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UNCORRELATED HEDGE FUNDS SOLVING INVESTOR QUANDARY: WHAT TO DO IF EQUITIES LOOK FAIRLY VALUED AND BONDS LOOK RICH

We believe there is a serious investor quandary globally. Towers Watson recently highlighted this issue when it lowered its recommendation on intermediate term government bonds to "Highly Unattractive" due to the low risk premium over cash and has downgraded equities to "Neutral" based upon the recent rally.[i] This presents a problem: most investors are likely over-allocated to equities but they have trouble justifying a shift to government bonds.

1. At Badon Hill, we feel that the right recommendation for some of our accounts is to shift some of their equity/bond allocation to uncorrelated hedge fund strategies.
   a. As a result, our average allocation to uncorrelated hedge funds is currently 35.5%.

2. We view low correlation, not low volatility, as the key metric for hedge fund selection.
   a. Low volatility, while desirable, also tends to breed low expected returns.
   b. We feel that it is not always necessary to sacrifice expected return in order to lower portfolio risk if the fund in question is truly uncorrelated.

3. IMPORTANT: AVOID CORRELATION SPIKE. The key to the selection process is finding uncorrelated funds that *remain uncorrelated* during times of financial stress.
   a. In 2008, many funds that had exhibited low correlation with equities in normalized periods suddenly and tragically exhibited a high correlation to equities.
   b. A simple analytical tool is a live 2008 track record showing low correlation during the crisis (particularly October 2008).
   c. If a fund performed poorly in 2008, they should have a material and credible reason why that performance will not be repeated (note: we do not view "we use less leverage now" as a strong response).
   d. Similarly, if the fund did not have live operations in 2008, they should have an intuitive and realistic reason why they would not have remained uncorrelated in 2008.

4. Although there are always some funds of interest in any hedge fund style, we feel that the styles with the most fertile hunting grounds in this regard are:
   a. Global Macro
   b. CTA
   c. Credit Long/Short (assuming they are sufficiently short)
   d. Volatility

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[i] Towers Watson Investment "Towers Watson Downgrades Global Sovereign Bonds to 'Highly Unattractive'", *Press Release,* 1 MAR 2012 http://www.towerswatson.com/press/6524