RVK INVESTMENT PERSPECTIVES
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Investing in Opportunistic Credit

Executive Summary

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The financial panic of 2008 and early 2009 sparked massive losses across virtually all asset classes. As is common during such periods, the crisis also created extraordinary buying opportunities—many of which involved traditional fixed income sectors. While the subsequent recovery of asset values over the past five years was a welcome relief to investors, one of the consequences is the increasing scarcity of attractive buying opportunities in traditional fixed income. This has led many investors to view fixed income as an unattractive asset class in its entirety. While we acknowledge that compelling opportunities are certainly less abundant and are more dependent on manager alpha, the conclusion that they have disappeared entirely is misleading.

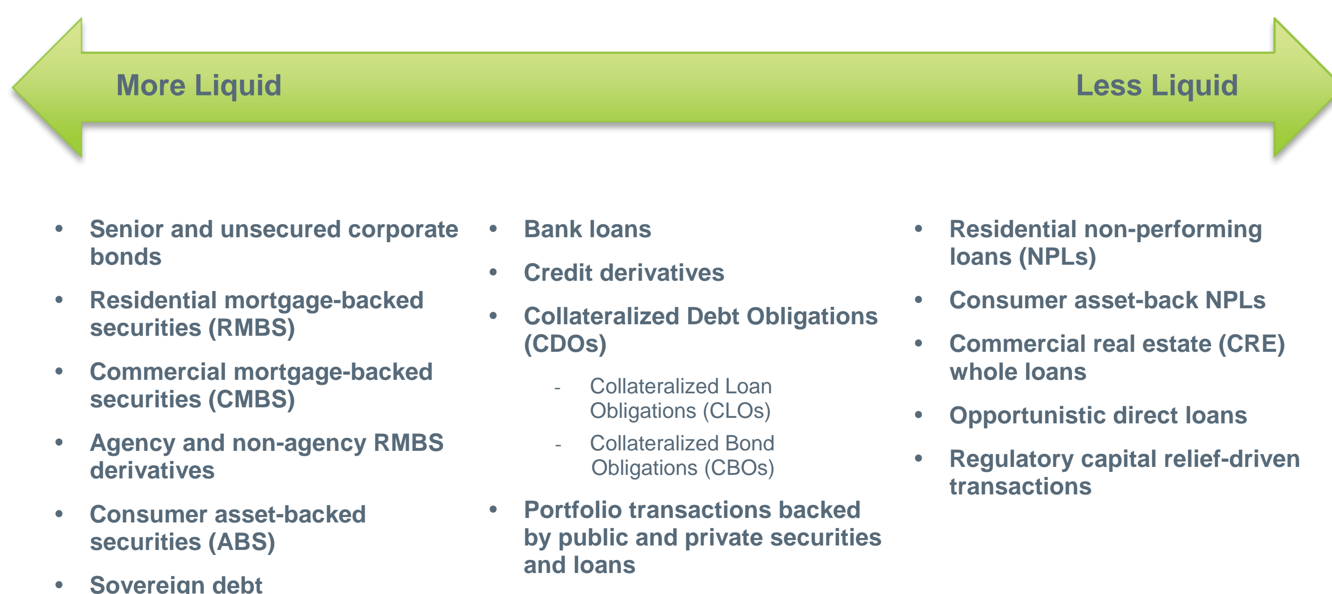
In the May 2014 issue of RVK Investment Perspectives, we presented a broad framework for evaluating institutional fixed income strategies. Although we cautioned that traditional fixed income returns will likely face headwinds due to rising interest rates, we also noted the continued presence of attractive opportunities in less traditional sectors. As an example, we currently believe that opportunistic credit, particularly in European markets, is compelling and worthy of investor attention. We also believe that there is value in U.S. structured credit markets due to higher yields and greater market inefficiencies, although we acknowledge that these markets are not as attractive as they were 2-3 years ago. The objective of this paper is to provide an overview of opportunistic credit, as well as high level guidance for clients who wish to explore the value of such strategies in their portfolios.

In the next section, we define opportunistic credit and outline several of the key benefits and risks. We then discuss two investment opportunities that we find particularly attractive in European markets and U.S. structured credit sectors. Finally, we conclude with a simple self-assessment tool that clients can use to help determine if opportunistic credit investments may be appropriate for their institution. Our hope is that investors will use this paper and the accompanying self-assessment tool to develop a deeper understanding of this opportunity and help frame their approach. If appropriate, we encourage clients to work with RVK consultants to identify specific investment opportunities that may prove to be attractive to their institution.

