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SOPHISTICATED ALTERNATIVE INVESTMENTS ACROSS THE CORPORATE CAPITAL STACK



Oliver Fochler
Managing Partner, CEO
Tel.: +4479224 36360



Alexandros Kyparissis
Analyst Hedge Funds
Tel.: +447843144007



The economic conditions being shaped during 2016 could be the vanguard of the investment environment for the years to come and there is certainly one winner: alternative investments. Over the last decade, the industry has grown exponentially, with alternative funds managing currently near \$10 trillion, with huge demand being originated from the U.S. and European investors. There is a variety of strategies/asset classes within the alternative investment spectrum from hedge funds and private equity to stamp, comic books and classic car collection, but this perspective's focus is on institutional quality alternative investments and specifically hedge funds, private equity and private debt comprising the largest piece of the spectrum.

The role of alternative investments in the financial and social ecosystem is multidimensional, which amplifies their importance and attracts further attention from investors and authorities. First of all, the plethora and diversity of strategies allows investors to gain their desired exposure, adding liquidity to both financial and real-world markets. Alternative managers are focused on innovation and designing new, unique and sometimes complex trading/investment strategies, which provide institutional investors with alternative, diversified and uncorrelated to traditional investments source of alpha. Investing in alternative managers requires expertise in risk management, thorough knowledge and deep understanding of alternative investments due to their complexity in nature, including both strategy and structure.

Sophistication within alternative investments has developed providing a variety of access possibilities for institutional investors across the corporate capital stack from traded debt in high yield bonds, collateralized loan obligations (CLOs) to more illiquid private debt strategies of levered loans, direct lending, and private equity featuring buyout and secondaries.

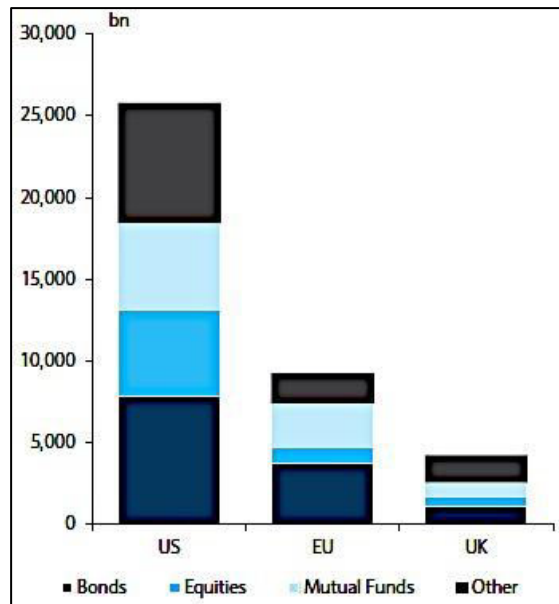


Figure 1. AUM of Insurance and Pension Funds, Amounts in \$, € and £, Source: Haver, Barclays Research

Figure 1 illustrates the inherent danger in the current allocation of two major institutional allocators, with their decisions having both social and financial extensions. Bonds and equities start to behave similarly, making the configured scenery look endangered as the low-yielding environment puts investors at the risk of default. The source of diversification should be expanded across all asset classes that their underlying strategy is truly uncorrelated with both traditional and alternatives markets.

An important aspect of alternatives investments is the regulatory landscape in which alternative managers are operating. Regulatory authorities force managers to provide high level of transparency to their managers enabling for building better relationships between General Partners and Limited Partners, attracting more capital and enhancing alternatives' public profile. But how much are alternatives affected and are the regulations assisting in the growth of the industry? The regulations targeting alternative investments are Undertakings for Collective Investment in Transferable Securities Directive (UCITS V) and Alternative Investment Fund Managers Directive (AIFMD), but others may also affect alternative vehicles such as IFRS, MIFID II, Basel III, Solvency II in Europe and Dodd-Frank, Volcker Rule and FATCA in the US. The crucial question is: do regulators add value to investors with their regulations and more importantly do they understand what they regulate? The pursuit of innovation is leading funds to adapt complex techniques and strategies that are not conceivable to an audience with a solid financial background, which makes the understanding of non-financiers equivocal. UCITS funds have not been yet through an actual crisis and the regulatory framework could be proven to be shadow-protecting investors. AIFMD is considered to bring a breath of fresh and positive air to the alternative space, by providing better risk management policies, better and more transparent reporting and by upgrading the role of the depository in the funds' structure and management equation.

