FRANKLIN TEMPLETON INVESTMENTS

TRUE DIVERSIFIERS

Five Reasons to Consider Multi-Strategy, Multi-Manager Hedge Strategies

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Topic Paper
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PERSPECTIVE FROM K2 ADVISORS

Today's financial markets present a variety of challenges. Things are changing. The post-2008 massive expansion of central bank balance sheets around the developed world—one of the most dominant market shaping forces over the last decade—is reversing. The enormous tide of liquidity that lifted assets globally—and in some instances indiscriminately—is receding. Markets are seeing increased volatility, sharp corrections, and increased inflation. In addition, macroeconomic concerns—including geopolitical hot spots, growing political uncertainty in Europe and the threat of trade wars—all pose legitimate problems for market stability.

Investors who are not prepared for these shifts may be exposed to significant risks, in our view. The challenge for investors going forward will be that the traditional diversifying relationship between bonds and risk assets may not hold true in this new era, particularly if bond markets start to feel the squeeze from rising interest rates. It's quite possible to see risk assets also decline as the "risk-free" rate (ex. yield on U.S. Treasury instruments) ratchets higher. Markets have become accustomed to exceptionally low discount rates—a shift higher could materially impact those valuations.

The good news is that multi-strategy, multi-manager (multi-strategy/manager) hedge strategies may be a valuable diversification tool for stock and bond portfolios in these environments. Historically these types of alternative investments have demonstrated a compelling risk/return track record in periods of higher rates and volatile markets, potentially better diversifying portfolios and helping to mitigate anxiety-inducing volatility.

Multi-Strategy, Multi-Manager Hedge Strategies: A Primer

What Is an Alternative Investment?

Alternative investments cover a varied set of asset classes and strategies that go beyond traditional stocks and bonds. Alternative investment asset classes include such things as real estate, real assets (e.g., commodities, infrastructure) and private equity, while alternative strategies primarily consist of hedge strategies. This paper focuses on hedge strategies as, in many cases, they may offer a high degree of investment flexibility through the utilization of various financial instruments and tactics, such as derivatives, options, futures/forwards, short selling and leverage. The added flexibility provided by hedge strategies enables investment managers to pursue maximum participation when their market expectations are positive and protection of capital when their views are negative. In our view, alternative mutual funds that offer hedge strategies may be an attractive addition to an investor's portfolio.

Why Alternative Investments Are Gaining Popularity in Retail Markets

Assets held in alternative mutual funds and exchange traded funds (ETFs) has grown rapidly, more than tripling over the past ten years, as illustrated in Chart 1. It is easy to understand why given the potential profile: added diversification and retail level accessibility. Investing via a mutual fund is more liquid (investors may invest and redeem on a daily basis), it has lower investment minimums than investing directly in an individual hedge fund; at the same time a mutual fund is subject to additional regulatory restrictions that limits its flexibility compared to privately offered hedge funds.

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HEDGE STRATEGIES COMMONLY USED IN ALTERNATIVE MUTUAL FUNDS

Event Driven: Based on corporate events, such as mergers, reorganizations, management changes

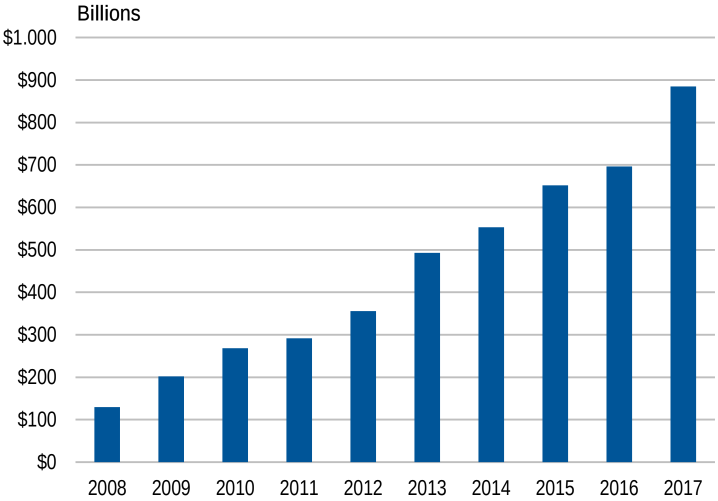
Global Macro: Focused on macro-economic driven opportunities across numerous markets and asset classes

Long-Short Equity: Seeks to buy attractive companies and short sell weak companies; seeks to produce returns while helping reduce unintended or market risks

Relative Value: Looks for perceived pricing inefficiencies between markets, companies, or within the capital structure of a specific company

Chart 1: Rapid Growth in Alternative Funds

Total Net Assets Held in Alternative Open-Ended Mutual Funds and ETFs 2008–2017



Source: Morningstar. Important data provider notices and terms available at www.franklintempletondatasources.com Historical assets held in publicly offered alternative mutual funds and ETFs. Total net assets are is USD.

