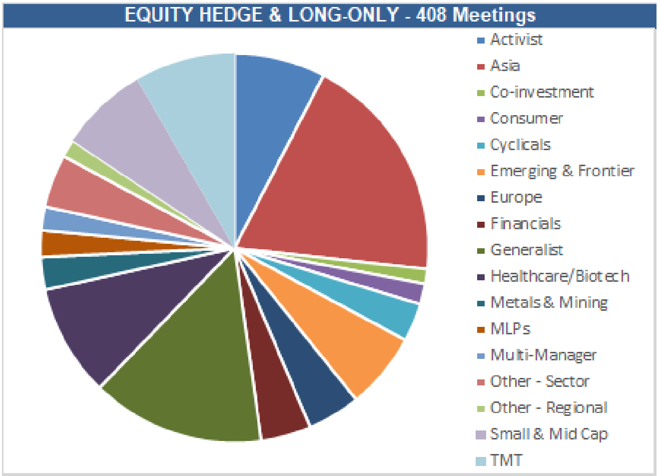
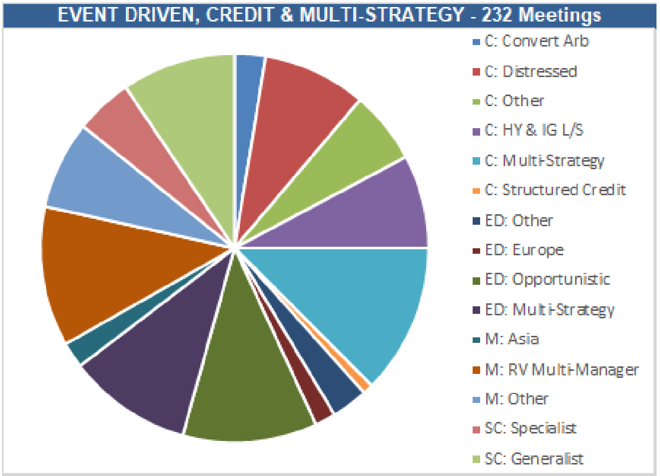
Dispatch from the Research Desk

2018 Review & Outlook

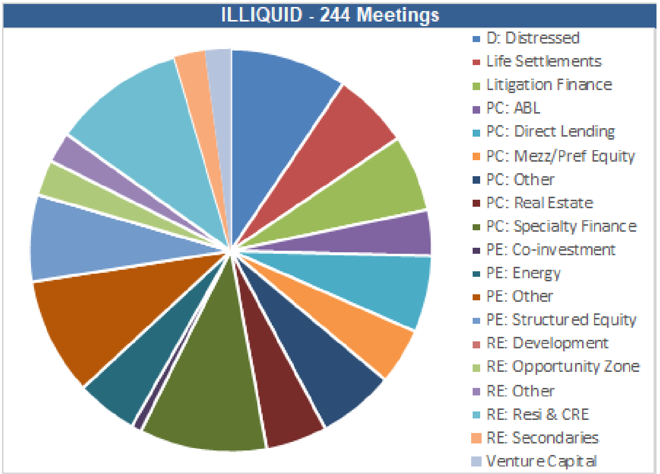
Research Calendar

During 2018, Atrato Advisors conducted 1,078 calls and meetings across 693 management companies within the alternative investment industry. By primary investment designation, the research coverage broke down as follows:

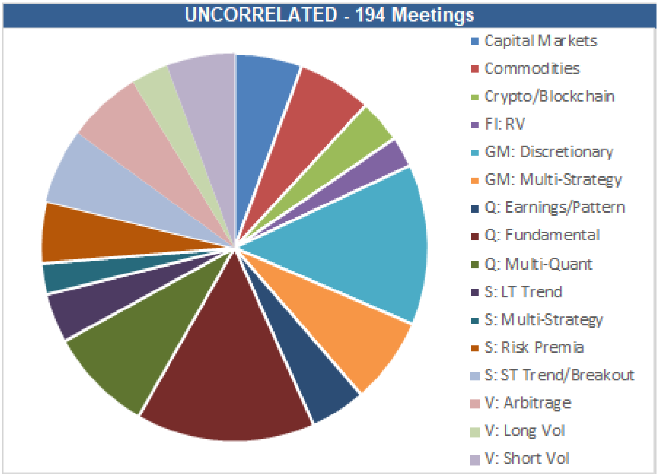




Event Driven (ED), Structured Credit (SC), Credit (C), Multi-Strategy (M)



Drawdown Distressed (D), Private Credit (PC), Private Equity (PE), Real Estate (RE)



