FOCAL POINT

ClearArc CAPITAL®

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Dare to be Different
Alternative Investing with Strategic Income Plus

Mitchell L. Stapley, CFA
Chief Investment Officer

Peter M. Kwiatkowski, CFA
Director,
Growth & Income Strategies

John L. Cassady III, CFA
Director, Fixed Income

David L. Withrow, CFA
President

Many of our heroes in the movies through the years have been the daring ones, the risk-takers, the characters who marched to the beat of a different drum. From James Dean and Marlon Brando, to the modern day Indiana Jones and Jack Sparrow, those who have "dared to be different" have become some of our biggest stars.

What does "dare to be different" mean in the investing world? In our everyday lives, we know that stepping away from the crowd can result in benefits, but that there are also risks. Someone who chooses to espouse an opinion away from the consensus may be praised or criticized for their stance— sometimes both at the same time. As a result, investors of all types have historically been shy to move away from the herd of Wall Street. We see this changing.

There has been a lot of attention in the media concerning investors seeking alternatives to "traditional" investments over the last several years. Large pension funds, endowments, and other investors are increasing allocations to hedge funds, and funds that invest in private equity, commodities, real estate, oil and gas pipelines, and other similar investments. Many so-called alternatives do not provide the benefits they claim, and offer pitfalls to the unwary. **At ClearArc Capital, we believe our Strategic Income Plus (SIP) strategy provides access to the desirable facets of an alternative strategy without sharing many of the same risks.** The Strategic Income strategy also offers an attractive yield and a portfolio that is fixed income-based to promote stability.

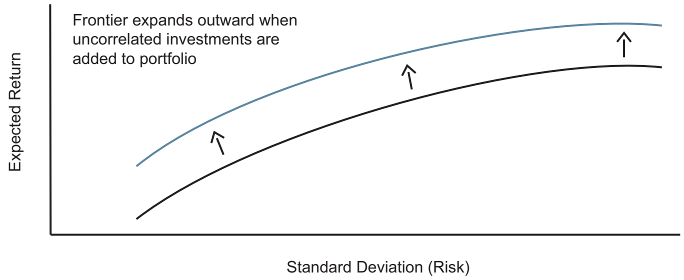
Let's explore the reasoning behind the quest for alternatives, risks that can be encountered along the way, and why Strategic Income Plus is worth considering as a timely and appropriate long-term alternative strategy.

Why do investors seek alternative investments?

Correlation benefits of alternative strategies – real or imagined?

One of the primary reasons investors seek alternative investments is that they do not correlate well with their other investments. Why is this a desirable attribute? The benefits of finding uncorrelated investments were most famously put forth by Harry Markowitz and his Capital Asset Pricing Model (CAPM) in the 1950s, along with the idea of an efficient frontier (Exhibit 1). An efficient frontier incorporates the idea that there are infinite combinations of investments within their complete market. However, only some of these are "efficient," meaning they offer the highest rate of return possible for a given level of risk (or lowest level of risk) for a given level of return. When constructing a portfolio, an investor should choose the most efficient combination of investments that gives them the risk/return combination they desire. Because higher long-term return means a higher risk level in a normally functioning market, the efficient frontier slopes upward. In other words, as you move up in return, you are also seeing a higher level of risk. Some investors can tolerate a greater level of risk, and will be positioned towards the upper right part of the frontier – those investors that are more conservative would be near the bottom left. But the point is, no matter your risk tolerance level, you want to be on or as close as you can get to the efficient frontier.

Exhibit 1
Sample Efficient Frontier



Source: ClearArc Capital. For illustrative purposes only, not indicative of a ClearArc Capital strategy.

So where does the correlation benefit come from?

To be considered a true alternative, a low correlation to both stocks and bonds is desired.

Each investor has a theoretical efficient frontier that would include the investment categories they are comfortable owning. But, if these investments all behave the same, there is no incremental benefit to adding a new investment. The benefit comes from adding securities that do not correlate well with other investments in the portfolio—hence, improved diversification of risk. Efficient portfolio management involves the mingling of assets that: a) move in different directions over time, b) are unrelated to each other, and c) help to smooth out the return experience.

Adding uncorrelated investments allows the efficient frontier to expand outward, giving an investor a better return for a given level of risk. This potentially magical outcome is why the search is on for investments that are not correlated to the standard stock/bond/cash allocations. Stocks historically are not correlated to bonds, but almost all investors can add exposure in those areas. To be considered a true alternative, a low correlation to both stocks and bonds is desired.

