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Valiance Quarterly Alternatives Review 2Q09

Welcome to our Quarterly Alternatives Review. We provide our general economic and market outlook and also summarise the implications for the current alternatives manager research, selection and allocation environment.

Whilst every effort is made to record our views internally and in the implementation of our alternatives asset allocation and manager selection, we draw to the reader's attention the following specific cautionary warnings:

- The Valiance Quarterly Alternatives Review is published up to one full calendar quarter in arrears. We deemed the opinions, views and summary contained herein as applicable in April 2009 but may not continue to do so at the time of publication. In particular the attached also includes a number of views which have developed during the 2nd Quarter 2009.
- 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 and health warnings at the end of the Review and ask that you read and acknowledge these as a condition of reading and considering this publication.

Finally, we believe that no one has the monopoly over investing wisdom, least of all us, and that differing views make for a healthy market. We therefore welcome your thoughts and input at any stage and would be delighted to engage with you further in addressing the challenge of how best to allocate assets to and across alternatives sectors and managers to maximise risk-adjusted return.

The General Economic and Markets Outlook…

Our consensus is that the recent rally since March is a premature indicator of longer term recovery. Whilst we believe the slow down in the rate of decline is real, we remain unconvinced that the necessary and widespread balance sheet rebuilding is in anything but its earliest stages.

The current *recession* may be shallowing and may even soon be over, at least technically. But *recoveries* (ie the regaining of all lost ground) are rarely if ever short in duration. This time round, economies should recover sooner than from prior recessions – we've noted before that the more globalised an economy and more coordinated and consistent the monetary and fiscal response to a crisis, the quicker the recovery. Nevertheless we believe this recovery still has 2 years and maybe more to run.

Notwithstanding this, retail spending and a number of other more responsive indicators are likely to recover following the reflationary inputs of major Western and other governments. Globally, whilst home markets in major emerging population countries have the capacity to stimulate economic activity over the medium term, the overall global impact of this should remain limited more immediately; these economies are largely savers first, spenders second and importers of anything but raw materials last. Commodities prices will no doubt respond well ahead of changes in consumer behaviour for these markets, particularly given the rapid decline in inventory over the last year or so. Nevertheless these markets with home consumers coming off a lower lifestyle spend base, may well show positive signs of recovery ahead of their more developed counterparts.

From a fiscal perspective, the transfer of mass private indebtedness to the public sector will ultimately mean public services spending cuts over the next two years or more, at least in real terms. Rapid recovery optimists expecting a quick return to the "norm" of recent years ought to consider that whilst many core economic drivers or at least indicators may indeed begin to recover over the next 6-18 months, they are likely to confront a significantly contracting public sector spend at the same time.

These thoughts give rise to our medium expected recovery which is more "truncated W-" or worse still, "L-shaped". In other words and in market terms we believe a UK equity market at c.4-4500 may well represent a base line trading area for two years or more.

For these reasons we remain a net seller on market rises, rather than a net buyer on market falls.

… and the Broad Implications for Alternatives?

In considering the relative attractiveness of alternatives, we acknowledge that credit and equity markets may well perform more strongly in the short term, in advance perhaps of a broadly equivalent outcome overall from alternatives for 2009 and into 2010. However, volatility should be higher in liquid, public "beta" markets than across the broad universe of alternatives managers and funds (we think this will persist for some time, in line with historic norms, at least until and perhaps also during the next crisis!). Nevertheless, the proportion, quality and range of opportunities remaining on the table for capture by a reduced number of "skilled" (or at least surviving) alternatives managers have expanded substantially. We are reminded for example that the hedge fund returns in the years immediately following previous market crises where among the highest recorded.

Given these dynamics, we believe meaningful allocations to alternatives remain worthwhile strategically for most investors.

From a new money perspective, a distressed investing rationale for many sectors also appears justifiable currently, alongside any strategic imperative. A reasoned conclusion could therefore be that if you're going to invest in alternatives from a strategic perspective sooner or later, then you'd better act sooner rather than later, assuming of course suitable governance capabilities. On this latter issue, selection continues to remain absolutely critical in our view, by strategy and style of fund manager as well as investing vehicle; your governance structure thus needs to be able to demonstrate these key elements are properly covered.

For individual alternatives sectors, the initial redemption wave is almost complete (note also our comments below on second-wave risks in Private Equity). Within sectors there is some evidence (eg amongst private banks) that allocations are switching / migrating from larger "leaders" to second tier players. This "failed leaders" strategy has seen outflows from many major / large brands in the sector, initially held in cash temporarily and then during the early part of 2Q09, we have begun to see these redeployed into what might be called "second tier" managers. There is also some anecdotal evidence that the gated hedge funds have been returning cash more quickly than previously expected by investors (in parallel with earlier-than-expected TARP repayments). This is also leading to new allocations into second tier and what might be termed "new leader" or "credible survivor" firms.

