Topic Paper
March 13, 2015

True Diversifiers: The Case for Multi-Strategy, Multi-Manager Hedge Strategies

PERSPECTIVE FROM K2 ADVISORS

For Financial Professional Use Only. Not For Public Distribution.

Not FDIC Insured | May Lose Value | No Bank Guarantee

Today's financial markets present a unique set of challenges. Caught between the anxiety induced by sharp declines during the financial crisis and uncertainty about the future direction of equity markets, many investors are searching for a path forward. Further complicating the situation is a fixed-income conundrum: limited income potential in a low interest-rate environment and the threat of capital losses induced by potentially rising rates as the US Federal Reserve reverses its easy-money policies.

Multi-strategy, multi-manager (multi-strategy/manager) hedge strategies may be a valuable diversification tool for the stock and bond portfolio. In our view, this type of alternative investment has demonstrated a compelling risk/return track record with the potential to help reduce anxiety-inducing volatility. Such characteristics may be useful for many investor portfolios, including those near or already in retirement. Individuals heading into retirement have a shorter investment horizon and less time to make up for lost savings with larger contributions. Meanwhile those in retirement may need to draw money from savings, which potentially shrinks the amount of invested assets they have to help recoup losses whenever financial markets improve.

Multi-Strategy, Multi-Manager Hedge Strategies: A Primer

What Is an Alternative Investment?

Alternative investments cover a varied set of asset classes and strategies that go beyond traditional stocks and bonds. Alternative investment asset classes include real estate, real assets (e.g., commodities, infrastructure) and private equity, while alternative strategies primarily consists of hedge strategies. This paper focuses on hedge strategies as, in many cases, they may offer a high degree of investment flexibility through the utilization of various financial instruments and tactics, such as derivatives, options, futures/forwards, short selling and leverage (See Box). The added flexibility provided by hedge strategies enables investment managers to pursue maximum participation when their market expectations are positive and protection of capital when their views are negative. In our view, alternative mutual funds that offer hedge strategies may be an attractive addition to an investor's portfolio.

Why Alternative Investments Are Gaining Popularity in Retail Markets

Investor demand for alternative mutual funds and exchange traded funds (ETFs) has grown rapidly, more than tripling over the past five years, as illustrated in Chart 1. It is easy to understand why given the potential profile: added diversification and retail level accessibility. Investing via a mutual fund is more liquid (it may invest and redeem on a daily basis), has lower investment minimums and provides simpler tax reporting (the familiar 1099 form) than investing directly in an individual hedge fund; at the same time a mutual fund is subject to additional regulatory restrictions that limits its flexibility compared to privately offered hedge funds.

HEDGE STRATEGIES COMMONLY USED IN ALTERNATIVE MUTUAL FUNDS

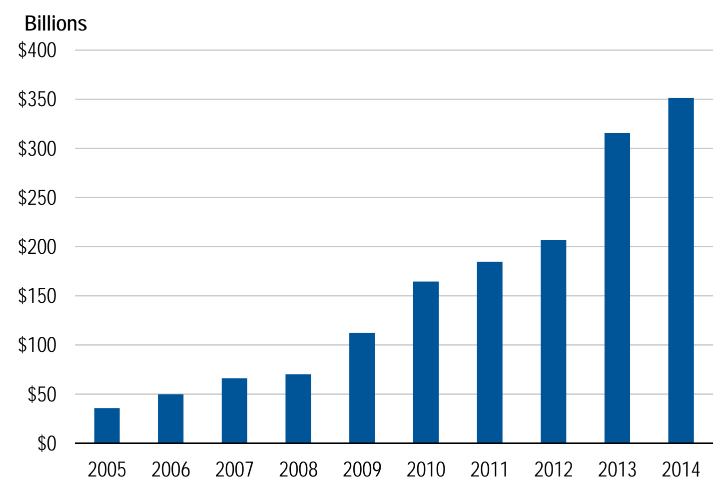
Event Driven: Based on corporate events, such as mergers, reorganizations, management changes

Global Macro: Focused on macro-economic driven opportunities across numerous markets and asset classes

