The Three T's

of Protecting Equity-Based Portfolios

By Jeremy Radcliffe, President and Chief Strategy Officer

Salient's mission is to help investors build truly diversified portfolios, and we believe that one of the most important things an investor can do is assess the risk contribution coming from various asset classes. Large institutional investors were early adopters of a risk-balanced approach to asset allocation,[1] similar to the exposure provided by our Risk Parity Fund. Investors who adopt this approach may not require much in terms of additional diversifiers for their portfolios.

Still, we find that most investors' portfolios today have relatively high allocations to equities—typically 50% to 90% of invested dollars. These investors are frequently presented with complex, allegedly diversifying and often expensive options to complement their equity exposure. Recent market volatility has heightened investor interest in protecting against equity losses. We think there are logical reasons to be skeptical of near-term equity market returns (see: "The Narrative Fix Is In"[2] by Salient chief risk officer Ben Hunt). Since we don't have a crystal ball, we believe that investors should consider allocations to diversifying strategies if they have portfolios with substantial equity exposure. We believe the following three approaches will diversify an equity-based portfolio.

Long-Term U.S. Treasurys: *The ultimate alternative asset*

Treasurys were recently referred to as the "ultimate alternative asset"[3] and we could not agree more. Unfortunately, many investors have been spooked (in our view, needlessly) by the specter of not just rising but potentially rocketing interest rates. We could go on about why we think long bonds offer compelling value today, but instead refer you to Lacy Hunt from Hoisington Management[4] in Austin, Texas. The punch line is: Treasurys work to diversify or protect equity-based portfolios when equity markets drop in value. But don't forget: shorter-term treasurys do not have the duration or interest rate exposure that are necessary in these circumstances!

FIGURE 1

Treasurys: Correlation to Equities

10-Year Monthly Correlation to the S&P 500 Index

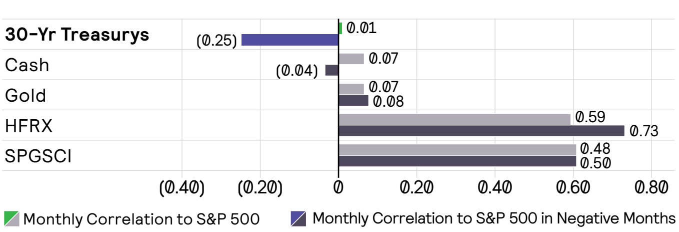
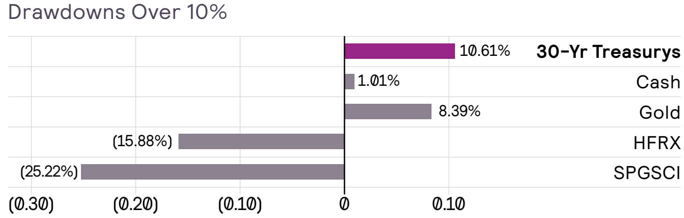


FIGURE 2

Treasurys: Performance in Down Markets

Average Performance During 12-Month S&P 500 Index Drawdowns Over 10%



Sources: Bloomberg, Salient Advisors, as of 12/31/15

Past performance does not guarantee future results. Index performance shown is not indicative of fund performance and is for illustrative purposes only. Index performance does not reflect the deduction of fees and expenses. One cannot invest directly in an index. See definitions for more details.

Trend-Following Strategies: *The trend is your friend*

I'll leave it to my colleague and our lead quantitative portfolio manager Dr. Rob Croce to explain the ins and outs of trend following,[5] but out of the various types of *managed futures* strategies, trend following may be a sound choice to protect your equity portfolio. The rationale is very simple: historically, trend-following strategies, like longer-dated Treasurys, tend to rise in value when equities are losing value and has a positive expected return over a full cycle, unlike something like short selling. An added benefit to investing in our fund is that Salient does not charge incentive fees, so more of the returns we generate go to investors. This is not the case with private managed futures funds. Many multi-manager mutual funds have performance fees embedded in their allocations to underlying managers.

