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January 2010

Valiance Quarterly Alternatives Review – 4Q 2009

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 4th Quarter 2009 but may not continue to do so at the time of publication.
- It does not necessarily contain our full and complete views on any specific investment 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.

General Economic and Markets Outlook

"To V or not to V?" has been the key question throughout the year, and now the path looks almost certain, with increasing indicator momentum building behind a clear reversal, and one that is certainly sharper than was anticipated by most at the beginning of the year, ourselves included. But whether the recovery is genuine and sustainable or only the first half of a W or other pattern remains debateable. Our investing stance on inflation consequently remains polarised, uncertain and unchanged from that set out in our previous 3Q 2009 Review ie avoid any decision on inflation (eg hedge), retain liquidity and diversification and revisit the issue regularly and frequently.

Throughout the "Noughties" we've experienced a credit–driven risk assets bubble funded by both private and public sectors; and we now understand broadly (if we didn't before) just what happens when credit capacity limits are reached in the private sector. This experience may well hold us in good stead if the less rosy end to a lukewarm economic recovery emerges and if we have to navigate a more abrupt bursting of what looks like another risk assets bubble currently underway, this time solely public-credit funded.

However, now that governments are the leading, and in most cases, the only players pumping debt into the system, there remain *major risks* and *additional uncertainty*, with *less avoidable consequences* than with a bubble part-funded also by private-credit. The key *major risk* is simply that the public money runs out (ie

investors stop buying government debt) at current yield and sovereign rating levels; on current market valuations in our view, this would be appear to represent a shock scenario for many investors putting money to work. The *additional uncertainty* is that politicians are now the major fiduciaries of the world….and their track record is worse than the bankers.

The *less avoidable consequences* would be that beyond a fast-retrenching private sector and national governments with economic credibility below current levels, there would be few effective risk distribution mechanisms to bail us out of a crash scenario and defer once more the fundamental payback for the "Noughties" credit excesses.

Perhaps broader supranational risk transfer institutions such as the UN (via the SDR) and the Euro could play a role in making such an outcome more palatable. But international governance structures, political mechanisms, population expectations and self-interest do not convince us that in extremis a positive, manageable outcome would necessarily prevail. Beyond that, dependence on the goodwill of the Chinese and other emerging economies, perhaps more than the "petroconomies", to support and drag us forward also looks unappealing.

Whatever path the economy, populations and markets take, we believe that investors' medium- and possibly long-term mean growth expectations, particularly among developed economies with larger financial services components, still need and should experience a reduction.

So what do markets say about all this? Aren't they supposed to be efficient at discounting the future?

Putting to one side the negative response to this second question demonstrated by the last 15 years' investing history, we continue to view markets as more or less overbought. In our view, valuation levels for both risk assets and what have until now been assumed as "risk-free" assets (T-Bills, Gilts, etc.), reflect shorter term money-flows and the absence of cash returns, rather than sensible prospective risk-adjusted returns.

And as implied above, we remain concerned at the trust being placed by markets in political stewardship of the economy.

The forthcoming refinancing of private sector debt, estimated at $7trn. or more over the next 3-4 years or so, across leveraged loans, mortgage-backed and other securities and structured products, will also deliver a hangover alongside the public sector funding challenge. In both cases much of this debt will, nay must, convert to equity, posting losses and giving rise to better future real returns. That means pain and solvency threats for public-sector equity stakeholders (ie taxpayers) and their private-sector counterparts. We do not believe the potential impact of these losses are yet recognised in bank, sovereign, economic or individual balance sheets, certainly relative to current market perceptions and valuations.

The Broad Implications for Alternatives

We continue to favour investment sectors offering exposure to significant operational expertise and gearing and/or offering betas largely uncorrelated with public markets, over more market-dependent strategies.

Meanwhile, in the absence of a major markets reversal, we foresee increasing positive cash flows from retail investors into listed risk assets, especially emerging markets, at least into the tax-saving/Sipps-driven UK 1st Quarter 2010.

