

# SKYBRIDGE VIEWS

December 2014 – Webcast Transcription (View full videos at [www.skybridgecapital.com/insights/](http://www.skybridgecapital.com/insights/))

## 1. Hedge Fund Industry: What is your view on hedge fund performance in 2014?

**Troy Gayeski, Partner & Senior Portfolio Manager, SkyBridge Capital:** Better hedge funds have done relatively well versus all asset classes the last seven years. It's true that the broader indices have struggled, but those that have a firm view on themes, manager selection and evolving their portfolio have actually done, on a relative basis, fairly well. So, the premise that all hedge funds have struggled is clearly not accurate to start with. If you look forward, however, though over the next five years – we are fairly convinced that over the next five years every asset class will be more challenging than the last five. Since the credit crisis, equities have had a meteoric rise, the Fed's Quantitative Easing policies have at least had something to do with that. I think there's very few that would have expected such a strong performance from not only equities, but bonds, but that's what's happened. Now, if you look forward, primarily because risk premia were compressed, valuations are more stretched and QE is ending. We think all assets, whether it's equities or bonds, will have lower returns with higher risk. Now hedge funds should have similar to marginally lower returns, but they should not suffer nearly as much from the end of QE. Not only because their strategies are not dependent upon equity appreciation, but also because they can short and shorting during QE has been very challenging. Furthermore, the bad news for all investors right now is that fact -- that the opportunities aren't as great as they were say at the end of 2008 or the end of 2011. The good news however, is due to the disintermediation of the banking system, which is basically a fancy way of saying the regulators and the politicians have kicked banks out of capital markets due to what happened in the crisis. Many hedge fund opportunities are far more lasting in time and far more significant. So if you look at mortgage backed securities, whether it's prepayment sensitive or credit sensitive, if you look at more complex high yield, if you look at European bank deleveraging, if you look at Basel III bank recapitalizations, even if you look at event driven equity, all of those strategies are benefiting on a secular basis from lack of prop desk competition and the fact that market makers don't have any balance sheets anymore. Furthermore, there are some strategies, like Basel III recapitalization, that only exist because of bank reform. So there is good news and bad news. The bad news is cyclically opportunities aren't as great today for any asset class as they were at the end of '08 or the end of '11, secularly, however, there are certain strategies that continue to benefit from this powerful secular force of bank disintermediation.

## 2. Hedge Fund Industry: Why invest in hedge funds?

**Robert Duggan, Partner & Portfolio Manager:** We like to point out to investors that all asset classes are very cyclical in nature, so hedge funds, if you look at hedge fund performance over the long term, you should expect hedge funds to generate somewhere in the mid to high single digits, at least that's what they have historically done. We think that going forward, given that we are in a low return environment for most

asset classes, returns in the mid single digits makes sense. So competitive with what we would expect from both equities and bonds over the long term makes a lot of sense to us. The second point is if you look at the volatility characteristics of hedge funds, they typically have a third to a half the volatility of the equity markets. So anytime you can add a position to your portfolio that has a positive return expectancy and is lower in volatility, you minimize the draw-downs during periods of stress. We like to point to that volatility aspect. Third, given that hedge funds tend to have lower betas and less correlation to both equities, credit and you can even point to other asset classes such as commodities, we think when you can add an exposure to your port that has low correlation, positive return expectancy, as well as low volatility, you put yourself in a pretty good position to compound capital at attractive and competitive levels of return over the long term. So we think hedge funds going forward make a lot of sense in the portfolio given how equities and bonds have traded over the last several years.

