THE JOURNEY TO SECOND-LEVEL THINKING

BENCHMARK PLUS MANAGEMENT

MANAGER SELECTION, PORTFOLIO MANAGEMENT AND THE GENERATION OF ALPHA

In his book, The Most Important Thing: Uncommon Sense for the Thoughtful Investor, Howard Marks outlines the concept of Second-Level Thinking. Early in the book he states the obvious, or what should be the obvious, that "Anyone can achieve average investment performance—just invest in an index fund that buys a little of everything. That will give you what is known as "market returns"—merely matching whatever the market does." If "average" and "market returns" are what you seek, you can stop reading here. There is a ton of research and data out there that will point you in that direction.

> "ANYONE CAN ACHIEVE AVERAGE INVESTMENT PERFORMANCE—JUST INVEST IN AN INDEX FUND THAT BUYS A LITTLE OF EVERYTHING."

To the contrary, in this paper, we will propose a foundation for the level of thinking and action required for second-level thinking and to achieve better than "average performance" or "market returns". Again we return to Marks, "In my view, that's the definition of successful investing: doing better than the market and other investors. To accomplish that, you need either good luck or superior insight. Counting on luck isn't much of a plan, so you'd better concentrate on insight." Yet, fewer and fewer investors, including those that consider themselves professionals, rely on superior insight. Rather, they roll the proverbial dice or flip the proverbial coin, hoping for and chasing returns they cannot substantiate or verify as being superior.

Why? Well, Marks has an answer for that and he calls it first-level thinking. He states, "First-level thinking is simplistic and superficial, and just about everyone can do it (a bad sign for anything involving an attempt at superiority)." He goes on to outline several traits of first-level thinking:

- "The difference in workload between first-level and second-level thinking is clearly massive, and the number of people capable of the latter is tiny compared to the number capable of the former."
- "First-level thinkers look for simple formulas and easy answers. Second-level thinkers know that success in investing is the antithesis of simple."
- "First-level thinkers think the same way other first-level thinkers do about the same things, and they generally reach the same conclusions. By definition, this can't be the route to superior results. All investors can't beat the market since, collectively, they are the market."

We are not trying to bash first-level thinkers. After all, someone needs to achieve "average" and "market returns." Hey, wait a minute, are you a first-level thinker and still reading this paper? If so, get ready, because you are going to have to shift your thinking to a whole new level.

Marks' refers to this next level as second-level thinking. Brilliant eh? To him, "Second-level thinking is deep, complex and convoluted." And, we couldn't agree more. He goes on to state, "your goal in investing isn't to earn average returns; you want to do better than average. Thus, your thinking has to be better than that of others—both more powerful and at a higher level. Since other investors may be smart, well-informed and highly computerized, you must find an edge they don't have. You must think of something they haven't thought of, see things they miss or bring insight they don't possess. You have to react differently and behave differently." Sound good and something you pride yourself in doing? It does to us.

"SECOND-LEVEL THINKING IS DEEP, COMPLEX AND CONVOLUTED."

But how would one achieve second-level thinking in our current world of efficient markets? Well, walk with us; think with us, on the first leg of a journey through our world of second-level thinking.

Do you really believe markets are efficient as defined by Markowitz, et. al. in the Efficient Market Hypothesis? Think about it. Do the following 9 principles hold true for all investments at all times? (See Sidebar)

Our answer is "Not a Chance!" So, where would a second-level thinker start? In our view, a good place to start is where these principles are being violated.

Look around, dig deep, it is happening in many different places and being executed through many different forms. Only, it's not evident on the surface through returns, correlations or volatility. It is buried in second-level thought, in the "deep, complex and convoluted" work second-level thinkers execute.

Let's examine two examples. The first is Trade Claims. Once a debtor files for Chapter 11 protection, creditors may opt to sell their claims rather than wait an undetermined time for an uncertain payment – these are known as Trade Claims. These claims are often held by 'mom & pop' companies – individuals more concerned with making payroll or paying suppliers than dealing with attorneys, analyzing recovery rates or duration – providing knowledgeable participants with an inefficiency they can capitalize on.

For the second, consider Appraisal Rights. Although independent boards should act

EFFICIENT MARKET HYPOTHESIS PRINCIPLES:

1. All public Information is freely and simultaneously available to all Investors.
2. Investors have homogeneous expectations of risk and return.
3. Investors make rational choices on the basis of risk and return. Risk and return are measured by the mean and variance of the portfolio's return.
4. There are no transactions costs.
5. There are no taxes.
6. There are no restrictions on holding, buying, or selling particular securities.
7. There are no restrictions on shorting securities.
8. Unlimited borrowing or lending at the risk free rate.
9. Identical investor time horizons.

responsibly, inside acquirers often have an incentive to offer minority shareholders substantially less than fair value. The goal of Appraisal Rights investing is to generate material returns by utilizing securities laws to enforce the rights of potentially disadvantaged shareholders. Appraisal Rights allow a minority shareholder to reject the price offered by a potential acquirer and argue for a higher "fair value" before a Court. In addition to the fair value determined by the Court, statutory interest is often awarded with such rate applying to the Court determined valuation and not the acquirer's take out offer. In the case of Delaware, this is Fed funds +5%, other jurisdictions may have different rates. Again, we see inefficiency for market participants with the skill and expertise to capitalize on it.

