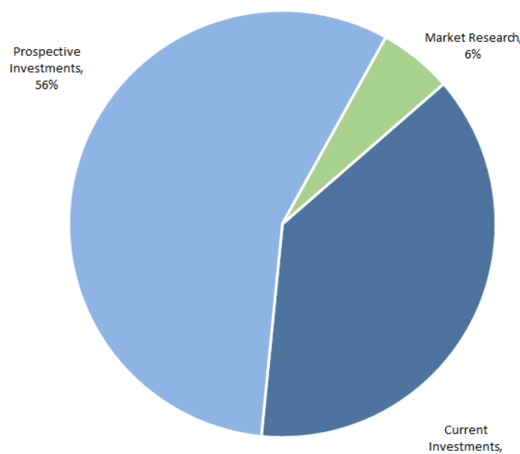
Dispatch from the Research Desk

ATRATO ADVISORS®

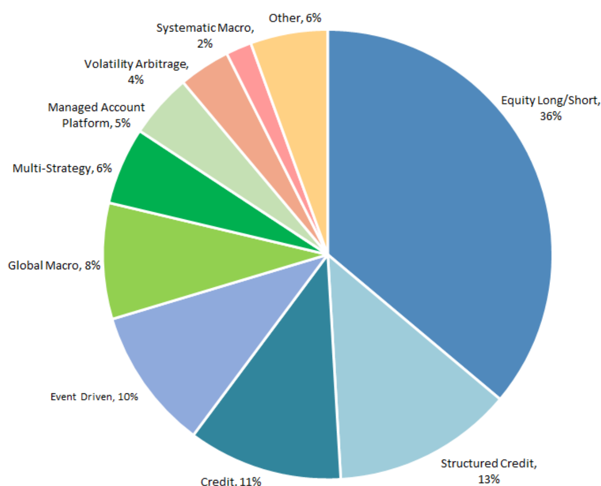
March 2016

Research Calendar

During the month of March, Atrato Advisors conducted 108 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 36%. Our focus was bifurcated, with an emphasis on those managers that underperformed (cyclicals, healthcare) and outperformed (varied) the most over the first quarter. The next largest group was structured credit at 13% with an emphasis on diversified managers and those with specializations in RMBS and CLOs. The next largest group was corporate credit managers at 11%, where the focus was to meet a diverse set of managers to understand the different potential approaches and exposures in the coming default cycle. Approximately 5% of meetings were spent vetting managed account platforms.

Thematic Viewpoints

Global macro managers shifted their focus to fixed income/inflation (US and Japan) and commodity (gold) trades, with smaller relative allocations to monetary policy divergence and Brexit trades following volatility and outsized losses in March due to the Fed's dovishness. Over the last several quarters, the consistent theme across discretionary global macro portfolios was long USD exposure. The theme started as long USD against short EUR and JPY due to monetary policy divergence. As trends evolved throughout 2015, this positioning migrated away from the EUR and JPY towards shorts in commodity and China-sensitive economies globally. The losses experienced by managers in the EUR-leg of the trade in December of 2015 caused diversification in currency positions to expand further. Many managers experienced substantial losses from these positions in March of 2016 as the FOMC dot-plots indicated two hikes (down from four) in 2016 and Ms. Yellen surprised the market with her dovishness. Over the course of the month, the USD weakened, emerging market currencies strengthened, bond yields fell, inflation breakevens rose, and credit spreads narrowed. These moves led to substantial rotations in portfolios. While managers still believe in the general long USD and short EUR, JPY, and commodity/emerging market thesis, concerns about crowdedness and risk-adjusted returns have caused managers to downsize these trades and become more tactical around calendared events. With increased inflation and growth expectations in the US, managers allocated capital to interest rate swaps, long breakevens (TIPS), and long gold.