Hedge funds is the most discussed asset class occupying the press with both positive and negative news and currently manage around 40% of the capital allocated in alternatives. On the positive side, we witness their comeback after a struggling start in January and February this year with event-driven and quant strategies leading the way. CTAs recorded a net inflow of \$16.6bn in the first half of 2016, while the rest of the asset class recorded net outflows of \$34.2bn according to Preqin. The leading strategies of the revival of the industry could be new, exotic strategies that will provide investors with uncorrelated sources of alpha. Investors need alternative strategies within the alternative investment industry and such strategies can be from cryptocurrency like bitcoin and volatility strategies to art and classic items strategies. But not all of them qualify as institutional quality strategies and this perspective is focussed on finance related strategies. Funds focussing on shipping and aviation, bitcoin, directors' dealings and volatility could offer more opportunities in the current saturated financial environment.

Hedge funds struggled so far this year and despite their recent streak of "green" months they still underperform traditional investing. The departure of big pension names and the fee structure of the industry monopolised the interest from the press, overshadowing the new opportunities sought by other institutions in the space. Equity and macro strategies are popular amongst investors, followed by multi-strategy funds and CTAs, despite CTAs' better performance and diversification profile to long/short equities.

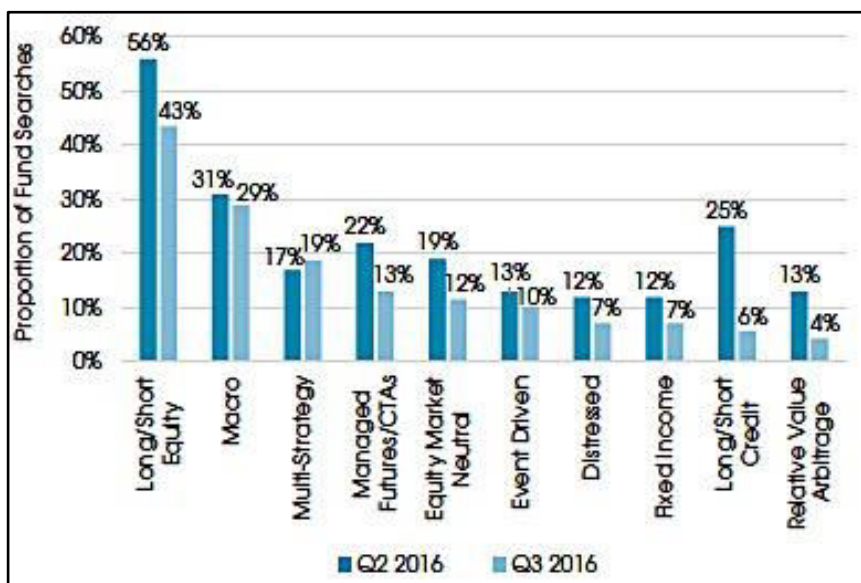


Figure 2. Hedge Fund Strategies Sought By Investors, Source: Preqin

Fixed income strategies are not of intense focus as evidenced in Figure 2, underlining the uncertain conditions around credit, and especially in Europe where, the troubled banking system is spreading the fear amongst investors who are looking for alternatives. Figure 3 highlights the downfall of European high yield and the tough conditions the sector is facing, making investors eager to seek higher compensation or alternatives such as CLOs and direct lending strategies. European CLOs as seen in Figure 4 have experienced very low default rates from 1997 and 2015 while corporate credit defaults were almost 5% in BB, 17.6% in B and 47.5% in CCC tranches. Further discussion will follow in the private debt section.



