GREENROCK
RESEARCH

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How We Think

We are forward thinking and focused on creatively solving investment problems. While there are many types of investors with a broad array of objectives, we recognize that the vast majority of our investors have three primary objectives: achieve competitive returns, minimize downside volatility, and minimize taxes. Thus, we strive to find investment opportunities that offer superior returns while we rigorously evaluate potential risks to avoid surprises. Additionally, we are sensitive to an investment's tax efficiency.

From the founding of Greenrock in 1996, we have believed that by studying the underlying investments (portfolio holdings) of a firm we will understand the implications of that firm and its strategy going forward. So, we always obtain holdings from managers monthly going back at least 5 years, and we perform portfolio construction and attribution work. This remains the case today. While we utilize MStar software, we do our own research. We use MStar to collect data and provide reports, not to make decisions for us.

After we have researched the history of any strategy, we need to make a judgment about the quality of the organization. We have developed a methodology for interviewing managers that allows us to get a good feel for what really makes a firm tick, how likely it is to stay on track, and what the drivers are for the people involved. We do this by interviewing everyone involved in the investment process individually. We ask everyone the tough questions. We are there to make a judgment not to grade on some scale. We do not ever need to retain a manager, so we are completely arbitrary. We have rejected firms because they looked disorganized, because the next generation was not really included in decisions, because they have had success and we thought they were getting lazy. We have clearly been wrong on rejecting some managers, but we believe that is a reasonable risk. Retaining the wrong firm is a much greater risk. So, this takes a lot of time, we just do not know how to nor do we think we should ever short cut this process.

The following are our thoughts on some of the factors that are commonly used when evaluating investment managers:

Diversification/Concentration: We prefer concentration and conviction over correlation to an index. We believe there are many closet index firms, and we would not recommend one. We think there are times, strategies and asset classes where indexation is appropriate, but we strongly prefer fundamental indexation at very low fees to cap weighted indexes.

Style Drift: We love style drift, one cannot get long-term excess returns without it. We believe style drift was invented by consultants for their purposes not for better investment portfolios.

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Sell Discipline: It should be the opposite of buy discipline. The keys to success in any strategy are a discipline method to buy stocks, a disciplined way to sell stocks and the research capabilities to support both of these. We never have and never will retain a firm without a well defined sell discipline.

Turnover: Generally, we have very low turnover among our managers. Now there are some strategies where higher turnover is appropriate, but very few. We think this is one of the ways in which the RIA community has taken their measuring stick from the pension community. 20% turnover theoretically means the existing portfolio will be completely changed in 5 years. Turnover for the taxable clients is costly. If you want a historical marker on the impact of turnover and the corresponding drag on return from paying taxes, look at the returns pre-tax and after tax achieved by Michael Steinhardt and Warren Buffett.

Track Record: While it is easier to say yes to a firm with long experience and a great track record, we do not have any specific requirements. We have created products with new managers, and we have been the first managers to use a new firm. We have used one person operations. Now the research requirement is greater for new and small firms, but we believe the best ideas do not always come in perfect packages.

Portfolio Structure

Clients retain us to increase their investment brain trust for future solutions. We believe the best way to find future investment solutions is to study past market behavior and investment successes. So, we study market behavior in various environments such as a low interest rate environment, in a GDP growth environment, when stocks were trading at high PEs, how Gold complimented a portfolio, etc. Given that current price and the risk of loss is of high importance to us, we structure portfolios in the context of the current market environment. Portfolios are designed to meet specific risk return objectives. We categorize investment opportunities into four groups:

- Global Fixed Income
- Global Core Equities
- Liquid Alternatives
- Special Investments

Global Fixed Income

The investment objective for our fixed income portfolios is to provide stability to the overall portfolio and contribute to cash flow/income. Following 32 years of declining interest rates, the current and foreseeable future of the bond market is challenging. The last time we saw interest rates as low as they are today was the decade of the 1940s. The only index that goes back to that period is the U.S. 10 Year Treasury. The total return for the 10 Year was 2.5% in the 1940s, 0.8% for the 1950s and 1.9% for the 1960s. These are the types of returns fixed income investors will achieve going forward.