Long-Short Equity: Seek to buy attractive companies and short sell weak companies; seeks to produce returns while helping reduce unintended or market risks

Relative Value: Look for perceived pricing inefficiencies between markets, companies, or within the capital structure of a specific company

Chart 1: Rapid Growth in Alternative Funds (US Mutual Funds and ETFs)
2005–2014



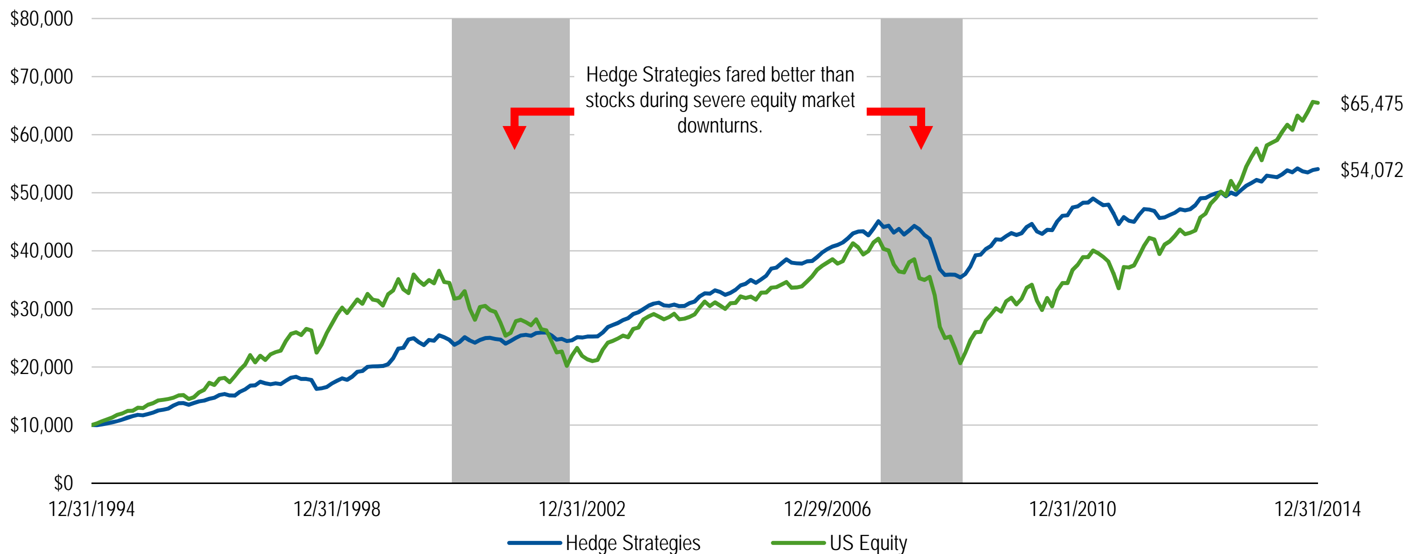
Source: Morningstar. Historical assets held in publically offered US alternative '40 Act mutual funds and ETFs.

How the Multi-Strategy/Manager Structure Works

A multi-strategy/manager portfolio consists of several distinct hedging strategies (the multi-strategy component) that are managed on a day-to-day basis by outside hedge fund managers (the multi-manager component). Each of these third-party managers specializes in one or more specific hedge strategies. The logic behind this approach is increased diversification, both across hedge strategies and within each strategy. Multiple hedging strategies are employed because our experience has shown us that each has distinct characteristics in different market

For Financial Professional Use Only. Not For Public Distribution.

Chart 2: Minimizing Negative Market Impact Has Provided Strong Long-Term Performance Historically
20-Year Period Ending December 31, 2014



Index	November 2000–September 2002	November 2007–February 2009
Hedge Strategies	0.92%	-21.42%
US Equity	-41.41%	-50.95%

For illustrative purposes only; not representative of any Franklin Templeton products' performance or portfolio composition. **Past performance is no guarantee of future results.** An index is unmanaged and one cannot invest directly in an index. Hedge Strategies represented by the HFRI Fund Weighted Composite Index. US Equity represented by S&P 500 Index. Source: FactSet, HFRI, S&P.

environments. Given the different characteristics of various hedging strategies, a multi-manager approach is intended to alter the risk/return dynamics through the use of highly experienced portfolio managers for each strategy.

