter

Global equities turned in a lackluster performance in the first quarter of 2014. The MSCI All Country World Index returned –0.6% in the quarter, with developed markets modestly beating emerging equities. Within developed markets, Japan underperformed the United States and the eurozone, a turnaround from having been the strongest performer in 2013. Bond yields declined slightly. Currency movements were slight, but on balance emerging currencies fell against developed currencies. Notable exceptions were the Indian rupee and the Indonesian rupiah. Aside from these exceptions and Italian equities, which also rose, the overall environment was generally characterized by modest movements of price away from fundamental value.



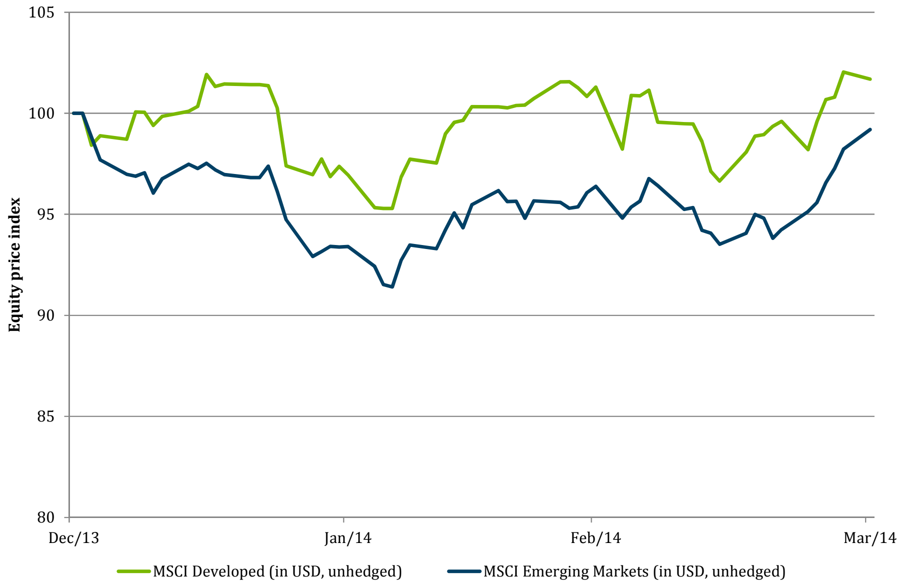

*Source: William Blair*

Notwithstanding the quarter's movements, the forward-looking investment opportunity, captured by the aggregate dispersion of prices from fundamental value, has declined in respect to equity and bond markets in the last year; hence, our recent strategy changes in these asset classes have mostly been to reduce risk exposure. On two occasions we reduced overweight exposure in European equities, and we also made a reduction to emerging market equity exposure in January (later in the quarter we made opportunistic increases in exposure, which are later detailed). As the opportunity within markets has declined, the opportunity within currencies has contrastingly increased (more exchange rates have moved away from fundamental value than toward it). We responded to these increasingly attractive fundamental signals at the end of February with broad-based increases in currency risk exposures. These types of dynamic responses to the magnitude of investment opportunities in the places where we see them are the vital essence of our investment process. In stark contrast to a practice of targeting a certain risk level regardless of its justification, our portfolios go where the opportunities lie—conserving risk capital if opportunities are diminished—and allocate risk capital only after new opportunities have manifest themselves in environments that are well understood and where risks are compensated. Moreover, over time we expect approximately half of portfolio active risk to come from our active currency strategy (with the other half coming from market exposure), and the present environment is such that the relative opportunities in each area are driving us back toward this long-term expectation of the allocation of risk capital. Further, viewed from an overall portfolio context, the typically low correlation between currencies and markets usually results in our active currency risk acting as a significant diversifier.




*Source: William Blair*

Beyond the realm of fundamental valuation, financial markets have been increasingly influenced by geopolitical and macro-thematic developments during the first quarter. We have used the second stage of our investment process (understanding why prices are different from values) extensively in this environment. Specifically, this second stage was meaningful in our analysis of events in Ukraine (where we deployed our game-theoretical framework to better shed light on market influences) and also in approaching the so-called "Fragile Five" (a macro-thematic influence that has built up in market consciousness, and revolves around the dependence on external financing for the growth of Brazil, South Africa, Indonesia, Turkey, and India). We regard gaining this type of understanding about these developments as vital, because it concerns making investment decisions about which (valuation-based) opportunities we wish to respond to and those we may wish to avoid.

