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Opportunistic Investing

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Opportunistic Investing

What is Opportunistic Investing?

- Owners of assets are motivated to sell when there are few willing buyers.
- Events may create price dislocations in security prices with no change in the fundamental value.
- Opportunities occur in every segment of the investment markets.

Opportunistic Investing

How does it work?

- Astute and nimble investors can profit from buying assets at a substantial discount.
- The ultimate contrarian investment strategy; often involves buying out-of-favor assets.
- Some strategies are complex, some are simple.
- Some assets may be publicly-traded; most assets may be illiquid or privately-held.

Opportunistic Investing

What are the benefits?

- Having different investments with different risks is called **"diversification."**

- Higher expected returns: 8-10%+

With each strategy you should ask…

- ➢ **What are the risks?**
- ➢ **How are those risks managed or mitigated?**

Opportunistic Investing

General Types of Opportunistic Investing:

- **Event Driven** - Unique, not repeatable, time sensitive.
- **Sustainable** – Repeatable, systematic opportunities.
    - Direct Lending (fixed income based)
    - Private Equity Secondaries (equity based)

Event Driven Example

June to Sept of 2015

- Oil prices drop from $113/barrel to $47/barrel
- Oil stocks drop in price 17%
- Oil **bonds** drop in price 40%-60%

- An oil pipeline company has long-term fixed rate contracts, not related to oil prices.

➢ **Buy** pipeline bonds at $45 and wait for market to realize the company is not impacted by oil prices.

Event Driven Example

What is the Risk?

- Oil prices don’t bounce back (commodity price risk)

- The market does not care if the bonds are dollar good or not and bond prices remain distressed.

Risk Mitigation:

- Hold the bond to maturity with a 12% yield.

Events that Create Opportunities

- **Shareholder activists** – Forced corporate restructuring, asset sales, spinoffs.
- **Litigation** – Product defects, asbestos, fraud.
- **Litigation Finance** – Fund the legal costs of lawsuits and share in the settlement.
- **Bankruptcy** – Reorganizations, spin-offs, asset sales at distressed prices.
- **Management changes** – Forced asset sales.
- **Regulatory Changes** – Forced asset sales (Dodd-Frank's banking reform reserve requirements!)

Direct Lending Example

Banks have successfully profited from lending for hundreds of years!

The Cardinal Rule for Successful Lending:

- The borrower has the **ability** to repay the loan, i.e., they have the cash flow and/or assets, ***and***
- The borrower has the **integrity** to want to repay.

If both are present, you have a performing loan,
If either is not present, you have a defaulted loan.
Everything else is paperwork!

Direct Lending Example

- Despite the best credit scores and good underwriting, **loan losses** will happen.

- So will **recoveries**:
  - 4% default but 2% is recovered = 2% net loss
  - Interest Rate Charged @ 10% - 2% loss = Net 8%

- Banks are successful at lending because they have a large number of loans in their portfolio, so the math works very consistently.

Direct lending is "banking" without the overhead.

Direct Lending

Comparison of Middle Market Lending to Large Corporate Debt Securities

Characteristic	Large & Middle Market Direct Loans	Large Corporate Syndicated Bank Loans	Short Duration High Yield Bonds	High Yield Bonds
Market Size	**$1.5 trillion**	$694 billion	$757 billion	$1.9 trillion
Description	**Senior Secured Lending**	Senior Secured Lending	Unsecured lending to below investment grade corporations	Unsecured lending to below investment grade corporations
Loan to Value Ratio	**Up to 65%**	Up to 70%	Up to 75%	Up to 75%
Rate Risk	**Floating**	Floating	Fixed	Fixed
Loan Duration (Yrs)	**2.5**	2.5	2.2	3.8
Liquidity	**Low**	Medium	High	High
Expected Return	**8-11%**	4-6%	4-6%	4-6%

Direct Lending

What are the Risks?

- Loan defaults increase, reducing returns or creating losses.

Risk mitigation:

- Break-even would require loan defaults to rise from current levels to higher than the interest rate being charged.

- Good direct lending managers still had positive returns post the 2008 credit meltdown.

- Loans are floating rate, little interest rate risk.

Private Equity Secondaries

What are Private Equity Secondaries?