So what do these firms look like? Well, the survivors of the first redemption wave and consequent restructuring that are best positioned to capitalise on continued commitments have, inter alia:

- maintained good communications and high levels of transparency with investors;
- adopted successful strategic positions ahead of and during the downturn; and thus
- protected clients from the major part of the drawdown environment (e.g. those that have experienced just a single digit or low teens downturn).

Notwithstanding these observations we do foresee a slow down in strategic allocations to alternatives over the short term. Similarly, whilst changes in the long-only manager space were perhaps preparing to peak in the middle of 2009, in line with end of year review cycles, these may well also slow down over the remainder of the year as investors concentrate more heavily on strategic and solvency issues.

Across all alternatives asset classes (and similarly for many long-only sectors) the dispersion of manager returns between winners and losers is still historically very high and selection skills therefore remain more paramount now than ever.

Private Finance/Asset Backed Lending

Whilst stresses continue in this market, opportunities for newly deployed cash and building new portfolios continue to grow. There is also some evidence that the government-backed banks (at least) are beginning to lend again with RBS and HBOS/Lloyds playing some re-entry part in leveraged loan syndications. These however have tended to be relatively small (at or below Euros 50 million) compared to historic deals.

Our perception is that not a lot of visible defaults have come through in portfolios, though this partly reflects the shorter duration of lending in this sector no doubt.

We have seen some new structures with innovative features for accessing illiquid markets such as ABL beginning to emerge. These include for example segregated accounts and "rights funds" where managers:

- commit to recycling eg up to 75% of capital;
- aim to pay up to 5% running yield each year;
- adopt a "snapshot" approach upon investment and redemption, ensuring that each investor gains the precise returns from deployments to which its capital has been exposed;
- ensure transparency into underlying deployments and performance; and
- take out performance fees annually and only on realised gains.

These developments show that some providers have learned from the impact of weaknesses in previous structures and adapted to meet the needs and expectations of investors.

Private Equity

LP interests are showing very little activity. Additionally there is a forthcoming overhang in 2010-12 where some big repayments from debt-structured LBOs in particular are due and there's not enough cash in the business to repay the capital.

A number of serious challenges remain unresolved here:

1) Fragmented debt ownership. The original deals were conducted on the basis that a refinancing and restructuring would present itself. This may have been reasonable in the days when all the debt was owned by the banks. However wider debt syndication during the last few years means that other investors such as CLOs are now involved in managing the default process and many have conflicting agendas.
2) Lack of skills and experience. These more recent leveraged loan investors have less experience in managing restructurings through a downturn.
3) Timescale challenges. The many varied legal and fiduciary positions of bondholders are likely to add to confusion and complexity in resolving situations. In many cases the timescale for resolution with full advice, input and due diligence from relevant parties will stretch beyond the capacity of the business to survive.
4) Lending support. During such periods it was traditional for banks (then the sole or clear majority debt-holder) to provide lending or trading support until the restructuring completed. With banks facing their own capital challenges and with a lower proportionate incentive to facilitate a rescue, such facilities will be much less likely in many cases.
5) Lower recovery rates. It is also noteworthy that historical debt recovery rates (at around the 60-80% level) are predicated on environments in which banks held the debt and provided capital to allow businesses to work out their problems.

Noting also the strong inverse correlation between recovery and default rates, we expect a punishing environment for junior debt holders, leveraged loans and multilayered structures (CLOs), with a much longer recovery period, higher default and lower recovery rates, control and legal issues leading to poor outcomes.

And that's just for the (leveraged loan) debt holders in 2006-08 vintage deals. Prospects for equity-holders in these deals hardly bear thinking about.

The first corollary of these factors will be a temptation for PE funds to continue to put cash into unexciting opportunities merely to keep control - some bigger deals have syndicated the debt across up to 60 debt holders or more. The second is that we may well see the first CLO default during the latter half of 2009. Such an event would create instant market awareness that the AAA sector will maintain full control and value at the expense of junior debt. This could in turn auger in a secondary redemption and risk sell-off wave in corporate debt, following the first wave, now en route to completion, which was dominated by the banks seeking to remove these assets from their balance sheets. ***STOP PRESS: we note with concern the recent significant CLO downgrades from Moody's. Freak-out quote of the week: "Most of the cuts were by one to four levels, though a class of Dallas-based Highland's Red River CLO was lowered by eight levels to Baa2." For more details please see*** **http://www.bloomberg.com/apps/news?pid=20601087&sid=aCHFfKqouGcY**.

The wider impact of such an event remains one of our key downside shock-event risks for all markets.

