Observations on Debt & Alternatives Markets

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Frontier Advisors Pty Ltd

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Frontier regularly conducts international research trips to observe and understand more about international trends, and to meet and evaluate first-hand a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high level assessment on the key areas and observations unearthed during this research venture. We would be pleased to meet with you in person to provide further detail on these observations.

Our research team

Kim Bowater, Michael Sommers and Daniel Selioutine of our Debt and Alternatives Research team travelled to the US in May 2014, meeting with 30 fund managers in New York, Charlotte, Seattle, San Francisco and Los Angeles.

The meetings covered numerous asset classes and investment strategies including private equity, traditional and alternative fixed interest and credit, multi-asset, multi-strategy, global macro, volatility and tail risk hedging managers. While much time was spent discussing and assessing the capabilities of the managers themselves, these meetings also allowed us to meet with a wide spectrum of investment professionals to enable us to accumulate a series of market views to compare and contrast.

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The risks are, there are no risks (for now anyway…)

Many managers we met with hold the view the current economic and market environment is relatively benign and improving. A common perspective is that Europe has essentially avoided crisis (minimal growth but prospect of a Euro break-up is very small), the Ukraine/Russia situation will likely not widen, China's hard landing is a reduced possibility (at least in the near term), and the Fed has manufactured a relatively smooth start to tapering following the turmoil of last year, with the US economy showing real signs of improvement.

However, managers are very alert to the potential for risks to impact what has been a very low volatile market environment, even expressing concern there are few tangible risk triggers on the immediate horizon. The uncertainty of pin-pointing the catalysts for future market stresses does not sit comfortably with the managers.

The US economy is on track

There is general agreement the US economy's improvement is showing strength and managers can't foresee rising rates any time soon given benign inflation. Some managers suggest both credit and equity markets have moved from a cautious to a very bullish phase. Company CEOs are now being penalised by the market for hoarding cash which has resulted in an increased level of M&A activity (expected in the future and observed of late), and the market is rewarding acquirers with rising share prices following an acquisition announcement.

Ukraine

Most managers believe the current situation in the Ukraine is the main known exogenous event that could impact markets, even those strategies that are mostly alpha-seeking rather than beta. The views are fairly consistent on how it may play out, how markets may respond, and what portfolio protection, if any, should be sought.

Most managers believe the situation will reach some sort of resolution, although some think beyond the expected evolution of the situation to consider what scenarios could occur, albeit with low probability. In that vein, managers considering the low probability of an escalation are either reducing portfolio volatility, exposure to Ukrainian debt or the Russian Ruble, or are purchasing put options on the S&P500 given the view markets will suffer a flight to safety in the initial stages of any further conflict. One manager recently felt there was the slightest probability of Russia invading the Ukraine with this manager even going so far as to buy a put option on the Friday to cover the weekend because "last time, Putin invaded Georgia on a Sunday so he has form invading countries on weekends".

It's different this time…

Managers hold differing views on how similar various credit markets seem, compared to pre-GFC markets. There is an acknowledgement credit spreads have reduced markedly, but these are still above the extremely low levels pre-GFC. Several feel there is still some small room for capital gains from further credit spread contraction. However, this is in the minority. There are mixed views on whether credit duration is risky or not, generally depending on the timeframe in which the manager views interest rate rises or increasing market uncertainty may occur – there is an element of "making hay while the sun shines" in this approach.

Other managers though feel the pre-GFC period for spreads was an anomaly and should not be used as the yardstick for where credit spreads could fall to. Those managers feel the better trade is to be shorter spread duration and hold concerns about the medium-term anticipating rising spreads and default rates (although not to GFC levels). Managers with the ability to move to other markets or use portfolio hedging, are generally using this capability, at least to some degree.

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Cov-lite: That's the market… what else can we do?

We met with a number of bank loans managers who all acknowledge the number of loans with little or no covenants are increasing. The managers recognise the issuers of these "cov-lite" loans would likely not have been able to issue these in the past and it possibly reflects a weakening of credit conditions overall (this is consistent with the message received on Frontier's recent European research trip).

On one hand, managers are acknowledging the increase in credit risk and that, given spread levels, there is an increasing likelihood they are not being compensated for the risks, which would likely reduce recovery rates.

Some argue it is more acceptable for the higher quality loans or where there is more capital structure buffer between equity and loan.

