AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

White Paper

Understanding Absolute Return **July 2013**

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We dislike the term ñalternative investments.ò We believe that investors are better served by thinking about investment opportunities across four different asset classes:

- Fixed income (bonds)
- Stocks (also called equities)
- Real assets
- Absolute return

These divisions are not bright lines in the sand, but instead general classifications that relate to a given investmentôs sensitivity to certain economic variables. For instance, high-quality fixed income does relatively well during recessions when interest rates fall whereas real assets do relatively well during periods of high inflation. Investments donôt always fit neatly into each bucket; high yield bonds, for instance, are a hybrid between stocks and fixed income ï they have interest rate exposure, but they are more driven by the underlying cash flows of the issuing company, aligning them with the economics of the stockholder.

These asset class distinctions are separate from investment vehicle distinctions. ñHedge fundsò and ñprivate equity fundsò arenôt asset classes, they are investment vehicles. A private equity fund can operate in the real estate sector, for example, aligning it more closely with real assets than with equities. Hedge funds can utilize a large variety of different investment strategies. Investors should be careful not to equate so-called alternative investments with particular investment vehicles; certain alternative strategies are available today in standard, regulated, liquid investment vehicles like mutual funds.

We believe that investors benefit from investment portfolios that are diversified across different asset classes. Ideally, over market cycles these asset classes will exhibit low to moderate correlations with one another. By including investments with similar expected returns but low to moderate correlations, portfolio returns can be increased while portfolio risk decreased; this is the ever rare ñfree lunch.ò It is a direct result of the mathematics ï asset classes that both move up over time but donôt move in lockstep offer the investor the opportunity to rebalance the portfolio by selling the high-priced asset and buying the low-priced asset, thereby improving portfolio results over time and lessening portfolio drawdowns. Our general view is that investors are over-diversified within asset classes but under-diversified across asset classes.

Accordingly, investors can benefit by adding real assets or absolute return vehicles to traditional stock-bond portfolios. Unfortunately, the allure of these assets has attracted a lot of overpriced, inefficient investment products to the market and they should never be seen as a panacea for investors. That being said, we do believe these asset classes can be very worthwhile for investors to consider, as long as they are treated with care and diligence.

The absolute return bucket includes investments that are expected to show little correlation with key economic variables such as inflation, interest rates and economic growth. The hope is that they provide positive economic returns over a variety of market cycles. While this sounds great, it is understandably difficult to achieve in practice. AMI has experience across a number of different investment strategies that fall under the absolute return umbrella; in this white paper, we discuss two core strategies that are included in our current investment portfolios ï arbitrage and distressed debt.

Arbitrage

Arbitrage is a technical term that denotes a relatively simple concept. A successful arbitrage investment is one that profits from a price difference between two investment securities that are fundamentally similar in nature; in theory, the two securities would be identical and the profit would accrue without risk. For example, imagine that you are at a flea market and find a collectible coin selling for $20. Your neighbor happens to be an avid coin collector and you know that he would be willing to pay $30 for that same coin. Aiming to make some money, you simultaneously purchase the coin at the flea market for $20 and enter into an agreement over the phone with your neighbor to sell it to him for $30. There will be some frictional costs in executing this arrangement ï you have to tie up some cash until your neighbor pays you, you have to pay for the phone call, you have to deliver it to his house, etc. But leaving those aside, you were able to secure a ñrisk-freeò profit from your *arbitrage* of $10.

Of course rarely if ever do investors find such guaranteed free lunches in investment markets. Even in your case, you have to consider the fact that your neighbor will squelch on his deal and you may be stuck with a $20 coin that you donôt want and canôt sell. Likewise in investment markets, arbitrage investments are not risk free. But investors are compensated for bearing these risks and most importantly the risks are not highly correlated with risk factors found in other asset classes, such as stocks or bonds. Further, properly-hedged arbitrage portfolios that employ little or moderate amounts of leverage have historically exhibited relatively low levels of risk.

There are various types of arbitrage investments, including:

- Merger arbitrage ï there is a fundamental relationship between the stock of a company being acquired and the proposed takeover price.
- Convertible bond arbitrage ï convertible bonds share a fundamental relationship with the stock that they can be converted into.
- Dual-class arbitrage ï sometimes corporations have different classes of stock that represent the same economic interest but trade at different prices.

