



Dear Investor,

For the fourth quarter of 2014, the Boothbay Absolute Return Strategies Fund posted net returns of 1.88%<sup>1</sup>, versus returns of the HFR Global Hedge Fund Index of -1.74% and Market Neutral Index of +0.96%, and a return of the S&P 500 of +4.92%. While we were pleased with our 4<sup>th</sup> quarter returns on a risk-adjusted basis, we are still increasing risk towards industry norms in order to increase absolute returns.

### **Building Out the Portfolio**

As we have previously discussed, we are running with a very low risk profile for what we expect to be a temporary period as we continue to build out the portfolio by adding more non-correlated teams. This is more a function of waiting to add more non-correlated trading groups to best increase expected return for a given level of increased risk than of raising risk by increasing current allocations to existing managers, which would increase risk proportionately with the increase in expected return. On a positive note, we are encouraged by the pipeline of trading groups, which is being aided by a few minor developments. One is that teams tend to free up at year-end, after getting compensation from their prior firms. Secondly, our portfolio manager sourcing abilities, which are largely based on networking and relationship building, continue to grow geometrically with more time, more relationships, and more name recognition. Lastly, recent changes at some prime brokers have left a large number of proprietary trading groups without homes, so there is a fair amount of new talent looking for capital. We are in the process of onboarding up to four or five new teams that fit into our favorite category of "other," as explained below. It is often these types of strategies that are most additive to the portfolio level risk /reward characteristics.

Not only will the portfolio become more diversified as we add traders, but the constituents of the portfolio should continue to improve as well. This is because time allows us to accumulate more top-tier managers, but it is also a function of the point in the life cycle at which we tend to engage managers. We often find managers 12 to 24 months after they have launched. In an ideal world, we would see at least three years' worth of returns before bringing them onboard. Thus, we tend to start with a small investment, effectively purchasing cheap optionality on managers. As another year passes, we have accumulated significantly more information on the new managers, allowing us to add more capital to the managers who continue to prove themselves, while eliminating or cutting managers who did not. It's as if we get to buy options based on stale prices. To this end, at year-end we have cut a few trading teams while increasing allocations to a few others, and we are continuing that process.

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<sup>1</sup> For Class 1F, other classes will have slightly different returns.



## Performance

Putting our first six months in perspective, most investors are aware that we are dealing with the temporary situation of high fixed costs (which gets reduced as percentage as we grow) and low variable earnings due to being significantly underinvested until we have a more diversified portfolio.

With the caveat that we are still very much dealing with the law of small numbers, I'd like to put some analysis on this brief period by analyzing the returns ex-operating costs and management costs – a great indicator of the risk/reward profile that will be more relevant when we increase our risk appropriately to dwarf any fixed expenses.

Against this background, gross returns (which are net of trader fees and financing costs) were approximately 3.04% (6.2%% on an annualized basis) for the six months ended December 31. The worst month on that gross basis during that time was a loss of 0.18%, our only negative month of gross performance to date. Annualized returns of over 30x the worst month is a very good way of demonstrating a good risk/reward ratio, and something that we would hope to be more relevant as we ramp up risk and grow assets and thereby reduce fixed costs contribution. The intent is to continually ramp up risk until net daily VaR (Value at Risk) hovers around 75-80 basis points on a monthly basis (compared to what we believe is an industry average of 90-100 BPs). We would hope to be 75-85% accomplished during some time in the second quarter of this year (versus roughly 55-60% at year-end 2014). Regarding capital raising, we are still closed to new funds (other than fulfilling day 1 commitments), until such time that we are materially more invested than we were at year-end. We think it inappropriate to take in more assets and further dilute the existing portfolio. We believe it will become appropriate to take on new capital when we are closer to being fully invested. At that time, judicious expansion will have the dual benefit of decreasing the impact of fixed costs associated with running such a model, along with allowing for larger allocation sizes that could get us access to portfolio managers who are currently slightly out of our reach due to minimum size requirements for managed accounts.

By design, the portfolio demonstrated a beneficial lack of market correlation during the fourth quarter's two large equity market drawdowns. The first one in October saw us draw down minimally, and we were actually positive during the market's early December swoon.

Thus, on a risk-adjusted basis, we undoubtedly over-performed for the fourth quarter (even with non-exciting absolute returns). While we did not materially increase risk in January (though we again performed well during that month), we are excited at the pipeline of new managers that we expect to bring onboard by April. For the quarter, three of the four strategy groups were positive. Fundamental L/S contributed 0.64%, Other 0.19%, and Quant Futures/FX 0.10%. Quant Equities cost us 0.19%.

As of year-end, we had eighteen First Loss portfolios totaling \$288 million. We lost a couple over the quarter. At the time, \$130 million from these portfolios was above high water. Another \$100 million was within 2% of being above high water and contributing. Still another \$53 million was between 2% and 5% away, while \$5 million was below that with no realistic near-term expectation of contributing to our [REDACTED]. We do expect to be initiating another \$40 million of new First Loss books (including some hybrids) by the beginning of next quarter.

It should be apparent that, with a couple of good months, a material portion of the First Loss book could be above high water and adding significant [REDACTED] for our fund; of course, assuming we are doing our jobs well, none should contribute to any losses (other than the cost of financing the book).

One of the primary goals in portfolio construction is to get the most additional return for a given level of risk at the fund level. In addition to having individually good risk-adjusted strategies, it's important to find ones that are not highly correlated. Calmer markets can occasionally disguise volatility and thereby fool investors into thinking correlation is not present. There are certain factors that hit asset classes from time to time that cause stress simultaneously. We seek idiosyncratic sources of return, which is why our favorite category to invest in is "other." While we run our equity books with very low net exposures, we want strategies that are as orthogonal as possible. We are excited that we are in the process of onboarding four such portfolio managers. They are doing things like ETF arbitrage, rights offerings, trading index additions/removals, implied carry rates, and other non-correlated strategies. These strategies tend to be even more idiosyncratic, thereby increasing return expectancy with the lowest fund-level increase in risk.

On the operational front, unfortunately it appears that despite the painstaking process that we went through to onboard Kaufman Rossin as administrator, they proved, despite their representations, unequipped to handle our admittedly complex structure at a price that we find acceptable for our investors. They sought a material increase in pricing in order to add more personnel to get our accounts completed in a timely fashion. As a result, we will be switching administrators. After much research, we have decided on NAV Consulting, an administrator with \$45 billion under administration, whose significant operations in India and ownership of all its own technology allow it to deliver fast service at a materially lower cost. Their first month-end should be February, and we would expect significantly timelier month-end reporting starting with the March NAV.

We are hosting our annual emerging manager networking event on February 24<sup>th</sup>. It's an opportunity for our investors to meet many of our portfolio managers as well as an opportunity for our portfolio managers to meet other potential investors whom we invite to the event. Our ability to bring relationships to emerging managers materially assists us in bringing in managed accounts on both platforms in a competitive marketplace. And lastly, we recently moved offices. We stayed in the same building, just moved two floors higher to the 6<sup>th</sup> floor (810 7<sup>th</sup> Avenue, Suite 615, New York, NY 10019).

As always, I am available to answer all investment and business inquiries and Daniel is available to answer any questions related to financial operations.

Sincerely,



Ari Glass

Managing Member, Boothbay Management