But on the other hand, managers are resigned to their fate on the basis of "what can you do, this is the market now". Long only bank loan managers accept this changing risk to their portfolios (their mandate is to invest in that market), but multi-sector credit managers should be agile enough to allocate away from bank loans if necessary as the risk/reward changes. This is a risk to watch going forward. Managers primarily in the high yield and loans spaces are challenged given spread movements and increasing risks in both sectors.

"The market" is different this time

A number of managers mention the composition of credit markets is markedly different this time around, relative to the GFC, and this could well change market behaviour relative to historical experience.

ETFs – three not-so-innocent little letters?

One area of concern is the preponderance of high yield ETFs.

There is a fear rapidly falling credit markets could result in ETF values moving away from the value of the underlying bonds that are used to back these ETFs.

Another concern was the Authorised Participant (the entity that sources the basket of assets that back an ETF and would be responsible for facilitating a redemption of an ETF) may choose (where allowed) to redeem an ETF during rapidly moving markets by giving the basket of assets to the redeemer, rather than paying in cash.

This would put the onus on the holder of an ETF to sell the assets to convert to cash, a process made all the more difficult in quickly falling markets. This has not happened yet but it is a risk to be mindful of given how much bigger the ETF portion is these days in different markets.

Retail investors

Another source of concern is the increasing number of retail investors in the high yield and other credit markets.

This type of investor is perceived to be "less sticky" than institutional counterparts, investing and redeeming with shorter time horizons. While this investor bloc does not represent the largest portion of the market, it has risen proportionally in both the high yield and loan markets.

Its selling and buying at the margin has the potential to drive short-term volatility in the markets.

Regulations: An opportunity but also a risk

Much has been made about the opportunity set that has been created by the increased regulation of banks. The deleveraging by banks has created opportunities for the funds management community (be it in credit, alternative or hedge fund organisations) to purchase bank assets (performing loans and non-performing loans). Banks have also reduced the amount of lending business and hold a preference for higher-quality borrowers. Regulators will no doubt be happy the banking industry is moving towards a more slimmed-down utility model which should protect deposit holders; that is after all the key remit for regulators which force banks to price loans with a buffer to hold credit capital for future defaults.

The consequence is this is shifting a large amount of loans and other bank business into the relatively less regulated world of funds management. While depositors should be more protected in a credit crisis, any defaults on loans held in the funds management realm will also have the ability to drive market stresses, especially if a fund manager is more prone to exit a defaulting position earlier than a bank would. This will be compounded by less market participants (brokers, etc.) to facilitate market liquidity.

Transmission mechanism from CLOs

The size of the CLO market has grown rapidly over the past few years since the GFC. These products are more actively traded now than they were in the past, and can represent a good access point into loan portfolios that can be priced differently to loans held directly. The CLO structures have also improved since pre GFC issuance. However, these structures are more complex than directly buying loan portfolios, so do require specialist management in our view.

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What did we learn from “the taper tantrum”?

Some of the macro and volatility managers we met with were surprised at the severity of the market moves last year during the tapering issues. Their sense is the market was far less prepared for the end to tapering even though the prospect had been discussed during the months in the lead-up.

Some of these managers believe, though, that any future surprise Fed announcements will not have as a big an impact as market participants have taken better steps since last year to better understand their portfolios.

Others believe the market will still tend to overreact, but hope for greater discernment in any sell off, particularly in emerging markets.

Beware the shadows

Market crises can lead to new behaviours that can themselves trigger their own excess.

One example we discussed is the increased use of systematic risk techniques by insurance companies that offer variable annuities (capital guarantee products) in the US.

Since the GFC, regulators have attempted to enforce better risk management for the industry and allow a capital saving for an issuer that has a continuous risk management approach in place.

These techniques, such as target volatility management using futures, tend to involve selling equities when volatility rises (generally via futures).

One of the tail risk managers we met believes this is the least understood yet one of the more dangerous risks lurking out there in a tail event whereby already rapidly falling markets would have losses magnified by the sheer size of the variable annuity market as the systematic hedging programs sell rapidly into quickly falling markets.

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Europe who?

Despite this being a globally connected world, with many managers having international locations, it is interesting how much home-bias exists with managers.

Members of the Frontier DART team recently travelled through Europe holding 33 meetings with managers across the same asset classes as this trip. On that earlier trip, Europe was a popular topic discussed by the managers and our colleagues found diverging views on Europe. There was a general view real growth would be low and inflation would be relatively well-behaved.