How the Multi-Strategy/Manager Structure Works

A multi-strategy/manager portfolio consists of several distinct hedge strategies (the multi-strategy component) that are managed on a day-to-day basis by outside hedge fund managers (the multi-manager component). Each of these third-party managers specializes in one or more specific hedge strategies. The logic behind this approach is increased diversification, both across hedge strategies and within each strategy. Multiple hedge strategies are employed because our experience has shown us that each has distinct characteristics in different market environments. Given the different characteristics of various hedge strategies, a multi-manager approach will typically seek to alter the risk/return dynamics over a full market cycle through actively managing allocations to a group of differentiated underlying strategies.

Potential Investment Benefits of a Multi-Strategy/Manager Alternative Fund

The multi-strategy, multi-manager alternative fund has these notable potential benefits in the current market environment:

- Attractive risk/return characteristics
- Reduced downside risk in extreme market conditions
- Relationship between higher interest rates and hedge strategy alpha
- Generally low to moderate portfolio correlation to traditional asset classes
- Enhanced portfolio diversification

Attractive Risk/Return Characteristics

Hedge strategies have historically provided attractive returns over the long term when compared to traditional asset classes. As Chart 2 on the next page shows, hedge strategies nearly kept pace with global equities over a 20-year period—which included major swings in the equity markets—with an annualized return of 6.38% for hedge strategies vs. 5.75% for global stocks.

The comparable performance of hedge strategies during that period was largely driven by faring better during the dot-com bust in 2001–2002 and the financial crisis of 2008–2009. At the same time, hedge strategies have often performed relatively well during periods of equity strength. Indeed, when measuring risk against returns, Chart 3 shows that hedge strategies have exhibited a level of risk more in line with fixed income and return comparable to equities.

Reduced Downside Risk in Extreme Market Conditions

The ability of hedge strategies to help reduce downside capture was evident in the most extreme negative equity market conditions during the 20-year period ended June 30, 2018. Chart 4 shows that among the five worst one-month periods for global stock returns over the past 20 years hedge strategies fared comparatively well.

In practical terms, periods of sharp equity market declines can be costly for an investor in terms of lost money and time to potentially recover, particularly in periods when correlations across various asset classes increase, such as the 2008–2009 financial crisis. Equities may not quickly regain losses after a sharp decline which is an increasingly important consideration for investors in or near retirement. By providing the potential to reduce impacts from sharp equity market declines, exposure to hedge strategies may help reduce the overall volatility in an investor's portfolio. In this way the threat of having to rebuild and maintain retirement savings following equity market downturns is potentially mitigated.

Chart 2: Minimizing Negative Market Impact Has Helped Long-Term Performance Historically

