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Valiance Quarterly Alternatives Review 3Q09

Welcome to the Valiance Quarterly Alternatives Review in which we provide our general economic and market outlook and also summarise the implications for the 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 early 3rd Quarter 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 since then and continue to do so.
- 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 acknowledge and accept these as a condition of reading and considering this publication.

Finally, we believe that no one has the monopoly on 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…

As we meet to consider our general economic and markets outlook, with its implications for alternatives markets and investors, we are cajoled by the recent market rally to reassess our general view.

To recap, we've for some time held the view that a long drawn out recovery, perhaps vulnerable to shocks and volatility is much more likely than a rapid V-shaped bounce. Given this, we're sure that only the latter would appear to justify the heights to which markets have currently risen (equity markets up 15% or more).

(October 2009 update: equity markets are now up a full 30-50% or more from their low points)

To our mind, a fundamental deleveraging process still remains necessary:

- to clean up the system (ie a mass debt for equity swap);
- for pain and psychological changes to be fully absorbed; and
- for fast-reverting prices to be consistent with medium term value.

The two biggest questions that remain for us in this context are:

1) Inflation or deflation – which is the bigger risk and likelihood?
2) Medium- and long-term government bond yields. As investors look to replace uncertain future income (eg equities) with more certain future income (ie bonds), will this irresistible demand force be sufficient to overcome the immovable supply resistance of once-in-a-lifetime fiscal deficits needing financing?

Both of these questions are critical to anticipating forward outcomes and of course are also hugely inter-related. That each issue might tend towards highly contradictory binary outcomes means that an unstable pathway forward is almost certain. Consideration of each issue therefore has serious implications for risk management in diversified portfolios.

On the first issue the question for investors boils down to whether and if so the extent to which inflation should be hedged in order to avoid the two ugly sisters of high or very low (ie negative) inflation. Both “tail” outcomes currently seem plausible, and it is perhaps a reflection on how far policy-makers lost their grip in allowing the debt and asset price bubble, that such extraordinary polarity can coexist. To bank on one outcome or trend and subsequently find oneself with a significantly mispositioned portfolio should the other outcome eventuate, could deliver major portfolio downside.

Hence, our general overall countenance is to avoid any decision on inflation (eg hedge), retain liquidity and diversification and revisit the issue regularly and frequently in light of emerging information. We would also argue for portfolio content offering what might be called ‘corner-shop’ cash flows. These are businesses with almost immediate pricing and cost flexibility, thus offering good protection should the economic environment and in particular inflation tip one way or the other significantly. A consistent portfolio theme perhaps would be to also retain exposures to volatility traders for the short-medium term as any journey from here will be a rocky ride, subject of course to some value in this trade remaining at the point of allocation.

On the second issue, ignoring supply and demand technicalities, we believe that government bonds ought to reflect a premium for inflation uncertainty, as well as the fear of higher inflation, the latter being a bias at least among policy-makers and perhaps also beyond. However we currently find the picture difficult to disaggregate and this is not helped by the supply and demand technicalities over the next few years which, as implied above, are probably the difference between two very large and unstable numbers. Again, a more volatile short-medium term environment is a natural corollary, until a clearer view emerges.

Moreover for long term investors, we still prefer real assets offering strong nominal medium-long term returns, especially if there’s an inflation-linked component or upside. Such assets remain identifiable among both more and less liquidity-distressed asset classes.

As is usual in our gatherings over the last 12 months, a good deal of discussion focused on the condition and lending capability of the banking sector.

New lending to new businesses continues to be very low; we've seen just a handful of genuinely new deals. Those new re-financings that are achievable tend also to be expensive, and so corporates are understandably focused on debt reduction. Individual bank lending limits appear to be coming in at around £20-25m per deal, with the impact of this being to inhibit overall M&A activity at the mid-market size - it only takes one of the 3 or 4 banks sharing the debt to meet a barrier during due diligence (which they must all now do, just like the old days), for the whole equity and debt structure and thus the deal itself to fall over.

All in all, there seems little incentive for banks to increase volumes rapidly whilst retail banking and to greater extent investment banking continue to operate at near record levels of profitability for the major players and therefore gain management attention. Moreover the need to hand-hold legacy portfolios, coupled with medium term uncertainty over lending business performance and refinancing possibilities also lead to negative management views on this stream.