A unique differentiator for the Strategic Income Plus strategy, compared to our competitors in the strategic income space, is that we do not heavily utilize high yield and emerging market debt. While these two sectors can provide high income, they generally have a higher correlation to equities. We have access to these sectors, but utilize them to a much lesser extent. In contrast, our use of the preferred asset class allows us access to an area where we consistently find inefficiencies, value opportunities, and a yield advantage – all with an added benefit of reduced correlations. Further, many non-traditional strategies focus on providing a specific spread return to LIBOR; whereas the foundation of our predominantly high quality strategy is to provide a spread to the Bloomberg Barclays U.S. Aggregate Index.

Exhibit 2

Correlation Matrix of Industry Investment Categories, January 2001 to March 2018

Correlation Table

	1	2	3	4	5	6	7
1.) Strategic Income Plus	1.00						
2.) ICE BofAML Preferred Stock Fixed Rate	0.89	1.00					
3.) ICE BofAML Preferred Stock Hybrid Securities	0.83	0.98	1.00				
4.) ICE BofAML US High Yield Master II	0.67	0.44	0.36	1.00			
5.) ICE BofAML Global High Yield & Emerging Markets Plus	0.68	0.43	0.35	0.95	1.00		
6.) Bloomberg Barclays U.S. Aggregate	**0.42**	0.29	0.27	0.20	0.29	1.00	
7.) S&P 500®	**0.47**	**0.36**	**0.31**	**0.67**	**0.68**	-0.11	1.00

Source: eVestment Analytics (1/1/01 to 3/31/2018).

■ **Strategic Income Plus** *has a relatively low correlation to both stocks and bonds as defined by the S&P 500® and Bloomberg Barclays U.S. Aggregate Indexes respectively.*

■ **High yield and emerging markets** *have higher correlations to stocks than preferreds*

Most alternative strategies profess to have a correlation advantage, but surprisingly, many have high correlations to either stocks or bonds. The ClearArc Capital Strategic Income Plus strategy has a 0.47 correlation to the S&P 500® Index and a relatively low correlation (0.42) to bonds (Bloomberg Barclays U.S. Aggregate) as well.

Land of Opportunity

Well executed and managed stock and bond strategies are very important to a diversified portfolio. It is no secret, however, that these well-established strategies are very competitive, with a lot of assets invested in these areas. New ideas are more difficult to come by.

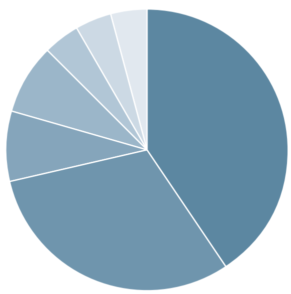
Alternative strategies are sought after because they find value in areas of the market that may not be as picked over and where there is more potential to find value. This allows a given manager more opportunities to discover alpha, or excess returns relative to the benchmark.

The Strategic Income Plus strategy is able to take advantage of a broader array of assets than traditional products. Exhibit 3 shows the core allocation of the Strategic Income Plus portfolio: bonds, preferred stock, convertibles, equities, and Real Estate Investment Trusts (REITs). Within those large areas we can invest virtually anywhere—international, mortgages, corporate bonds, and so forth. This allows us to move tactically and efficiently between asset classes. In addition, we have the flexibility to utilize derivatives and currency to manage tail risk or seek efficient exposures. While our broad mix in the ranges shown has served us well over time, the flexibility within that mix has been important. On the Strategic Income Plus team we have a deep bench of professionals who perform ongoing analysis into every area in which we invest.

Exhibit 3
Investment Process

Strategic Income Plus Target Allocation

Bonds	40-60%
Preferreds	30-50%
High Yield Debt	0-20%
Emerging Market Exposure	0-20%
Convertibles	0-10%
Equity REITs	0-10%
Equities	0-10%



Typical Bond Sectors	Typical Preferred Sectors
Corporates	Hybrid
Mortgages	Senior Bond Equivalent
Treasury & Agency	QDI eligible only
ABS	DRD/QDI Eligible
CMBS	REITs
Sovereign	Trust
Municipals	Convertibles

Source: ClearArc Capital. For illustrative purposes only, not indicative of a ClearArc Capital strategy.

What "Off-Benchmark" Means

Recently, there has been a lot of debate about benchmarks. Holding a manager accountable to outperform a particular benchmark has the advantages of being measurable, definable, and objective. However, in alternative products, short-term focus on performance against a benchmark can be harmful. Alternative managers, almost by definition, must be allowed to step "outside the box" with their investment ideas. This goes back to the flexibility discussed in the previous section.

In fact, we would go as far to say that being exclusively locked into a benchmark is a riskier strategy than having exposure to "off-benchmark" investments. Without "off-benchmark" exposure, you will be back to the first issue we discussed—too correlated to everything else in the portfolio.

