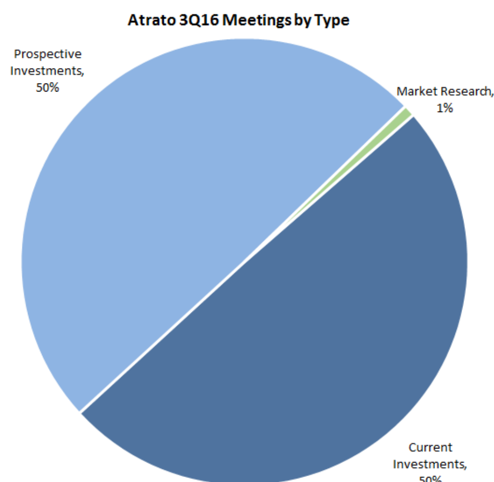
Dispatch from the Research Desk

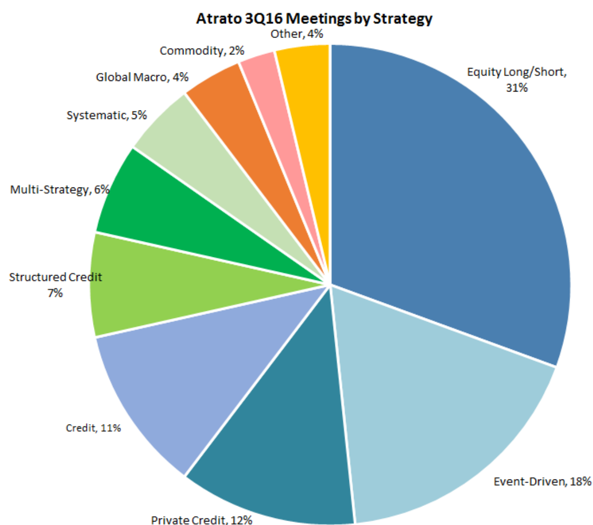
3Q16 Review & Outlook

Research Calendar

During the third quarter, Atrato Advisors conducted 242 calls and meetings within the alternative investment 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%, across generalists and sector (biotech, financials, healthcare, MLP, real estate, TMT, utilities), market cap and geographic (China, Emerging Markets, Europe, Frontier Markets, Nordic Countries, Pan-Asia, Southern Europe, UK, US) specialists. The next largest strategy group was Event-Driven at 18%, with an emphasis on opportunistic and niche (closed-end fund, appraisal rights) strategies. The team also surveyed a large number of opportunities across private (Private Credit: 12%) and public (Credit: 11%, Structured Credit: 7%) credit strategies. Private credit strategies included middle market direct lending, real estate bridge loans and specialty finance funds.

Thematic Viewpoints

Investor flows have diverged materially, with some investors allocating more capital to passive strategies and increasing their beta profiles, and others remaining committed to alternatives but reducing beta profiles. Investor sentiment towards hedge funds remains extremely poor with large underperforming funds continuing to bleed assets and smaller start-ups having a challenging time garnering investor interest, almost regardless of performance. Given the relative outperformance of passive investment strategies since the financial crisis, many investors, particularly institutions, are allowing more beta and volatility in their portfolios by taking a more passive approach. In this environment, factor-based risk premia strategies have been extremely popular given generally low fee and diversified exposure profiles. For investors that remain committed to hedge funds, the incremental trend of flows has been toward lower beta strategies. These investors generally believe the market is in a late-cycle stage which substantially increases the risk of passive allocations relative to backtests. Along these lines, there have been outsized investor flows into illiquid credit strategies that aren't marked-to-market.

Public credit dynamics suggest that increased conservatism is warranted for high yield credit strategies, and distressed portfolio managers are at odds for how to proceed based on commodity-related bets taken earlier in the year. Based on the length of the current bull market and current leverage levels (2016 average Debt-to-EBITDA of 5.0x exceeds the pre-2008 crisis peak of 4.9x), credit investors fear we are in the late stages of a credit cycle. With forecasts calling for continued positive but low economic growth, higher inflation and a sustained interest rate hiking cycle, the expectation is that defaults will increase. Over the last two cycles, the average default rate for high yield increased to 7% on average in the three years following periods of high leverage. With a record 25% of the leveraged credit markets controlled by daily liquidity vehicles and broker dealer inventories at record lows, the potential for higher than typical market volatility as defaults increase is substantial.