Potential Investment Benefits of a Multi-Strategy/Manager Alternative Fund

The multi-strategy, multi-manager alternative fund has these notable potential benefits in the current market environment:

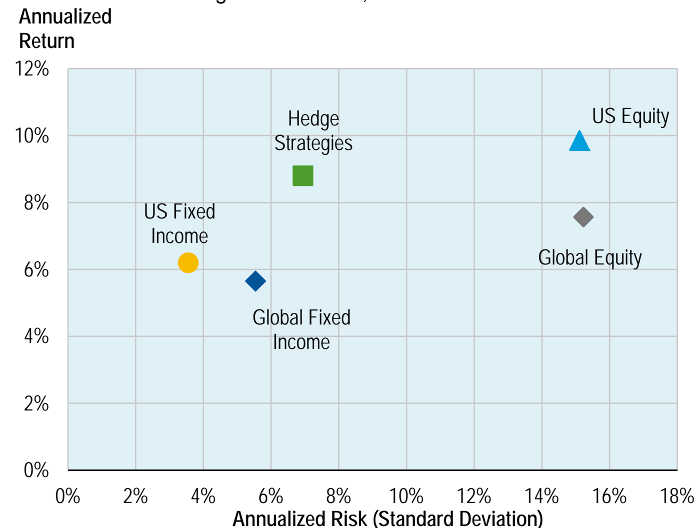
- Attractive risk/return characteristics
- Reduced downside risk in extreme market conditions
- Generally low portfolio correlation to traditional asset classes
- Enhanced portfolio diversification

Attractive Risk/Return Characteristics

Hedge strategies have historically provided attractive returns over the long term when compared to traditional asset classes. As Chart 2 shows, hedge strategies nearly kept pace with equities over a 20-year period—which included major swings in the equity markets—with an average annual return of 8.80% for hedge strategies vs. 9.85% for stocks. The comparable performance of hedge strategies during that period was largely driven by faring better during the dot-com bust in 2001–2002 and the financial crisis of 2008–2009. At the same time, hedge strategies performed relatively well during periods of equity strength.

Indeed, when measuring risk against returns, Chart 3 shows that hedge strategies have exhibited a level of risk more in line with fixed income and return comparable to equities.

Chart 3: Hedge Strategies Have Shown Equity-Like Returns with Bond-Like Risk
20-Year Period Ending December 31, 2014