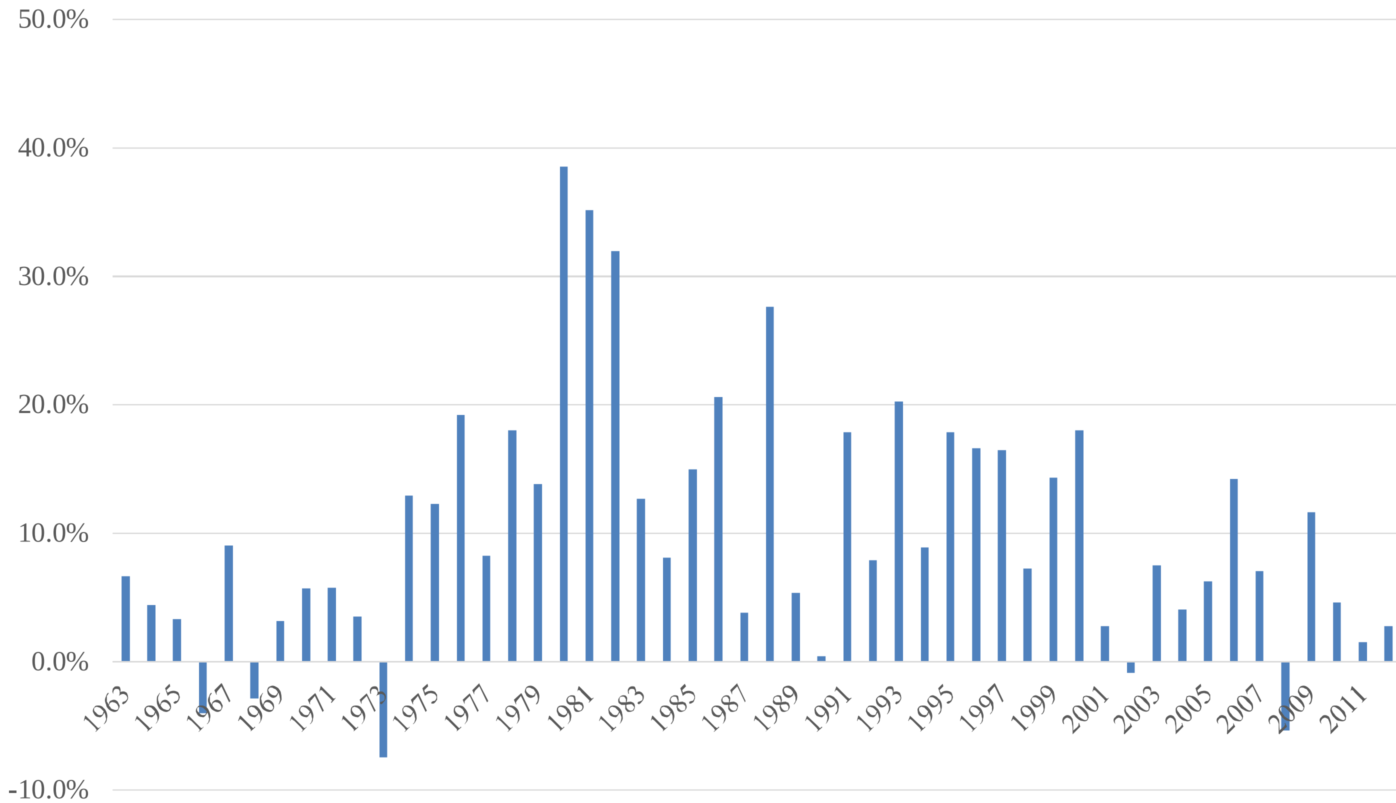
There are several other common types of arbitrage investments. In all cases, investors try to profit by going ñlongò the relatively underpriced investment security and ñshortò the relatively overpriced investment security, betting that within a reasonable time frame the prices of the two securities will converge and the investor can exit at a profit.

The simplest example is a cash merger. Suppose that you own shares of stock in company ABC; you bought the stock five years ago for $10 and now the shares are worth $15. ABC announces that they will be acquired by XYZ company for $25 in cash, with an expected closing date in six months. The price of the shares quickly moves upward to $24. Why doesnôt it go to $25? Well, the deal isnôt final until it is approved by both regulators and shareholders, so there is a chance that the deal falls through and the $25 doesnôt materialize. But you bought the stock at $10 and it just increased from $15 to $24. If the deal goes through, you will only get $1 more, but if the deal fails, the stock could very well fall back to $15. Accordingly, your likely response is to sell the stock at $24. At that time, *arbitrageurs* step in to purchase the stock at $24, waiting to profit if and when the cash merger is executed at $25. If the deal does fall through, the arbitrageur will likely lose money. The deal could also take longer to execute, which would lower the annualized return on the investment. If the deal executes in six months, however, the arbitrageur would have generated an approximate 8.5% annualized return on his investment ([$25-24] / 24 = 4.17% return for six months, which must be compounded to get an annual figure).