Marks states that, "for your performance to diverge from the norm, your expectations—and thus your portfolio—have to diverge from the norm, and you have to be more right than the consensus. Different and better: that's a pretty good description of second-level thinking." So, we have identified a violation of the Efficient Market Hypothesis principles which could point to the potential for superior returns (i.e. different and better). Now what? Well, next we look for a way to express this violation in the market. If we are so inclined, we can pursue a strategy to trade this inefficiency directly. However, all but a very select group possesses the expertise, experience, fortitude and skill to pursue this path. If this is the case and we are not among this select group, we need to seek out those that are. Where do we start and what do we look for? Before continuing though, let's return to Mark's, "the key turning point in my investment management career came when I concluded that because the notion of market efficiency has relevance, I should limit my efforts to relatively inefficient markets where hard work and skill would pay off best."

MANAGERS ARE SELECTED BASED PRIMARILY ON THE DEGREE THAT TWO CRITERIA ARE MET:

1) IS THE MANAGER EXPLOITING ONE OR MORE MARKET INEFFICIENCIES?
2) DOES THE MANAGER HAVE ANY COMPETITIVE ADVANTAGES IN EXPLOITING THE INEFFICIENCIES?

For us, the question of structure comes into play here. Registered investments, mutual funds and ETFs, are substantially restricted by the securities they can own and the liquidity they must provide investors. They do not offer the flexibility required to capitalize on most inefficiencies. In our view, hedge funds, through their Regulation D offering, do offer the flexibility required. Again, we are only referring to structure here.

Okay, so hedge funds it is (Remember, we are on a journey together. We could talk for hours about why hedge funds are the most efficient structure and are happy to do so. But, for this journey and the sake of time, let's assume we agree). In a February 2016 Preqin Special Report, Hedge Fund Manager Outlook, they reported that there were over 15,438 active hedge funds globally. That is a ton of funds. Sorting through this list and identifying those that specialize in the specific inefficiency identified is at the core of second-level thinking. This is one expertise of firms like Benchmark Plus. We have built this expertise over 18+ years that is complimented by a network of industry experts. But, say you are all-in on the concept of second-level thinking and do the work yourself. In the end, you find a hand full of managers that meet your stringent criteria for consideration.

Next, the goal is to use second-level thinking to determine if this handful of managers possess a competitive advantage in exploiting the inefficiency. There are a number of areas in which a manager can develop a competitive advantage:

1) **Access to superior technology:** An example is a large proprietary trading group. Although their hedge fund is totally separate from their marketing making business they share the same technology to monitor and trade the option and equity markets. This allows them to place over 50,000 trades a days. To replicate this technology would cost over $100 million.

2) **Market Access:** There are some markets with restricted access. These have included certain trades in Canada and India that a couple of our managers have exploited by having preferential access due to nationality or special government grants.

3) **Reputational Advantage:** There are a few ways reputation can help (or hurt) a manager. One of our managers is an activist manager that has a reputation for never accepting green mail and always working for solutions that end up benefitting all shareholders. As a result, once it is known that he is involved in a particular situation (through 13d filings), other hedge funds and investors will piggyback the manager. This increases the probability of the activist manager success as the shareholder base is now stocked with like-minded shareholders. Another example is a well-known manager who is able to get access to companies, other investors, and analysts just because of his reputation as a great investment manager.

4) **Special Skills, Previous Experience or Contacts:** This is a grab bag for characteristics that managers may have that enable them to get things done or find out information that other managers would have difficulty in doing.

Now you have your list of screened managers. Using second-level thinking, is there a way to conduct a further screen to sort out those managers with the highest probability of producing alpha? We believe there is and it is a process for which we have developed a proprietary system. It is at this point where we request return and exposure data for the manager's portfolio: combined, long and short independently. Once uploaded, we run a regression analysis for each component of their portfolio. Here is where the art, versus the science, begins to materialize. Our system points us in the direction of likely systematic risk factors embedded in the portfolio. However, we cannot take this at face value. We need to compare the stated strategy of each manager with the result of the regression, to begin the process of developing a customized benchmark for each manager. In other words, using the number of observations, R2 and best strategy fit, which index or indices combine to best hedge embedded systematic risk and isolate the alpha of each manager.

Why does hedging systematic risk and isolating alpha matter? Regarding systematic risk, it comes down to the best use of resources and reducing the drag caused by fees. Our second-level thought process leads us to conclude that we do not want to pay hedge fund fees for

ALPHA, BY DEFINITION, SHOULD BE HIGHLY UNCORRELATED TO MOST MARKET FACTORS AND IS THE "HOLY GRAIL" INVESTORS SEEK.

systematic risk factors that should cost basis points to achieve. Removing these embedded factors also provides us with a true look at the alpha production capability of each manager. Alpha, by definition, should be highly uncorrelated to most market factors and is the "holy grail" investors seek. How can an investor be sure they are paying for alpha, when they do not have a systematic and process driven approach to identifying it and hedge out exposure that is due to systematic risk? In short, they can't.