High yield credit and distressed funds have generally performed well this year, but there has been a high degree of dispersion between funds based on the constituents of their portfolios. The best performing funds, many of which are up over 20% YTD, are those that had material commodity exposure and participated in the post-February 2016 rally. Many of these same managers generated outsized losses in 2015 due to early exposure to the same themes. Managers that have generated outsized returns this year are generally operating at high levels of exposure due to organic appreciation and increased allocation to bankruptcies that cured themselves quickly with the recovery of commodity prices. More conservative managers utilized the broad credit sell-off in the first quarter to acquire bullet-proof credits with no commodity

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exposure that traded off for purely technical reasons. As these credits rallied, these managers have tended to reduce exposure. The expectation for these managers is that the default cycle is still early and that they would rather be in performing businesses at stressed prices when market-selloffs occur than be in stressed and distressed situations. These managers are waiting for substantially higher levels of defaults and lower prices before committing capital, and are therefore generally sitting on high levels of cash. More so than usual, incremental distressed allocations can give allocators widely different risk exposures due to manager style.

Given low yields available in public credit markets and volatility concerns, investor capital has been moving into long-lock private credit funds. In particular, substantial capital has been raised into middle market direct lending funds. Investors are excited about the opportunity set because middle market loans generally have more financial covenants, about 0.65x less leverage, and earn a premium spread greater than 150 bps over syndicated loans. The most popular funds have been those focused on sponsor-backed middle market companies with moderate size (EBITDA of $10-75 million). The market appears to be extremely competitive for the smaller-end of the middle market (<$25 million of EBITDA) and least competitive for the larger-end of the middle market (>$50 million of EBITDA). Investors have been primarily allocating to senior secured-focused funds, and the target returns available range from the mid-single digits to low-teens, depending on the amount of financial leverage applied. Target returns on more junior-oriented funds are also in the 10% to low-teens range, so investors have to choose whether they are more comfortable with financial or structural leverage at this point in the cycle.

A variety of structured credit and private credit strategies are offering attractive returns to take advantage of solid consumer and housing fundamentals, and are supported by the trend of continued bank disintermediation. In a world of generally cautious investor sentiment, investor consensus is that consumer and housing fundamentals remain attractive. For example, consumer debt levels have dropped to their lowest levels in over 25 years as measured by the financial obligations ratio and the total consumer debt service ratio. Furthermore, home affordability is robust with US mortgage rates and home affordability at attractive levels (adjusted for inflation, home prices are 20% below the peak achieved in 2006), and the monthly supply of new and existing homes remains below five months. The question for many investors is how to gain exposure to the consumer and/or housing themes and still generate acceptable levels of return given the degree to which these trends have been priced into RMBS markets.

Within the public structured credit markets, Atrato Advisors has identified a number of strategies that are allocating to short duration assets in structures that deleverage quickly as the underlying loans amortize over time. On the more liquid end of the spectrum, we have seen managers allocate to consumer loans and subprime auto subordinate debt with moderate amounts of financial leverage to achieve double digit returns. For more traditional non-agency RMBS, the unlevered returns are in the mid-to-low single digits. On the less liquid part of the spectrum, three to seven year fund structures allocating to re-discount lending and specialty finance strategies have become prevalent. The underlying loans tend to be unsecured small business, unsecured consumer, and secured bridge loans to residential and commercial properties. In most instances, these vehicles are able to provide substantially similar returns to direct lending funds, with materially lower weighted average loan lives.

