



Frontier International

International research insights from Frontier Advisors

Debt, Alternatives and Innovation Team

Issue 17, October 2015

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.

This involved meeting with fund managers in the multi-sector debt, bank loans, private equity, currency and insurance-linked securities sectors in a range of US markets.

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 recent research venture. We would be pleased to meet with you in person to provide further detail on these observations.



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Slowing China and an inactive Fed. What's the view from the US?

Background

The actions (or inaction) of the US Federal Reserve and the implications of slowing growth in China have been major market forces in recent times. The most recent offshore research trip undertaken by Frontier's debt, alternatives and innovation team (DAIT) provided an opportunity to discuss these themes with numerous multi-sector debt managers.

These managers invest across a broad spectrum of credit securities, rates and currencies, so their portfolio positioning provides useful insights into (1) how they view the current market environment and outlook, and (2) in the context of this, where they see the greatest risks and opportunities.

Fed tightening

Several managers expressed some surprise that the Fed did not begin the tightening cycle in September 2015, since in their view the durability of the US economy had been sufficiently strong.

While the consensus was that a mid-2016 raise would likely be too late with US unemployment almost at the NAIRU level, there was significant divergence between managers in terms of the likely timing of the Fed's lift-off point:

- Several expect the Fed to raise rates in 2015 (despite the recent poor jobs report) given the Fed's desire to get off the zero bound and the fact that the US is nearing the Fed's estimate of full employment. Sluggish wage growth however means that December is much more likely than October.

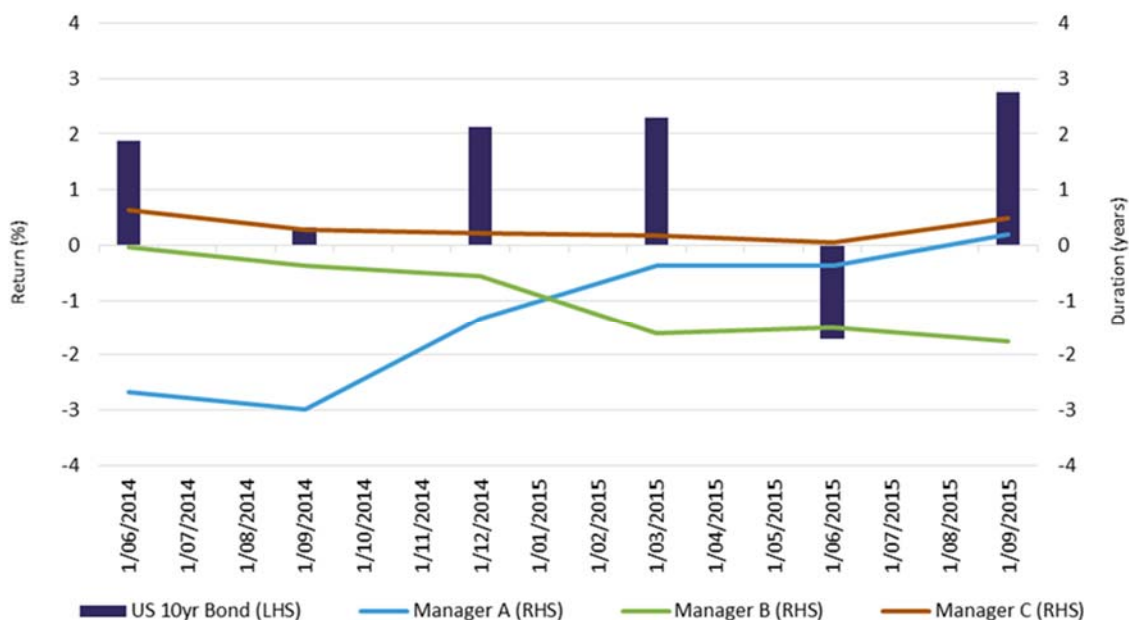
- Others believe that tightening in December is too risky, as it is a period characterised by lower investment flows (lower liquidity) and therefore the impact of market volatility would be much greater. In addition, there are some political risks emerging in the US that may again impede debt ceiling decision making in the near term. A lift-off in early 2016 is therefore more likely.

Regardless of the lift-off point, all managers agree the pace of interest rate rises will be most important, something Frontier has also been highlighting for some time. While this is true, managers' views of timing have had a significant impact on positioning and thus performance to date.

In mid-2014, most multi-sector debt managers, as well as many other market participants, were expecting the Fed to begin tightening by June 2015, and reduced US duration positioning as a result.

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Chart 1: Manager US duration positioning



While Chart 1 represents only a handful of managers, similar positioning can be observed across many more.

Obviously the Fed tightening cycle has a material impact on other positions (e.g. US dollar), but holding onto short US duration positions as the Fed lift-off point moves further and further out has detracted from performance for many strategies, and for most has been the major contributor to disappointing performance over the past 12 months.

While Frontier has discussed each manager's duration positioning and performance and is comfortable with the rationale for their positioning, the above is a reminder of the nature of many multi-sector strategies – they are absolute return seeking debt strategies and (in many cases) ability to implement negative duration positions, cannot generally

be considered a substitute for traditional bonds in terms of providing a defensive (long duration) asset exposure.

To assess the potential for these managers to experience short term negative returns, the broader investment approach needs to be considered.

There are a broad range of strategies across the risk return spectrum - some managers will aim to constrain portfolio losses via their risk framework process, via position sizing or constrained sector and duration ranges (e.g. not being explicitly short duration), while others are primarily focussed on fundamental views of long term value rather than short term market fluctuations. All these factors can result in periods of underperformance versus more trade bond exposures.