Coupled with our market views above, these observations continue to frame our recommendation for a meaningful allocation to alternatives, even beyond today's levels. For those investors whose alternatives allocations may not yet have shrunk back below long-term strategic maxima (eg following fast-rising listed markets outperformance), it is well worth holding back from sales of alternative assets "forced" by a rigid governance structure. On the contrary, we believe that taking risk off the table from listed markets and re-investing in assets that provide at least some diversification continues to look the better ploy from here.

Private Equity and Debt

Among the bigger PE funds with capital to deploy, there's a keen desire to seize some of the space occupied previously by investment banks and to play a lead role in fundraising. Restructuring teams have been rebuilt or expanded and signs of future deal demand are emerging. For small-medium deals, most of the noise remains merely talk and overall the picture remains extremely patchy at best.

Consistent with our general theme, operational matters rather than deals continue to take precedent among PE houses and related markets. Workouts remain the norm as the only way forward for many, though "extend and hope" ploys are also being enacted. Secondaries ought to be a preference but although secondary funds have succeeded in raising capital where LBO launches have failed, again the unwillingness of sellers to swallow valuation pain prevails and so many recent secondary funds remain fully uninvested.

Private equity markets therefore remain like treacle, definitely fluid, but neither frozen nor very liquid. Only a steep precipitation might unlock this inertia, but otherwise transactions are not going to loosen quickly without the further sustained heat of public stimulus.

Where the need for liquidity is acute, as is the case in a fast-shrinking number of areas, opportunities remain for operational players able to rape and pillage….and deliver the associated necessary pain.

January 2010 Update: Private Equity sub-sector Outlook

Reflecting our current quarter review focus on Private Equity we summarise below our outlook on the main sub-sectors.

Venture Capital: Primary valuations have come down dramatically and the best VC funds, historically closed to new LPs, have reopened to all investors. Selectively deploying capital with the best global VC houses where legacy issues are clear makes sense. The equity market could provide a one to two quarter window minimum for resurgent IPOs suggesting a richer environment head for VC fund realizations; just in the nick of time for many high quality companies requiring follow on finance. By sector, cleantech valuations may now be underscored by global 'green' public sector budgets.

Mezzanine Debt: Mezzanine has re-priced and now offers compelling risk adjusted and absolute returns. Equally, buyout firms have no choice but to offer mezzanine debt funds a role in the corporate capital structure given their bankers' desire for larger subordination below their senior buyout loans. Finally, tight credit conditions mean corporates continue to seek growth capital in any form it comes. Offsetting these favorable developments is a lack of buyout deal flow especially at the large and mega end meaning new mezzanine debt is not being manufactured. Mezzanine debt in the lower middle market and in sponsorless format through lowly levered capital structures on corporates with strong cash flow is the best place to be. Avoid old mezzanine debt where the evaporation of equity cushions has made mezzanine seem more like equity.

Distressed Debt: The high levels of public level support have meant banks have been slow to liquidate problem loans. Protecting their capital, solvency and regulatory positions, banks simply have nothing to gain presently from selling any debt and they're therefore emerging as the main price setters in secondary transactions. Distressed debt funds have therefore been slow to identify opportunities and deploy capital. This should change as the central bankers put pressure on banks to recognise their problems and equity markets afford recapitalisations to cover the costs. The full story will re-emerge only gradually as anaemic economic growth takes hold and as the refinancing window slowly opens.

Buyouts: A credit sensitive strategy. Credit remains available for the highest quality transactions and sponsors but only in the middle market. This indicates where focus should be applied.

Secondaries: 2009 was the year that the great secondary markets PE liquidation never occurred. We continue to prefer the transparency afforded by direct secondaries in which an underlying corporate is bought rather than a secondary LP stake.

Private Finance / Other

We continue to favour private niche financing and credit risk strategies, such as trade finance and asset-based lending, over the medium term. Investors considering these strategies need to select carefully however as we believe the general trend is for spread widening.

A bias towards shorter term lending strategies is consistent with the recognition that a recovery, if only partial, is now more or less certain but may not be sustainable. Longer-term lending uncertainties, in terms of inflation and credit, continue to pose risks for which the likely reward is more debateable.