We frequently demonstrate our proprietary system by using multiple real-world manager examples. One example involves an activist manager who is very popular and who has grown assets steadily over the past several years to multiple billions. On the surface, their annual returns since inception appear strong and their standard deviation seems in line with expectations. In fact, we were excited to get our hands on the return and exposure data, hoping the analysis would yield significant alpha. However, as we find can be the case more times than not, looks can be deceiving. When our analysis was complete, it revealed significant negative alpha. But, how can this be? A manager with what appears to be strong returns and acceptable risk, can produce negative alpha? Well, it turns out that this manager was actually long small cap and short large cap. Virtually 100% of their return could be explained (and hedged) using widely available indices, and for basis points in fees versus the 2% and 20% fee structure this manager charges.

For a second real world example, we reference a small cap manager who has limited AUM and returned capital on several occasions. We like to see managers who are disciplined and understand their capacity constraints in order to extract maximum value. On the surface, this manager's returns look good, but not exceptional. Most first-level thinkers will stop there and take a pass. However, for the second-level thinker, this is only the beginning of the story. They are willing and able to dig deeper to complete the analysis and they will be glad they did. Although this manager's returns appear a little better than average, their alpha production is far from it, averaging greater than 10% per year. When you dig into the long and short books independently, they reveal that this manager is making most of their alpha on the short book. This is highly unusual and of even more value to a portfolio. Not only is alpha significant, but it is diversified, being produced primarily on the short side.

> "ONLY SKILL CAN BE COUNTED ON TO ADD MORE IN PROPITIOUS ENVIRONMENTS THAN IT COSTS IN HOSTILE ONES."

From here, second-level thinkers are not satisfied with aggregating a portfolio of independent alpha producing managers. Although a majority of systematic risk can be hedged at the individual manager level (the art), some residual exists and should be addressed at the portfolio level. It is at the portfolio level where the fine tuning of this residual risk happens. We find that some of the residual risks offset each other. However, without fail, further hedging of the residual risk is required.

Leg one of our journey is now coming to an end. We are planning additional legs where we delve deeper into the intricacies of our second-level process. Our goal in this leg of the journey was to provide you with a foundation for second-level thinking as applied to investing in hedge funds. We believe we have successfully managed a portfolio of hedge funds using this second-level thought and process for over 18 years. Thus, we are not able to distill our experience and journey into a single document. However, there is more to come if you are willing and able to continue the journey with us. We will return to Mark's for the final word, "everything in investing is a two-edged sword and operates symmetrically, with the exception of superior skill. Only skill can be counted on to add more in propitious environments than it costs in hostile ones. This is the investment asymmetry we seek. Superior skill is the prerequisite for it."

Nothing presented herein is intended to constitute investment advice, and under no circumstances should any information provided herein be used or considered as an offer to sell or a solicitation of an offer to buy an interest in any investment fund, whether or not sponsored or managed by Benchmark Plus Management, LLC ("Benchmark Plus"). Any offer to sell or solicitation of an offer to buy such a security may be made only by the delivery of the relevant Confidential Private Placement Memorandum or similar document ("PPM") specifically addressed to the recipient thereof. Unless otherwise noted, source of all data, charts, tables and graphs is Benchmark Plus.

Past performance is not indicative of future results. No guarantee of investment performance is being provided and no inference to the contrary should be made. It should not be assumed that an investment in any Fund managed by Benchmark Plus or its affiliates will be profitable. The past performance of the Funds managed by Benchmark Plus may not necessarily be repeated. There can be no guarantee that any investment strategy employed by Benchmark Plus will be successful.

Risk Disclosure: Investments in hedge funds and other investment funds, including those managed by Benchmark Plus and such funds' investments in any other funds (collectively, the "Funds"), are speculative and involve a high degree of risk and are intended only for experienced and sophisticated investors. The use of leverage, derivatives, and other investment strategies can increase the volatility of investment returns and result in higher risk. Opportunities for withdrawal/redemption and transferability of interests will be restricted, so investors may not have access to capital when it is needed. There is no secondary market for the interests in the Fund, and none is expected to develop. An investor should not make an investment unless it is prepared to lose all or a substantial portion of its investment. The fees and expenses charged in connection with this investment may be higher than the fees and expenses of other investment alternatives and may offset profits. As with any investment strategy, there is potential for profit as well as the possibility of loss. The portfolio is under the discretionary trading authority of Benchmark Plus, which typically invests the Funds' assets with managers of other private investment funds (the "Fund Managers"). The primary portfolios managed by the Fund Managers in which the Funds invest may not be diversified among a wide range of investments or types of securities. This lack of diversification may result in higher risk. Asset allocation and portfolio diversification cannot assure or guarantee better performance and cannot eliminate the risk of investment losses.