### **3. Hedge Fund Industry: How will Calpers' decision to stop hedge fund investing impact the industry?**

**Ray Nolte, Co-Managing Partner & Chief Investment Officer:** We get a lot of questions ever since Calpers came out and said they would be exiting their hedge fund program and what ramifications that would have for other investors. Obviously they are always viewed as a thought leader in the industry but I think when the CIO came out and really discussed what was driving that, it really did make a lot of sense. You look at a fund the size of Calpers, north of \$300 billion, you look at the amount of assets they allocated in hedge funds, about \$3.5 billion, not quite 1.5 percent of their overall book, and they made a conclusion that for it to be meaningful and serve a purpose in the portfolio it would have to be significantly higher than that. You can throw out, just to keep the numbers round numbers, a 10 percent allocation to hedge fund strategies, which would be a \$30 billion overall allocation and I think they concluded that would be just too large – and that would in fact make them one of the largest even fund of funds operators if they ran a portfolio of that magnitude. So 1.5 percent based on the staff and the resources they needed to allocate to it and the impact on the portfolio being de minimis, I think they made a call that was appropriate for them. I think they were also very quick to the point out that the portfolio they had had achieved largely the objectives that they wanted it to achieve in terms of dampening volatility, dampening risk, protecting the portfolio in drawdown periods. I think the performance overall of their book was consistent with the performance objectives of the fund. It was really a scaling and a sizing issue for them.

### **4. Macroeconomic Outlook: What are your views on the current state of the US economy?**

**Troy Gayeski, Partner & Senior Portfolio Manager, SkyBridge Capital:** So the US economy, again it is not Regan-esque, it's not Clinton-esque, it's not even Bush two-esque in terms of growth levels. However, and we know there are a lot of negative people out there, but the bottom line is that the US economy continues to get marginally better year over year. If you look through the bottom of the crisis through 2013, we averaged roughly 2 percent growth per year. This year it looks like we are going to hit around 2.5 percent, maybe higher depending how the 4th quarter turns out. That's not great, but it's progress. If you look at next year, given the strength of the private sector, not only job creation but very marginal increase in wages, which is not as good as we would like but is still very real. If you look at the debt levels of the average consumer, if you look at how lean and mean corporate America is, we think the

private sectors are in the best shape by far that they have been since the crisis, if not going back to the early two thousands, so the private sector is in good shape and if you look at the public sector, people forget that from 2009-2013, the public sector was a meaningful drag in the economy. Not only because the Federal government embraced the austerity in 2013, but states and municipalities who can't issue debt, they were firing people and cutting costs left and right. So next year is a year where the government should actually turn to a positive contributor as opposed to having no impact or being a drag. So we can see next year being 3 percent, which again isn't fantastic, but it is enough to keep the economic picture moving forward, it's enough to keep capital markets relatively stable. It's not enough to drive equities up another 50 to 100 percent from here, but it's one of the principal reasons we think even though gains will be more muted, the current bull market is going to continue.

#### **5. Macroeconomic Outlook: Will the results of the 2014 mid-term elections have any impact on markets?**

**Ray Nolte, Co-Managing Partner & Chief Investment Officer:** We were leading up to the elections and that was one of the risk factors that contributed to some of the de-risking that we did back in Q2 with some of the uncertainty around that. I think that the conventional wisdom was the Republicans would pick up seats. Very high probability they were going to take control of the Senate, now that they have accomplished that, I think it's going to be the ball back in their court to see what they can do with that. I think the initial reactions of the market will be a positive reaction. But I think for that to really have sustainable power, we now need to see the President work well with the Congress to address some of the real fund problems that exist whether that's around tax policy, especially corporate tax policy, cash captured or held offshore, see if we can get some of that back in here to really help the US economy more. Immigration policy and reform and I think we have a very interesting position now where you can get some compromise, we can get the parties working together. So we're hopeful that they will do that and if so I think that will be beneficial to the broader markets but also to many of the hedge fund strategies, especially the event driven equity strategies which would be very positively supported by good economic policy coming out of Washington.

#### **6. Macroeconomic Outlook: What is your view on the current state of Fed policy?**

**Ray Nolte, Co-Managing Partner & Chief Investment Officer:** I think our view in terms of Fed policy, and we've just seen October pass and the Fed has ended the QE program, which I think everyone was anticipating. I think now we are going to be in a prolonged period of time of low rates. There is a lot of talk of lower longer and I think we are probably in the camp of lower longer that the Fed will not move aggressively to raise rates. Our thought right now is it is probably second quarter of '15 before you start to see any potential move up in the fund's rate and I think one needs to remember the Fed has a lot of other tools in their toolbox that they can utilize beyond just increasing rates. They now have a \$4 trillion balance sheet. They can choose to either rollover maturities, they can reinvest effectively the principle in interest. They can let that wind down. So there's a lot of mechanisms the Fed has to control policy going forward.