Nevertheless there is a sense that bank managements have got to grips with the worst of the damage and here we include the grand old dame, the Bank of England. For the record, we agree with the Governor's assessment that full economic repair and workout could take up to five years. During this period, limitations on core consumption such as job insecurity, public sector spending, stagnant house price growth and general sentiment are we believe pervasive enough to suggest at best a low growth economy for the next few years.

The key question for investors exposed to listed equity markets remains whether recent rises have pulled indices beyond fair value. We believe that not only does the economic outlook, risks and recovery inhibitors suggest that they have overstretched themselves, but also, in reacting so positively to lower-than-expected losses and above-guidance earnings, the market may be failing to fully appreciate the impact of the past year's inventory downsizing.

For long term investors, such considerations can help identify and tactfully exploit cash realisation opportunities, as well as buying instances eg if and when corrections appear. We ourselves continue to adopt a sell-on-strength approach.

For those with a 3-7 year time horizon, for example pension funds adopting a medium term buyout strategy, banking a 15%+ 6-month return (as at the end of June 2009) on the long only equities portion of the portfolio is more than useful. Such clients may therefore feel more strongly that the time is right to top slice their equity holdings.

Whilst in nominal terms corporate bond spreads have reduced from c.7.5% to c.6.5% (as at the end of July 2009), the real short-medium term yield currently available would still seem attractive. For pension fund investment strategies that are ultimately targeting a corporate bond yield-based buyout valuation, increasing allocations to this, the matching, asset class is also tempting from a risk-reducing perspective.

…and the Broad Implications for Alternatives

We continue to see a wide spread of winners versus losers and have also noted the impact of increased survivorship bias on alternatives indices returns. The impacts of this factor on hedge fund of fund and single fund "market" performance are addressed thoroughly here. On a positive note we have now seen several large institutions follow through on implementing increased allocations to alternatives, following decisions made originally during early or mid-2008. The mass redemption wave seems to be ending with allocations to many risk assets now on the rise.

Hedge Funds

The emergence of a dozen or so hedge fund start ups demonstrates how quickly this talent class always manages a "return to birth". Moreover amongst the survivors and elsewhere there is undoubtedly a sense of improved sentiment. For some, the last year's experience has offered support, if not proof of a risk/return rationale for hedge funds (ie 2/3rd of equity market upside with 1/3rd of the downside). However this performance result may also be broadly achievable, possibly more cheaply, through derivatives-based strategies.

Whilst we acknowledge the recent impact on returns (and thus sentiment) of rising equity markets and the reduced beta that many so-called "hedge" funds appear to deliver, it would not be fair to darken the name of all practitioners with the same "beta-transform" brush. Many managers have already exceeded return expectations for 2009 through alpha strategies, leading to an end to mass redemptions for many if not most single strategy funds*. For funds of funds and other investors, side pocket and other portfolio restructurings designed to release cash, coupled with sensible operational changes appear to have succeeded in delivering liquidity back to investors sooner than previously expected.

(October 2009 Update:* 26% of all hedge funds have "fully recovered" their losses from 2008, i.e., they have regained all losses to meet or surpass previous peak performance levels*. Source: Credit Suisse/Tremont)

Canny investors seeking to adjust within or allocate to hedge funds might take note of the changes of fortune for specific hedge fund sectors between 2008 and 2009. If they also believe in a talent and market reversion to the mean they might consider a short play on those sectors that have enjoyed a very fruitful 2009 to date, possibly remaining long volatility, for reasons and subject to the conditions we have set out earlier. Additionally there are undoubtedly continuing niche opportunities, particularly where information advantages are secured.

Overall a sensible approach to allocations adopts a methodical process that questions investment beliefs, such as:

- To what extent are you seeking to ride beta or invest solely in alpha?
- Given your chosen blend between the two, what types of skills are appropriate to each and at what cost are they available?

The approach should also shun relatively lazy, reputational-based allocations. If governance structures and budgets allow, it must delve deeply into the investment process and business of hedge fund managers, or else admit its limitations and avoid the sector completely.

Long term, we expect a real 4-5% annualised return from the hedge fund sector. We believe that pension fund investors and others considering the sector for first time, as well as those whose investments have grown with the sector over the years, will continue to support allocations to this sector.