- Investor purchase **existing private equity** limited partnership interests from the current investors looking to sell, normally at a discount to the current portfolio value.

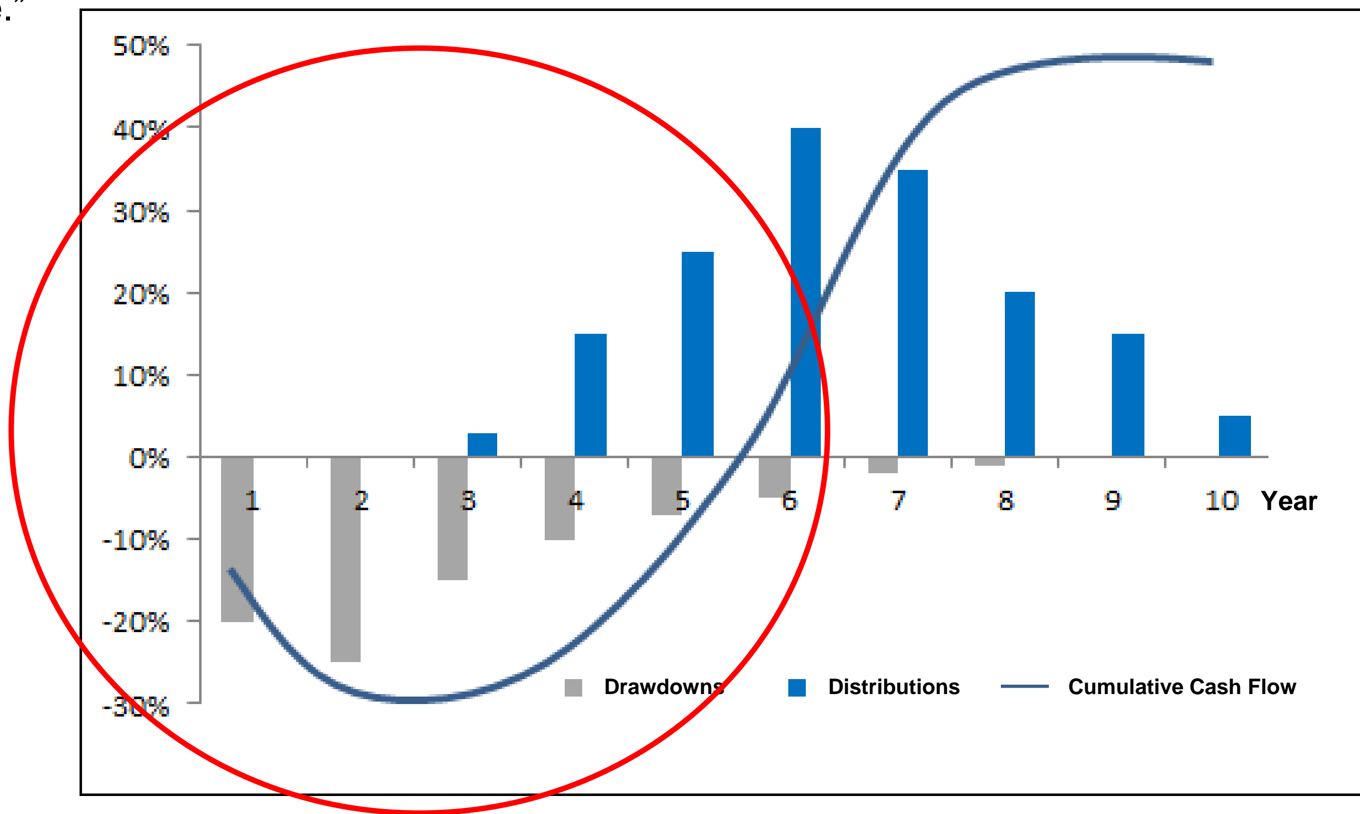
- Sellers include financial institutions, pensions, foundations, endowments, family offices and high net worth individuals.

- Deal flow was over $40 billion in 2015 with a 22% annual growth rate since 2005.

- Geographic distribution of sellers: 48% US based, 37% European, 15% rest of the world.