However, there were a range of opinions on the outcome for Europe with some predicting a break-up and others believing it would continue as a unified bloc due to political will-power or the ECB ensuring stress does not return to Europe.

In the US, though, many managers do not mention Europe in their list of major risks to the markets.

When it is mentioned, it is a fairly similar message of a continent that will muddle through, rather than break up. This is surprising since Europe still has the potential to move markets, especially now the European Central Bank and the Bank of Japan are the two central banks diverging from the Federal Reserve and Bank of England in loosening monetary policy rather than tightening.

Volatility and correlations opportunities emerging

Realised volatility across most asset classes has been sitting at historically low levels, driven by coordinated central bank liquidity operations around the world. This is now starting to change with central banks beginning to diverge in monetary approaches.

The Bank of England looks set to be the first central bank to begin tightening with the Fed expected to follow soon after. Meanwhile, the ECB has a bent towards the loosening side while the Bank of Japan is still trying to reflate its economy.

Volatility, global macro, and tail risk hedging managers note a recent pick-up, albeit slight, in volatilities. Correlations within a stock index have also started to change.

This should present trading opportunities, especially for relative-value volatility managers who have suffered in 2013 from the benign volatility environment.

Tail hedgers note that now is the right time to look at tail hedges before the cost of protection rises should markets begin to fall.

In an environment where market betas look well priced and there is uncertainty to the downside, expanding the investment opportunity set to other strategies and investment methods has merit in our view.

We recognise these areas, such volatility and option trading, are complex and come with their own challenges (often including higher costs).

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Tail protection is just a cost of doing business

It is interesting how many managers have a relatively continuous (or at least active) portfolio hedging program in place to protect against tail events which they know they cannot predict, but know with certainty will occur at some stage in the future. Even managers with absolute return event-driven portfolios, which on the face of it will have little market beta, are aware (some painfully so from 2008) rapid market falls can still impact the portfolio and need to be protected against.

These managers view this as a cost of doing business and not a wasted expense. They also believe having the protection in place allows them to take on risks elsewhere to balance the overall portfolio risk levels.

This is similar to Frontier's view, given current market valuations in equities and bonds, and the risk that bonds will not act as a suitable dampener to any equity falls in the future, that it is prudent to use tail risk protection in an investment portfolio.

Indeed, we think it is worth observing that absolute return managers such as a hedge funds, tend to take a more absolute perspective on risk.

While it can be more short term in nature, it is also more consistent with institutional investors as a whole, compared to long only managers, whose perspectives need to be considered in the context of their mandate.

Beta is over … alpha is king

With volatility across most asset classes at low levels (albeit picking up), with key markets (equity and credit) considered at least fully priced, and with making a beta play hard to profit from, many of the managers emphasise the attractiveness of relative value bets, "alpha-seeking" and idiosyncratic structured opportunities in the current environment.

Different alpha plays include structured credit, rather than normal credit beta, and relative-value trades (e.g. profiting from security or sector selection), and direct loans to situationally distressed companies.

This was a similar message to that received by Frontier's DART team on its recent European research trip.

We reiterate our stance on active management - Frontier continues to advocate active management when we have high conviction in a manager's team, strategy, investment process, and "edge" but it is crucial to be vigilant about distinguishing genuine alpha strategies from what only appear to be on the surface.

In the higher alternative credit/opportunistic strategies space, we also prefer strategies that aim for an asymmetric payoff.

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Conclusions

Our US focused research trip progresses our manager research in several areas including a broad variety of credit strategies, volatility, multi-asset, multi-strategy, global macro and tail hedging strategies.

We have identified a number of emerging trends and risks for clients to monitor when making asset allocation decisions given the prospect of increasing market volatilities should central banks begin a tightening cycle. Other market-specific risks include increasing use of cov-lite, retail investor and ETF cohorts, and other market developments that may propagate market falls.

Given the dissipating beta opportunities, we reiterate our preference for active "alpha" strategies where manager skill can generate appropriate returns net of fees.

We also prefer managers with more "strings to their bow" – via more diverse opportunity sets, use of options including protection strategies, and those that take a more absolute return approach. We apply a high hurdle on these opportunities and have identified a select number of managers on this trip we believe are of interest and on which we will conduct further work.

Please speak to us for more information on these managers and ideas.

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