Figure 3. BofA Merrill Lynch Euro High Yield Index Effective Yield, Source: BofA Merrill Lynch, Federal Reserve Bank of St. Louis

Initial rating	Euro CLO (1997-2015)	European Corporate Credit - 5 year default rate (1981-2014)
AAA	0.0%	0.0%
AA	0.0%	0.2%
A	0.0%	0.4%
BBB	0.0%	0.9%
BB	0.8%	4.9%
B	0.0%	17.6%
CCC/C	0.0%	47.5%

Figure 4. Historical Default Rates at S&P, Source: Barclays Research

The biggest peer of hedge funds, private equity, is facing a challenging year with the biggest concerns being the pricing of private assets, the global economic uncertainty, the fundraising and the regulations in the industry. The demand for private equity is increasing amid the challenging financial environment and especially for secondary transactions. Figure 5 exhibits clearly the massive increase in secondary transactions volume which was boosted by the refinancing of deals due to decreasing interest rates. With the Volcker rule approaching summer 2017, the volumes will be boosted by banks, with Greenhill Cogent expecting less bank contribution for the remainder of the year.

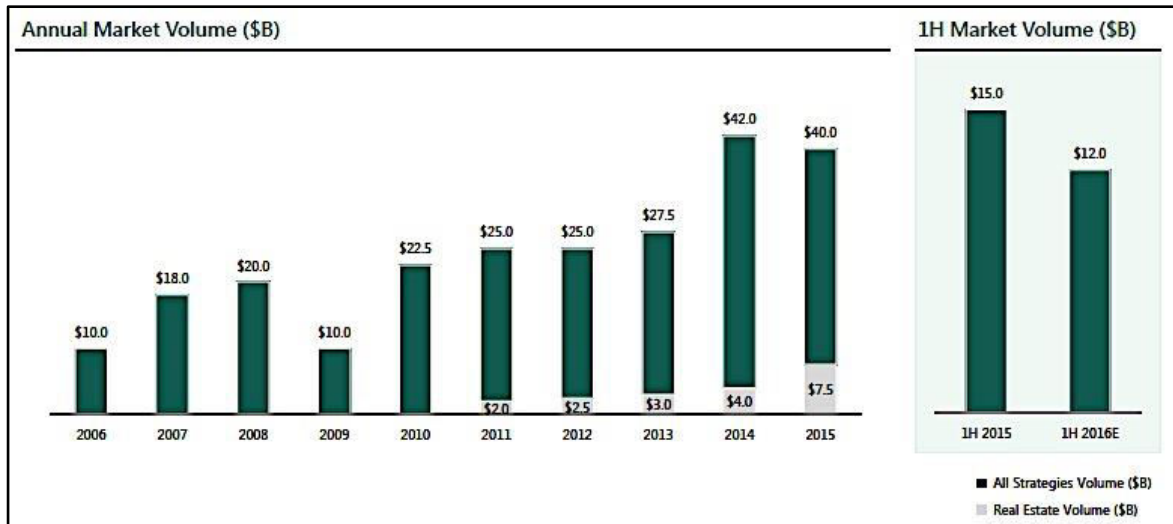


Figure 5. Global Secondary Transaction Volume, Source: Greenhill Cogent

As mentioned above, one of the major challenges for private equity is the pricing of private equity funds. Figure 6 highlights the wider bid in buyout funds as a result of investors seeking safer assets with the strong buyout activity supporting the pricing levels.