20-year Period Ending June 30, 2018

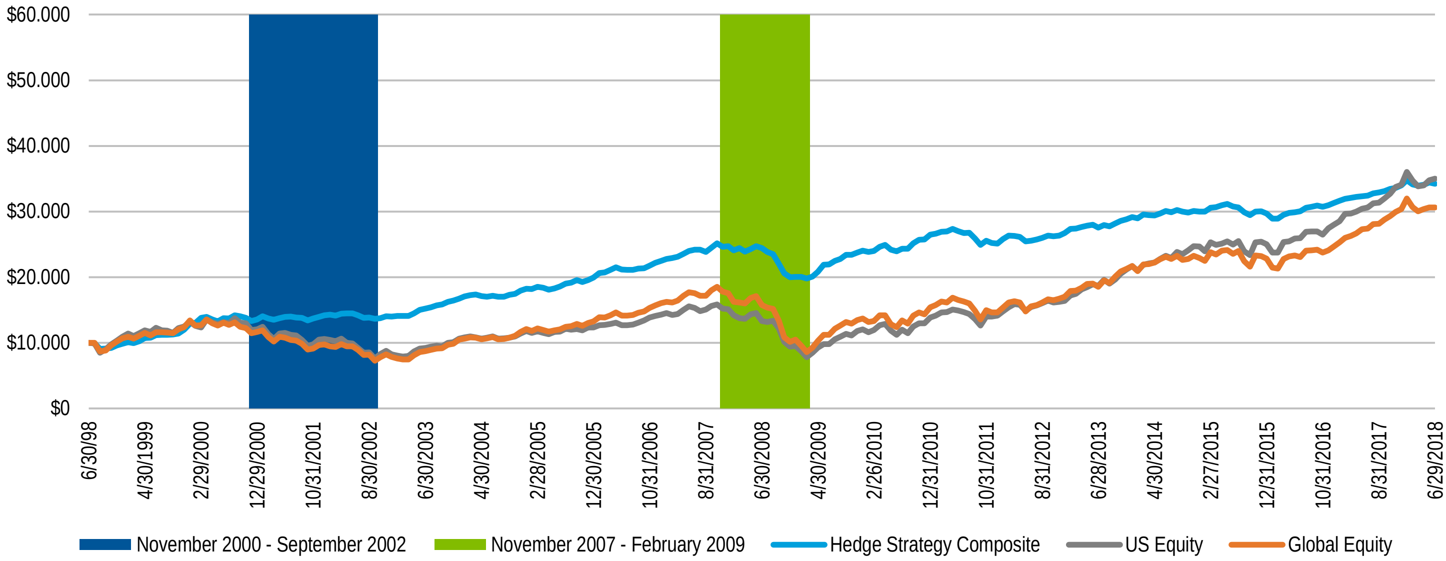


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Chart 3: Hedge Strategies Have Historically Shown Equity-Like Returns with Bond-Like Risk

20-year Period Ending June 30, 2018

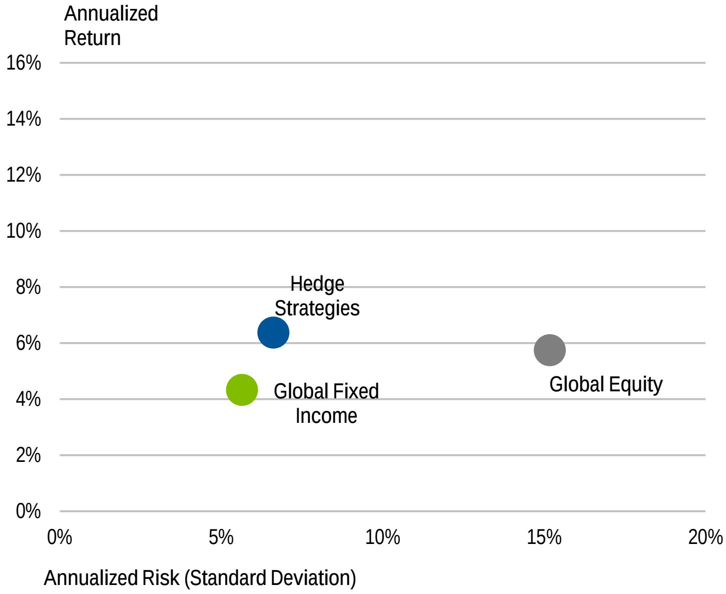

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Chart 4: Hedge Strategies Protected on the Downside in Extremely Negative Equity Markets

