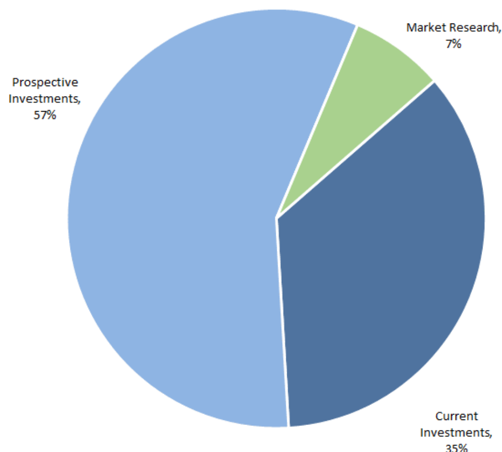
Dispatch from the Research Desk

ATRATO ADVISORS®

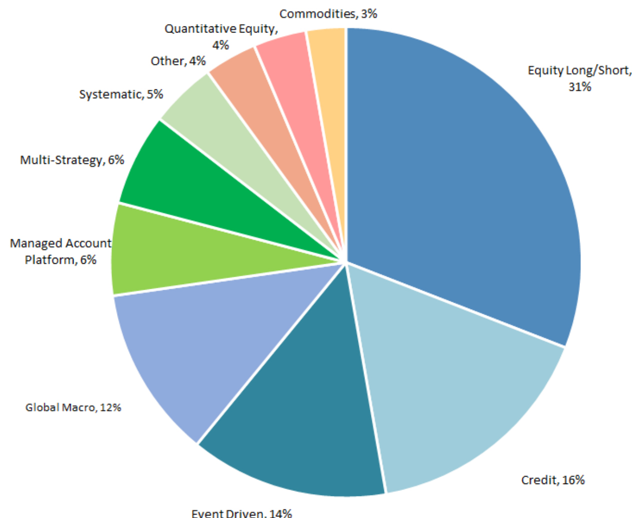
February 2016

Research Calendar

During the month of February, Atrato Advisors conducted 110 calls and meetings within the alternative industry that approximately broke down as follows:



By strategy, the research team allocated its time as follows:



The largest strategy group by meetings was Equity Long/Short at 31%. Credit was the next largest group of managers at 16%, and consisted of a large variety of typically US corporate credit and structured credit managers. The Event Driven manager group was the third largest at 14% and consisted primarily of opportunistic managers that allocate across equity and credit securities. The managers were largely divided between those that are rotating capital meaningfully to credit, and those that have continued to be exposed to equity securities. Approximately 6% of meetings were spent vetting managed account platforms by technological infrastructure, terms and manager offerings.

Thematic Viewpoints

The volatility in the financials sector this year has created opportunities to buy (European banks, asset managers) and sell (insurance companies, ASEAN banks) at disparate valuations. Financials, particularly in Europe, underperformed markedly to start the year. The concerns about slowing growth conditions, lower rates in the US and Europe, and commodity write-offs caused investors to price draconian, recession-like scenarios into market prices. Most fundamental investors took the view that economic conditions in the US and Europe remained supportive (particularly in the US), the banks were well capitalized (Tier 1 capital ratios 2-4x pre-crisis), and that commodities risk to the European financial system was minimal ($500 billion total, 60-70% of which is investment grade). The exceptions to the generally positive European financial landscape were Deutsche Bank (and its ongoing operational restructuring) and Italian banks. Italian banks have been problematic because they don't have enough capital based on current core Tier 1 capital ratios and NPLs. The $25-30 billion or so of capital that is required to shore up the small and medium sized banks is not a lot of capital in the grand scheme of Europe, however, investors are waiting on the sidelines until the recapitalizations and/or mergers to improve balance sheets occur. We also noted an increase in asset manager long positions, particularly after Carlyle announced a 20% share buyback at the valuation lows in February. Over the same period that European banks struggled, insurance companies outperformed materially and became attractive short candidates. Their price appreciation occurred despite the fact that insurance companies are also negatively impacted by low rates, the turning of the credit cycle and limited underlying growth. Financials managers are also focused on China-related financials, particularly in ASEAN countries where valuations to book value are high relative to other parts of the world.