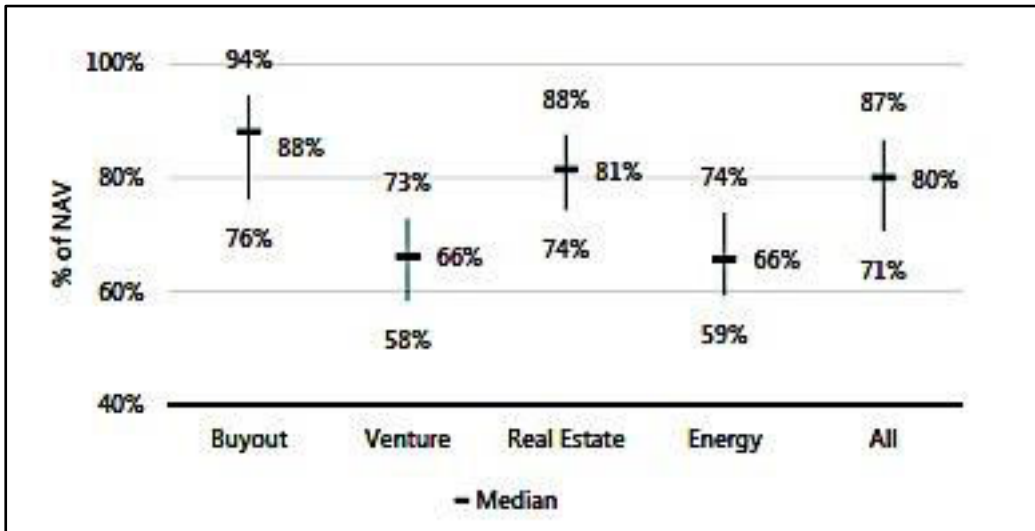


Figure 6. Bid Dispersion by Fund Strategy (1H 2016), Source: Greenhill Cogent

Figure 7 shows that the demand for capital from European companies and private equity plays an important role in providing capital with the number of PE-backed deals increasing massively both in volume and value during 2014 and 2015. The performance in the asset class is what attracts more investors as they are looking for alternative sources of returns in the longer term and being compensated for the illiquidity of the typical 10 to 12-year private equity structures.

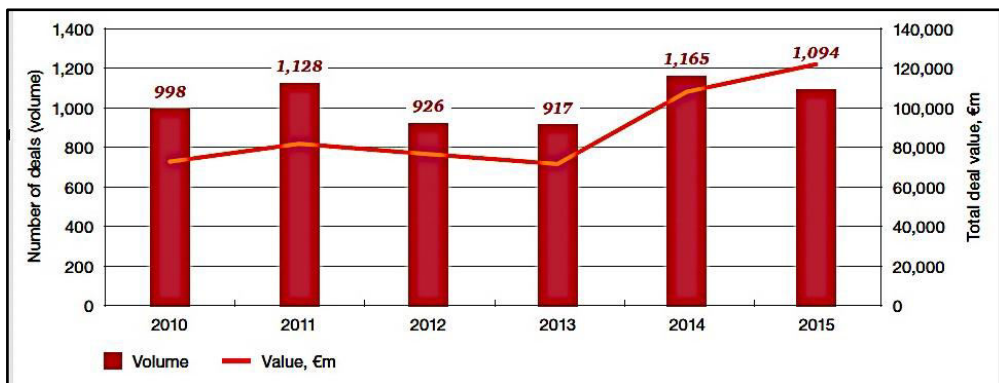


Figure 7. European Private Equity Trends, 2010-2015, Source: PWC

Figure 8 elaborates on the performance of private equity secondaries from 1998 to 2013, with their post-08' crisis performance getting better throughout time.

