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October 25, 2013

Information Days

What scatters, what sticks together, and why?

After evaluating a great deal of data, a statistician finds that as ice cream sales increase, the rate of drowning deaths increases sharply. Based on this strong correlation, the scientist concludes ice cream consumption causes drowning. Even to the untrained eye, it is fairly obvious the analyst failed to take into account weather; during warmer summer months, people swim more and crave cool refreshments like ice cream. Temperature - not ice cream consumption - is the underlying variable that drives both drowning and ice cream consumption.

Seem obvious? The same mistake is commonplace among professional investors who still practice asset allocation; they build portfolios based in large part on the correlation relationships between asset classes, even though there are typically strong underlying economic variables causing those correlations to exist in the first place and, more importantly, change over time. (The underlying credit cycle that lurked beneath asset class correlations in 2007-08 and eventually devastated traditional portfolios, is just one example of many mistakes like this in the past few decades).

At Rain, we refer to those lurking variables as risk factors and they are the core points around which we build portfolio diversification. Rather than focus on how different strategies correlate with each other based on their asset-class classification or historical performance patterns (we've all read the disclaimer "past performance is not an indication of future results. . ."), our analytics are more

concerned with how strategies may be *economically integrated* with each other. Then we stress test those relationships.

From a diversification standpoint, understanding how a hypothetical pair walking down the middle of a street together might be related (or integrated) is enormous; is it a man and his dog tethered by a leash, a husband and wife, two neighbors going to the same yard sale around the corner, or complete strangers? After all, the correlation between a man and his dog tethered by a leash will be far more integrated and persistent than even that between husband and wife, who may at some point go different directions to run errands only to converge again later at home; or the neighbors who, having done their business at the yard sale, go separate ways, versus the perfect strangers who happened to be walking next to each other by pure coincidence. *Often times, the only way to tell the difference is to measure how each pair reacts during that brief moment when a car drives by, or to capture data over staggered intervals of time (before and after the yard sale), and so on. Which scatter, which stick together, and why?*



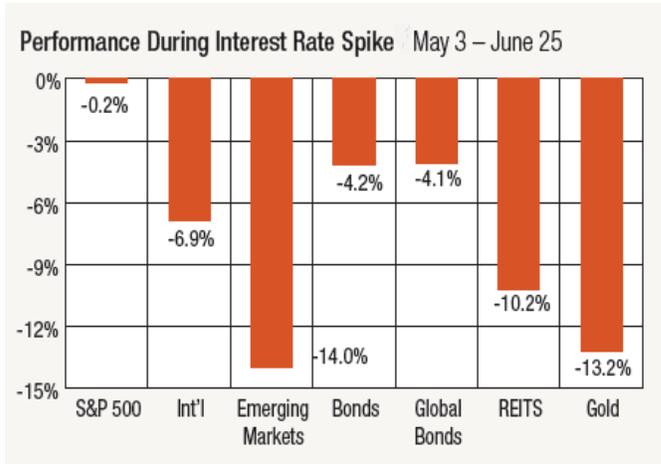
At Rain we talk a lot about what we call 'information days,' brief periods of time that are extremely rich with information. We find that evaluating narrow time periods of isolated stress (or euphoria) can be just as informative about manager positioning and underlying risks as longer-term statistics, if not more. The

days for instance between May 3 and June 25 yielded a tremendous amount of information about the downside behavior of different assets during a period of fairly extreme interest rate volatility in the middle part of the yield curve. The typical correlation relationship that investors had become accustomed to during the preceding years – the US dollar strengthens as US yields fall, while credit spreads widen and stocks sell off – completely inverted during the May-June period because risk was driven by the stronger underlying economic integration of these variables, rather than the more spurious relationship between asset classes that persisted during less turbulent markets. Likewise on September 18, the day the Fed announced it would not yet slow its bond purchases, assets with any direct or indirect interest rate risk rallied strongly. Were an entire portfolio to have done well that day (as most traditional asset allocation approaches did), it would have likely had a large slug of underlying interest rate risk running through it.

These small and isolated stress tests quickly get lost in the longer-term numbers analysts typically rely on. Or worse, they're not even measured because standard analysis of asset classes tends to focus on largely unrelated variables. For us, however, the micro stress tests help fill out more of the *texture* of risk that becomes important when trying to identify how different assets might be economically integrated with each other. Most importantly, this helps inform how different assets are likely to behave in a crisis environment.

As the data tell us today, interest rate risk has bled across asset classes in a way that resembles how credit began to dominate asset prices in 2007. The biggest difference is that this time it is the intentional effect of monetary policy, whereas the credit bubble was a much more indirect and unintended consequence of monetary policy. The core purpose behind quantitative easing is to stoke investment by driving investors out of 'safer' government bonds into assets with similar characteristics, such as credit risk and duration. This has driven investors to buy corporate debt,

high yielding equities, and so on. These are all forms of direct investment that translate into real GDP growth, but they're also all investments that are driven by declining yields elsewhere. That is the economic lever by which the Federal Reserve has 'infused' asset prices with interest rate risk in a way that is very different from previous interest rate cycles.



The risk elephant in the room is interest rates. A traditional analytic approach would likely miss this fact, obscure it or confuse the dark foreshadowing as a buying opportunity. Information days have provided us with valuable insight into how ostensibly different assets are tethered together by an interest rate leash right now. The integration is an intentional element of quantitative easing and will likely have devastating

consequences for portfolios that are not deliberately built with underlying risk factor diversification in mind when the Fed changes course.

Q3 Update

Rain portfolios have been resilient during turbulent markets this year in large part by missing the interest-rate-related potholes that have come along. During the third quarter in particular, Rain portfolios continued to benefit strongly from the tilt toward high quality, developed-country equities and away from assets that we view as particularly sensitive to interest rate volatility, namely most fixed income sectors, commodities, emerging markets (equities and debt), and inflation related assets, like TIPs. Our defensive posture toward interest rate volatility does also have implications for the growth side of portfolios; we are increasingly cautious in core growth strategies for the mere reason that equity markets cannot entirely escape interest rate volatility either. At the most basic level, the discount rates that factor into equity valuation models are directly tied to prevailing interest rates. Interest rate volatility therefore impacts perceptions of the value of companies' future cash flows which will likely translate into a rougher ride in equity markets as rates normalize. In Rain portfolios, we will be placing greater emphasis on low correlation growth strategies.