Doesnôt this investment entail a lot of risk though? First, most arbitrage transactions, unlike this one, can be better *hedged*, meaning that the downside can be somewhat protected. A cash merger involved just one investment security, whereas most arbitrage investments involved two investment securities. Second, while the risk of any deal falling through may be high, a diversified portfolio of arbitrage investments has historically been relatively low-risk because the deals arenôt strongly correlated with one another. While we typically advocate concentrated portfolios within specific asset classes where investors focus on their best ideas, arbitrage is one exception, as explained by Warren Buffett:

> [S]ome investment strategies ï for instance, our efforts in arbitrage over the years ï require wide diversification. If significant risk exists in a single transaction, overall risk should be reduced by making that purchase one of many mutually-independent commitments. Thus, you may consciously purchase a risky investment ï one that indeed has a significant possibility of causing loss or injury ï if you believe that your gain, weighted for probabilities, considerably exceeds your loss, comparably weighted, and if you can commit to a number of similar, but unrelated opportunitiesé Should you choose to pursue this course, you should adopt the outlook of the casino that owns a roulette wheel, which will want to see lots of action because it is favored by probabilities, but will refuse to accept a single, huge bet.[2]

Because most arbitrage transactions are unrelated to one another, a diversified portfolio of arbitrage investments that is not heavily leveraged has historically exhibited a low level of risk. Importantly, merger arbitrage results have been largely uncorrelated with traditional asset classes like stocks and bonds. Arbitrage transactions are often driven by their own idiosyncratic characteristics, somewhat separate from the variables that drive stock and bond returns. Below we plot returns for merger arbitrage all the way back to 1963:



Only five out of fifty years have posted negative annual returns, and the average of those five down years is just -4.1% with the worst year registering only -7.5%. These figures do understate one downside of arbitrage ï during market panics like that seen in the fall of 2008, arbitrage can be hit quite hard as merger deals may fall apart with a greater probability and *spreads*, the difference between the prices of the two securities being arbitraged, may widen. However, in many instances merger deals end up being executed and spreads come back in, so the pain is hopefully short-lived. We also want to make a big caveat: this data set suffers from serious flaws. The data used prior to 1990 is simulated data from research done by Mark Mitchell and Todd Pulvino,[3] and the data since 1990 is the Hedge Fund Research Index Merger Arbitrage series, which tracks managers pursuing arbitrage investments and suffers from several material biases.[4] Further,

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[2] 1993 Annual Letter to Berkshire Hathaway Shareholders, Warren Buffett, March 1, 1994.

[3] ñCharacteristics of Risk and Return in Risk Arbitrage,ò *The Journal of Finance*, Vol. LVI, No. 6, Dec. 2001.

[4] For instance, the index underrepresents underperforming or failed managers, who often will stop reporting their numbers to HFRI when they encounter difficulties.

merger arbitrage is just one sleeve of diversified arbitrage strategies; other sleeves have different return histories and risk profiles.

That being said, our own experience with arbitrage supports the notion that a diversified portfolio of well-hedged arbitrage investments with little leverage should exhibit low to moderate risk. Accordingly, we believe that such portfolios can be considered as a fixed income alternative. There are no free lunches ï with short-term interest rates so low, low-risk arbitrage portfolios will offer modest returns (there is some relation between arbitrage spreads and yield on short-term fixed income instruments). We would be happy if our arbitrage investments could return 3-5%. However, unlike fixed income, we donõt believe that our arbitrage investments will be severely impaired in a rising interest rate environment. Because arbitrage transactions are usually executed within a short timeframe, rising interest rates have relatively little impact on investment results.

Distressed Debt

Distressed debt entails purchasing bonds in companies that are experiencing potentially severe financial difficulties. Such bonds typically trade at large discounts to their so-called par value and may be expected to or have already entered bankruptcy. This of course sounds like a risky endeavor and we would point out that unlike arbitrage, where we hope to see risk levels on par with those seen in bond markets, distressed debt shares a risk level more akin to stocks. However, we believe that (a) distressed debt isnõt as risky as it might sound and (b) distressed debt, like arbitrage, can generate attractive returns during periods when stocks and bonds post lackluster results.

Investment risk is a function of the price paid for an investment security ï what is risky at one price may be conservative at a much lower price. A distressed company may own some wonderful underlying assets, but simply be shackled with excessive financial obligations. The distressed investor can purchase the senior bonds of the distressed company, guide it through bankruptcy and come out on the other side with a significant ownership stake in an attractive, newly capitalized organization.

