RAIN CAPITAL MANAGEMENT

March 13, 2012

Natural Selection

What adapting markets mean for portfolio construction

In financial markets, equilibrium is a constantly moving target; the textbook "steady state" or "balance" doesn't exist in an open and global economy. Some external shock is introduced and markets adjust to find the new balance between supply and demand for different assets. In the meantime, this sows the seeds of some new disruption elsewhere down the line. In the investing world, dislocation and volatility create opportunity and, from a risk management perspective, provide valuable real-world stress-test information. 2011 was an important year in this respect and had material implications for portfolio construction that we want to share with you.

the "zero" problem. . .

Firstly and perhaps most importantly, was the flight-to-safety impact on treasury bond prices. We discussed this in depth in our last communication and will summarize. Irrespective of where interest rates go from here, at the current low level of long-term US rates, treasuries and core bond strategies cannot stand alone as the "safe," or defensive, part of a portfolio. They will continue to serve in a smaller role as an important deflation hedge. However, their interest rate sensitivity makes them unable to deliver the same return stability and principal safety in a zero-interest-rate environment as they had provided over the past three decades of gradually declining rates.

. . .less dependence on traditional bonds for safety

We are focusing a portion of the defensive side of client portfolios on strategies that can deliver safe and stable returns, largely independently of interest rate and / or credit spread movements. We are particularly excited about the managers we are working with as they are relationships we know extremely well and have used, in many cases, for years. In every case, the investment toolset and risk management expertise goes well beyond the confines of a narrower bond mandate.

In this part of portfolios, we are also exploring different strategies that will benefit from changing volatility in the market, a position that we believe is typically underfunded in a world still dominated by volatile equities and increasing correlations. By design, ultra low rates have served to provide tremendous liquidity to

121 SW Morrison Street, Suite 850 • Portland, OR 97204 • toll free: 866.752.0430 • main: 503.822.1700 • fax: 503.227.2398
www.rain-capital.com

financial markets; liquidity, in turn, has served to dampen volatility (a common measure of stock market volatility touched levels today not seen since the historic lows preceding the credit crisis). Beyond the liquidity environment underpinning this, we also believe low volatility reflects complacency about risk. A funding in this space is expected to be supportive of returns during most market environments, but particularly solid during the volatility in asset prices that could result from a sharp reversal in monetary policy.

the euro problem. . .

Europe's ongoing sovereign debt and currency crisis will continue to be a source of concern. Progress on restructuring Greek debt and the implementation of the European Central Bank's version of quantitative easing go a long way toward providing much needed support to European sovereign bond markets and banks. The measures, however, are likely to have implications elsewhere. The fear of a resurgent Germany that drove closer political and monetary union under the Maastricht Treaty is alive and well, and may even be amplified by the disproportionate economic benefit Germany gained from union vis-à-vis less productive economies. Those politics made fiscal union difficult then and we believe will continue to complicate efforts to make any sweeping reforms to the euro-area economies. In other words, we believe the continent's poor growth outlook is well anchored in a weak political environment.

. . .a focus on high quality, well-diversified duration

In relative terms, we believe European rates have the economic and political basis to stay low for longer than those in the US (the US economy looks downright solid in comparison: stronger labor markets, improving manufacturing output, solid corporate balance sheets, stabilizing home prices, consumer credit growth, and so on). However, concern about credit risk in Europe requires being very selective about where to maintain bond duration; to control for this in traditional bond strategies, we are tilting toward well-diversified strategies that favor liquid bonds of countries with high quality balance sheets and independent monetary policy: the likes of the United States, Germany, the UK, Sweden, Denmark, Switzerland, Australia and select emerging market countries with solid balance sheets and low inflation risk.

capital flight. . .

It is not enough to take a narrow look at "Greece" or "Europe" exposure without exploring the various risk factors and knock-on effects associated with it – it's impact on liquidity, volatility, growth and so on. One of the more likely secondary effects the European crisis will be on certain emerging markets investments. Bank for International Settlements data show a heavy dependence on European banks for lending in these markets; emerging Europe (Poland, Hungary and Romania in particular) shows the greatest vulnerability to capital flight, with Latin America and Asia significantly less so. European banks will be responding to the crisis and to higher capital requirements (targeted for mid-2012) by further deleveraging. The first stop likely will be to shed assets that have the greatest impact on capital requirements, namely emerging markets. The effect is two-fold – a contraction in lending in these markets may depress growth while the sale of foreign assets will depress asset prices in those countries, both of which could hurt liquidity and cause volatility to rise.

. . . a focus on locally financed, self-driven growth

While we are positive about long-term prospects in the emerging and frontier markets and will seek to capture that element of global growth in portfolios, we are currently not fully funded there. This benefitted clients during the sharp selloff in 2011 and we believe will continue to be advantageous as the Europe crisis plays out. We have positioned the bulk of our emerging markets exposure through managers that are either reasonably well hedged or who invest in high quality, growing companies that are conservatively capitalized or are entirely self-financed. Another focus is on companies that benefit from the growth of the emerging middle class (domestic demand driven) in these countries, rather than the more vulnerable export sector. We believe these elements, combined, make for a safer way to invest in markets that remain a strong long-term growth engine of the world.

opportunities in a transitional domestic economy. . .

Finally, the renewed strength that the US economy began to show late last year has translated into a number of opportunities in credit and equities domestically. On the credit side, our managers are tilting away from richer high yield and treasury bonds in favor of mortgage-backed securities and high quality corporate bonds. This reflects both opportunities in a battered-but-stabilizing mortgage market as well as a continued interest in safer credit given an uncertain global macro backdrop. A number of our managers have found an unlikely value in "distressed" subprime mortgages; much of what constitutes subprime these days is made up of relatively higher quality borrowers than just a few years ago in large part because so many bad credits have defaulted and fallen out of that cohort.

. . .capturing safe growth versus stretching for yield

Nearly across the board, our equity managers are focusing on high-quality growth as a way to more safely capture equity market returns. This means attractive valuations, reasonable debt levels, positive cash flow, earnings stability and solid business economics (the gist here is tenacious companies with financial flexibility and strength at reasonable prices, which we believe translates in to a better margin of safety in down markets). Both in credit and equities, we are particularly watchful of the incredible stretch for yield that is occurring in the market. We are evaluating managers for the unintended risks that are being traded for higher yields as well as the substitutes that are being used for yield (after all, just because a stock pays a dividend, doesn't mean it belongs in a bond portfolio!)

Overall, we're cautiously optimistic about the recovery domestically, with an eye toward the various external macro forces that could disrupt it. As you know, we believe true diversification is a proactive process that requires looking under the surface of stated asset class objectives to identify underlying performance drivers and risks that could pervade multiple asset classes. It also happens to be a decent way to identify opportunity. 2011 got a number of issues out on the table that were useful in developing positioning around interest rates, credit, growth, volatility, currencies and liquidity. These are the core drivers of the economy and capital markets as they seek equilibrium; not surprisingly, they're also the core drivers of diversification in client portfolios.

Chris Abbruzzese David Reichle Ellen Kim

121 SW Morrison Street, Suite 850 • Portland, OR 97204 • toll free: 866.752.0430 • main: 503.822.1700 • fax: 503.227.2398
www.rain-capital.com