Blackstone

Market Commentary
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Revisiting Radical Asset Allocation
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In December of last year I suggested a "Radical" Asset Allocation program for institutional investors. I created it in reaction to the hours I had spent as a member of several investment committees where I had listened to and participated in discussions of the global investment environment, but which, in the end, only made very small changes in the asset allocation no matter how profound were their conclusions about the outlook. My investment philosophy is that making many small changes will produce disappointing results. It is the big ideas that make a difference and you should spend your time developing them.

I further think that the future is going to be very different from the past. The policy portfolios modeled on the approaches of the endowments of Harvard and Yale have served institutions well for the last thirty years but will not work as well in the future. You can no longer count on "reversion to the mean." The idea that you could look at historical returns and standard deviation for various asset classes and create a portfolio that would reflect your return objectives and risk tolerance will provide less favorable results in the investment landscape I see before me. That strategy will, perhaps, produce low single-digit-returns, but if you want to earn high-single-digit returns, which I think is a reasonable objective, you are going to have to structure your portfolio very differently from what had been considered prudent in the past.

The Radical Asset Allocation portfolio will be more volatile and less liquid than traditional institutional portfolios and it will probably be viewed by most investors as lower in quality. In my view, money managers are paying a high price to achieve quality in their portfolios and that will result in low returns. Buying 10- year United States Treasury notes yielding 2% is parking money while you are waiting for an opportunity in a higher-risk asset; it is not investing.

At the time I introduced the Radical Asset Allocation I said that I doubted that any portfolio anywhere in the world looked like the one I was presenting. I planned to talk with major investors around the world for a year about the thinking behind the recommendations, but I did not expect that at the end of that period there would be a portfolio that would look exactly like the one I had conceived. My hope was that I could persuade some investors to move in a "radical" direction in their asset allocation, and I think I accomplished that, although not without some vigorous arguments along the way.

Now, however, it is time to take a look at how the portfolio has done and to make some changes based on how the world has developed. My view of 2011 was too optimistic at the beginning of the year and the investment environment has been much more difficult than I anticipated. The United States and European economies have been weaker than I expected; the European sovereign debt crisis remains unresolved; emerging markets have grown more slowly than I projected; and U.S. Treasury yields have dropped, rather than risen as I thought they would. Stocks in the United States have not performed well and equities in the emerging markets have been very disappointing.

Below is an analysis of how the various categories within the Radical Asset Allocation portfolio have done as of October 31. I have indicated the benchmark I have used in calculating the performance.

Asset Class	% Allocation	October 31st Year-to-Date Performance	Benchmark
1. High-Quality Multinational Growth Stocks	10%	+.82 %	Standard & Poor's 100
2. Emerging Market Equities	20	-11.53	Morgan Stanley Capital International Emerging Markets Index
3. Hedge Funds (all strategies)	20	-5.44	Hedge Fund Research Institute Weighted Composite
4. Private Equity	10	-14.87	LPX50 Listed Private Equity Companies
5. Real Estate	10	+10.98	National Council of Real Estate Investment Fiduciaries Property Index
6. Gold	5	+20.70	Gold Spot
7. Agricultural Commodities	5	-13.09	S&P GSCI Agriculture Index Spot
8. High Yield Securities (including leveraged loans, mortgages and mezzanine)	20	+5.29	JP Morgan High Yield Bond Index
9. U.S. Treasurys	0		
10. Cash	0		
Total	**100%**	**-2.99 %**	

Selection of the appropriate benchmarks for the portfolio was easy in some cases and difficult in others. The Standard & Poor's 100 index is a good proxy for the large-capitalization multinationals I wanted to use in that part of the portfolio. Similarly the Morgan Stanley Capital International Emerging Markets Index is widely accepted as a measure of the performance of the equities in developing countries. For the hedge funds I picked the Hedge Fund Research Institute Weighted Composite which is widely employed to track performance across all hedge fund strategies. Perhaps the most difficult benchmark selection was for private equity. There is no easy way to track the individual investments of the private equity firms, so the proxy I used was the index of the stocks of those private equity firms that are public. This index measures the performance of the firms as businesses themselves, not just the performance of the companies in which they invest. Such factors as their ability to raise capital and how well the firms are managed come into play. The LPX50 Listed Private Equity Index measures the performance of 50 private equity firms listed on global exchanges, and that was the best benchmark I could find, although I recognize its imperfections.

For real estate I used the National Council of Real Estate Investment Fiduciaries Index, which is a widely accepted benchmark in that industry. The performance of gold was calculated on the per ounce price change of the metal itself. For agricultural commodities I used the S&P Goldman Sachs Agriculture Commodity Index since I wanted an index that avoided industrial metals. I was more interested in tracking the commodities that benefited from the rising standard of living in the developing world. In the case of the high-yield fixed income category I wanted something broader than the standard high yield index since I planned to use mortgages, leveraged loans and mezzanine financing instruments in this section of the portfolio. I picked the J.P. Morgan High Yield Bond Index as the proxy but that wasn't ideal for my purposes. The overall performance was calculated using benchmarks and there is always the possibility that the actual funds or stocks selected do better (or worse) than the benchmarks.