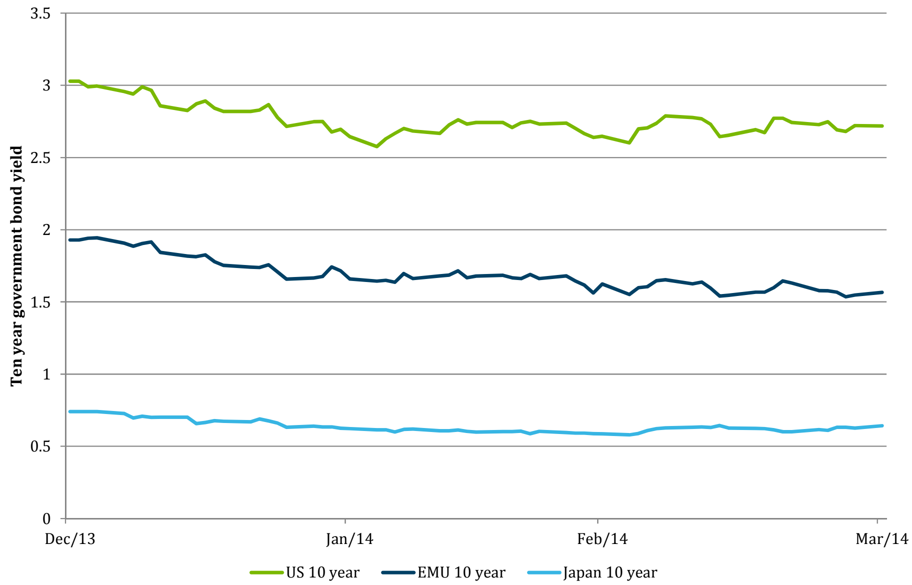



*Source: William Blair*



222 West Adams Street
Chicago, Illinois 60606
+1 312 236 1600

We have analyzed the situation in Ukraine as being a theater of strategic bargaining between four major players: Russia, the United States, the eurozone (proxied by Germany), and China. As we usually do, we assessed these players' objectives, as well as the relative strength of their bargaining powers with which to advance their objectives. This game theater is mostly one of opposed objectives. For example, Russia has a very strong interest in regaining political control of Ukraine given: 1) Russia's political legacy, 2) the dependency on the country's agricultural output, and 3) its role as a transit country for Russian natural gas. The United States and the eurozone, however, are directly opposed to forcible annexation of sovereign territory by Russia. Interestingly, certain objectives are strongly aligned: all three players have an interest in the gas supply continuing to flow, since workarounds on either side (alternative supply to Europe, alternative revenue to Russia) do not have near-term replacement capacity. For its part, China is torn between conflicting objectives. As The Economist wrote in March, "the precedent of secession [to China] is anathema, because of Tibet; the principle of unification is sacrosanct, because of Taiwan." Thus, China has the potential to be a spoiler (in respect of outcome), but will also likely remain out of the front line in much of the bargaining process.

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We consider Russia's aggregate power to be the greatest among the four players in this situation, which was corroborated by its occupation of Crimea being met with relatively little push-back beyond targeted sanctions. We find it unlikely that Crimean annexation by Russia will be the end-game, but Russia will probably consolidate its "victory" in this regard before any next move. Our strategy response—coming directly out of our analysis—is therefore to be reactive to opportunities that events like this cause in markets. Russian equity, in particular, has been very attractive from a valuation perspective for quite some time. But we took our first (small) long exposure to this market only in March after Russia's aggressive move into Crimea and the eurozone's and United States' relatively passive reaction, which increased the attractiveness of Russian equity. We made an additional move following the secession referendum in Crimea (viewed as illegitimate by the West), selling a small notional put option exposure on Russian equity after a sharp rise in implied volatility (a short put exposure is also a bullish directional stance, and portfolios benefit from selling volatility when it is high). Thus, from an investment perspective, restraint followed by a tactical increase in risk aptly characterizes our approach.

Turning to the "Fragile Five," we added this emergent theme to our macro-thematic framework of modeling themes as risk factors. These five large emerging economies—Brazil, South Africa, Indonesia, Turkey, and India—have been grouped together in market conventional wisdom because of the economic fundamentals they have in common: current account deficits that have grown in recent years and growth that has faltered. These developments have raised fears that they will struggle to attract the capital flows required to balance their external accounts, leading to currency depreciation and equity market underperformance (though we see most of the thematic influence, and also the valuation opportunity, in the currency realm). On top of this, all five countries have general or presidential elections in 2014, starting with India (general election in April) and culminating with Brazil (presidential election in October).

In comparing and contrasting the five, we find cause for significant differentiation along all these lines. In summary, the current account deterioration is more severe in some (Turkey, South Africa) than others (Indonesia and India, where, according to IMF projections, improvement is expected from this point), and the dip in economic growth has been sharper in some (Brazil, Turkey) than in others (India and Indonesia, again). With regard to elections, what we believe is a central issue is the likelihood of reform-minded politicians and political parties winning power in 2014. This manifests itself as most likely where opinion polling indicates the loss of power to long-standing incumbents (India and Indonesia), and less likely where power will be retained by dominant incumbents (Turkey, South Africa, and probably Brazil).

Thus, in comparing the relative "fragility" of the five, we discern that India and Indonesia fare much better than the others, and that the market's grouping of all five into a thematic influence is changing, or will change further. We find it interesting that the Indian rupee and Indonesian rupiah have also been punished by market participants more heavily than the other three currencies, such that they currently provide stronger valuation signals. Correspondingly, our currency strategy reflects our thematic analysis in addition to the valuation opportunities—we have significant overweight exposure to the Indian and Indonesian currencies in portfolios, but have so far set aside the (smaller) positive valuation signals coming from the Brazilian real, South African rand, and Turkish lira.

Looking ahead, we believe our investment philosophy and process is well equipped to navigate a forward-looking environment where market (equity and fixed income) opportunities are generally diminished and currency opportunities are enhanced, and that we have developed the appropriate tools to gain insight and understanding in environments where geopolitical influences are significant and macro-thematic forces cut across the investment landscape. We remain vigilant in our assessment of new relevant information and in capturing future investment opportunities in a timely manner—balancing the relationship between risk taken and compensation expected.

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222 West Adams Street
Chicago, Illinois 60606
+1 312 236 1600