FIGURE 3

Trend: Correlation to Equities

10-Year Monthly Correlation to the S&P 500 Index

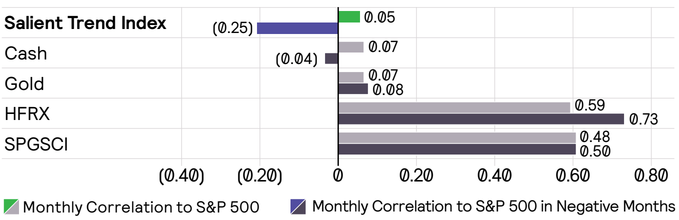
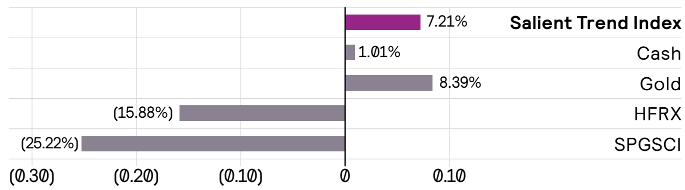


FIGURE 4

Trend: Performance in Down Markets

Average Performance During 12-Month S&P 500 Index Drawdowns Over 10%



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Tactical Trading: *Trust the seasoned experts*

The final way we know to protect equity-based portfolios is utilizing an experienced manager who adjusts exposure to the equity markets to de-risk a portfolio. De-risking a portfolio not only helps reduce the risk at that level of return, but it can enhance returns, protecting a portfolio's capital while being able to take advantage of market disruptions to add value. At Salient, we partner with 35-year veteran Christopher Guptill of Broadmark Asset Management whose strategy has successfully navigated the last two bear markets. Based on the tenets of Marty Zweig's[6] philosophy, Broadmark's strategy blends qualitative and quantitative metrics to judge the market's direction and adjust exposure accordingly.

FIGURE 5

Tactical: Correlation to Equities

10-Year Monthly Correlation to the S&P 500 Index

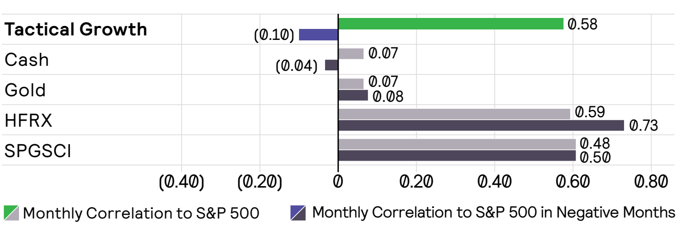
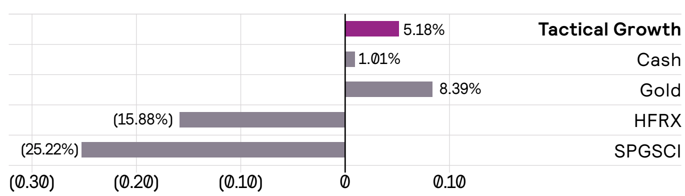


FIGURE 6

Tactical: Performance in Down Markets

Average Performance During 12-Month S&P 500 Index Drawdowns Over 10%



Sources: Bloomberg, Salient Advisors, as of 12/31/15

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Other Strategies

But what about the many other strategies being positioned as diversifiers? Below are some of the more common of these, and our argument for rejecting them as diversifiers. Note we do not reject them as valid investments, rather we simply don't think investors should count on them for bear market protection.

