WILLIS INVESTMENT COUNSEL
Principled Investing

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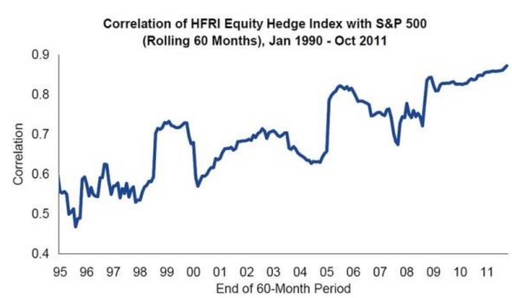
WIC MANAGED VOLATILITY AND INCOME STRATEGY

An Alternative to Alternatives

The past 13 years of low returns, record volatility, and 40%+ market declines in 2000-2002 and again in 2008, has reminded investors of the *grim arithmetic of negative compounding*. This volatile period of low returns led many institutional investors to embrace an *absolute* return investment framework (characterized by more market neutral and benchmark agnostic strategies). Along the way, institutional investors redefined how they measured performance in order to better align outcomes with objectives. This "new mindset" among institutions fueled enormous growth in the allocation to *alternatives.* And the trend continues today as investors reach for higher returns in a low bond yield environment:

> "Sovereign wealth funds, endowments, pension plans - across the board institutional investors are rushing into alternative asset classes to escape the purgatory of low returns they expect from public markets over the next few years. But a new report from State Street Corp.'s Center for Applied Research says these investors are failing to make decisions that will help them meet their individual objectives, manage risks and handle the greater portfolio complexity these moves will bring. "Irrespective of their stated goal, institutional investors are exhibiting herd mentality by increasing their exposure to alternatives," says Suzanne Duncan, the report's author. "While there is nothing wrong with alternatives, what's worrisome is that investors feel unprepared to handle the risks and complexity." *All the Wrong Moves, by Julie Segal,* Institutional Investor, December 2012/January 2013.

The rising popularity of alternative investments may be working against the industry as excess returns have steadily deteriorated as alternative assets have piled up (typically how things work). The Bloomberg Global Aggregate Hedge Fund Index, which tracks the aggregate performance of the $2.2 trillion hedge fund industry, increased only 1.1% in 2012. The story for long/short hedge funds is even bleaker. The chart below on the left illustrates how the HFRI Equity Hedge Fund Index[1], has experienced steadily declining excess returns since 1995. The chart on the right reveals how correlations between hedge fund returns and the S&P 500 has risen to nearly 100% in the past couple of years, meaning there is essentially no difference between hedge fund returns and passive long-only market returns.



Source: Factset, Morgan Stanley Research

[1] Comprises over 50% of hedge fund assets and consists largely of long/short equity hedge funds.

There are many theories about why hedge fund performance has deteriorated: high market correlations, over-crowding, a reduced talent pool, and of course high fees. Regardless of the reason, investors are increasingly asking themselves why they are paying high hedge fund fees[2] for market returns and market correlation. Many hedge funds also use leverage, provide lesser liquidity to investors, and lack transparency. This is a lot of baggage for "market-like" returns.

COMPLEXITY INCREASES RISK

The greatest "baggage" may be the inherent complexity associated with many alternative strategies. By definition, risk management difficulty increases when transparency decreases and when understandability of the drivers of risk and return decreases. The corollary is an institution can enhance risk management with less complex alternative strategies that are completely transparent, that don't use leverage, and that are far more understandable. We believe Willis Investment Counsel's *Managed Volatility and Income Strategy* (MVIS) is just such a strategy – it is an alternative to more complex, riskier *alternatives*. The essential attributes of the MVIS are:

- A high-quality, broadly-diversified equity portfolio holding 60-70 stocks
- Covered call options are written on 90% of the stocks held in the portfolio
- Via covered calls, net exposure to the equity market is maintained at ~55-65%
- Downside capture of 60-70% is targeted and is what we manage to
- Dividend yields are significantly greater than the S&P 500 dividend yield
- Dividend cash flow is supplemented with covered call premium cash flow
- Superior Sharpe Ratio over full market cycles is our primary objective

Although the MVIS is an equity portfolio, it is a hybrid with some bond-like defensive elements – high cash flow, relatively low beta, and less net exposure to the equity market with its option structure. It is worth noting that the MVIS is not burdened with the high fees, complexity, leverage, and lack of transparency that typifies most hedge funds:

"Deficiencies" of Alternatives	WIC Managed Volatility and Income Strategy
Understandability	• 65+ investment grade multi-national companies with covered calls written on substantially all holdings
Transparency	• 24/7 real-time portfolio access via custodian and prime broker affiliate website
Liquidity	• No lock up period; monthly liquidity • Equities are widely held (i.e., highly liquid) • Sufficient open interest in covered call positions
Fees	• 1.00% (or lower) management fee • No performance fee

[2] Hedge funds typically charge "2 and 20," which means they charge a 2% annual management fee and take 20% of annual profits.

We consider the MVIS to have elements of an absolute return-oriented strategy. While we benchmark performance relative to the Sharpe Ratio and the S&P 500, we view the MVIS as a less complex, less risky alternative to investing in the stock market. The MVIS provides clients a means to retain exposure to the stock market at a meaningfully lower level of total and downside risk, and benefit from a level of current cash flow (dividends and option premium income) above what can be attained in the equity or fixed income markets. The MVIS has many of the desired attributes of alternatives:

Attributes of Alternative Investments	**WIC Managed Volatility and Income Strategy**
Capital protection	• Delta adjusted exposure targeted at 0.55 - 0.65 • Standard deviation < 0.65 • Regression beta < 0.65
Manager skill	• WIC has evaluated large cap stocks for 34 years
Alignment of interests	• Portfolio manager has significant equity stake

It is worth repeating that unlike hedge funds, WIC does **not** charge performance fees[3], nor do we require extended lockups on investor capital. Investors can access their capital monthly without exit fees or other charges. Investors have 24/7 online access to examine the securities owned in the portfolio and also have access to the firm's portfolio managers. Willis Investment Counsel claims compliance with the Global Investment Performance Standards (GIPS) and has been independently verified for the last 13 years by Ashland Partners and Company. The MVIS composite, which began in July 2010, is also GIPS compliant. Verification and performance examination reports for the MVIS are available upon request.

For more information on Willis Investment Counsel's *Managed Volatility and Income Strategy* contact Jay Kilroy at 770-718-0706 or at jkilroy@wicinvest.com.

For more commentary, we invite you to visit our website at www.wicinvest.com.

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[3] A fee typically charged based on the increase in a fund's net asset value ("NAV"). Performance fees are widely used by hedge funds, which typically charge a performance fee of 20% of the increase in the NAV of the fund.