While hedge funds and others that profess to be alternative strategies do have some unique approaches, today many of these products are now measured and managed versus a benchmark. Additionally, there are so many managers using the same approach that alpha is harder and harder to generate, given all the assets moving to hedge funds and the less liquid areas in which they play. In some cases, it may be easier to stick with plain, long-only stock or bond strategies.

We hold the Strategic Income Plus strategy as a better alternative. While it uses well-known asset classes, the unique mix has allowed it to behave like an alternative strategy should. The strategy's targeted mix and flexibility within that mix, have produced low correlations to traditional asset classes over long periods of time.

Liquidity, Transparency, and Leverage

There are three potential problems with alternatives that we feel require further discussion—liquidity, transparency, and leverage. Let's spend a minute on each one:

Liquidity: According to the financial dictionary, liquidity is "the degree to which assets of a company or an investment can easily be sold or converted into cash." This translates directly into the ability of an investor to withdraw cash when needed. Hedge funds are well known for turning into "roach motels" at the worst possible time—when the markets are having difficulties.[1] You can get in all too easily, but you can't get out. Other alternative strategies that may not be hedge funds by definition, can share the same problem. While any portfolio can potentially suffer liquidity problems if market conditions are bad enough, the Strategic Income Plus portfolio is managed to provide a much greater degree of liquidity than its alternative peers.

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Transparency: In most alternative strategies, transparency is at a minimum. Hedge funds often organize offshore to avoid regulations and reporting requirements, as well as for other reasons. Investors are unaware of how concentrated the portfolio is in any one area or security, and even more importantly, where those securities are being priced. Many hedge funds and other alternatives are often referred to as a "black box" where a model, unintelligible to anyone but the managers themselves, decides the direction of the portfolio. In addition, there have been recent instances where the manager was pricing securities in the portfolio much higher than where they could reasonably be sold in the market, thus overstating performance of the portfolio. While we do respect the need for managers to protect proprietary trading programs and the like, we also feel investors deserve as much clarity or transparency as can be provided to them.

Leverage: Leverage is usually defined as a certain amount of assets being controlled by a smaller amount of assets by borrowing the difference. Many alternative strategies employ leverage as a central tenet, and this can certainly enhance returns when things are going well. Leverage becomes a big problem, though, when market conditions turn ugly and borrowing facilities dry up. If the portfolio can no longer borrow (or the terms become onerous enough), it must sell assets—usually in an unfavorable pricing environment. Or, securities pledged as collateral for borrowings can decline in value, sparking margin calls and the unfortunate selling into a down market. The Strategic Income Plus portfolio does not use leverage as a central tenet of the strategy—it is only used in targeted situations and closely monitored.

Fees

Hedge funds are the alternative strategy best known for the high fees they charge their clients even though these fees have declined recently. The more recent standard has been 1.4% of assets plus 17% of profits over a certain return hurdle.[2] When you add this feature to some of the points discussed above, a manager would have to generate impressive returns to make it worth investing. And of course, by looking at the fee structure, it is clear a manager has plenty of incentive to "swing for the fences" in baseball parlance and go for big returns. This, combined with the previous discussion points, has led to performance much different than expected in many cases.

The Strategic Income Plus strategy has displayed results like an alternative strategy, but the fee structure is much more reasonable. Because of this, there is no urgent need to swing for the fences every year. We seek solid long-term results.

[1] *"When Hedge Funds Bar the Door," WSJ A1, 2 July 2008, Vol. CCLII no.2*

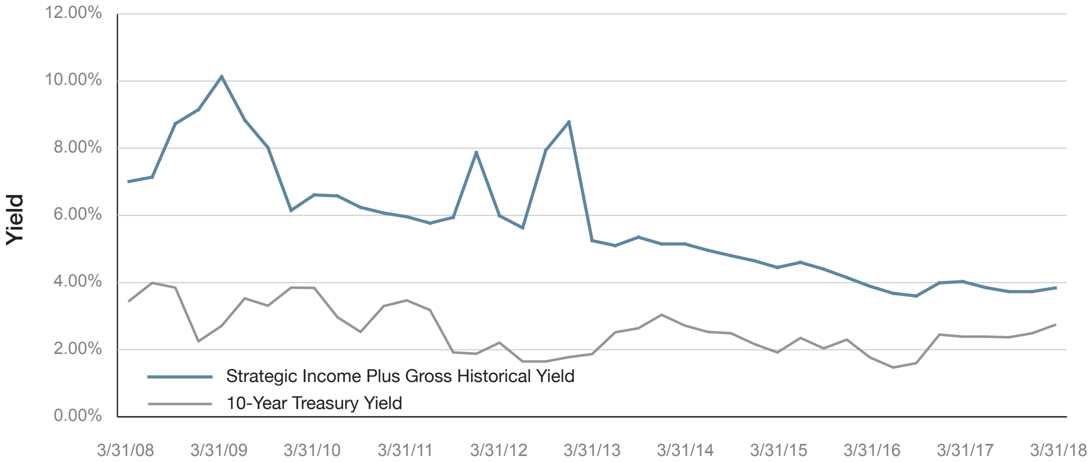
[2] *http://www.economist.com/news/finance-and-economics/21595942-cost-investing-alternative-assets-fallingslowly-down-14-and-17*