The nature of distressed markets holds appeal for us as a value investor; Howard Marks, a pioneer in the distressed debt arena, writes:

> [O]ne of distressed debt investingõs great advantages is that it embodies an anti-error business model. Distressed debt investors:
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> - Almost never invest in companies where everythingõs going well and investors are enthralled; thereõs no such thing as a financially distressed company that everyone loves;
> - By definition rarely invest before the emergence of significant problems, hopefully meaning fewer negative surprises are left in the bag;
> - Are in business to buy debt at significant discounts, often from forced or highly motivated sellers. ñDistressed debt at parò is an oxymoron and, at least in theory, distressed debt investors are bargain hunters whose ardor rises as prices fallé not the reverse like so many other investors.[5]

Historical returns from distressed debt have been impressive, though we again caution that the data set, generated by the Hedge Fund Research Index, suffers from serious flaws:

[5] ñItõs All a Big Mistake,ò *Memo to: Oaktree Clients*, June 20, 2012.

	1990	1991	1992	1993	1994	1995	1996	1997
Distressed Debt	6.4%	35.7%	25.2%	32.5%	3.8%	19.7%	20.8%	15.4%
S&P 500	-3.1%	30.5%	7.6%	10.1%	1.3%	37.6%	23.0%	33.4%
High Yield Bonds	-9.6%	46.2%	15.8%	17.1%	-1.0%	19.2%	11.4%	12.8%
	1998	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Distressed Debt	-4.2%	16.9%	2.8%	13.3%	5.3%	29.6%	18.9%	8.3%
S&P 500	28.6%	21.0%	-9.1%	-11.9%	-22.1%	28.7%	10.9%	4.9%
High Yield Bonds	1.9%	2.4%	-5.9%	5.3%	-1.4%	29.0%	11.1%	2.7%
	2006	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**Annualized**
Distressed Debt	15.9%	5.1%	-25.2%	28.1%	12.1%	-1.8%	10.1%	12.0%
S&P 500	15.8%	5.5%	-37.0%	26.5%	15.1%	2.1%	16.0%	8.6%
High Yield Bonds	11.8%	1.9%	-26.2%	58.2%	15.1%	5.0%	15.8%	9.1%
	Standard Deviation	**Worst Drawdown**						
Distressed Debt	6.6%	-27.4%						
S&P 500	15.0%	-50.9%						
High Yield Bonds	9.3%	-33.3%						

Like merger arbitrage, we think that distressed debt provides attractive diversification to a stock/bond portfolio. David Swensen, Chief Investment Officer at Yale University, writes:

> Because of the complexity of the issues surrounding bankruptcy, many market participants sell positions regardless of price, creating an opportunity for hard working investors to profit. By assessing the timing of the companyꞌs emergence from bankruptcy and valuing the expected package of securities, players in the distressed securities arena generate returns more dependent on events important to the bankruptcy process than on the level of the overall stock market.[6]

Distressed debt investing is in part attractive because it is not easy to do. Distressed debt investors not only have to have the research skills to dig into complicated and messy situations, they also need the flexibility and speed to operate in somewhat illiquid markets as well as the operational expertise and support to deal with bankruptcy reorganizations. In our mind, success in distressed debt investing requires a specific focus on the asset class.

At the beginning of 2009, high yield debt – bonds in companies that are not investment grade but arenꞌt distressed – looked particularly attractive. They posted incredibly strong returns the following year. Yet recently the high yield bond indexꞌs yield (measured by the yield-to-worst) dipped below 5%. After factoring in historical losses from defaults of 2-3%, this represents a rather paltry return for a relatively high-risk asset class. We feel that opportunities in distressed debt continue to persist, however, and maintain a core allocation to the space.

[6] *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment*, David Swensen.

External Managers
In the case of both arbitrage and distressed debt, successful results require specialization, resources and expertise. For instance, our core arbitrage manager has a heavy investment in trading systems and monitors arbitrage opportunities every day. Our distressed debt manager has two attorneys on staff to help manage investments through the bankruptcy process and perform diligence on loan documents. These are complex and potentially illiquid markets, and we want managers focused on their core area of expertise.

As we have discussed before, we utilize external managers that have a particular specialty to complement our core in-house stock and bond portfolios. This allows us to create diversified portfolios without sacrificing idea quality. In previous pieces we have outlined what we look for in managers (and by extension what we believe you should look for in us). This includes an alignment of interests, signified by material co-investment by managers, a commitment to transparency and honesty, the temperament to be patient for investment opportunities and a dedication to value investing and in-depth research. In arbitrage and distressed debt, opportunities do not occur in consistent intervals. Accordingly, outstanding results are achieved by those managers that remain flexible and who invest conservatively when opportunities are sparse and aggressively when opportunities are plentiful.

We have spent numerous hours researching our core arbitrage and distressed debt managers. Weôve met with them personally, visited their offices, and get frequent updates on the portfolios. We believe that these absolute return strategies will help us build more efficient portfolios, achieving superior returns at reduced levels of risk.