FIGURE 7

Diversifying Strategies: What They Are and What They Aren't

Strategy	What it is	What it is not
Hedge fund (e.g. long/short, relative value or event driven)	**Long-term diversifier** Hedge funds can provide long-term diversification for traditional portfolios.	**Short-term diversifier** These funds are expensive and more correlated with equities in times of market stress, almost regardless of the type of underlying strategy.
Short selling	**Hedge for downside risk** If you can get the timing right, outright shorting the equity market works.	**Consistent driver of return** This strategy has a (decidedly) negative expected return over a full market cycle so may be more likely to destroy value than to protect it.
Covered call writing	**Option premium** Selling covered calls is a very popular strategy. This strategy is ultimately a bet on markets "stalling" so an investor can enhance the yield on an equity.	**Portfolio protection** The income from writing calls is likely insufficient to protect an investor in any kind of sustained drawdown, and the investor may pay a high price for this income by capping equity upside.
Cash	**Risk-off asset** Holding high levels of cash may dampen volatility.	**Tactical diversifier** It is hard for a cash allocation to appreciate when equities are going down, particularly at today's short-term interest rates.
Gold	**Hedge against monetary policy** We believe gold may offer higher diversification benefits by being an effective bet against central bank competence (see: Epsilon Theory).	**Efficient investment vehicle** Historically, gold has not offered consistently strong returns.
Long commodities	**Equity diversifier** Longer term, commodities are a good diversifying asset class and a hedge against inflation.	**Protection in drawdowns** Given the sub-par performance of the commodity complex over the last 1 ½ years, we believe that commodities offer good value on the long side today, but do not offer contemporaneous protection in an equity bear market.

Definition of Terms

Barclays Global Aggregate Bond Index provides a broad-based measure of the global investment grade fixed-rate debt markets.

Covered calls is an options strategy where an investor holds a long position in an asset and then sells call options on that same asset in an attempt to generate increased income from the asset.

Correlation is a statistical measure of how two securities move in relation to each other.

HFRX Equity Hedge Index is comprised of private funds with strategies that maintain both long and short positions primarily in equity securities and equity derivatives.

Salient Trend Index includes three sub-portfolios that each follow a different signal—long, medium and short—and comprise futures contracts across global interest rates, equities and commodities. The index is based on a quantitative framework. The Index is calculated daily, rebalanced monthly, and targets a 10% volatility level.

S&P GSCI Commodity Index is a composite index of commodity sector returns representing an unleveraged, long only investment in commodity futures that is broadly diversified across the spectrum of commodities and serves as a measure of commodity performance over time.

S&P 500 Index is an unmanaged index of 500 common stocks chosen to reflect the industries in the U.S. economy. The S&P 500 was selected as Representative of the US Equity market, which is the largest in the world, and domestic to the vast majority of our client base.

Treasurys (or Treasury bonds) are debt obligations issued and backed by the full faith and credit of the U.S. government.

1. James Comtois, "Risk-parity backers not fazed by poor 2015 performance," *Pensions & Investments* (pionline.com), February 22, 2016
2. Ben Hunt, "The Narrative Fix Is In," *Epsilon Theory* (episilontheory.com), March 11, 2016
3. Tadas Viskanta, "Treasury bonds: the ultimate 'alternative asset' class," *Abnormal Returns* (abnormalreturns.com), January 27, 2016
4. Hoisington Investment Management Company, *Quarterly Review and Outlook* (http://www.hoisingtonmgt.com/pdf/HIM2015Q4NP.pdf), Fourth Quarter 2015
5. Roberto Croce, Ph.D., *A Primer on Momentum* (http://www.salientpartners.com/static/pdfs/Momentum%20Primer.pdf), January 24, 2013
6. Martin Zweig was an American stock investor, investment advisor and financial analyst known for selecting growth stocks that also have certain value characteristics, via a system that uses fundamental analysis and market timing.

You should consider the investment objectives, risks, charges and expenses of any mutual fund carefully before investing. The prospectus contains this and other information and is available, along with information on other Salient and legacy Forward funds, by downloading one from salientforward.com. The prospectus should be read carefully before investing.

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There are special risks associated with an investment in commodities and futures including market price fluctuation, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors, all of which must be read in their entirety.

Borrowing for investment purposes creates leverage, which can increase the risk and volatility of a fund.

Debt securities are subject to interest rate risk. If interest rates increase, the value of debt securities generally declines. Debt securities with longer durations tend to be more sensitive to changes in interest rates and more volatile than securities with shorter durations.

Derivative instruments involve risks different from those associated with investing directly in securities and may cause, among other things, increased volatility and transaction costs or a fund to lose more than the amount invested.

Investing in exchange-traded funds (ETFs) will subject a fund to substantially the same risks as those associated with the direct ownership of the securities or other property held by the ETFs.

Not FDIC Insured | No Bank Guarantee | May Lose Value

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