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Valiance Quarterly Alternatives Review 1Q09

In this, the first of our Quarterly Alternatives Reviews, we provide our general economic and market outlook. We also summarise our views on the implications of the current environment for alternatives manager research, selection and allocation to a variety of alternatives sectors.

Whilst every effort has been made to present our views accurately we draw to the reader's attention the following specific cautionary warnings:

- The Valiance Quarterly Alternatives Review is published one full calendar quarter in arrears. The opinions, views and summary contained herein were applicable to our alternatives implementation programme, advised funds and clients in January 2009 but may not remain so at the time of publication.
- The Valiance Quarterly Alternatives Review does not necessarily contain our full and complete views on any specific economic, market or implementation matter. On any aspect you should always assume that our full views comprise a number of other relevant points.
- We draw your attention to the general risk warnings at the end of the Review and ask that you consider these when reading this publication.

We believe that no one has the monopoly over investing wisdom and therefore welcome your thoughts and input at any stage. We would be delighted to engage with you further in addressing the challenge of how best to allocate assets across alternatives sectors and managers to maximise risk-adjusted return.

Our General Economic and Markets Outlook…

We believe the following with a high degree of conviction, although where qualification is required we set this out also:

1. The world economy, faced with massive deleveraging, is entering or has entered a recession, the depth and length of which will vary from country to country. The more heavily geared / indebted economies may suffer most and for longest, although corporate flexibility, labour mobility, sector diversification and a government's capacity to borrow long term in the markets and spend wisely will mitigate the trauma. Whilst the US may well be one of the first significant economies into a recession, it is not yet clear whether it will necessarily be one of the first to emerge from a slowdown (as in previous recessions). As with the UK, the significant impact of deleveraging on highly geared economies that are more dependent on property and financial services could be more dominant this time around.
2. We are concerned that "recession" will become "depression" (defined on output measures as a decline of 10% or more across the economy) - based on recent quarterly numbers, this situation is more or less upon us.
3. With a sustained reduction in the availability of borrowing and the increase in its cost (at least relative to base rates) investor behaviour and fund flows are likely to continue to reflect a rebuilding of personal, corporate and institutional balance sheets. In the early stages of 2009 a continued desire for cash and capital preservation will continue to be paramount for investors. The most (public) liquid markets (and funds) will continue to experience high levels of volatility, net redemptions and withdrawals for cash. In the absence of further significant deteriorating news, fundamentals or external shocks to the system (e.g. terrorist / war events etc.), we expect this process to stabilise towards the middle of 2009.
4. By the end of 2Q a quite potent combination of: a) the perception of the lowest returns available from cash for at least a generation; b) the work-through from deleveraging; c) other public-funded assistance measures; d) much more attractive i.e. lower prices; and e) more desperate sellers, will bring some investors (e.g. new-funded PE funds) back to the risk table with a more resilient appetite. Perhaps from then towards the end of the year, a refocus on fundamentals and valuations could well lead to the bottoming out of investor fear and the return of risk appetite and more "normal" market behaviour.
5. Additionally, whilst a more globalised world means that market correlations are higher when major economic or market events push returns downwards, such a world (and in particular with the help of larger home markets in Asia this time around) may show greater resilience and recover more quickly than currently expected. National reflationary policies have never before been applied so widely or consistently on a global basis, nor has the world ever been so deeply interconnected.