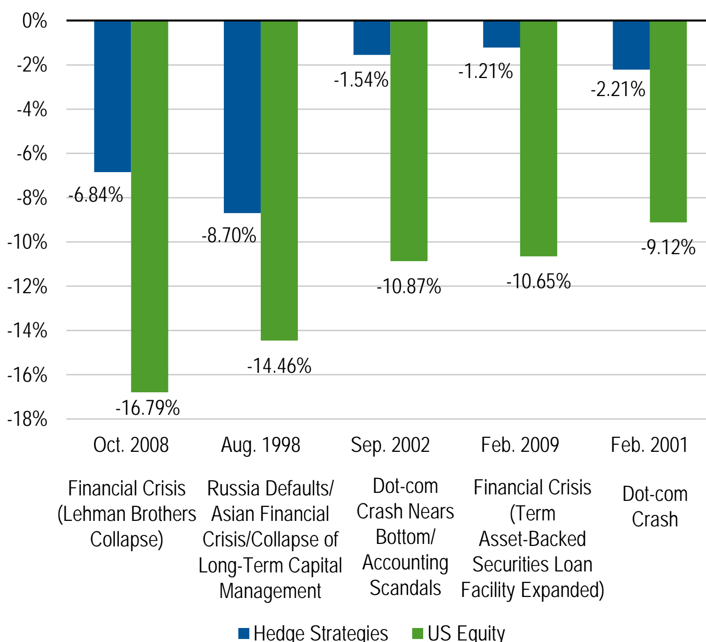


For illustrative purposes only; not representative of any Franklin Templeton products' performance or portfolio composition. **Past performance is no guarantee of future results.** An index is unmanaged and one cannot invest directly in an index. Hedge Strategies represented by the HFRI Fund Weighted Composite Index. US Equity represented by S&P 500 Index. Global Equity represented by the MSCI World Index. US Fixed Income represented by the Barclays U.S. Aggregate Index. Global Fixed Income represented by the Barclays Global Aggregate Index. Source: FactSet, HFRI, S&P, MSCI,[1] Barclays.

Reduced Downside Risk in Extreme Market Conditions

The ability of hedge strategies to help reduce downside risk was evident in the most extreme negative equity market conditions during the 20-year period ended December 31, 2014. Chart 4 shows that among the five worst one-month periods for US stock returns over the past 20 years hedge strategies fared comparatively well. In practical terms, periods of sharp equity market declines can be costly for an investor in terms of lost money and time to potentially recover, particularly in periods when correlations across various asset classes converge, such as the 2008–2009 financial crisis. Equities may not quickly regain losses after a sharp decline which is an increasingly important consideration for investors in or near retirement. Exposure to hedge strategies may help reduce the overall volatility in an investor's portfolio which could lessen the potential threat of having to rebuild and maintain retirement savings following equity market downturns.

Chart 4: Hedge Strategies Protected on the Downside in Extremely Negative Equity Markets
Five Worst One-Month Performances of the S&P 500 Index
December 31, 1994–December 31, 2014



For illustrative purposes only; not representative of any Franklin Templeton products' performance or portfolio composition. **Past performance is no guarantee of future results.** An index is unmanaged and one cannot invest directly in an index. Hedge Strategies represented by the HFRI Fund Weighted Composite Index. US Equity represented by the S&P 500 (TR) Index. Source: FactSet, HFRI, S&P.

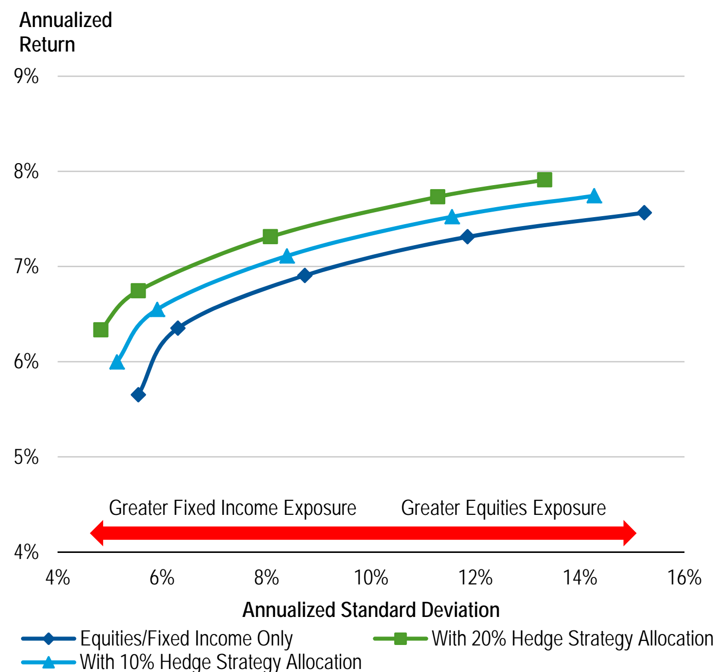
Generally Low Portfolio Correlation to Traditional Asset Classes

We believe hedge strategies may help to lower overall portfolio correlation—a measure of how closely investments move together—to stocks and bonds during periods of elevated market volatility. We've observed minimal correlation between hedge strategies and fixed income—both US and global—over the past 20 years; a period that covers multiple interest rate cycles and various macroeconomic events. While we have calculated comparatively higher correlations with US and global stocks, Chart 2 shows that a higher degree of correlation may not necessarily be uniform. Certain hedge strategies have historically followed stocks fairly well in good times, while providing a fair degree of downside protection.