Yield

The Strategic Income Plus strategy has a history of generating a yield higher than the 10-year Treasury Note, with minimal use of leverage. Yield is rarely a consideration for other alternative strategies, but when it is a focus, investment managers usually insert the use of leverage to increase the yield. Potential clients with a need for high and stable income should consider the Strategic Income Plus strategy as an addition to the portfolio (Exhibit 4).

Investors will likely enjoy lower-than-historic returns from the capital markets.

Exhibit 4
Yield Chart, March 2008 – March 2018



The yield chart above represents yield gross of fees for a representative account in the Strategic Income Plus strategy for periods ending 12/31/2008 through present. Institutional separate account clients will experience different results. The fund's gross yield data represents the distribution rate at calendar year end, grossed up for expenses, relative to capital values. Specific institutional client fees, up to ClearArc Capital's maximum fee of 0.45%, will cause the yield to be lower than what is displayed. Monthly or quarterly income allocations for other account types and other yield calculations may produce different results including increased variability. The information presented is for illustrative purposes only. Clients may experience different results from the figures represented in the chart depending on a variety of factors, including account fees, account size, cash flows, client specific investment opportunities and restrictions, and the methods used in calculating yield. The yield for the strategy represents yield to effective maturity, which encompasses both yield to maturity and yield to call as appropriate based on a representative account. Treasury yield data represents yield to maturity. This illustration does not reflect the Strategic Income's yield against its benchmark, the Bloomberg Barclays Aggregate U.S. Index. Source: Strategic Income Plus data from ClearArc Capital, dividend data used from Thompson, 10-Year Treasury data from the U.S. Department of the Treasury (www.treasury.gov).

Let's summarize how the Strategic Income Plus strategy stacks up versus other alternative strategies (Exhibit 5).

Exhibit 5
Strategic Income Plus versus Alternative Strategies

	Strategic Income Plus	Other Alternatives
Correlation	Low correlation to stocks/bonds	Higher correlation to stocks
Benchmark	True off-benchmark exposure	Many now tend to have specific benchmarks
Liquidity	Higher degree of liquidity; limited restrictions on withdrawals	Potential restrictions on withdrawals; tend to invest in less liquid securities
Transparency	Highly transparent; securities typically market priced; regulated	Tend to be unregulated; pricing mechanisms not clear; portfolio securities may be undisclosed
Leverage	Rarely used	Used (usually heavily) in many strategies
Fees	Between fixed income & equity pricing	Tend to be highest in industry
Focus	Long-term	Depends on fee structure; can be focused on generating outsized returns in current year
Yield	Historically higher than Bloomberg Barclays U.S. Aggregate Index and 10-year Treasury	Not usually a consideration

Summary

As we look beyond today's market and consider things to come, one thought remains: investors will likely enjoy lower-than-historic returns from the capital markets. Common sense suggests that we need to lower our expectations. Moreover, this condition may lead plan sponsors, consultants, and other fiduciaries away from traditional styles (the boxes) and toward strategies that are off-benchmark, off-grid, and unique. The future requirements may likely include those investment strategies that provide consistent and valuable "alpha" in an absolute sense, or those strategies that improve overall or efficiency of risk (diversification), or both.

At ClearArc Capital, our portfolio concept called "Strategic Income Plus" is an example of where the future is heading and yet we have managed this strategy successfully for many years. Time-tested over a host of market cycles, the concept involves a variety of asset types that exhibit a high and stable yield character. The result of this focus, combined with the flexibility to invest virtually anywhere within our broad, income producing asset mix, is a unique investment opportunity meant to complement more traditional portfolios. In closing, we believe that our "beyond the traditional" thinking contributes to our clients' success - now and in the future.

For additional information on ClearArc Capital or its strategies, please email ContactUs@ClearArcCapital.com or visit www.ClearArcCapital.com.

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