

**Investment Recommendation**

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*April 24, 2015*

**Re: MKP Opportunity Master Fund**

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**Recommendation: Reduction of the approved allocation to the MKP Opportunity Master Fund for the San Jose Absolute Return Portfolios**

Albourne supports moving forward with the allocation to the previously approved MKP Opportunity Master Fund (“MKP” or the “Fund”) for inclusion in the San Jose Retirement Services Absolute Return portfolios but at a reduced size of \$5 million for Police and Fire Department Retirement Plan and \$7 million for Federated Employees Retirement System.

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**Summary**

MKP is a discretionary macro manager with a fundamental emphasis across global markets. They were originally proposed in March 2014 to be included in the originally “Hedge Fund” portfolios. Allocations of \$20 million for the Federated Employees Retirement System and \$10 million for the Police and Fire Department Retirement Plan were recommended. However, as a result of the restructuring of the San Jose hedge fund portfolio and some minor organizational and risk process changes at the firm, Albourne recommends smaller allocations of \$5 million for Police and Fire and \$7 million for Federated.

The drivers behind the proposed reduction include: 1) the restructuring and bifurcation of the “Hedge Fund” portfolio and the resulting slight modifications to the return objectives and risk tolerance of the “Absolute Return” portfolio; 2) the rotation into the Brevan Howard Master Fund which increases the potential overlap between the two funds; 3) the potential for increased risk and drawdown as a result of minor adjustments to the risk management process; and 4) Albourne’s one notch downgrade in the investment rating conviction.

**Drivers to Allocation Reduction****1) The restructuring and bifurcation of the hedge fund portfolio and the resulting slight modifications to the return objectives and risk tolerance of the “Absolute Return” portfolio**

The restructuring of the hedge fund allocation resulted in a more Macro oriented Absolute Return portfolio that significantly limits the risk introduced by credit and equity exposures. This adjustment reduces the expectation of the beta impact on the return of the portfolio, therefore requiring the remaining Macro, and Relative Value strategies to a lesser extent, to generate higher levels of uncorrelated return than perhaps originally anticipated. This allows for incorporation of funds into the portfolio that exhibited higher levels of volatility as they seek higher returns. Therefore the role of MKP, despite being a high quality fund that is expected to add value, is diminished somewhat as funds with slightly higher risk/higher return potential are likely to play a more prominent role that previously envisioned.

## Investment Recommendation

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**2) The rotation into the Brevan Howard Master Fund which increases the potential overlap between the two funds**

The rotation from the Brevan Howard Multi-Strategy Fund into the Master Fund increases the potential for overlap between Brevan Howard and MKP. That doesn't necessitate avoiding MKP but it does result in a preference for a smaller allocation.

**3) The potential for increased risk and drawdown as a result of minor adjustments to the risk management process**

The implemented changes to the risk process are likely to slightly increase the risk profile of the Fund. Although this fits nicely with the restructuring of the hedge fund allocation and the Absolute Return portfolio, at a higher volatility level Albourne would recommend a slightly smaller allocation to the Fund when evaluated against the current fund composition and the other funds that are being assessed for inclusion in the portfolio.

**4) Albourne's one notch downgrade in the investment rating conviction**

The contracting process was slow and during that delay MKP experienced their largest historical drawdown which caused them to examine the risk process and make some minor organizational adjustments. As a result of the changes, Albourne reduced the investment assessment of the MKP fund from a B4 to a B3 in September of 2014 to reflect some uncertainty following the changes. San Jose took the opportunity to delay the funding until the Staff felt confident re-underwriting the recommendation. At a B3 the Fund is not one that Albourne is actively recommending to clients. That said though, and although the rating for the Fund has not been increased, Albourne is encouraged by the enhancements and the turn-around in performance so far in 2015. Given how far along San Jose is in the process with the manager, the continued confidence of the Staff, and the reduced recommended sizing, all support continuing to move forward with an investment.

### Due Diligence

There have been no rating changes or issues of note in the operational assessment of MKP since the original recommendation was made.

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## Investment Recommendation

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