Enhanced Portfolio Diversification

The benefits mentioned above combine to make hedge strategies a valuable complement to a typical stock/bond portfolio. An investor who diversifies by adding exposure to a multi-strategy/manager alternative fund may be able to further improve the overall risk/return profile of the portfolio, as shown in Chart 5. An allocation to hedge strategies may help reduce the overall volatility of the portfolio. This may be compelling for many investors, including those who remain sensitive to volatility following the financial crisis as well as individuals around retirement. Investors in or near retirement may still prefer the potential for equity-like return potential to achieve their financial goals but also desire reduced volatility. Plus, the threat of capital losses due to a normalization of long-term interest rates may lessen the general appeal of bonds.

Chart 5: Diversifying with Hedge Strategies May Benefit an Investor's Portfolio
20-Year Period Ending December 31, 2014

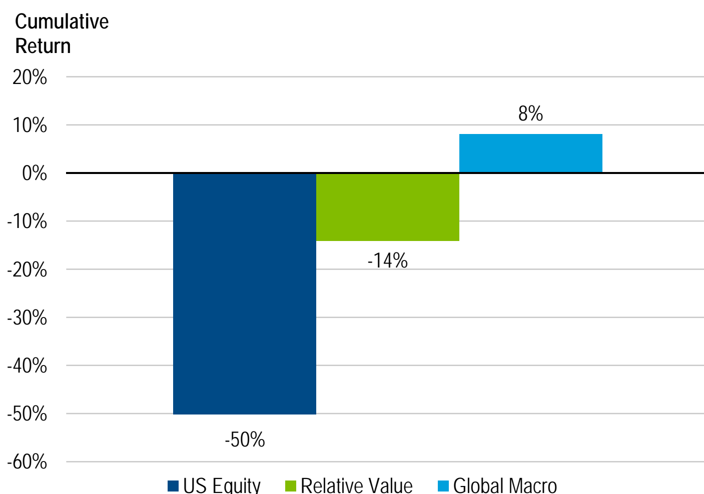


For illustrative purposes only; assumes monthly rebalancing; not representative of any Franklin Templeton products' portfolio composition or performance. **Past performance does not guarantee future results.** An index is unmanaged and one cannot invest directly in an index. For the *Equity/Fixed Income Only* portfolio, the initial allocation starts at 0% Equity (EQ)/100% Fixed Income (FI). Moving right along the frontier, the portfolios increase equity exposure with points representing 25%EQ/75%FI, 50%EQ/50%FI, 75%EQ/25%FI, and 100%EQ. As the hedge strategy allocations are added, EQ and FI allocations are reduced by equal amounts, respectively. Equity is represented by the MSCI World Index. Fixed Income is represented by the Barclays Global Aggregate Index. Hedge Strategies are represented by the HFRI Fund Weighted Composite Index. Source: FactSet, MSCI,[1] Barclays, HFRI.

The Importance of a Multi-Strategy Approach

A multi-strategy approach provides, in our view, a constructive level of diversification within a portfolio. Among the various types of hedge strategies, each may perform differently in a given market environment. For example, experience has shown us that Global Macro strategies are typically counter cyclical in performance, providing potential capital growth opportunities in declining equity markets. At the same time, Relative Value strategies are constructed with the purpose of reducing the impact of market direction on performance. Chart 6 illustrates that even during the financial crisis—when US equity markets plunged and correlations between stocks and bonds surged—Global Macro and Relative Value strategies held true to form.

Chart 6: Global Macro and Relative Value Hedge Strategies Fared Relatively Well During Financial Crisis
October 2007–February 2009



For illustrative purposes only; not representative of any Franklin Templeton products' performance or portfolio composition. **Past performance is no guarantee of future results.** An index is unmanaged and one cannot invest directly in an index. US Equity represented by S&P 500 (TR) Index. Relative Value represented by the HFRI Relative Value Index. Global Macro represented by the HFRI Macro Index. Source: FactSet, S&P, HFRI.