Commodities (C), Global Macro (GM), Quantitative Equity (Q), Systematic Macro (S), Tactical (T), Volatility (V)

Macro Overview

At the time of this writing, The S&P 500 was up almost +18% from its December lows. The appreciation of the markets came after significant policy changes from the US Fed, the Trump Administration and Chinese authorities. While market sentiment improved enough to facilitate the bounce in markets, economic conditions globally have continued to weaken. While investors have cheered the recovery in equity markets, most remain skeptical regarding the near-to-medium term potential for continued price appreciation. According to NowCast Models, GDP growth in the US continues to slow, and is approaching 2%, while China appears a bit more stable but well below the 6-6.5% growth target (4-5%). At Davos, in mid-January, the IMF downgraded global growth projections and highlighted the growing recessionary risks. While much of the global focus has been on the US and China over recent quarters, the slowdown in Eurozone growth that began in early 2018 became more pronounced into year-end with Italy technically entering a recession in the fourth quarter. Europe has struggled over the last year primarily due to external forces (tightening global conditions due to US rate hikes, foreign trade related to China, business confidence) and several idiosyncratic issues related to the German economy (motor vehicle production, chemical production). In aggregate, it's likely that the stance of central banks this year will be supportive to balance generally weak conditions and markets will have to consider those factors in addition to the political risks that could turn a period of weak growth into something worse.

Key Factors

- US/China Trade War: After 30-years of relative strength and stability, US/China relations are being re-worked. While the basis for renegotiations appears sound as China is now the second largest economy in the world and has global leading companies in a variety of industries, the structure of the dialogue caused negative technical market conditions and slower growth in the real economy in China and broader Asia. Regardless of the outcome of negotiations this year, expectations are for continued slowing in 2019 relative to 2018 given less favorable trading agreements for China going forward. Outside the US, the rest of the world will now be far less likely to continue offering favorable terms and investment access to China. The near-term binary deadline is likely to be March 1st, unless postponed by the Trump Administration as requested by Chinese negotiators. While some of the issues the US is negotiating for should be relatively easy to agree upon, it is unlikely that China will scale back its plans for local global competitors in the robotics and other high technology industries. As it is currently structured, if some agreement is not struck by March 1st, the 10% US tariff imposed on $200 billion of imports in July of 2018 would increase to 25%. Were this to occur, the political and economic consequences would likely cause substantial market volatility. In general, the market expects the deadline to be pushed back, and for futures negations to occur incrementally so that the binary risks to the market are lower. An announcement on a potential postponement is expected to occur only a few days prior to the deadline.

  It's worth noting that 2018 was a record year in terms of domestic bond defaults in China, at 38 companies and 0.7% of all bonds outstanding according to Goldman Sachs (2016 held the prior record at 18). The defaults that occurred onshore in China largely reflect tighter financial conditions across the economy because leverage ratios have largely been stable for the last few years. Given economic expectations for 2019, defaults are expected to pick up, especially if trade conditions with the US deteriorate further.

- Central Bank Balance Sheets: As we have noted over the last several dispatches, global central bank activities are likely to weigh on asset prices globally over the coming years (put differently, we expect forward returns on risk assets to be low over the medium to long-term). Central banks in the developed world have almost $20 trillion of assets on their balance sheets. At this time, the Bank of Japan and Swiss National Bank are continuing to expand their balance sheets, the ECB balance sheet is stable and the Fed's balance sheet is declining slowly at $50 billion per month. Particularly in the US, central bankers are looking at generating some cushion for accommodative policy action in the future (lower interest rates, balance sheet capacity). While balance sheet capacity has not particularly seemed to be been a concern for markets, that may come into question were it to occur in a crisis. While Jerome Powell's recent dovish tone in early January has given the market reasons to celebrate and may provide a short-term boost to valuations/technicals, unless there is a material near-term slowdown investors should expect continued movement toward normalization by a data dependent Fed over coming quarters.

- PE & VC Dry Powder: Following the theme of lower expected returns for risk assets in the future, the massive dry powder trends within the private equity and venture capital markets have only continued to grow. With dry powder estimated to be over $1 trillion, and as high as $1.5 trillion, as of November 2018, the pace of capital raising has consistently exceeded capital deployment in recent years. In addition, according to recent surveys, 90-95% of investors have plans to increase their future commitments. While managers seem to be calling capital at a similar pace to prior vintages (percent called by fund age), the fund sizes have gotten larger which has caused the cash balances to grow. Coincidentally, the median price for buyouts has increased consistently over the years. Managers not only have to compete with one another, but they also have to compete with strategic buyers who have access to cheap financing and a lot of equity capital. Due to market multiples, a shrinking number of public companies and competition from strategic buyers, the average deal sizes have doubled in recent years and debt and acquisition multiples also remain near cycle highs, but below 2017 (11.6x EBITDA in 2018 vs 12.9x in 2017).