Overview of Opportunistic Credit

For purposes of this paper, opportunistic credit encompasses a broad array of fixed income investments, which can be accessed via specialized, multi-sector fixed income funds, direct hedge funds, funds of hedge funds, and private equity funds. Depending on the focus of the opportunistic credit strategy, fund managers may invest in a wide variety of corporate securities, structured securities, and private investments. **Figure 1** lists the types of investments (organized by relative liquidity) that are typically held in opportunistic credit strategies. In addition, the **Glossary** on page 8 defines each type of security.

Figure 1: Spectrum of Opportunistic Credit Opportunities by Liquidity



Source: Och Ziff Capital Management. (2014).

Key Attributes of Opportunistic Credit Strategies

As highlighted in **Figure 1**, opportunistic credit strategies cover a broad array of securities, which have many differences and similarities. **Figure 2** outlines several common return attributes, risks, and investment constraints, as well as the resulting benefits and risks. In short, opportunistic credit strategies may provide investors with an additional tool to enhance investment returns and increase total portfolio diversification. However, benefits may be accompanied by significant risks and investment constraints, many of which may be unacceptable for institutional investors. Before considering an investment in opportunistic credit strategies, institutions must properly assess their risk tolerances and investment constraints. In order to help investors think through these issues, we have provided a short self-assessment on page 7.

Figure 2: Opportunistic Credit Strategies—Investment Profile

Return Attributes

1. **Skill-Based Returns**—Managers generate returns by identifying major market dislocations and cases of asset mispricing. Returns are, therefore, dependent primarily on manager skill rather than market beta.
2. **Exposure Flexibility**—Because returns are less dependent on benchmark tracking, managers generally have greater flexibility to alter exposures to suit market conditions.
3. **Lower Interest Rate Sensitivity**—Manager performance generally depends less on overarching interest rate movements.

Risk Attributes

1. **Investment Complexity**—The strategies and underlying holdings are considerably more complex than traditional fixed income, making performance monitoring more difficult.
2. **High Volatility Potential**—Some strategies experience volatility that is higher than traditional fixed income strategies.
3. **Idiosyncratic Manager Risk**—Many strategies are offered by smaller firms with lower asset levels. This increases the potential impact of adverse firm events, such as key person loss or loss of assets.
4. **Headline Risk Exposure**—Adverse manager events and/or events affecting underlying securities can increase headline risk.

Key Constraints

1. **Allowable Investment Vehicles**—Strategies are generally accessed via private equity or hedge funds, which may be undesirable to some investors.
2. **Liquidity Restrictions**—Many funds restrict liquidity for months (or several years), which may be undesirable.
3. **Operational Due Diligence Complexity**—Operational due diligence requirements are generally more complex due to the highly specialized nature of these strategies.
4. **Benchmarking Limitations**—Few strategies have viable, investable benchmarks, which adds to the complexity of performance monitoring.

Benefits and Risks to Consider

Benefits

- ✓ Higher return potential due to significant opportunity for active manager value-added in inefficient markets.
- ✓ Stronger protection against interest rate increases due to low duration risk in many strategies.
- ✓ Strong potential diversification benefits due to low correlations with traditional fixed income investments.

Risks

- ✓ Heightened due diligence and performance monitoring requirements due to investment complexity and absence of clear benchmarks.
- ✓ Possibility of higher volatility for individual investments.
- ✓ Significant illiquidity and access constraints for many investors.
- ✓ Time sensitivity of opportunities due to potential rapid repricing of distressed securities.
- ✓ Higher fees, especially for private equity and hedge funds.

Sources: RVK, Inc. (2014); Och Ziff Capital Management. (2014).