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What about China?

While the Fed's actions have been front-of-mind for many market participants and observers over the past year, the other key issue facing the managers we met with in the US is the slowdown in Chinese growth.

We observed a divergence in views regarding China – several managers are (relatively) bullish about its prospects relative to market pricing, yet others are much more concerned.

The bulls

The more positive managers pointed to the fact China has already been decelerating for a period of time, and while long term growth expectations in the 4-5% p.a. range are lower than the 7% p.a. reported by the government, these expectations are more sustainable and are also off a greater economic base. They acknowledged the transition from infrastructure spending (refer chart 2) towards services and consumption is extremely important, and note this has already begun but will take some time to flow through as services and consumption are relatively slow growing components of the economy.

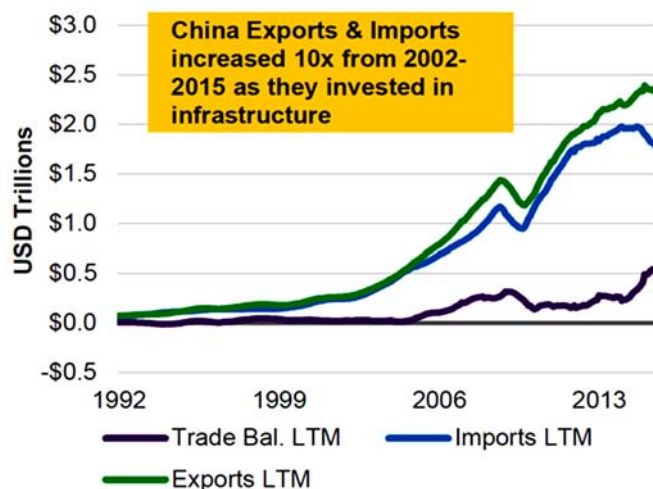
These managers also commented that a scenario very close to a China hard landing is

already priced into the market (e.g. in emerging market debt and currency, as well as commodities markets), and significant value is therefore available to investors willing to tolerate short term volatility. Recent changes to portfolio positioning have largely related to the opportunistic purchasing of securities that have been deemed oversold but will benefit from Chinese consumption such as Malaysia (electronics), and Korea (whitegoods).

The bears

Several managers however retain significant concerns regarding the outlook for the Chinese economy, noting the housing boom means future negative price growth, which will present a major headwind as the economy attempts to transition towards a consumption-led growth path. These managers also believe the potential for policy mismanagement by the government is a very real possibility that could not only derail future growth but also impact further upon market sentiment. They have generally implemented short positions in several Asian currencies and have minimal emerging market debt positions, instead focusing on higher quality positions within spread sectors.

Chart 2: Chinese imports and exports



CLOs, and how bank loan managers are dealing with risk retention rules

Frontier met with several leveraged loan market participants in the US, and discussed the potential impacts of the US credit risk retention rules on the bond loan and broader market, and how they plan to respond.

The risk retention rules were adopted in 2014 and come into effect in December 2016. Despite the fact the rules do not come into place for another year, CLO managers are already positioning themselves because CLOs can typically refinance after two years. All CLOs issued prior to the effective date will be grandfathered, however for new issues the final rules will require the sponsor of securitisations to retain at least 5% credit risk. The rules also prohibit the sponsor from hedging or transferring the credit risk associated with the securitisation. These restrictions are likely to result in some changes to the CLO market, which has traditionally been dominated by asset managers that did not directly invest in the CLOs for their own account and also don't necessarily have the balance sheet to do so. Going forward, CLO managers must make meaningful investments in the CLOs they manage - most CLOs are US\$400-600 million in size, so a commitment of US\$20-30 million is required from the CLO management firm.

Most managers we spoke to agreed reduced CLO issuance was likely going forward. The new rules also create barriers to entry for new managers, and challenges for small managers in particular, who manage only a few CLOs. CLO managers with scale, as well as access to long-term and captive capital, will likely benefit at the expense of smaller competitors. One manager believes 99 of the 106 CLO managers in the US will be able to address the risk retention rules (the others likely being acquired by other firms), while

another noted some of the smaller issuers are creating majority-owned affiliates, which allows a related fund to assume the risk. Since such a fund only requires 51% ownership by the CLO manager, this approach effectively results in a 50% reduction in the capital impact of the risk retention rules. Another potential approach has been the establishment of a manager subsidiary with dual-hat employees. It is unclear at this stage however whether these approaches are in full compliance with the retention rules.

Bank loan technicals are unlikely to be significantly impacted, with US\$60-80 billion p.a. in CLO issuance widely forecasted for the future, which is a healthy level. However, this may reduce if some risk retention approaches being planned for are determined to not be compliant with the regulation.

We find the specific responses of some managers to the risk retention rules to be somewhat troubling, specifically those that involve raising external capital from investors to fund the exposure that they are required to maintain. The concerns with this approach are that (1) it is not in the spirit of the risk retention rules (that sponsors are aligned with investors through 'skin in the game'); and (2) it is unclear whether such an approach is fully compliant with the US laws. We note the consequences of non-compliance include criminal actions being brought. The provision of capital to CLO managers by investors is a potential investment opportunity that has recently arisen on the back of new regulations, however at this stage it is not something that Frontier is prioritising as a potential investment opportunity given the concerns described above.

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