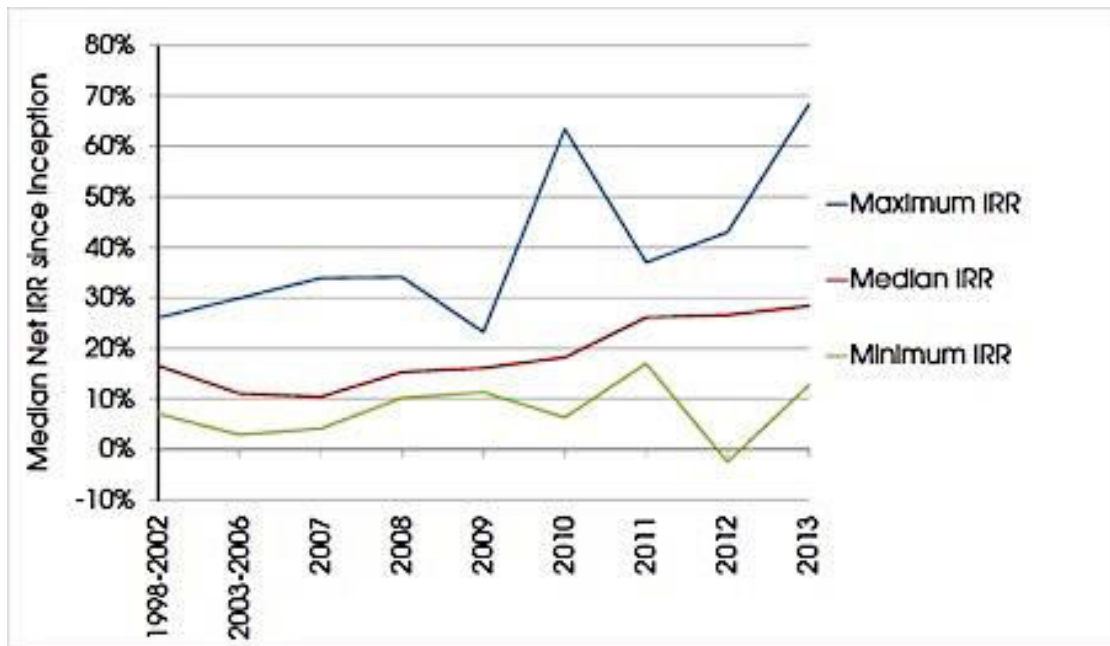


Figure 8. Secondary funds' Performance, Source: Preqin

Regarding exit opportunities, we evidence a huge decline in the number of exits with the biggest hit taken by corporate acquisitions and IPOs, while secondaries made their presence stronger constituting more than 50% of the exit universe in 2016.



Figure 9. Distribution of Exits for Global Private Equity Buyout Deals by Type as of 30/9/2016, Source: Pitchbook

The last case concerns the smallest asset class among alternative industry and the one with the biggest potential for growth: private debt, with Europe being "the Promised Land" for private debt funds. The fundraising momentum is in favour of European-focussed funds and the existing regulatory framework is succour to the managers' efforts to exploit the abundance of opportunities created by the retreatment of banks in lending to lower middle market and SMEs due to punitive risk-weighted asset (RWA) requirements. Cheap borrowing costs has led to accumulation of record-high debt figures globally according to IMF.

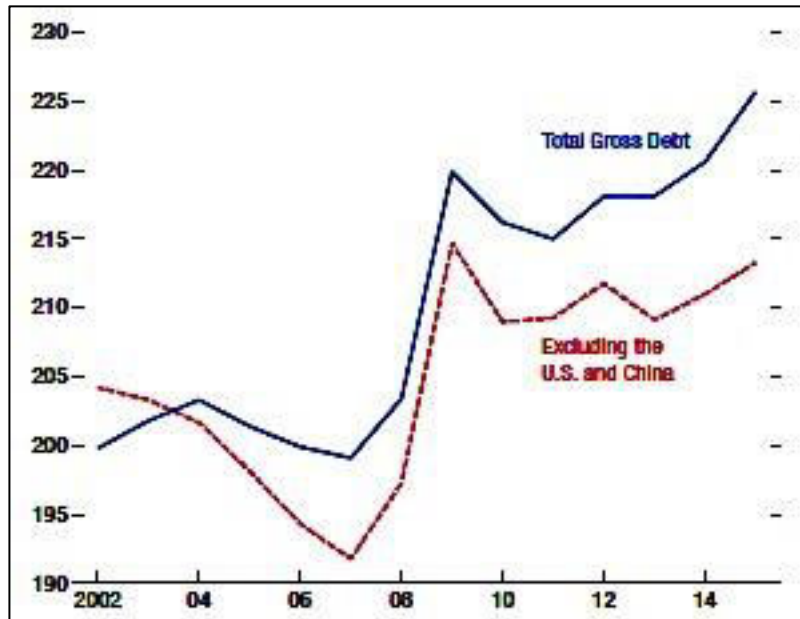


Figure 10. Global Gross Debt as Percentage of GDP (Weighted Average), Source: IMF

Company defaults reached their highest level since after 08' crisis with more of them coming from the US according to S&P and specifically from energy related companies. This urges investors to look for more compensation for the risk they are bearing on their high yield bond investments. ECB on the other side continues its corporate bond purchases as seen in Figure 10, with BoE following ECB's example leading to spread tightening. Corporate debt has been the core alternative to government bonds, which as seen in Figure 11, which are not exhibiting sufficient yield for investors who are seeking other alternatives.