The Importance of a Multi-Manager Approach

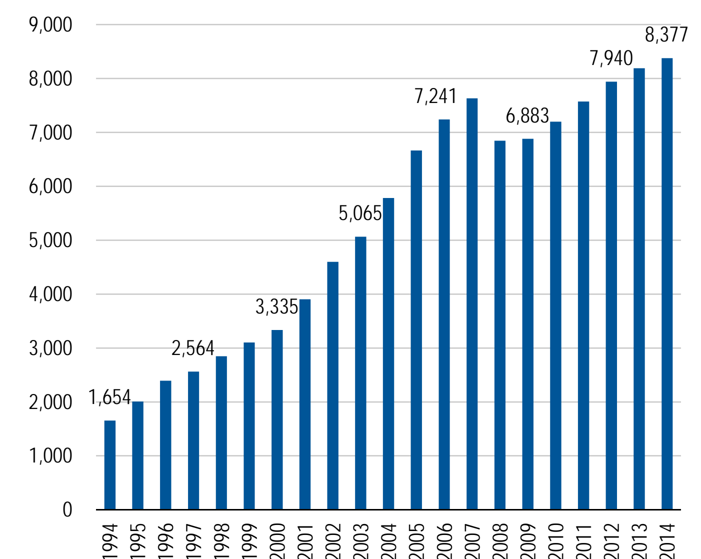
Among individual hedge funds over the past seven years, less than half outperformed the average return among all hedge funds in a given year, with 2011 the only exception.[2] Even harder has been the ability to generate positive returns during turbulent periods. In 2008 and 2011, when the average return among hedge funds was negative, only a quarter were able to generate positive returns.[2] Such results validate our view that seeking out managers within each strategy with the strongest track records over time increases the opportunity to achieve strong long-term performance. Further diversification through selecting multiple managers within each strategy may also help provide a measure of protection against manager-specific risks. Managers can have varying styles or approaches within the same hedge strategy, possessing expertise within a certain area (e.g., region, sector or financial instrument).

Building and Managing a Portfolio Requires the Right Expertise

The overall success of a multi-strategy, multi-manager alternative fund relies heavily on the investment team that builds and manages it. From the multi-strategy perspective, overall portfolio performance may be meaningfully impacted by the level of exposure to each strategy. If the investment team managing the portfolio has a keen understanding of financial markets and the characteristics of individual hedge strategies, the team may have a better ability to adjust exposures in ways that improve overall return potential and help reduce volatility.

From the multi-manager perspective, robust due diligence is necessary when selecting third-party portfolio managers. As Chart 7 shows, the universe of hedge funds has expanded five fold over the past 20 years. The rapid expansion in hedge funds places a greater importance on due diligence in order to have the necessary knowledge about outside managers and the people, procedures, investment practices and systems that they employ. While performing due diligence, it is especially critical to understand operational risks which includes system failures, weak oversight procedures, regulatory violations and inadequate risk monitoring. For example, strong performances over one or two years may be achieved by taking on unintended or underappreciated levels of risk, which could lead to a serious reversal in performance (or even closures, as occurred during the financial crisis) when market conditions change. It is vital in a multi-manager approach to select third-party managers who have track records of solid and consistent performance with appropriate levels of risk.

Chart 7: As Hedge Funds Proliferate, Finding the Best Gets Tougher and More Valuable
Estimated Number of Hedge Funds
1994–2014



Source: Hedge Fund Research, Inc. – www.hedgefundresearch.com

For Financial Professional Use Only. Not For Public Distribution.

Conclusion

Current equity and fixed income markets pose a unique set of challenges for investors made all the more complicated by lingering emotional scars inflicted by the financial crisis. The universe of alternative investments offers investors a potentially attractive diversification option, which has helped drive the rapid growth of this asset class. What's more, the increased ability to invest in alternatives through the mutual fund format has made it easier for investors to add this asset class to their portfolios. More specifically, we believe multi-strategy/manager alternative funds are a particularly compelling alternatives investment option. The hedge strategies employed by these funds have generally exhibited a solid risk/return profile, even in the most extreme market conditions. In our view, diversification into multi-strategy/manager alternative funds may be valuable for a wide range of investors, including those in or near retirement.