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Thus, our allocations to fixed income are at historic low levels. Investors will not achieve their investment return needs using a traditional allocation to fixed income; it will reduce their volatility, but the returns will be like the 1940s, 1950s and 1960s.

We have three goals for our fixed income portfolios:

- A yield greater than the Barclays Aggregate Index.
- Negative correlation to the stock market.
- A targeted return level that is positive whether interest rates remain low or rise.

Global Core Equities

The investment objective for our equity portfolios is to provide long-term growth and contribution to cash flow/income. We believe there are three ways to build equity portfolios: active, passive and dividends. We are strong advocates of dividend-oriented strategies for several reasons:

- Academic studies have shown that dividend strategies outperform over long periods of time. We have written a paper on this topic using the data from Jeremy Siegel.
- Companies that pay dividends are typically financially strong, higher quality companies. These characteristics are consistent with solid long-term investments.
- Dividend strategies often perform better in difficult markets because the dividend serves as a cushion and bolsters total return.
- Dividends can make a significant contribution to income for clients who have income requirements.
- Individual investors understand dividends. Seeing the cash flow hit their custody statements provides them with a feeling of security.

The portfolios are always structured to have a high current dividend yield from companies that have a history of dividend raises. In the uncertain investment climate in which we operate, we really value cash flow. Generally, our portfolios have dividends of 50% to 100% greater than their respective index with the expectation that dividend growth will be greater than the index.

Additionally, we build global equity portfolios that are diversified geographically, by sector, and by market capitalization. We favor low turnover strategies for improved tax efficiency. While the overall equity portfolio is diversified, we like conviction and favor managers that have concentrated portfolios.

There are three factors that flow through all of our equity portfolios, a higher dividend than their respective index, a high active share, and managers who add value through stock selection. We believe high active share is a necessary component of a portfolio that will outperform an index over time. Active share expresses the percent of an index that cannot be explained by the index.

Liquid Alternatives

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We did our first alternative investment research project in 1998, and recommended alternative investment fund of funds as part of an allocation starting in 1999. While our clients were happy to have these in their portfolios in 2000, 2001, and 2002, we were concerned with the structure. These funds have high fees, liquidity issues, gates, lockups, etc. While the funds we used did well, we continued to look for liquid alternatives that avoided some of these problems.

The evolution of the ETF world allowed for the development of a new breed of alternatives managers. These managers could emulate hedge funds using ETFs, provide transparency and daily liquidity, and had significantly lower fees. In 2005, we started shifting from illiquid fund of fund managers to liquid ETF managers.

The investment objective for our liquid alternatives portfolios is to provide overall portfolio stability by producing a return pattern that is different than stocks and bonds. These portfolios also provide much mower volatility than equities. Given the challenging fixed income environment, the importance of liquid alternatives has been exacerbated. We have used an assortment of managers/strategies in this area including global asset allocation, hedge fund replication, absolute return strategies, and managed futures. Today we use one fund that employs four strategists with distinct methods of broadly allocating assets to achieve a risk/return pattern that accomplishes our goals.

Special Investments

We define special investments as either temporarily undervalued asset classes or opportunistic private or illiquid investment opportunities. Our definition of temporary is years not months. The investment objective of this category is to enhance overall portfolio returns and/or to generate high relative levels of cash flow/income. We are not looking for high returns necessarily, although we have achieved very high returns. We are, rather, looking for entry points for a strategy that is unusual and complements the overall portfolio. While we often have ideas and opportunities in this area, there are times when we have no active special investment ideas. Historically, we have used REITs, MLPs, Financial preferreds, REIT preferreds in this category. Today there are no investments in this category.

How We Pick Funds

The above outlines how we think and what we believe about each asset class. The selection of each fund or combination of funds requires us to study each sub asset class. It is not enough to say what we believe about equities, we need to study how asset classes different in their makeup and fund choice. For example, the factors for success in domestic large cap differ from those of domestic small cap. In addition, the universe of large cap managers is much larger than that of small cap. So, we start by reviewing the universe and then make a judgment on the choices. You will see in large cap value and large cap growth, we have traditional managers; while in small cap we use factor funds. We use a London manager for Global because we think the orientation from London adds to the diversification of our portfolio. We would suggest this is the art part of our research, it is a judgment. That said the principles outlined above are never violated.

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