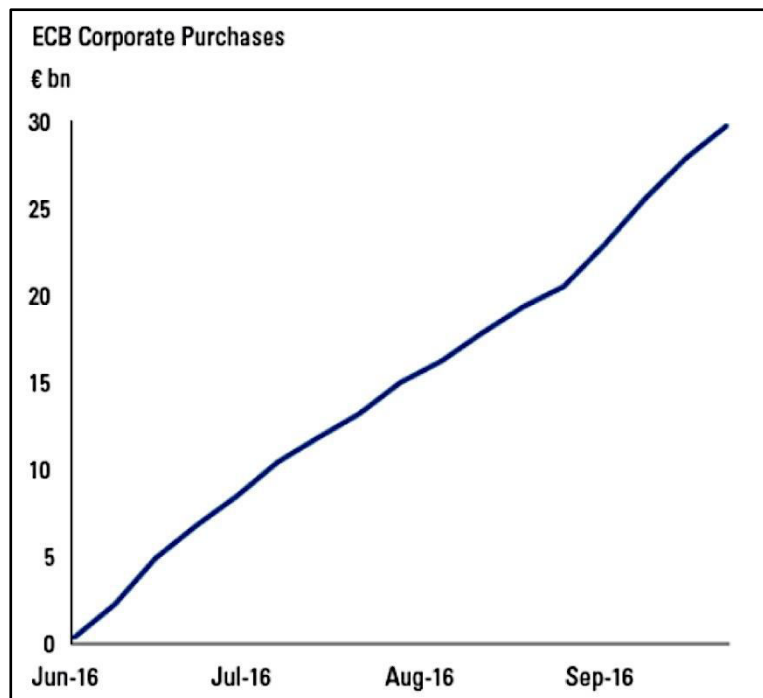


Figure 11. ECB Corporate Purchases, Source: GSAM, ECB

Country	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	20-Year	30-Year
Switzerland	-0.87	-0.90	-0.94	-0.90	-0.87	-0.78	-0.73	-0.61	-0.51	-0.45	-0.19	-0.07	0.08
Japan	-0.26	-0.24	-0.24	-0.25	-0.24	-0.24	-0.24	-0.22	-0.18	-0.13	0.01	0.22	0.30
Germany	-0.53	-0.55	-0.56	-0.51	-0.42	-0.38	-0.31	-0.23	-0.10	0.03	0.13	0.36	0.63
Austria	-0.50	-0.50	-0.44	-0.42	-0.39	-0.22	-0.16	-0.07	0.09	0.23	0.31	0.81	1.07
Netherlands		-0.49	-0.46	-0.42	-0.25	-0.23	-0.11	-0.01	0.13	0.25			0.75
Belgium	-0.51	-0.49	-0.46	-0.41	-0.35	-0.25	-0.14	0.12	0.28	0.43	0.81	0.90	1.34
Finland	-0.52	-0.48	-0.45	-0.33	-0.28	-0.12	-0.06	0.03	0.17	0.34	0.58		0.78
France	-0.50	-0.44	-0.40	-0.33	-0.20	-0.14	-0.03	0.09	0.25	0.39	0.75	1.04	1.22
Sweden	-0.50	-0.63		-0.52	-0.33		-0.06			0.30		1.06	
Denmark		-0.40			-0.17	0.31					0.29		0.74
Ireland	-0.18		-0.31	-0.15	-0.07	0.12	0.30	0.50	0.66	0.73	1.09		1.59
Italy	-0.15	-0.06	-0.01	0.19	0.40	0.59	0.79	1.00	1.21	1.38	1.71	2.04	2.43
Spain	-0.16	-0.10	0.00	0.24	0.45	0.49	0.73	1.09	1.24	1.42	1.82		2.57
United States	0.57	0.76	0.91		1.21		1.49			1.68			2.48

Figure 12. Major Global Government Yield, Source: Pension Partners

Rationally, debt investors would be looking elsewhere to achieve their required yield, but where is that? As discussed earlier in the perspective, high yield becomes riskier as long as zero-interest rate policies stay put from central banks and investors require higher yield. The CLO asset class is a very attractive alternative for both European and US markets, but the most attractive is direct lending, which aims to capitalise on banks' drawing back from middle market lending, as loans to SMEs/Lower Middle Market are both capital intensive and limited in liquidity. Financial institutions are discouraged from investing in structured credit by increased capital charges under Basel III for banks and Solvency II for insurance companies, making the European loans to middle market companies an underdeveloped asset class, which subject to proper selection criteria, could represent a very attractive value.