5 Worst Monthly Returns of the Global Equity Market

20-Year Period Ending June 30, 2018

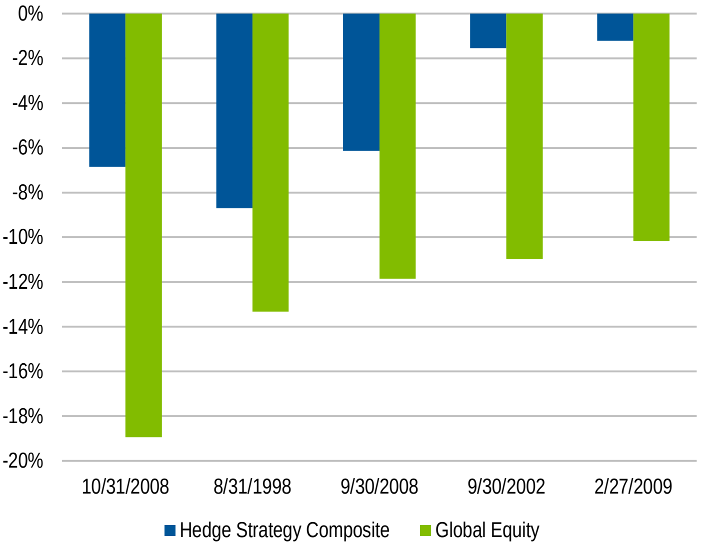

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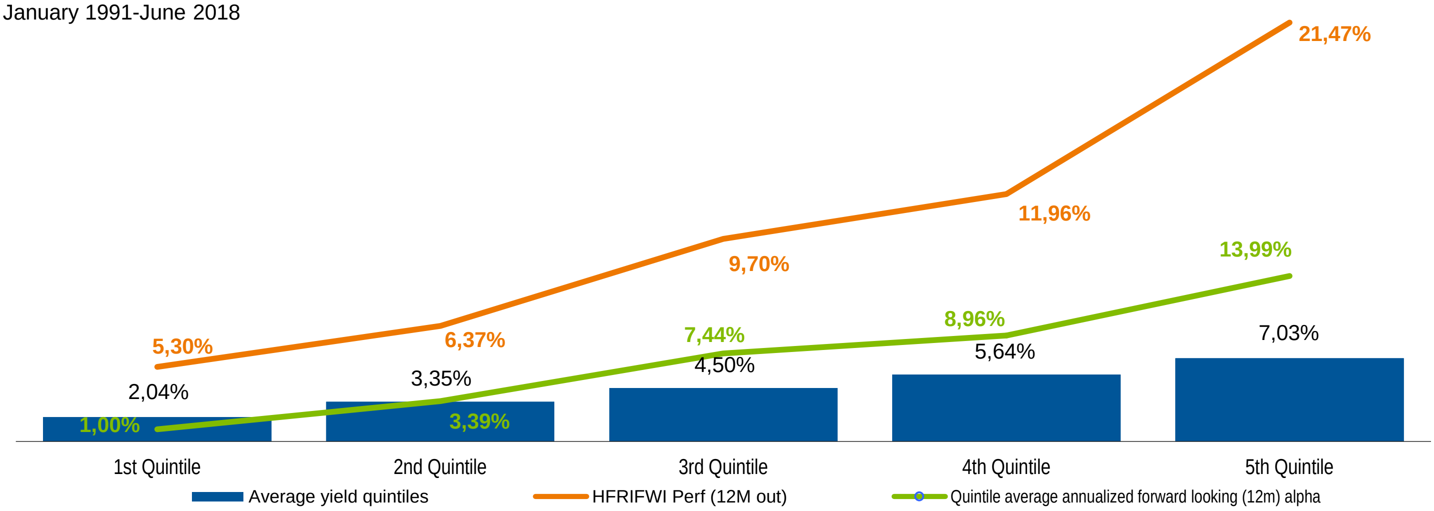
Chart 5: Higher Nominal Yields Have Coincided with Future Periods of Above-Average Performance for Hedge Strategies[1,2]
HFRI Fund Weighted Composite Index Returns and Forward Alpha at Different 10-Year U.S. Treasury Levels
January 1991-June 2018



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Source: Bloomberg, HFR, and S&P Dow Jones Indices. January 1991 through June 2018. Important data provider notices and terms available at www.franklintempletondatasources.com. Alpha calculated relative to the S&P 500 Index. The Factor Response Curves show the average performance of the index during the review period in months when the factor falls into the performance quintiles indicated. The blue bars indicate the average performance of the factor over all months when the average performance of the factor falls within the given quintile. The green line represents Hedge Strategy Alpha (Forward Looking – 12 Month) vs. S&P 500 , are measured through May 31, 2018, and are solely based on historical data. Each underlying yield data point has a corresponding hedge fund alpha vs. the S&P 500, where alpha is measured over the subsequent 12 months from the point where the yield is measured (last yield measurement in illustration is as of May 31, 2017). **Past performance is not an indicator or guarantee of future results.** Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges. Unlike most asset class indexes, HFR Index returns reflect fees and expenses. Source for HFR: Hedge Fund Research, Inc. - www.hedgefundresearch.com. The HFR indices are being used under license from Hedge Fund Research, Inc., which does not endorse or approve of any of the contents of this report.
1. Alpha is a mathematical value indicating an investment's excess return relative to a benchmark. Measures a manager's value added relative to a passive strategy, independent of the market movement.
2. S&P 500 Index – The S&P 500 Index is a market-value weighted index provided by Standard & Poor's which consists of 500 stocks chosen for market size, liquidity, and industry group representation. Includes reinvestment of dividends. HFR Monthly Indices (HFR) are equally weighted performance indexes, utilized by numerous hedge fund managers as a benchmark for their own hedge funds. The HFR are broken down into four main strategies, each with multiple sub-strategies. All single-manager HFR Index constituents are included in the HFR Fund Weighted Composite, which accounts for over 2000 funds listed on the internal HFR Database to the existing capital structure.