6. As 2009 unfolds and individual governments and central banks deal separately with their own challenges, albeit against a backdrop of generally consistent reflationary policies, market correlations can be expected to reduce from current high levels. The attractions of diversification will come back into vogue over the medium term.
7. The longer term cautionary note is that just as the seeds of this debt bubble and subsequent crash were sown in the low-interest rate solution to the equity market crash of 2000 and the fear post 9/11, so too are we laying the foundations of the next financial trauma through the current fiscal and public sector "solutions".
8. Leading the pessimistic assault on confidence everywhere will be:
    a. The continued absence of, or difficulty in obtaining, a desired level of borrowing. For at least 10 years individual, corporate and public sectors have become accustomed to easy borrowing; living through the new environment will require a comprehensive "lifestyle change".
    b. A continued drip feed of deflationary statistics, in particular y-o-y trailing RPI figures, which towards the latter part of 2009 (if not earlier) will widely report negative numbers. We expect this negative territory to be relatively short lived and inflationary concerns to start to mount again in late 2009 and into 2010.
    c. Unpalatable job-losses and housing repossessions.
    d. A safety first capital preservation approach, likely to remain throughout the year for many investors. Whilst cash balances remain historically very high amongst institutional and individual savers, few will want to be earliest into the fray and will prefer to see some ongoing sustainability and stability before re-entering markets, given the harsh governance light shed on their more recent performance results.
    e. More broadly, the political imperative to help ease pain will lead to increasing short-medium term budget and fiscal deficits, particularly in the more highly geared economies such as the US and UK. This will have significant impact for tax rates and bond market yields; both are likely to increase over the medium term in real terms as governments seek further funding and investors seek higher risk premiums for support. Transferring mass private sector indebtedness to the public purse does not in itself cure the problem.
9. In due course these factors will increasingly self-regulate to reduce volatility and also nominal levels of inflation and return on capital. Only when such data – across commodities, inflation, GDP growth, return on equity – become steadier and less prone to the wild swings seen in the last 18 months can we really feel we have returned to a "steady-state" world economy. This process may take some years. Economic and business shocks will also eventually subside and business news will then revert to its more normal place at the end, rather than the start, of news bulletins. Only in such circumstances will fear have been removed from investors' mind sets, preparing the way for steadier returns, probably with lower nominal return levels for the medium term thereafter.

… and the Broad Implications for Alternatives?

We believe the key issues for alternatives funds and investors are:

- An increase in demand for managed platforms – benefitting from fee reduction (clients are now adamant that they will never again pay high fees for "dressed-up" beta) and transparency/control
- Fund of Funds structures will continue to come under pressure, especially in hedge funds
- Prime brokerage costs should be assumed as having a 1-2% impact (and nearer the latter) included in return generation prior to delivering investor's returns. When combined with 2%/20% and 1%/10% FoF fees, it makes for a high hurdle if investors are to receive a decent return
- An overall re-rating of alternatives is therefore a possibility, or a reduced long term expectation for the component asset classes, potentially undermining hitherto higher expected strategic allocations from long term investors
- Over the short-medium term, the world will be alive with "once in a lifetime" valuations, "distressed opportunities", and other "exceptional" chances to buy at hitherto undreamed of "rock-bottom" prices brought about by "dislocations". Well-positioned exploiters of these strategies will be thinner on the ground but may be found among "privileged" investors such as TARP managers and the larger, better-integrated cross-disciplinary alternatives firms. There is likely to be additional new players, the "skilled" structuring teams who are fully aware of the covenant wrinkles of specific debt deals they designed within a bank, but who are now running "distressed" funds, (possibly including their previous bonuses) and pitching to buy the debt from banks at 10-20% of par value
- Severe short term pressure on secondaries pricing (FoF portfolios in hedge funds and portfolio deals in PE); start at 50% discount and move down from there
- Implementation outsourcing remains a potential growth area for alternatives. In-house governance budgets allocated to this sector will reduce, perhaps more than proportionally (vs. long only exposures) as a result of the higher perceived difficulties in execution in this area. However, unless the story and overall proposition are solid, the extreme of this argument reduces governance and allocations similarly, to zero.

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Hedge Funds

Since this has been an area of such varied movement and commentary, we summarise both our key thoughts below, before also noting our main conclusions:

- undoubtedly the huge turmoil in these businesses is delivering a massive shake out; this will continue for some time – we believe a reasonable view is that around 50% of providers will close formally or effectively.
- even for the survivors, a major revision to the models hitherto being practiced is underway.
- identifying the survivors in advance, almost impossible in the second half of 2008, may well be getting easier, but remains a much larger than "normal" risk
- those that do survive will by definition be the better investors and businesses;
- opportunities available for making good returns on newly invested money will explode. Whilst this may be true of many areas within alternative and traditional investment sectors, we believe that unlevered opportunities per manager could increase for hedge fund operators to a greater extent than elsewhere and will be more effectively exploited within this sector (if you believe as we do that this sector naturally attracts better investors than say long-only operators in public markets and will continue to do so).
- The vast restructuring of the global financial system will throw up larger than normal mispricings and a bevy of capable talent with insider or good quality deal knowledge. For this also to be exploitable requires 3 things:
  1. the availability of fresh investor capital
  2. the ability of agency providers (FoF managers in our case predominantly) to identify such combinations on sensible terms;
  3. our ability to select the better FoF managers.

