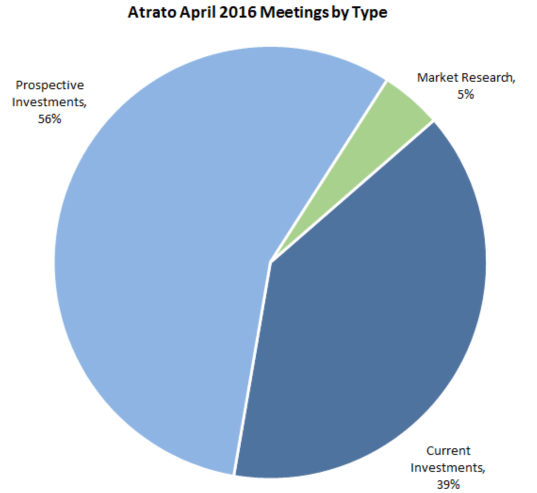
# Dispatch from the Research Desk

April 2016

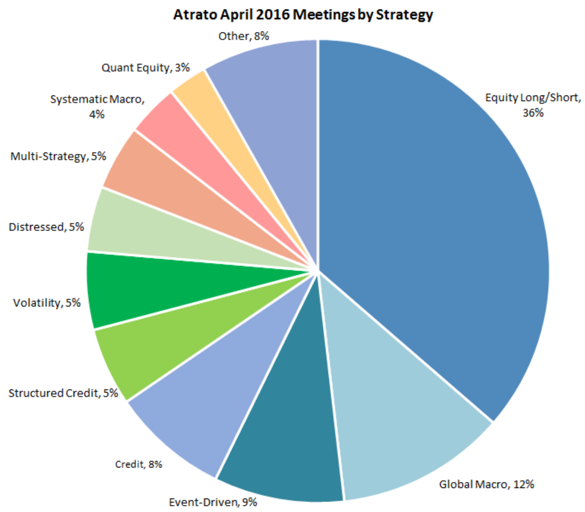
ATRATO ADVISORS®

## Research Calendar

During the month of April, Atrato Advisors conducted 110 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 36% across generalists and sector (biotech, financials, healthcare, TMT, utilities), market cap (micro, small, mid) and geographic specialists (Asia, Emerging Markets, Europe, Frontier Markets, Nordic Countries, US). The next largest strategy group was global macro at 12%, with an emphasis on managers with emerging markets orientations. Thereafter, all other strategy groups were fairly diversified, though the aggregate time spent with different credit sub-strategies (Credit, Structured Credit, Distressed) was notable at 18%. Lastly, the increased volatility so far in 2016 created an interesting opportunity to vet and assess the returns for Volatility strategies.

## Thematic Viewpoints

Energy sector valuations have traded dramatically YTD and a variety of hedged and directional strategies have emerged to take advantage of fundamental dislocations. The fortunes and valuations of energy companies have changed materially over the last few months. While it was doom and gloom for most companies in the sector in February as oil reached a low price of $26 bbl, oil rallied throughout the month of April to $46 bbl and was over $48 bbl at the time of this writing. As a result, energy bonds and equities have appreciated substantially. We have seen a variety of trades emerge from the recent price action. A more long-oriented strategy is one that is looking to identify documentation anomalies within bond indentures that give the holder atypical rights with respect to seniority (in some cases relative to loans), pledged collateral, and covenants (with the ability to enforce and place a company in bankruptcy). The strategy involves the use or threat of litigation to further cause revaluation of the securities held by the fund. This tends to be a heavily negotiated strategy, and favorable outcomes can come through a variety of forms as the company and senior lenders work to eliminate the securities that threaten their position. Another common strategy involves capital structure arbitrage trades with short equity and long bond positions. While many of these trade structures have been profitable, the magnitude of the rally in some energy stocks caused the net positions in certain cases to be unprofitable. Most managers have held and pressed their shorts on the assumption that oil is unlikely to remain consistently over $50 this year. While oil supply and demand are likely to come in balance late in 2016, inventories will continue to be drawn down and price spikes should be met with increased supply, which should keep oil range bound and below $60 throughout 2017. The full elimination of Iranian sanctions should also provide increased supply to the market. Despite supply/demand conditions, the rally in equity valuations implies substantially higher future oil prices for many companies that cannot survive with current balance sheets at sub-$60 oil prices.

Macro portfolio positioning has continued to evolve and a greater dispersion of positions and risk utilization has become evident between developed and emerging markets-focused funds. Over the last several months there has been a material rotation within macro portfolios. We highlighted the growing diversification of risk-taking over the last several months in response to crowded drawdowns in EUR (short) and USD (long) positions in December and April. As losses were incurred in long USD, short EUR and short equities themes in April, exposures to those themes were reduced further. What emerged are two different types of risk exposure. More developed market-oriented funds have generally been allocating less overall risk (VaRs are low) and focusing on tactical opportunities to trade around Brexit news flow, long Gold, long USD, and Treasury curve steepening. Over the course of May, the market shifted from discounting almost zero probability of a rate

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hike in June to a 30% probability of a hike since economic conditions appear to be stable. With the opening of the June hike window, managers have structured more positions around the anticipated speed of future rate hikes through steepeners. Within emerging market oriented macro portfolios, we have identified more risk-taking (higher VaRs), mostly structured around Chinese growth and leverage conditions. Conviction in the short thesis has improved over the last several months as the anticipated spillover of Chinese stimulus to peripheral Asian economies has not occurred as it did during prior stimulus periods. In addition, market participants have focused on China's total debt-to-GDP (280%) and concerns that NPLs could reach 20-25% of GDP in the current cycle. While most funds have some short exposure to CNY, many managers have found peripheral Asian economies as a cleaner expression of the trade given the opaqueness of data from China. One notable country of focus is Singapore, where funds are short the SGD against USD and baskets of trading counterparties and equities (financials and real estate-related firms). The country and financial sectors have benefited from decades of growth in China, and many of the financial institutions are important in lending to Chinese and Chinese-sensitive businesses that are also suffering from the changing composition of Chinese economic growth.

Allocations to conservative merger arbitrage deals and tactical merger arbitrage spread trading have been profitable for firms YTD, while riskier deals and deal breaks have caused losses. Some deal breaks are generating opportunities for special situation equity investments. Mergers have been a major topic of interest over the last several quarters as market and economic uncertainty combined with leverage and regulatory concerns to make spreads extremely wide. As we noted last year, many multi-strategy funds materially increased their allocations to the strategy in absolute terms at the expense of legacy distressed and special situation equity allocations. In general, the funds that have allocated to safe deals close to completion have done quite well, capturing high single digit annualized returns in a market that has otherwise been volatile. Smaller funds focused on conservative deal closures were able to capture additional returns from tactically trading deal spreads around macro and sector news flow. The most challenging portion of the merger market were the deals with regulatory scrutiny (Pfizer/Allergan, Halliburton/Baker Hughes, Staples/Office Depot) as the Treasury created new rules to combat mergers with inversion characteristics and the FTC cracked down on antitrust risks. Other transactions, notably ETE/Williams, have been heavily impacted by changing sector valuations and the leverage required to facilitate the transactions. As a result of federal regulation, 2016 has experienced a record amount of withdrawn M&A deals according to Dealogic. While the deal breaks have been painful in some portfolios, there is also a growing special situations equity opportunity as deal break fees (Halliburton to pay Baker Hughes $3.5 billion, Pfizer only to pay $150 million to Allergan) can dramatically change the competitive dynamics for targets post deal failure.

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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