Relationship Between Higher Interest Rates and Hedge Strategy Alpha

Looking at chart 5 above, historically we see a positive relationship between US interest rate level and forward hedge fund alpha[1]: higher rates levels have translated to higher hedge fund alpha. This could be of interest to investors concerned about the possibility of rising rates moving forward.

As you can see, when interest rate level averages have been at their lowest, represented by the first quintile bar on the left, average forward alpha levels have also been at their lowest. But as we move from lower yield levels to higher average levels across the five quintiles, we see a corresponding rise in average alpha as well.

Clearly higher nominal yields of US government bonds, such as five-year Treasuries, have on average historically corresponded with increased average annualized hedge fund alpha as well.

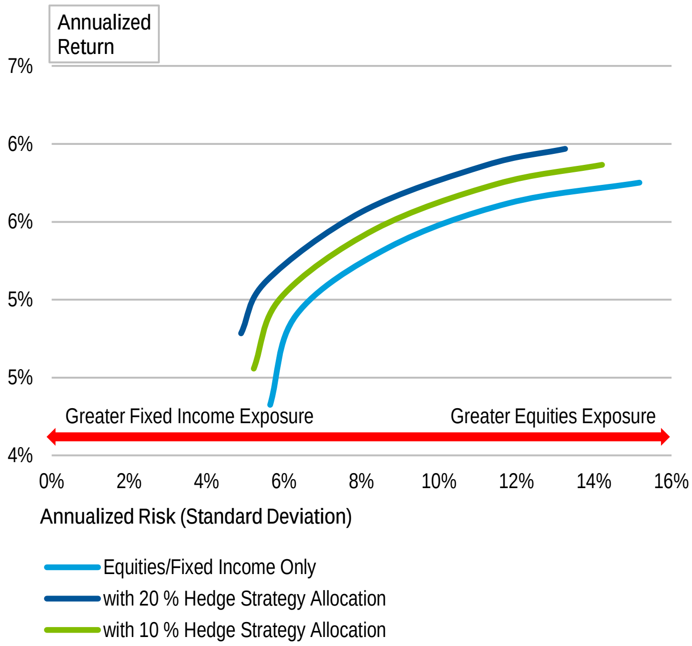
In our experience the vast majority of hedge funds are defensive with respect to interest rate risk, while some macro managers see it as a speculative opportunity.

Generally Low to Moderate Portfolio Correlation to Traditional Asset Classes

We believe hedge strategies may help to lower overall portfolio correlation—a measure of how closely investments move together—to stocks and bonds during periods of elevated market volatility. We've observed varying but generally low correlation between hedge strategies and fixed income—both US and global—over the past 20 years; a period that covers multiple interest rate cycles and various macroeconomic events. While we have calculated comparatively higher correlations with global stocks, Chart 2 shows that a higher degree of correlation may not necessarily be uniform. Certain hedge strategies have historically followed stocks fairly well in good times, while providing a fair degree of downside protection.

Chart 6: Diversifying with Hedge Strategies May Benefit an Investor's Portfolio

20-year Period ending June 30, 2018



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Enhanced Portfolio Diversification

The potential benefits mentioned above can combine to make hedge strategies a potentially valuable complement to a typical stock/bond portfolio. An investor who diversifies by adding exposure to a multi-strategy/manager alternative fund may be able to further improve the overall risk/return profile of the portfolio, as shown in Chart 6.