- Secular Stagnation: While the markets were rallying early in the year from December lows, they found themselves with a skeptical audience. According to a Bank of America investor survey with 173 participants and $515 billion of assets under management, allocators globally have been shifting capital according to secular stagnation themes. As a result, global equity allocations declined to their lowest levels since September 2016 by early February. The primary beneficiary of the rotation out of stocks was to cash, with the largest percentage of participants having an overweight cash position since January 2009. Through early February, the high yield bond market was off to its strongest start since 2009. However, performance across the quality spectrum has diverged materially as allocations have moved up in quality across the broader high yield market, with CCC-rated bonds underperforming YTD and since June of last year. This investor sentiment indicator is somewhat double sided, as growing cash on the sidelines and higher levels of quality in portfolios reduces near-term upside, but also diminished potential downside given more conservatively positioned portfolios. Extrapolating from this trend, investors are likely to take profits and more conservatively position themselves if markets continue to appreciate in the near-term.

Thematic Viewpoints

NPLs: The opportunity set in NPLs appears attractive and growing with slowing economic conditions globally. The opportunity set for Chinese NPLs is substantial, with significant government support for Chinese banks to recognize their bad loans and clean up their books. Non-performing real estate loans in China are expected to have a face value of $3 trillion. At the same time, there are significant barriers to entry for Chinese NPL buyers. There are few firms that have a long history of generating strong returns on Chinese NPL portfolios. Those with access, are generally targeting IRRs of 20% net to investors, and trying to minimize the risks of capital impairment by selling and/or working out the loans quickly, rather than going through 18-month court processes. The avoidance of court processes is only really feasible if assets are purchased at appropriate discounts to facilitate some haircut in a workout with a borrower.

Unique Financing Platform: Atrato Advisors has identified a financing platform which gives investors venture capital exposure in a credit plus warrants payoff structure. The platform sources typically former, but also current, executives of large private technology companies and seeks to facilitate the conversion of their options into shares. A major issue for former executives at private tech companies is that their options typically expire worthless unless they can come up with the capital to pay for the taxable gains at conversion. As the options typically represent the majority of individuals net worth, and are illiquid, this is often not feasible. The financing platform has created a structure where they are willing to finance the options at approximately one-third of the last round valuation, with a PIK interest of 7-18% and a stock fee of 5-23% upon a trigger event. The strategy targets returns in the mid-20s with a 3-4 year average life. Given the PIK interest and stock fee, the valuations of the private companies can fall substantially before investors' capital would become impaired.

Innovative Tax Strategies: After generating lackluster returns for much of the last decade, managers have sought additional mechanisms for adding value to client portfolios. A theme where we saw growth last year and expect to see exponential growth over the coming year, is tax advantaged strategies. In some instances, the tax advantages are coming from vehicle structures and insurance wrappers, such as Insurance Dedicated Funds, where the universe of eligible investments across mutual funds, hedge funds, private equity, private credit and real estate funds has grown substantially over the last few years. Another mechanism for enhancing after-tax returns has come from quantitative equity strategies, where managers have realized that by slowing down long trading signals (to realize long-term capital gains) and speeding up short trading signals (to realize more short-term capital losses), they can substantially improve an investors after-tax returns in most calendar years when the market is positive. The cost of this strategy is that pre-tax net returns are expected to be slightly lower. As the early adoption of these strategies has begun, we have seen managers bring more tax experts into their teams and get more creative by expanding into non-cash equity asset classes where different types of trades and instruments are given different treatment under the US tax code structurally and/or by investor election. Many investors ignored these elections in the past when pre-tax returns were high enough and after-tax returns weren't a primary concern, but are now identifying optimal ways to use the elections to pass on substantial after-tax benefits to clients. One such election we have identified allows managers to pass on operating losses on losing trades while winning trades are given 60% (long-term) / 40% (short-term) treatment (typically leaving the investor with only long-term gains at year-end). In most instances, they are facilitated by operational mechanisms and aren't radical departures from existing strategies and therefore don't require a reduction in pre-tax returns.