Reviewing the performance of the various asset classes in this difficult and volatile year is revealing. The high-quality multinationals did better than the S&P 500 as investors searched for financial strength and value. In spite of the fact that the economies of the developing countries grew at impressive rates in many cases, the index for these markets dropped significantly and this was one of the most serious drags on the performance of the overall portfolio. The other weak sector was private equity. This category may have been hurt by too much money chasing too few deals resulting in overpayment, as well as by the weak stock market, the reduced leverage available for financing buyouts and the generally soft economy. While competitive factors played a role in hurting private equity performance, they actually helped real estate. Many large real estate funds that had been active in the past have either closed down or scaled back. In addition there was not as much overbuilding in the positive economic cycle prior to 2008 as there had been in previous favorable periods. As a result real estate recovered along with the economy and the property index had positive performance. I originally established a position in gold as an insurance policy against a sharp downturn for financial assets and not as a speculation on the rise in precious metal prices. It performed well as a portfolio protector in 2011. It remains in the portfolio for its original purpose. The performance of agricultural commodities was disappointing. I was bearish on U.S. Treasurys when I created the Radical Asset Allocation model and I was wrong. I allocated no capital to this asset class and the 10-year U.S. Treasury had a total return of 13.37% through October.

I would describe the performance of the Radical Asset Allocation portfolio so far this year as lackluster. I am hopeful that the results will be positive by year-end. I also believe that an astute money manager would outperform the benchmarks. The portfolio suffered because I believed the markets would perform better than they actually did.

As a result of the experience so far this year, I am going to make some small asset allocation adjustments. I am also going to be more specific in how I would distribute assets among the various hedge fund strategies. Nine different types of hedge funds are listed below, and that may be too many for some of you.

Hedge Fund Distribution by Strategy

Long/Short Equity	10 %
Activist	5
Multi-Strategy	15
Credits – Fundamental	15
Credit – Distressed	5
Mortgage	15
Commodities	10
Macro	20
Quantitative	5
Total	**100 %**

If I had to divide my hedge fund allocation into only three categories, it would look like the following. The hedge fund strategy weightings are my own and do not reflect the view of the Blackstone Hedge Fund Solutions group, although I did solicit their advice.

Equity	30 %
Credit	40
Macro	30
Total	**100** %

I believe the equity markets have declined sufficiently this year to give investors a number of attractive

investment opportunities across the globe, which is why I have placed a major emphasis on common stock strategies.

As for adjustments in the overall portfolio, they are shown below.

Category	Original Radical Asset Allocation	Revised
High-Quality Multinational Growth Stocks	10%	10%
Emerging Market Equities	20	15
Hedge Funds (as revised)	20	15
Private Equity	10	10
Real Estate	10	10
Gold	5	5
Agricultural Commodities	5	5
High Yield Securities	20	15
U.S. Treasurys	0	10
Cash	0	5
Total	**100%**	**100%**

When I conceived of the Radical Asset Allocation portfolio, I had a three-year time horizon, but I recognize that events develop differently than one expects and periodic changes are necessary. While I believe that the portfolio did reasonably well so far this year, it was probably too aggressively constructed for institutional investors and in revising it I have lowered the risk. While I am optimistic that the outlook for next year won't be as bleak as many observers forecast, I believe it is sensible to recognize the many uncertainties facing the investment environment and to recast the Radical Asset Allocation somewhat more conservatively. I still believe the yield on the 10-year Treasury is headed higher over the long term because of the U.S. debt problems, but I am allocating some capital here to dampen volatility. I made some other changes with a similar objective. The original Radical Asset Allocation had no cash component. My thinking then was that the portfolio was designed for the invested portion of a client's strategy but that if institutions wanted to hold some cash in reserve, they could trim some points from the other categories. The revised Radical Asset Allocation portfolio has a small cash component.

Market Commentary

During the equity free-fall in August and September I was worried that the stock market would have a major impact on the economy in the all-important fourth quarter. Ordinarily the stock market is a discounting mechanism which anticipates reality; but at times when the market is especially strong or weak it can influence the economic outcome. Several factors contributed to the late summer decline: the downgrade of the U.S. government debt from AAA to AA+; the polarity of Congress and the dysfunctionality of the U.S. government as shown in attempts to raise the debt ceiling and reduce the budget deficit; the continued sovereign debt crisis in Europe; and the weak Philadelphia Federal Reserve report and other data indicating the economy might be moving back into a recession.

Since then a number of indicators have provided some reassurance that a recession is not imminent. The S&P 500 has rallied almost to its level at the beginning of the year level temporarily removing the fear that the stock market would ruin the fourth quarter. Various economic indicators have become more positive. The much-followed Philadelphia Fed index which wrought so much havoc last month moved from -17.5 to +8.7. Initial unemployment claims continued to move lower; bank loans increased, showing

business people had the confidence to borrow; durable goods orders improved; industrial production was positive; and housing starts were strong. Most economists raised their estimates of second half growth to 2.0% or more and recession fears diminished.

There continue to be major problems facing the markets. Congress continues to wrangle over the deficit reduction program; the European sovereign debt crisis persists with little evidence that a permanent solution will be agreed upon; and security analysts are revising their earnings estimates downward, but even the revised numbers do not indicate the market is overvalued. It is a warning sign, however. Another set of disturbing signs include the economy hovering at stall speed in the third quarter and the S&P 500 declining by 20% at its low point. Conditions like these often, but not always, precede recessions.

I still believe the economy will continue to grow at least into the first part of 2012. I further expect an imperfect plan to deal with reducing the budget deficit to be developed by the Congressional Super Committee. I am hopeful that the European Union and the euro will survive for the time being because both Sarkozy and Merkel have committed their support. Three years from now there may be a restructuring of the membership. I see evidence of some natural momentum in the U.S. economy that I hope will build rather than falter. If I am right, there may not be as many pessimists around at Christmas as there are now.