Hedge Funds (updated as of June 09)

This sector always seems to provoke the greatest level of debate amongst us internally. Perhaps this in part reflects the breadth of investor attitudes to and views on hedge fund investing. It certainly reflects an industry that remains in transition.

The key lessons of the last year or more have been absorbed into mainstream hedge fund thinking and thus attitudes to liquidity, transparency and fees have probably changed forever….on both the investor and fund manager sides. However, the prospect of a complete change of spots for the leopard is highly unlikely in our view. The reader should therefore observe and consider our notes of reality and caution that pepper the otherwise broadly positive update below.

From patterns of both volume and price (ie NAV discount) in the secondary markets for hedge funds, as well as informal anecdotal and formal reported positions, it is clear that the redemption wave and consequent restructuring pain is more or less complete.

A significant number of funds have improved their liquidity terms and this is helping all investors reshape their portfolio going forward. The improved liquidity (or more precisely the improved liquidity mismatch) ought to help funds of hedge funds (FoHFs) in particular, but we still believe that too many continue to carry inappropriate liquidity mismatches. Our first concern therefore is that with the recent rise in markets and recovery in hedge fund returns (do also see our specific comments on this below), these good intentions may fizzle out against a broadly bullish backdrop, spattered as it is (in our view prematurely) with talk of "recovery" and "green shoots".

We hope these otherwise good intentions don't pave a road back to the hellish state the industry found itself in at the back end of 2008. Unfortunately the strength of hedge fund industry returns for 2009 so far (ie to end May 2009) gives rise to further caution and our second cause for concern. Two points about these returns raise questions in our minds that we have asked and addressed before; but somehow they seemingly refuse to go away:

1. Are hedge funds really about alpha at all or just a clever ruse to extract more fees for beta? The monthly returns over the year to May 2009 appear to demonstrate a clear correlation between hedge funds in aggregate and listed credit and equity markets; just pick through these to see a return pattern that can perhaps be described as dampened equity market returns. That hedge fund returns over 2009 to date of broadly 8-10% feel like a good result is of no use in our view if this correlation stays the same or rises in a downturn or shock environment for liquid credit and equity markets. We are concerned about this from a theoretical standpoint, of course. But more practically, we are concerned because we currently attribute a small but nevertheless non-zero probability to a number of "shock" scenarios, any one of which could cause a dramatic lurch downwards for markets.

   It can certainly be argued that the application of leverage, shorting and specialised research and selection skills can bring about diversification to investors' asset allocation through exposure to "different" return streams brought about by these factors. But in aggregate, the hedge fund beast looks a lot like the equity market beast – this shouldn't be a surprise perhaps, given that the large bulk of these investor types now tend to play in the same markets.

2. What does the wide difference between aggregate hedge fund returns and aggregate fund of hedge fund (FoHF) returns say for the investing model of either…or indeed both? Our take on the extreme differences (the average hedge fund outperformed the average FoHF by some 1% pm YTD), is that FoHF providers have been struggling with magnified operational problems compared to some of the hedge funds. The FoHFs have therefore tended to rein-in risk quite heavily in some cases, whereas the hedge funds have done what they normally do – take known investment risks. Thus, as premiums for taking risk have returned, the latter have generally been better rewarded than the FoHFs. Perhaps it's sad to say, but the cynic in us believes that many FoHFs will now worry most about missing out on any beta uplift and will stuff more "risk" into portfolios through increased beta exposure. (We might also discuss the average annual fee differential, also present over longer time periods, of perhaps c.1-1.5%pa historically).

   That this does not necessarily argue strongly for all investors to "go direct" to individual hedge funds reflects more the governance challenges that remain for investors allocating to alternatives than any view on likely relative returns.

We suggest the critical take-away conclusion from the above is that delivering the strategic rationale for hedge fund investing is really about selecting those providers offering genuine diversifying talent on sensible liquidity, transparency and fee terms. To paraphrase the "bricks and mortar" TV shows, it's all about selection, selection, selection!

In looking in more detail at selected hedge fund styles, although convertible arbitrage appears to have been one of the leading investing styles to date in 2009, this may have been expected following its rout in 2008 and the major shrinkage of players in the sector. Moreover, we are not convinced that the weak homogeneity of these funds supports any clear conclusions as a hedge fund "sector". In particular we suspect much of the sector universe results have arisen from long-only convertible funds. Indeed long-only convertibles represent a strategy we currently favour for research ideas as:

1. a good yield today plus an equity option could deliver both a high cash+ nominal return short term and protect against inflation over the medium term and:
2. If rights issues dry up, then as a way of raising money, convertibles could be the next fundraising avenue for corporates. Indeed into early May we have just seen the largest total convertibles issuance for some time.

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