## **7. Portfolio Positioning: To what themes is the portfolio currently allocated?**

**Robert Duggan, Partner & Portfolio Manager:** The key themes in our portfolio today, I'd say from a top level, are relatively unchanged from where we came into the year. It's really just the makeup of those underlying exposures, so from a higher level we still continue to like the event driven equity space, we continue to see managers being able to take advantage of the robust corporate activity that's been occurring in the markets. Corporate balance sheets, particularly in the US, remain very strong and we continue to see very accretive deals being done which is a positive and provides significant opportunity for those types of managers. So event driven equity/event driven multi-strategy managers continue to be our favorite exposure. We are balancing out those exposures because those do have more beta to the equity markets. We are balancing those with underlying exposures at a lower beta and more defensive in nature and these tend to be in the mortgage backed securities market where we continue to play the prepayment sensitive mortgage theme, which has been a very profitable exposure for us. Additionally we continue to have exposure to the credit sensitive mortgage theme and other structured credit exposures.

## **8. Portfolio Positioning: What are your plans to bring risk back up in the portfolio?**

**Ray Nolte, Co-Managing Partner & Chief Investment Officer:** After the correction that we saw in October, and the real shake out, and I think you can debate, was it a true correction or not? The S&P was down about 9.8, the broader indexes such as the Russell 2000 were down significantly more than that, but I think the price action was indicative of a true shakeout and I think that reset the market and we are looking forward to gradually taking risk back up in the 4th quarter. I think it will be a gradual increase but nothing material.

## **9. Portfolio Positioning: Explain the Basel III strategy.**

**Troy Gayeski, Partner & Senior Portfolio Manager, SkyBridge Capital:** We have 8 percent right now in the Basel III bank recapitalization theme and basically the whole premise behind that theme is that as regulators continue to pressure banks to recapitalize, they have to retire junior debt securities, typically at a premium to where they trade. This is very accretive to the banks, regulators like it a lot. It is a way to put the scars of the crisis even further behind the global banking system. The too-big-too-fail banks in the US are done with this, the Bank of Americas or the Morgan Stanleys of the world, they have done it long ago, however the regional banks in the US coupled with some of the too-big-too-fail banks in the UK or continental Europe have a lot of wood to chop going forward. So that's a multiple year investment theme. We might take it up to 10 percent going into next year; we haven't decided yet. We wish there were more managers that had the expertise to execute on it but there are very few that do in a meaningful way. So that will probably continue to be our fourth largest theme for quite some time.

## **10. Portfolio Positioning: Are you considering allocating to any new themes?**

**Robert Duggan, Partner & Portfolio Manager:** Right now we don't see any significant new themes that we are looking to add to the portfolio. As you know, we are a very opportunity-set driven manager, so therefore if we do see some sort of dislocation in the markets across any asset class that's likely to lead us to a potential new opportunity set or a new theme to express in our portfolios. However, from where we sit

today, we think that a balanced portfolio between strategies that can capture some of the upside in the continued equity bull run, particularly within the event equity space, taking advantage of the corporate activity environment that we are currently in. Balancing those exposures with lower beta, more defensive strategies that we think can grind out returns in the 6-10 or 8-12 percent range, with relatively low volatility and low beta versus other parts of our portfolio.

#### **11. Portfolio Positioning: How much turnover was there in the portfolio in 2014?**

**Troy Gayeski, Partner & Senior Portfolio Manager, SkyBridge Capital:** Over the past quarter, there has been roughly, it depends on when you start, because the majority of the turnover began at the end of May and concluded at the end of July. So over that time horizon we turned over roughly 35 percent of the portfolio and for the year it was roughly 44 through that 7 month window. Now if you roll the clock further it is over 70 percent, because what we did at the end of October was ramp risk back up so we did a variety of swaps for underlying managers from kind of their low octane products back to their high octane products. It's been a very active year for this year.

#### **Important Information**

All investments are subject to risk, including the possible loss of the money you invest. We recommend that you consult a professional advisor about your individual situation.

For more information about SkyBridge Multi-Adviser Hedge Fund Portfolios – Series G (“Series G”), call 1-888-759-2730, to obtain a prospectus. Investment objectives, risks, charges, expenses, and other important information about a fund are contained in the prospectus; read and consider it carefully before investing.