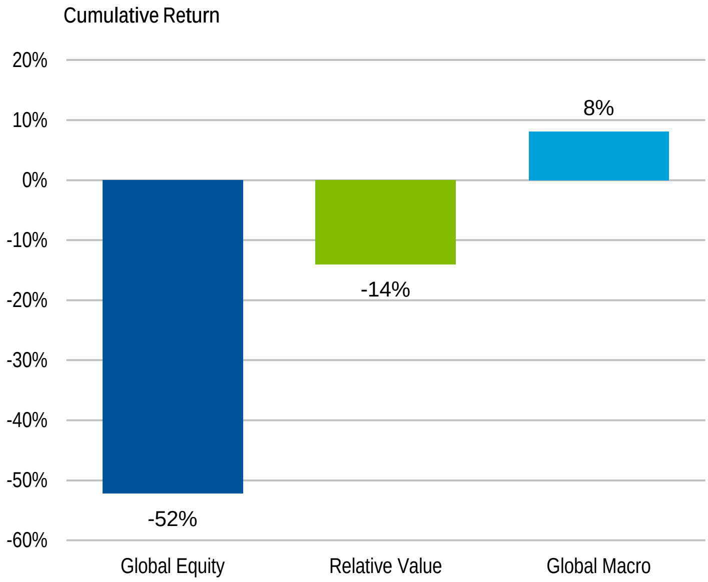
An allocation to hedge strategies may help reduce overall volatility of the portfolio. This may be compelling for many investors, including those who remain sensitive to volatility following the financial crisis as well as individuals around retirement. Investors in or near retirement may prefer the potential for increased returns but still desire potentially lower volatility than equities. Plus, the threat of capital losses due to a normalization of long-term interest rates may lessen the general appeal of bonds.

The Importance of a Multi-Strategy Approach

A multi-strategy approach provides, in our view, a beneficial level of diversification within a portfolio. Among the various types of hedge strategies, each may perform differently in a given market environment. For example, experience has shown us that Global Macro strategies are typically counter cyclical in performance, providing potential capital growth opportunities in declining equity markets. At the same time, Relative Value strategies are constructed with the purpose of reducing the impact of market direction on performance. Chart 7 illustrates that even during the financial crisis—when US equity markets plunged and correlations between stocks and bonds surged—Global Macro and Relative Value strategies held true to form.

Chart 7: Global Macro and Relative Value Hedge Strategies Fared Relatively Well During Financial Crisis

October 2007–February 2009



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The Importance of a Multi-Manager Approach

Among individual hedge funds over the past ten years, less than half outperformed the average return among all hedge funds in a given year, with 2011 the only exception. Even harder has been the ability to generate positive returns during turbulent periods. In 2008 and 2011, when the average return among hedge funds was negative, fewer than 27% were able to generate positive returns.

1. Source: Morningstar, from January 2008 through December 2017. Important data provider notices and terms available at www.franklintempletondatasources.com.
Past performance is no guarantee of future results.

Further diversification through selecting multiple managers within each strategy may also help provide a measure of protection against manager-specific risks. Different managers may have varying styles or approaches within the same hedge strategy, possessing expertise within a certain area (e.g., region, sector or financial instrument).

Building and Managing a Portfolio Requires the Right Expertise

The overall success of a multi-strategy, multi-manager alternative fund relies heavily on the investment team that builds and manages it. From the multi-strategy perspective, overall portfolio performance may be meaningfully impacted by the level of exposure to each strategy. If the investment team managing the portfolio has a keen understanding of financial markets and the characteristics of individual hedge strategies, the team may have a better ability to adjust exposures in ways that improve overall return potential and help reduce volatility.

From the multi-manager perspective, robust due diligence is necessary when selecting third-party portfolio managers. As Chart 8 below shows, the universe of hedge funds has expanded five fold over the past 20 years.