ABOUT FRANKLIN TEMPLETON ALTERNATIVE STRATEGIES AND K2 ADVISORS

Franklin Templeton's alternative capabilities include 130 dedicated investment professionals managing over US $49 billion in assets as of December 31, 2014. The group manages a suite of global specialized and alternative investment products, including hedge funds, real assets, private equity, debt, and multi-asset strategies and customized portfolios. Franklin Templeton utilizes a multi-boutique structure that allows each investment team to stay true to its style while our global platform provides a unique perspective on investing.

K2 Advisors is a part of Franklin Templeton, providing hedge fund solutions to investors across the globe. Established in 1994, K2 Advisors has differentiated itself within the hedge fund world by combining a rigorous analytical process and an insistence on holdings-based transparency. The approach allows K2 Advisors to understand each hedge fund manager intimately and build portfolios that best match client needs.

IMPORTANT LEGAL INFORMATION

This material is intended to be of general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice.

The views expressed are those of the investment manager and the comments, opinions and analyses are rendered as of the publication date and may change without notice. The information provided in this material is not intended as a complete analysis of every material fact regarding any country, region or market. **All investments involve risks, including possible loss of principal.**

Investment in hedge funds is a speculative investment, entails significant risk and should not be considered a complete investment program. An investment in hedge funds provides for only limited liquidity and is suitable only for persons who can afford to lose the entire amount of their investment. There can be no assurance that the investment strategies employed by hedge fund managers will be successful.

The identification of attractive investment opportunities is difficult and involves a significant degree of uncertainty. Returns generated from hedge fund strategies described in this presentation may not adequately compensate investors for the business and financial risks assumed. Investment in these types of hedge fund strategies is subject to those market risks common to entities investing in all types of securities, including market volatility. Also, certain trading techniques employed by hedge fund managers described in this presentation invest, such as leverage and hedging, may increase the adverse impact to which a hedge fund may be subject.

Hedge funds are not required to provide investors with periodic pricing or valuation and there is generally a lack of transparency as to the underlying assets. Investing in hedge funds may also involve tax consequences and a prospective investor should consult with a tax advisor before investing.

Data from third party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments opinions and analyses in the material is at the sole discretion of the user.

Products, services and information may not be available in all jurisdictions and are offered outside the U.S. by other FTI affiliates and/or their distributors as local laws and regulation permits. Please consult your own professional adviser for further information on availability of products and services in your jurisdiction.

Issued in the U.S. by Franklin Templeton Distributors, Inc., One Franklin Parkway, San Mateo, California 94403-1906, (800) DIAL BEN/342-5236, franklintempleton.com - Franklin Templeton Distributors, Inc. is the principal distributor of Franklin Templeton Investments' U.S. registered products, which are available only in jurisdictions where an offer or solicitation of such products is permitted under applicable laws and regulation.

For Financial Professional Use Only. Not For Public Distribution.