Return Catalysts for Opportunistic Credit

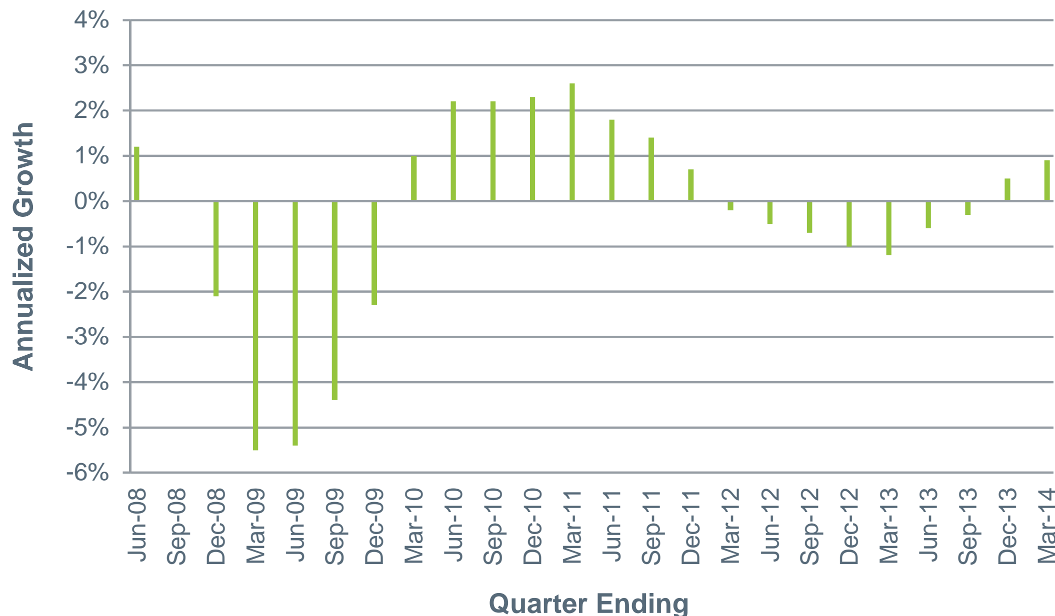
If opportunistic credit is deemed to be an appropriate strategy, the next question investors should ask is "why now?" While this is by no means the only time in history in which opportunistic credit is attractive, there are two economic developments in particular that make opportunistic credit strategies especially attractive in the current market environment.[i] We have summarized these two trends below and on the following pages.

Balance Sheet Repair in Europe

The strength of the U.S. recovery over the past few years has overshadowed the slower, but meaningful recovery in Europe. As recent as 2012, there were serious fears of a Greece exit from the Euro and the potential for contagion to spread to weaker European economies, such as Portugal, Ireland, Italy, and Spain. Due in large part to aggressive, albeit delayed, actions by the European Central Bank (ECB), these fears have largely subsided. In fact, in late 2013, the Eurozone economy finally emerged from a protracted recession (**Figure 3**) and entered a period of relative stabilization. As illustrated in **Figure 4**, this stabilization is most visible in the normalization of interest rate spreads on the sovereign debt of the weakest members of the Eurozone. Praising the ECBs actions, the IMF stated in a June 19, 2014 report that the Eurozone has "struck the right balance between demand support and debt reduction."[1]

Figure 3: Eurozone Real GDP Growth (Annualized)

(April 1, 2008 – March 31, 2014)

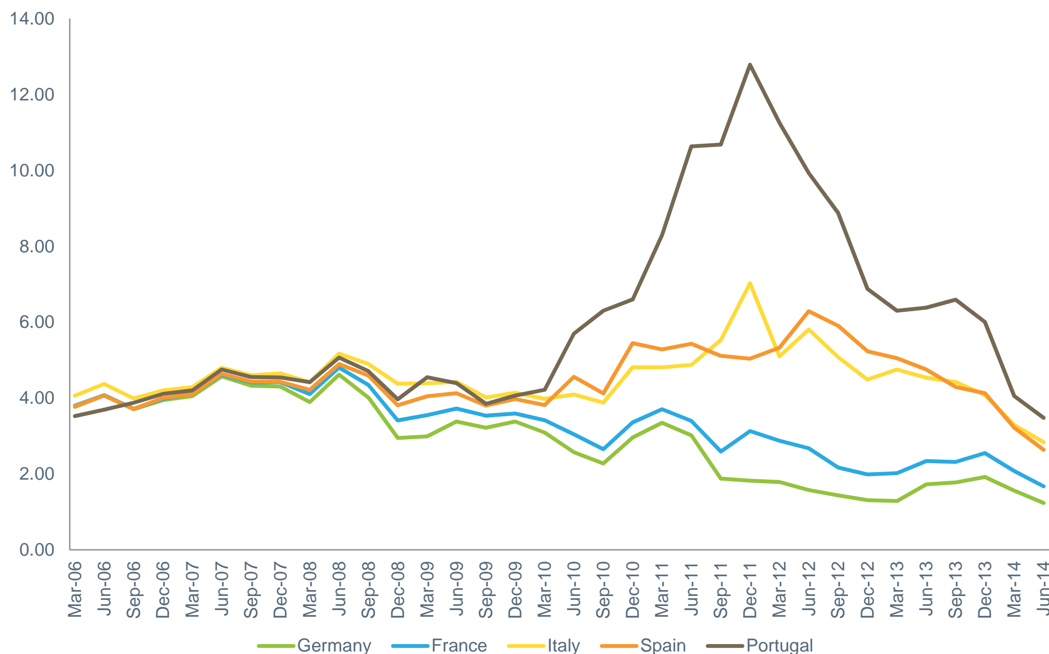


Source: Trading Economics. (2014).