Hedge Funds

In a short 3-4 months, belief has gripped the hedge fund world that 2009 may in fact be an excellent year for investors and surviving management teams. There is even a palpable whiff of excitement in some quarters and something approaching unbridled optimism over the possibilities of UCITS III giving a much-needed boost to the business over the coming couple of years. In our view too many UCITS III funds for comfort will emerge at some point in the near future. We remain concerned that without fundamental change in the operating mentality and infrastructure underpinning these funds, the cloak of respectability conferred on UCITS III operators may ultimately prove an illusory safety-blanket for some investors.

Nevertheless we fully expect the marketing engines that are the essence of the hedge fund industry to go through the gears and enable it to do what it does best – that is, raise money.

The failure of funds of funds (FoFs) to match the overall hedge fund averages in 2009 is explainable and perhaps understandable given the two levels of liquidity mismatch risk they manage. A higher-than-normal cash carry element, built up between late 2008 and early 2009 and yielding lower-than-normal return contributions, might well have been the prudent approach for FoF business management. But such large spreads, particularly in 2009, ("never mind the quality, feel the width" – see table below) will for some investors again call into question the additional fees charged for FoF portfolio management. Though a potential blow against the FoF rationale, the overall business impact for FoF providers may be mitigated by offering the managed accounts and greater transparency now considered more normal. Higher FoF cash levels might yet help regain some ground, and be useful tactically, if wider markets reverse for example!

Periods to 31st December 2009 (Source: HFRI in $ terms*)	**Average of Hedge Funds**	**Fund of Funds Composite**	**"Outperformance" of Fund of Funds by Single Hedge Funds**
1 Year Return (%)	20.0	11.2	8.8
3 Years Return (%pa)	6.3	3.6	2.7
3 Years Risk (%pa)	8.6	7.8	

**** Subject to revision***

Real Estate

Overseas investor support for prime UK commercial sites is likely to continue, reflecting overseas currency-based perspectives on value, as much as yields and longer-term strategic allocation drivers. The assumption prevails that in property there's been less of a rebound to date compared to listed markets.

For longer term pension fund investors, able to take a less liquid stance on investing, property may well offer decent forward yield today as well as future inflation protection. Indeed the limited supply of index-linked gilts issuance relative to demand has pushed long term real yields on inflation-linked bonds beyond "normality" to all-time lows. Unsurprisingly therefore, demand for inflation swaps continues apace.

Inflation-challenged investors are now also looking at real estate to meet their specific hedging needs. Assets such as ground rent securitization and sale-leaseback can provide the inflation protection benefits required and are being met with some interest. The former can be difficult to obtain in small quantities and usually deliver a more moderate yield enhancement alongside inflation-hedging qualities. Sale-leaseback strategies offer investible possibilities for even small-medium pension schemes seeking inflation protection, and in some cases with significant potential upside; of course with higher expected return comes higher risk in the individual underlying investments and so credit and diversification skills become more critical. We also expect a number of un-leveraged property structured products to emerge, perhaps sponsored by those banks with more real estate tipping onto their books than they care to welcome. Click here for a recent IPE article which discusses these products.

Clearly there are a range of direct funds and structured opportunities in this sector. Investors will thus need to consider carefully the credit, liquidity and manager risk attributes of each offering, alongside their own currency and hedging requirements. If you're interested in a brief summary of these products please email us directly via property@valiance.co.uk.

8th January 2010 Update: Real Estate to benefit from allocation shift out of bonds into alternatives
(Source: bfinance)

Following a particularly difficult period, real estate is poised to be the main beneficiary of a major shift in global institutional investor allocations while other asset classes such as hedge funds and fixed-income elicit less excitement. This and other findings are based on a global pension fund asset allocation survey from bfinance.

Having warmed to equities, pension funds are now moving down the liquidity scale, investing in riskier asset classes and diversifying into alternatives. The clear winner this time around is property, the first among asset classes to generate strong excitement among investors. Twenty-seven percent (27%) of respondents now expect to increase their target allocation to property in the coming six months.

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