  Of these, we assume by our operational definition and discipline the latter two. Analysis and understanding of the first remains key.
- In particular, perhaps newer or smaller niche FoF managers may have an edge if they
  1. have performed significantly better than other, larger counterparts
  2. have retained existing investor confidence
  3. are managing to attract new (and preferably longer term) monies.

Our Conclusions

Clearly in an environment where forced liquidation, deleveraging, reduced availability of borrowing and an absence of performance fees are the norm, all hedge fund operations will be under strain. This will continue further into 2009. Whilst hedge funds outperformed their long only counterparts in 2008, this is only a relative statement and many investors remain shocked at the degree of loss from strategies whose first and primary goal was pitched as being capital preservation.

Furthermore we have written several times of the susceptibility of funds of hedge funds as an operating mechanism generally. In particular big bulge brand players whose primary aim is to reduce risk on the downside through close due diligence and monitoring and gain capacity with the better hedge fund managers have clearly failed. Until hedge funds and funds of hedge funds stabilise, which we do not expect until perhaps the second quarter of 2009 identifying in advance key winners and losers is likely to test the skills of even the most focussed and talented fund of hedge fund manager. That said, we believe there are some rationales we should follow in general in considering investment within this area and we have published these already.

In summary therefore, we believe the key issues for Hedge Funds markets and managers are:

- In between investment banks and (long only) fund managers, hedge funds retain a role going forwards, but given the demise of the former and the other factors mentioned already, stability for many as businesses remains in question. the larger survivors may well morph into diversified strategy/product houses, not dissimilar to the original investment bank models
- As vehicles for executing asset swap trades, they risk disintermediation through increasing direct and advised access (at scale especially) at higher/unjustifiable fees
- The prevailing investor psychological impact on hedge funds could prove problematic for allocations short term
- An emphasis on liquidity argues for Global Macro, CTA and some L/S equity
- Smaller (or smaller increases in) allocations could prevail in the short term, justified in the context of a balanced risk portfolio

Private Finance/Asset Backed Lending (PF/ABL)

We believe the key issues for PF/ABL markets and managers are:

- A reduction in the ability to take charge of assets, or execute a formal legal challenge for recovery, will become increasingly problematic; the corporate equivalent of homeowners posting back the keys
- In the UK, the threat of "pre-pack"s undermining collateral quality/recovery will be an additional worry; leading to greater focus on the rights / seniority of charge-holding lenders in deferring, disrupting or blocking pre-packs
- Currency hedging risks and volatility will prevail
- Demand should arise from the scaling back of lending by UK banks and more importantly the complete withdrawal of foreign banks from this space
- Going forward the preferred approach should be to deploy fresh capital into fresh opportunities rather than buy into legacy portfolios. However, the effect of holding cash at current interest rates could have a material drag on returns
- Risk disclosure amongst practitioners at FoF and underlying fund levels must improve
- A conservative approach to security should remain a primary philosophy amongst practitioners

Private Equity

We believe the key issues for Private Equity markets and managers are:

- Secondaries are potentially attractive, although vintage is a big issue. Forward opportunities at declining values are coming on stream slowly with much lower gearing and less chance of default. How much, if any, value lies in 2006 and 2007 vintage equity at 80:20 debt:equity deals at the larger end?
- Credit quality issues in existing portfolios will grow
- With regard to public equity, a dividend cut supported by a rights issue has typically been a rewarding buy signal and an eye should be kept open for private equity equivalent scenarios

Infrastructure

We believe the key issues for Infrastructure markets and managers are:

- Farmland is now attractive, following recent price corrections
- The proper sustainability of "sustainability" investments outside government subsidies remains questionable, although strong public sector spend will support development in the medium term
- Impact from regulatory authorities and public sector influences could introduce idiosyncratic risk that is not profit driven

Currency/Other

We believe the key issues for Currency and Other markets and managers are:

- Currency: This asset class could usefully be seen as subsidiary to, or replaced by, Global Macro as:
    - Some high quality managers inhabit the latter sector (Quantum, Tudor, BH, Drawbridge, Caxton, etc.) with a wider alpha and investing opportunity set to consider
    - The asset class expands in bull markets (and should thus shrink over the short-medium term); the implications of which are broadly positive for the USD
    - Reasonable returns with low volatility may only be accessible with confidence via multi-manager offerings (giving depth, transparency, liquidity, alpha opportunities and diversification)
- CTA skills are also worth considering in the context of liquid, clearly diversifying opportunities

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