High yield/distressed managers remain excited about the opportunity set, but there is substantial debate about the appropriate fund structure to take advantage of assets that are less liquid due to regulation. According to JP Morgan, as of quarter-end, the par amount of high-yield bonds trading at or below 90% of face value was $439 billion, the highest since the credit crisis and $331 billion (9x) higher than in June of 2014. This included 169 energy bonds, 48 metals and mining bonds, and 222 bonds in other sectors. Most managers favor the opportunities available at current prices and expect the opportunity set to be fruitful going forward as more credit events occur. While some managers have substantial balance sheet committed already, others have remained patient. Cautious managers made small allocations to non-commodity distressed situations (branded consumer/retail) and non-core loans from European banks (many are real estate related). Managers debated the appropriate vehicle/liability structure for liquidity conditions. Since the financial crisis, dealer credit inventories are down 80%, but the leveraged loan market has doubled and trading volumes have risen. The vast majority of the increased trading is due to the assets that are held by daily liquidity mutual funds and ETFs, which have almost doubled in size since 2009. Managers fear that current market structure will lead to substantially more price volatility and illiquidity (price gaps), and that investor capital will have to be substantially longer in duration

than in prior cycles to be managed through the upcoming volatility. If prudent managers don't have the proper duration of capital, they will be forced to take only marginal positions in less liquid and deeply discounted opportunities or to hold more cash. As a result of these conditions, we have seen substantially more opportunistic closed-end/hybrid (3-5 year life) vehicles recently come to market. We have also seen a substantial increase in the number of closed-end vehicles focused on RMBS and CLO opportunities.

Fundamental equity managers battled against negative technicals and substantial de-risking across multi-manager platforms during the first quarter, often controlling risk by reducing gross exposure but holding and even growing conviction positions throughout. De-risking was a major theme throughout the entire first quarter, which according to Morgan Stanley was the worst quarter for stock picking alpha in at least seven years. As managers de-risked their portfolios, longs were sold and shorts were covered. These conditions were particularly dramatic in cyclical sectors (energy, metals/mining, and financials). Nevertheless, the historically defensive healthcare sector proved vulnerable, with biotech stocks falling sharply on funding/capital concerns and specialty pharma stocks trading down following regulatory and fundamental concerns over Valeant. When markets rallied sharply in March, junk (highly levered or high cost producers with high short interest) rallied the most. In such overbearing market conditions, many managers lost absolute dollars on both longs and shorts. Within the multi-portfolio manager firms, we saw a substantial number of stop-outs in the sectors highlighted above, and gross equity risk was reduced materially from January through early March. While the transition was extremely challenging, the current leverage and exposure from the equity platforms should provide a stable base upon which equity managers can build exposure (and the positive impact that has on crowded positions). In general, single portfolio manager funds reduced gross exposure; however, they did not identify the fundamental justifications to reduce the sizes of their largest positions, so in many cases concentration increased. Managers exposed to specialty pharma generally did not cut their positions, and while most didn't have the stomach to add to Valeant, we saw additions to Endo Pharmaceuticals, Allergan, and Teva. With all of the terminations of cyclical portfolio managers from the larger platforms, we were surprised to see some opportunistic hires by firms looking to garner cyclical exposure going forward on the assumption that alpha potential will be extremely high in a period of commodity price stabilization.

European event driven managers believe that Europe is roughly two years behind the US in terms of the M&A cycle, which translates to expectations that strategic large cap M&A in Europe is at an inflection point. On the other hand, they believe the US looks rather stretched, perhaps contradicting previous statements we've made from our discussions with US event driven managers. With that said, one fund is focusing on corporate restructurings (mainly management changes), as 50% of the MSCI Europe (250 companies) changed their CEO/CFO in the last 24 months. Given the lack of GDP growth across Europe, the restructurings are a primary facet for stock price appreciation. Lastly, the manager mentioned an increasing level of activism in Europe, with some prominent managers playing an increased role in their attempts to create their own catalysts. For example, ValueAct is involved in Rolls Royce. In Europe, activism's role is behind the scenes and more relationship driven than in the US, where managers and management teams often clash in the public eye.

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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