[i] The observations in this paper are based on July 2014 market conditions, which are subject to change in periods subsequent to publication of this paper.

Figure 4: Eurozone Sovereign Debt Yields

(March 31, 2006 – June 30, 2014)



Source: Bloomberg. (2014).

Although markets recovered substantially during the first six months of 2014, many investment professionals acknowledge that the Eurozone continues to face significant challenges, such as excessive debt burdens and painfully high unemployment. Key to tackling these challenges is the strengthening of the European banking system, and it is this effort that is generating interesting credit opportunities. Specifically, in order to comply with stricter regulatory requirements, many European banks are cleansing their balance sheets by selling lower quality assets, deleveraging, and recapitalizing as needed. The large-scale disposition of lower quality assets is providing skilled managers with the opportunity to buy individual securities or entire portfolios at discounted prices. These investments typically involve a high degree of complexity and have limited interest from traditional fixed income managers, which creates an environment of greater inefficiency. The combination of these factors produces an inefficient market with increasing supply and limited manager expertise. The few managers that have appropriate specialization and strong local networks in this market are benefitting from a significant competitive advantage and rich buying opportunity.

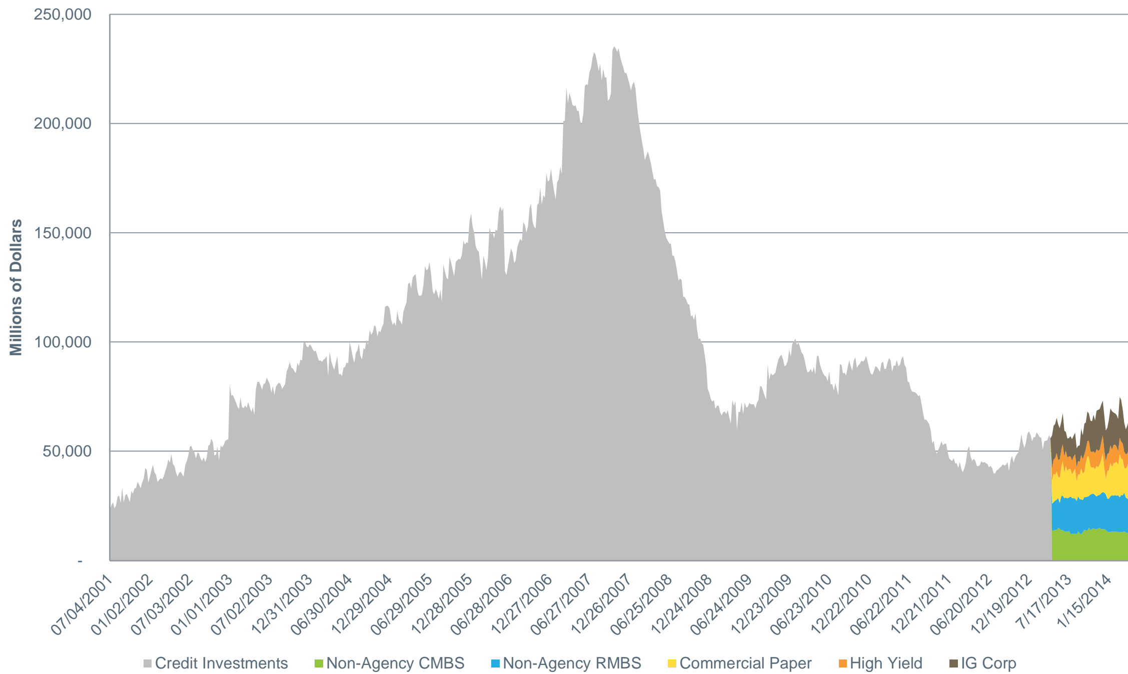
Growing Inefficiency in U.S. Structured Credit Market