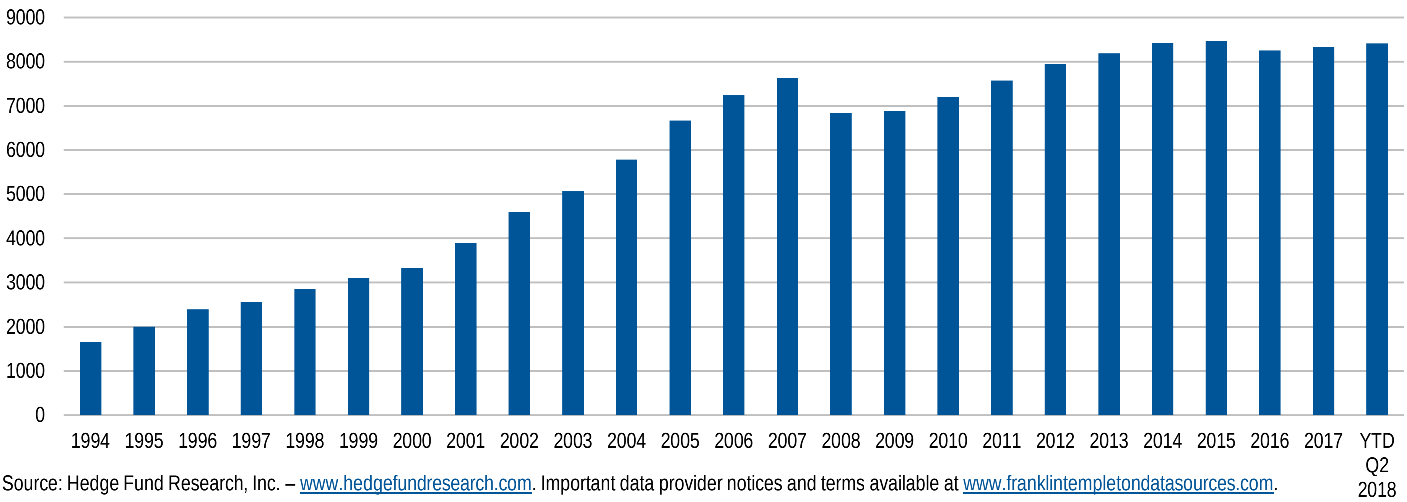
The rapid expansion in hedge funds places a greater importance on due diligence in order to have the necessary knowledge about outside managers and the people, procedures, investment practices and systems that they employ. While performing due diligence, it is especially critical to understand operational risks such as system failures, weak oversight procedures, regulatory violations and inadequate risk monitoring. For example, strong performances over one or two years may be achieved by taking on unintended or underappreciated levels of risk, which could lead to a serious reversal in performance (or even firm closures, as occurred during the financial crisis) when market conditions change. It is vital in a multi-manager approach to select third-party managers who have track records of solid and consistent performance with appropriate levels of risk and strong operational controls.

Conclusion

Current equity and fixed income markets pose a variety of challenges for investors. While things remain relatively tranquil on the surface, macroeconomic concerns—including geopolitical hot spots, major central bank policy divergence, rising rates and inflation—all pose legitimate problems for market stability. The universe of hedge strategies offer investors a potentially attractive diversification option. What's more, the increased ability to invest in these strategies through the mutual fund format has made it easier for investors to add this asset class to their portfolios.

More specifically, we believe multi-strategy/manager alternative funds are a particularly compelling solution. Hedge strategies employed by these funds have generally exhibited a solid risk/return profile, even in the most extreme market conditions. In our view, diversification into multi-strategy/manager alternative funds may be valuable for a wide range of investors.

Chart 8: As Hedge Funds Proliferate, Finding the Best Gets Tougher and More Valuable
Estimated Number of Hedge Funds
1994–YTD Q2 2018



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WHAT ARE THE RISKS?

Investments in alternative investment strategies and hedge funds (collectively, “Alternative Investments”) are complex and speculative investments, entail significant risk and should not be considered a complete investment program. Depending on the product invested in, an investment in alternative investments may provide for only limited liquidity and is suitable only for persons who can afford to lose the entire amount of their investment. There can be no assurance that the investment strategies employed by K2 Advisors (“K2”) or the managers of the investment entities selected by K2 will be successful.

The identification of attractive investment opportunities is difficult and involves a significant degree of uncertainty. Returns generated from alternative investments may not adequately compensate investors for the business and financial risks assumed. An investment in alternative investments is subject to those market risks common to entities investing in all types of securities, including market volatility. Also, certain trading techniques employed by alternative investments, such as leverage and hedging, may increase the adverse impact to which an investment portfolio may be subject.

Depending on the structure of the product invested, alternative investments may not be required to provide investors with periodic pricing or valuation and there may be a lack of transparency as to the underlying assets. Investing in alternative investments may also involve tax consequences and a prospective investor should consult with a tax advisor before investing. In addition to direct asset-based fees and expenses, certain alternative investments such as funds of hedge funds incur additional indirect fees, expenses and asset-based compensation of investment funds in which these alternative investments invest.

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