The environment for global macro strategies appears to be improving, and the US rate hike cycle and the European elections should be just a few factors that drive increased risk taking over the coming quarters. The macro environment continues to be primarily driven by monetary policy and predicting how and when changes in monetary policy are going to occur. Managers have struggled to generate an edge over the last several years, particularly given the large degree to which the entire market has been focused on central bank meetings and the speeches of central bank governors and proxies. Risk levels across global macro strategies fell to exceptionally low levels over the summer as volatility compressed, with a large number of small tactical trades across asset classes and no meaningful existing or identified long-term thematic trades. While the month of August was relatively calm, September was more eventful and global macro funds were able to increase risk from the lows seen earlier in the quarter and capture some of the prevailing trends.

In late September and early October, a number of trends began to develop within global macro portfolios including bond weakness (curve steepening) in developed markets, USD outperformance (against EUR and a basket of Asian currencies), long gold and long inflation-linked bonds in the US and UK. In addition, managers have worked to identify shorter-term trades that should be independent of monetary policy decisions, including being long the Russian Rubble as the currency is still fairly cheap and recent developments amongst OPEC members decreased the downside price risk in oil. After a largely disappointing year with respect to capital deployment, risk levels and the absolute level of returns, managers are excited about the developments they see unfolding over the coming quarters. December should be an interesting month given the anticipated Fed rate hike and the Italian referendum. Current polls on constitutional reform in Italy suggest the government will lose, which will support the growth of populist and nationalist political strength in Europe. The Italian referendum will be a prelude to the major continental elections in Germany, France and Spain (third election plausible for December) in 2017.

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Flows have been strong to passive equity strategies allocating to low beta stocks, often to the detriment of valuation-based shorts in hedge fund portfolios. As market participants have become more concerned about late cycle risks, flows to bond-like/defensive equities have increased. One popular strategy has been minimum variance portfolios, which seek to allocate to the lowest volatility stocks within a given universe. The objective is to capture the performance of an index or market while taking less price volatility risk. The strategy has been criticized both by quantitative equity hedge funds, because it has no embedded measure of expected return, and by fundamental equity funds, as the strategy ignores fundamentals (earnings stability is expected to be captured by the low volatility profile absent of the concept of value). As a result, these portfolios tend to trade at a premium multiple relative to their benchmarks. These portfolios became particularly vulnerable in the summer as the positive momentum factor brought more non-valuation sensitive investors into the mix. After extremely high flows and strong relative performance through the early third quarter, these ETFs have struggled with greater investor churn, and outflows in September and October. With high multiples and increased investor crowding, the negative risks to these strategies have increased substantially.

Many fundamental managers struggled with their shorts this year as a result of the progressive overvaluation of stable equities even if they exhibited zero-to-low growth profiles. Most managers have held or sized up these types of shorts under the assumption that a reversal of ETF flows could cause a dramatic repricing of the stocks in the short-to-medium term. While these shorts tend to be fundamentally oriented, changes in broad investor sentiment (ETF flows) is likely to have the largest impact on valuations near-term. Investors believe that the turbulence witnessed in September and October for minimum variance ETFs is a positive indicator for the short opportunity set going forward.

The dominance of large online e-commerce platforms over smaller platforms and traditional bricks and mortar retailers is a major theme across hedge fund portfolios. In general, equity managers are long dominant e-commerce platforms and retailers with strong internet franchises that have the ability to disintermediate bricks and mortar retailers. The most obvious behemoth that we see as a long position in many portfolios is Amazon, but managers have differentiated themselves by allocating to comparable businesses (broad-based or niche) that dominate particular countries or geographic regions across the world, notably internet-based retailers in China and Japan. There has also been substantial differentiation across portfolios in the structure of short exposure, though positioning has been heavily oriented toward US mall-based retailers, particularly those that have appreciated after pitching EBITDA turnaround stories to the market. A similar theme exists with larger e-commerce or online consumer platforms moving into niche sectors and dominating established but smaller incumbents. The barriers to entry for the large platforms have been smaller than anticipated by many investors, especially since it allows users to consolidate their e-commerce/online applications. While the betas of online consumer platform shorts are high, the expectation of catastrophic declines as the larger platforms take market share has kept the trade compelling for managers. Bricks and mortar retail shorts are also prevalent across high yield credit portfolios.

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.

Contact

Brian Reich
President
BReich@atratoadvisors.com
(212) 582-2200

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