As the U.S. economy has recovered, yields on structured credit securities, such as non-agency residential and commercial mortgage-backed securities (RMBS and CMBS) have declined. All else being equal, this has led investors to question whether the bull market in this sector is over. However, despite the general recovery, specialist managers have noted growing inefficiency, as dealers have substantially reduced their inventories, particularly in smaller, off-the-run securities. This is creating an environment in which highly skilled managers with a meaningful competitive advantage can add substantial value by exploiting this inefficiency. In addition, although investor skill is the key return driver, investors also appear to have a tailwind, as the fundamentals for these securities continue to improve. This is reflected in lower delinquencies in the residential sector and higher occupancy and rental pricing power in the commercial sector. **Figure 5**

shows the growing market inefficiency, while **Figure 6** shows one sample metric that demonstrates improving market fundamentals in the commercial real estate market.

Figure 5: Dealer Inventory of Key Credit Securities

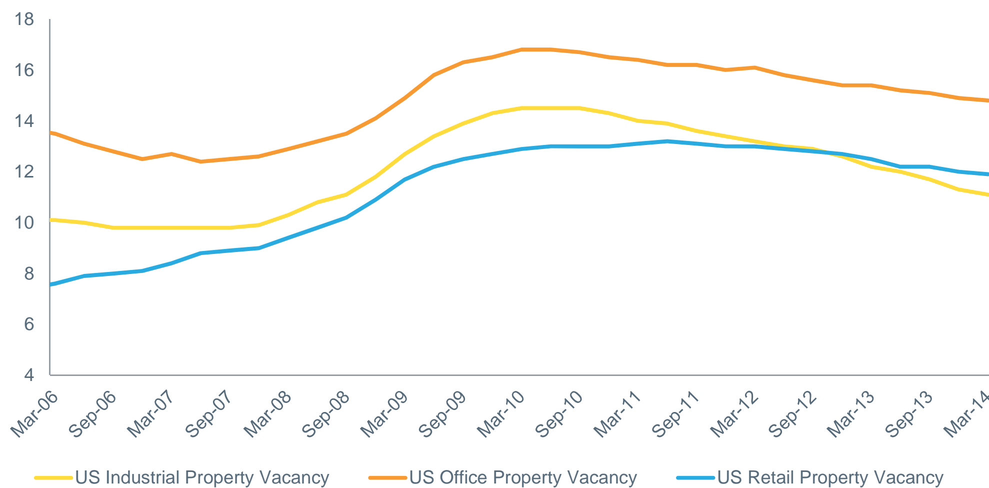
(July 4, 2001 – June 30, 2014)



Sources: Federal Reserve of New York (2014), Voya Investment Management (2014).

Figure 6: CBRE Vacancy Rates

(March 1, 2006 – March 31, 2014)



Source: CBRE Group (2014).

In summary, while the beta trade may be largely over in the U.S. structured credit market, investors may still have an opportunity to achieve attractive gains by investing with niche managers that possess the skills required to exploit growing inefficiencies. In addition, all else being equal, these securities also have a yield advantage relative to more traditional fixed income securities.

Conclusion

Investors continue to express anxiety about future fixed income returns given extremely low interest rates and the growing perception that higher rates are coming soon. This is leading many investors to view fixed income in its entirety as an unattractive asset class. While we concur that fixed income investing, particularly in traditional sectors, may not be as attractive as it was a few years ago, we believe that pockets of opportunities still exist. In this paper, we have highlighted opportunistic credit as one such area. For investors with the risk tolerance and flexibility to pursue such strategies, the benefits of return enhancement, diversification, and reduced interest rate exposure may be well worth the risks. We encourage our clients to review the self assessment below and contact their consultant if exploration of this opportunity may be attractive for their institution.

Opportunistic Credit Self Assessment

Instructions: *The goal of this self-assessment is to help investors consider several key questions related to investing in opportunistic credit strategies. If investors answer "no" to any of these questions, opportunistic credit strategies may not be appropriate for their organization.*

Key Questions	Yes	No
1. Is our fund able to accept potential increased risks at the total portfolio level, such as higher equity-like risk exposure, that may accompany these investments?	☐	☐
2. Does our fund have the ability to add investments with a high degree of illiquidity (i.e., potentially multi-year lock ups)?	☐	☐
3. Is our fund authorized to invest in direct private equity or hedge funds?	☐	☐
4. Is our fund comfortable investing in fixed income strategies that lack a viable fixed income benchmark?	☐	☐
5. Is our fund appropriately staffed to conduct (or willing to outsource) the required operational due diligence?	☐	☐
6. Is our fund able to accept the higher level of idiosyncratic manager risk associated with these strategies?	☐	☐
TOTAL	_____	_____

Source: RVK, Inc. (2014).