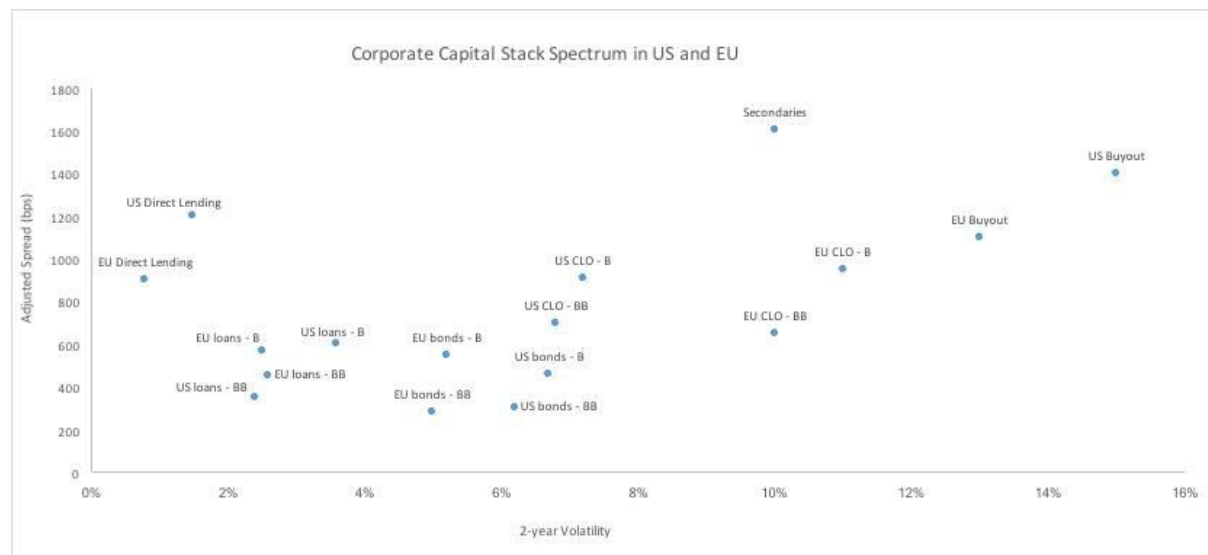


Figure 13. Corporate Capital Stack Spectrum in US and EU, September 2016, Source: Stone Mountain Capital Research, Barclays Research

Institutional investors and especially pension funds and insurance companies are unhappy with their current yield earned, so their attention is drawn to uncorrelated strategies who can deliver alpha. Direct lending, which is the leading sub-strategy of private debt, can offer the required diversification as seen in Figure 13 and produce yield depending on managerial skill to exploit inefficient and fragmented markets for smaller corporates. Interest rates are expected to rise in the medium term and investment in direct lending strategies in Europe and the U.S. will become even more attractive as defaults peak, especially in Europe where the capital markets are relatively underdeveloped compared to the U.S.

Sophisticated investors are able to play the entire corporate capital stack from traded and liquid debt in high yield bonds and CLOs to more illiquid private debt in levered loans and direct lending, to illiquid private equity in buyout and secondaries. Figure 13 describes European and U.S. differences in return and volatility for lower middle market corporates with BB and B ratings.

Figure 14 demonstrates diversification benefits of private markets due to low positive or negative correlation of middle market loans with traded bond and equity markets.

<i>Asset Class</i>	<i>Corporate Bonds</i>	<i>High Yield Bonds</i>	<i>Broadly Syndicated Loans</i>	<i>Middle Market Loans</i>	<i>10 year Treasury Bonds</i>	<i>S&P500 Index</i>
<i>Corporate Bonds</i>	1	0.52	0.38	0.30	0.37	0.12
<i>High Yield Bonds</i>	0.52	1	0.86	0.75	-0.46	0.69
<i>Broadly Syndicated Loans</i>	0.38	0.86	1	0.91	-0.54	0.55
<i>Middle Market Loans</i>	0.30	0.75	0.91	1	-0.48	0.52
<i>10 year Treasury Bonds</i>	0.37	-0.46	-0.54	-0.48	1	-0.64
<i>S&P500 Index</i>	0.12	0.69	0.55	0.52	-0.64	1

Figure 14. Correlation Between Public and Private Assets from 1999 to 2015 Source: S&P LCD, Morningstar, TIAA Global Asset Management

Investments in the corporate capital stack provide sophisticated institutional investors liquid and illiquid investments possibilities in debt, mezzanine and equity layers and deliver uncorrelated alpha, supporting the search for yield in a low rate environment.

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