Regional Banks: Regional banks experienced a significant selloff during the fourth quarter, as market participants questioned whether the economy is late cycle and if bank earnings can truly improve going forward. The selloff could also be attributed to yield curve flattening and guidance cuts from larger banks. In addition to those fundamental concerns, the sell-off spiraled into de-risking as an estimated $20-25 billion of de-grossing occured across multi-manager pods invested in the sector. Eventually, the financial stocks seemed to be pricing in a recession, as financials tend to lead the market lower in such a scenario. Investor sentiment was at such an extreme, that Morgan Stanley data showed that hedge fund net exposure to financials was in the 4th percentile since 2010 and Goldman Sachs data showed it was in the 9th percentile and the largest underweight relative to the S&P 500. Early February also brought a large merger between BB&T and SunTrust, which creates the sixth largest commercial bank in the US and is the largest bank deal since the global financial crisis. One manager pointed to this deal as a manifestation of the loosening of regulations for regional banks. Another manager expected it to be a major catalyst for consolidation among smaller banks and for new investor capital to flow into the sector. In well-structured regional bank transactions, we have historically seen the shares of targets and acquirers rally on deal announcements. With the release of 13-Fs, data shows that Berkshire Hathaway spent the second half of 2018 buying shares of four of the five largest US banks. Lastly, with respect to valuations, depending on the region of the US, Median P/TBV multiples range from 1.55 to 1.74, with 2019 P/E ratios of 11.3 to 13.0, which is much more favorable than the broader market.

As an aside, specialty finance managers allocating to consumer-backed portfolios have not noted any weakening in borrower profiles and would be one of the first market participants allocators deal with to pick up on consumer weakness. Private credit and private equity investing in real estate has remined strong for multi-family and commercial real estate, another core credit element of regional bank portfolios that should be performing in-line with peers. In general, we have heard that banks are only taking the most conservative deals at conservative leverage levels, which means losses should show up in the manager portfolios before it shows up in bank portfolios.

MLPs: As readers of this dispatch will know, we have found the opportunity set in MLPs to be attractive since the energy sector volatility of 2015 that caused the investor-base washout. We remain constructive on the opportunity set for MLP managers in 2019, particularly in the wake of the sharp energy selloff in the fourth quarter, which set up an attractive entry point for long-term investors. MLPs scan as attractively cheap on an absolute and relative basis across the most common metrics for the industry: yield, price to DCF, EV to EBITDA, spread to Treasuries, and spread to investment grade and high yield credit. MLP valuations have declined over the last two years despite material improvements in balance sheets, distribution coverage ratios, c-corp conversions, a migration to self-funding business models (less dependence on equity funding) and LP/GP simplification as well as removal of most incentive distribution rights (IDR) structures. Another positive is the lack of major pipeline projects, which means the companies will probably be able to stay out of headlines and political agendas. Public MLP valuations continue to lag for technical reasons, such as substantial retail outflows during the fourth quarter. Some investors have turned their backs on MLPs because tax reform made their structure less appealing, and rising rates combined with volatile energy commodity prices have caused uncertainty (the market has done little to differentiate midstream energy companies with greater natural gas or oil exposure, or based on sensitivity of earnings to commodity prices changes). A growing theme amongst public and private investors in the sector is that private equity transactions in public MLPs could be the catalyst to alleviate investors' doubts on fundamentals. If private equity investors can be viewed as good evaluators of fundamentals and long-term business trends, then there is attractive upside if PE firms believe they can close this discount. Given valuations and market rumors, there could potentially be a few LBOs this year or public MLPs could start to sell individual assets to PE firms. For example, Stonepeak Infrastructure and Brookfield are considering taking Tallgrass Energy {TGE} private. Other deals include Blackstone's EagleClaw paying for Caprock Midstream and Crestwood initiating a JV with First Reserve. Lastly, one large energy private equity team that is currently in the market mentioned they would rather capture the value in midstream than give it to third parties, especially at a time when valuations are being reset and consolidation is expected.

As always, if you would like any additional information on Atrato's manager meetings or would like to discuss the implications of thematic viewpoints on portfolio construction, please don't hesitate to contact us. Thanks for reading.

Warm regards,

Michael Boensch, CFA, CAIA
Partner, Director of Research

About Atrato Advisors

Atrato Advisors (www.atratoadvisors.com) is a boutique consulting firm that provides highly individualized research and advisory solutions to the alternative investment allocator community. We work with family offices, wealth management firms, asset managers, fund of funds, foundations and endowments looking to expand the scope and depth of their alternative investment coverage, partnering with them on sourcing, portfolio construction, manager research and/or operational due diligence.

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