Glossary

Agency and Non-Agency RMBS Derivatives—Mortgage backed securities formed by dividing the cash flows from a pool of mortgages into various tranches such that the payment characteristics of the new obligations differ substantially from the underlying mortgages. Examples include Collateralized Mortgage Obligations, Interest Only ("IO") Strips, and Principal Only ("PO") Strips.

Bank Loans—A bank loan (or leveraged loan) is debt from companies with below investment grade credit ratings. Leveraged loans are typically secured with a lien on the company's assets and are generally senior to the company's other debt. Companies often issue leveraged loan predominantly to fund leveraged buyouts.[2]

Collaterized Debt Obligations (CDOs)—Asset-backed securities that hold a pool of collateralized debt (such as mortgages and auto loans) that may be subdivided into various tranches (representing different levels of risk).[3]

Commercial Mortgage-Backed Securities (CMBS)—Debt obligations that represent claims to the cash flows from pools of mortgage loans on commercial properties, such as office locations, retail space, apartment buildings or other real estate properties designated for commercial use.

Commercial Real Estate (CRE) Whole Loans—Whole loans on commercial real estate properties, such as office buildings, retail space, apartment buildings, or other real estate properties designated for commercial use.

Consumer Asset-Backed Non-Performing Loans (NPLs)—Whole loans on consumer loans (e.g., auto loans) on which the borrower is in non-performing status due to delay and/or failure to make timely payments or comply with loan covenants.

Consumer Asset-Backed Securities (ABS)—Securities that cover a broad range of consumer-oriented asset types, such as revolving consumer assets (credit cards); synthetic securities; operating assets; auto loans and leases; manufactured housing; and student loans.[4]

Corporate Bonds (senior)—Bonds issued by corporations that are senior relative to other securities in the capital stack in the case of corporate bankruptcy.

Corporate Bonds (unsecured)—Bonds issued by corporations that are not secured by any underlying assets, such as real property, inventory, accounts receivable or other corporate assets.

Credit Derivatives—A derivative whose value is linked to the probability of specified credit-related events occurring, such as a downgrade, nonpayment, bankruptcy, or a default. The most common example is a credit default swap.

Off-the-Run Securities—Seasoned government bonds are off-the-run securities; they are not the most recently issued or the most actively traded.[5]

Opportunistic Direct Loans—An originated loan by the investment manager to a third party without the use of an intermediary.

Regulatory Capital Relief-Driven Transactions—Transactions resulting from the evolving regulatory environment and ongoing deleveraging within the European banking system. Common practices include bank capital raises, debt exchanges, liability management exercises, and asset sales.

Residential Mortgage-Backed Securities (RMBS)—Debt obligations that represent claims to the cash flows from pools of mortgage loans on residential properties.[6]

Residential Non-Performing Loans (NPLs)—Whole loans on residential properties for which the borrower is in non-performing status due to delay and/or failure to make timely payments or comply with loan covenants.

Sovereign Debt—Debt securities of foreign countries outside of the United States.

Endnotes

[1] Santa, Martin. “Eurozone Has Correct Fiscal Stance to Cut Debt, Help Growth.” *Reuters.* (June 19, 2014).

[2] *NASDAQ.* http://www.nasdaq.com/investing/glossary/l/leveraged-loan. *(July 14, 2014)*

[3] TheStreet.com. http://www.thestreet.com/topic/47401/collateralized-debt-obligation.html. (June 19, 2014)

[4] *Standard & Poor's.* http://www.standardandpoors.com/ratings/structuredfinance-abs/en/eu. (July 14, 2014).

[5] “CFA Level 1 Program Curriculum: Equity and Fixed Income Investments.” *CFA Institute.* (2014). G-22.

[6] *U.S. Securities and Exchange Commission.* http:www.sec.gov. (June 19, 2014)

About RVK

RVK was founded in 1985 to focus exclusively on investment consulting and today employs over 100 professionals. The firm is headquartered in Portland, Oregon, with regional offices in Chicago and New York City. RVK is one of the ten largest consulting firms in the U.S. (as defined by Pensions & Investments) and has a diversified client base of over 190 clients covering 28 states. This includes endowments, foundations, corporate and public defined benefit and contribution plans, Taft-Hartley plans, and high-net-worth individuals and families. The firm is independent, employee-owned, and derives 100% of its revenues from investment consulting services.