Australia: Issued by Franklin Templeton Investments Australia Limited (ABN 87 006 972 247) (Australian Financial Services License Holder No. 225328), Level 19, 101 Collins Street, Melbourne, Victoria, 3000. **Austria/Germany:** Issued by Franklin Templeton Investment Services GmbH, Mainzer Landstraße 16, D-60325 Frankfurt am Main, Germany. Authorized in Germany by IHK Frankfurt M., Reg. no. D-F-125-TMX1-08. **Canada:** Issued by Franklin Templeton Investments Corp., 5000 Yonge Street, Suite 900 Toronto, ON, M2N 0A7, Fax: (416) 364-1163, (800) 387-0830, www.franklintempleton.ca. **Dubai:** Issued by the branch of Franklin Templeton Investment Management Limited (FTIML) in Dubai. Gate, East Wing, Level 2, Dubai International Financial Centre, P.O. Box 506613, Dubai, U.A.E., Tel.: +9714-4284100 Fax:+9714-4284140. Authorized and regulated by the Dubai Financial Services Authority. **France:** Issued by Franklin Templeton France S.A., 20 rue de la Paix, 75002 Paris France. **Hong Kong:** Issued by Franklin Templeton Investments (Asia) Limited, 17/F, Chater House, 8 Connaught Road Central, Hong Kong. **Italy:** Issued by Franklin Templeton Italia Sim S.p.A., Corso Italia, 1 – Milan, 20122, Italy. **Japan:** Issued by Franklin Templeton Investments Japan Limited. **Korea:** Issued by Franklin Templeton Investment Trust Management Co., Ltd., 3rd fl., CCMM Building, 12 Youido-Dong, Youngdungpo-Gu, Seoul, Korea 150-968. **Luxembourg/Benelux:** Issued by Franklin Templeton International Services, S.à r.l. – Supervised by the *Commission de Surveillance du Secteur Financier* - 8A, rue Albert Borschette, L-1246 Luxembourg - Tel: +352-46 66 67-1 - Fax: +352-46 66 76. **Malaysia:** Issued by Franklin Templeton Asset Management (Malaysia) Sdn. Bhd. & Franklin Templeton GSC Asset Management Sdn. Bhd. **Nordic regions:** Issued by Franklin Templeton Investment Management Limited (FTIML), Swedish Branch, Blasieholmsgatan 5, Se-111 48 Stockholm, Sweden. FTIML is authorised and regulated in the United Kingdom by the Financial Conduct Authority and is authorised to conduct certain investment services in Denmark, Sweden, Norway & Finland. **Poland:** Issued by Franklin Templeton Investments Poland Sp. z o.o.; Rondo ONZ 1; 00-124 Warsaw. **Romania:** Issued by the Bucharest branch of Franklin Templeton Investment Management Limited, 78-80 Buzesti Street, Premium Point, 7th-8th Floor, 011017 Bucharest 1, Romania. Registered with CNVM under no. PJM05SSAM/400001/ 14.09.2009, and authorized and regulated in the UK by the Financial Conduct Authority. **Singapore:** Issued by Templeton Asset Management Ltd. Registration No. (UEN) 199205211E, 7 Temasek Boulevard, #38-03 Suntec Tower One, 038987, Singapore. **Spain:** Issued by the branch of Franklin Templeton Investment Management, Professional of the Financial Sector under the Supervision of CNMV, José Ortega y Gasset 29, Madrid. **South Africa:** Issued by Franklin Templeton Investments SA (PTY) Ltd which is an authorized Financial Services Provider. Tel: +27 (11) 341 2300 Fax: +27 (11) 341 2301. **Switzerland & Liechtenstein:** Issued by Franklin Templeton Switzerland Ltd, Stockerstrasse 38, CH-8002 Zurich. **UK:** Issued by Franklin Templeton Investment Management Limited (FTIML), registered office: Cannon Place, 78 Cannon Street, London, EC4N 6HL. Authorized and regulated in the United Kingdom by the Financial Conduct Authority. **Offshore Americas:** In the U.S., this publication is made available only to financial intermediaries by Templeton/Franklin Investment Services, 100 Fountain Parkway, St. Petersburg, Florida 33716. Tel: (800) 239-3894 (USA Toll-Free), (877) 389-0076 (Canada Toll-Free), and Fax: (727) 299-8736. Investments are not FDIC insured; may lose value; and are not bank guaranteed. Distribution outside the U.S. may be made by Templeton Global Advisors Limited or other sub-distributors, intermediaries, dealers or professional investors that have been engaged by Templeton Global Advisors Limited to distribute shares of Franklin Templeton funds in certain jurisdictions. This is not an offer to sell or a solicitation of an offer to purchase securities in any jurisdiction where it would be illegal to do so.

1. MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI.
2. Source: Morningstar, from January 2008 through December 2014.

See www.franklintempletondatasources.com for additional data provider information.

Please visit www.franklinresources.com to be directed to your local Franklin Templeton website.

For Financial Professional Use Only. Not For Public Distribution.

Copyright © 2015 Franklin Templeton Investments. All rights reserved.