In the cold light of day, whilst hedge funds may not have delivered or be capable of delivering significant diversification in periods characterised by global banking crises and wholesale economic and financial retrenchment, their continuing place in many investor portfolios seems secured.

However hedge fund managers are not necessarily out of the woods yet, as the old ways of doing business are for all but a very select few, dead and buried. Some investment commentators have

dubbed the emerging environment as "the era of the investor." Though this may indeed come to pass (and any such shift will surely be welcomed as movement in the right direction), investors exposed to the sector over many years are entitled to cry, "Shame!" over past imbalances in the investor / manager relationship.

Finally at this point in the investment cycle, after a low has been reached and whilst most investors with slow decision-making processes are still evaluating "what it all means" for forward strategies, there is good money to be made in sector selection. As with active asset allocation, this yields best results at and around extreme turning points, both peaks and nadirs. For our views on particular hedge fund sectors please contact hedgefunds@valiance.co.uk.

Private Equity and Debt

As with many surviving financial services practitioners, most private equity operators are working feverishly on stabilising portfolios, restructuring businesses and preparing for a much busier 2010. Whilst there has been some return to M&A activity among listed US and European companies, there is little sign or expectation that the large buyout sector will recover for some time. Here again, focus on existing businesses remains sharp, with some major debt restructurings looming in next year or two.

Sources for future lending to support activity continue to remain thin, as noted above. Perhaps the emerging private high yield bond market will come to the rescue of the sector. From both demand and supply sides, three factors supporting this development stand out:

1. Offering bond finance at much lower multiples will provide a further range of returns and risks for companies and the investors who finance them to negotiate.
2. Investors psychologically, tactically and strategically are increasingly preferring contractual to contingent returns. In doing so private debt markets may find a happy yield target level for such finance at or around the 8-12% range, somewhat below historic private equity returns but nevertheless both reasonably attractive in a historical context and on a risk-adjusted basis.
3. Secondary markets in private debt continue to offer exceptional forward yield opportunities and we suspect are near or past a distressed nadir. These may support further issuance and supply into 2010-11 as debt restructurings of the 2006-08 vintages get pushed though.

A potential constraint on this development could be the impact on European insurance companies of new solvency and capital regulation. The Solvency II regulatory environment (which is planned to come into being in 2012) is currently threatening to straightjacket bond investing freedoms, in effect driving insurance companies to hold a greater proportion of government debt. Although the cynic might observe how usefully this plays into the hands of the deeply fiscally-challenged European governments, this legislation was in fact brewing long before Lehmann collapsed. Nevertheless, if insurance companies shy away from buying bank and other private debt, then this market's growth will be stunted at best.

While discounts and therefore value opportunities among listed private equity funds have narrowed, there potentially remain a number of decent valuation opportunities for buyers if structural change can be implemented efficiently. Where this is the case and, subject to vintage of invested businesses, such opportunities are worth a second look if allocating into the sector. Mid-market could be a particularly valuable area, where funds have to date only drawn down and/or invested a small minority of committed capital. Also, mezzanine debt, direct and indirect secondaries and lower mid-market buyouts would seem in our view to be good hunting grounds at

this stage of the cycle. For secondaries in particular a gradual increase in volumes is likely given pricing dynamics, the strain under which many GPs are operating and the desire of many PE investors to trim or divest.

Although these observations may hint at glimmers of hope amongst a handful of "opportunity pockets", for most direct practitioners the pressure just to survive remains intense. In grappling with the new reality employer/employee relationships and loyalty are being sorely tested and in many businesses personnel turnover and organisational change are contributing to the stress.

Private Finance / Other

Valuation and operational stresses continue in structured real estate and shipping finance, the "real estate on water" sector. We believe some life settlement exposures may be experiencing multiple challenges though such problems are we believe limited to particular portfolios of lives and should be exposed by detailed due diligence. Secondary opportunities and new, more equitable managed account methodologies for accessing them will offer the best prospect of return, risk and governance outcomes for investors allocating here.

Innovative debt rather than equity instruments seem the best bias, given medium term uncertainties. Trade finance could prove attractive, where over-collateralised and backed by senior secured, preferably liquid, assets; an acute shortage of (bank) capital in this sector has undoubtedly improved forward lending margins here.

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