Short-biased metals and metals-related equity trading has increased this year as the market has continued to price in more optimistic assumptions than managers can justify with evidence in the physical commodities markets. Metals have largely rallied from January lows, but fundamental managers remain largely negative about expected price action, particularly as Chinese manufacturing surveys deteriorated throughout February to reach their lowest level since November 2011. Physical market participants have not seen indicators of a pickup in demand, so many are drawing the conclusion that USD depreciation and the sharp rally in oil prices in February caused short covering, particularly for China slowdown-related base metals trades. With USD appreciation expected to resume and persistent deleveraging in Emerging Markets and China, drivers of additional demand and higher prices appear lacking. Investors have discussed directionally short-biased futures positions in aluminum, where the market is in oversupply already and there are no signs of production cuts, and iron ore,

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where recent price rallies have occurred despite China's stated objectives of reducing capital investments. Based on these same expected drivers for underlying commodity prices, equity managers have looked to increase short exposure to the metals and mining sector over the past month. While the trade has faced some headwinds given general optimism, managers sized up the trade during February and early March.

The bullish structured credit positioning discussed at year-end remains in place given credit spread widening and persistent illiquidity conditions, though concerns about the CMBS new issue market have grown as the capital to refinance 2006-2007 vintage deals appears lacking. Year-to-date, the structured credit markets have suffered from illiquidity and supply/demand issues. The issues and price trends remained consistent with the second half of 2015, but accelerated as general credit market conditions have deteriorated. The themes plaguing the market are relatively well know, as regulations have greatly reduced the ability and economic incentive for dealers to hold onto structured credit, with risk retention rules only causing further uncertainty in the securitization markets. CLOs fell in concert with the spread widening in the bank loan market, with equity and mezzanine tranches widening materially. Markets were particularly concerned about the levels of commodity exposure within the structures, with an emphasis on overcollateralization triggers and how actively or passively managers were high-grading their portfolios as the underlying loans traded off. Managers have generally favored rotating into the more actively managed structures where possible. We witnessed similar spread widening and manager buying in the Bank TruPs CDOs, legacy RMBS, and high yield ABS markets. While those markets remain compelling, some managers have expressed concerns about the broader CMBS markets. While many believe that there are attractive issues in legacy CMBS vintages, the concerns are that newer issues may come under pressure if the bullet maturities from 2006-2007 can't be refinanced at as high a rate as anticipated by the market. The most pessimistic managers on CMBS believe that defaults could be as high as 40%, relative to the 25% expected by most market participants, and have sought positions in control bonds that will give them the right of first refusal to purchase the underlying assets from the special servicer post-default.

Global macro portfolio diversification continues as managers reduce risk and/or trade more tactically until fundamental conditions become more apparent. The theme touched upon last month regarding the greater diversification within discretionary global macro portfolios has intensified. While the USD long trades persist in portfolios, the currencies against which it trades have generally diversified. In addition, equity, fixed income and commodity trades have diversified as well, with managers either running with lower exposures or allocating more capital to short-term tactical trades until the indicators of true fundamental economic strength or weakness become more decisive. One trade that stood out within multiple portfolios was bearishness on South Africa. Most of these shorts have been expressed through the ZAR on the expectation that weak growth and high inflation will likely be negative for domestic credit. With pro-cyclical monetary and fiscal policies, inflation concerns are likely to grow and weigh on the currency. After some marginal downgrades with stable outlooks by credit rating agencies late last year, some market participants have dismissed the possibility of a near-term ratings downgrade from investment grade to junk. However, managers with a more pessimistic view of the economy believe that a summer downgrade by S&P could be a major catalyst to revaluation for the currency.

As always, if you would like any additional information on Atrato's manager meetings or would like to discuss the implications of thematic viewpoints on portfolio construction, please don't hesitate to contact us. Thanks for reading.

Warm regards,

Michael Boensch, CFA, CAIA
Partner, Director of Research

About Atrato Advisors

Atrato Advisors (www.atratoadvisors.com) is a boutique consulting firm that provides highly individualized research and advisory solutions to the hedge fund investor community. We work with a number of institutions including family offices, wealth management firms, asset managers, fund of funds, foundations and endowments looking to expand the scope and depth of their hedge fund coverage, partnering with them on sourcing, portfolio construction, manager research and/or operational due diligence.

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