Private Euity J-Curve and Cash Flows

Private equity funds "draw down" committed capital from investors early in a fund's life and invest that capital over time. Distributions on realized investments generally do not occur until a few years after capital is initially drawn from investors. Additionally, fees are paid on committed capital, rather than invested capital. This results in negative cumulative cash flows in the early years of a private equity investment: the "J-curve."



For illustrative purposes only. Not indicative of any particular investment.

Source: http://blog.dealmarket.com/j-curve-analysis-could-impact-pe-industry/

INVESTMENT PERFORMANCE SERVICES, LLC

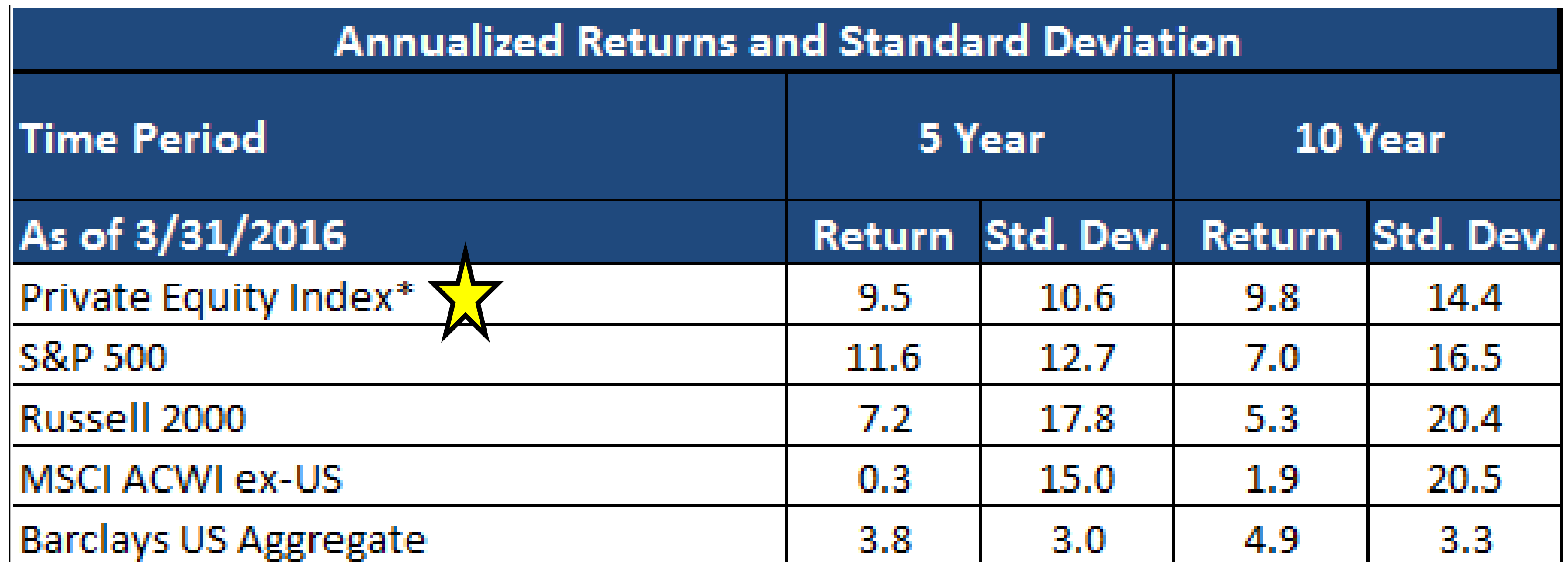
Private Equity Secondaries

Why Private Equity Secondaries?

- Known pool of diversified assets with multiple vintage years - Provides both sector and time diversification.
- Almost immediate cash flow, no “J” curve.
- Illiquid investments - But with a much shorter time to realization of capital distributions vs. primary private equity funds.
- Predictability - The potential for outsized returns may be reduced, but so is risk of outsized loss.

Private Equity Secondaries

Private Equity: Attractive Risk/Reward Characteristics



Annualized Returns and Standard Deviation				
Time Period	5 Year		10 Year	
As of 3/31/2016	Return	Std. Dev.	Return	Std. Dev.
Private Equity Index*	9.5	10.6	9.8	14.4
S&P 500	11.6	12.7	7.0	16.5
Russell 2000	7.2	17.8	5.3	20.4
MSCI ACWI ex-US	0.3	15.0	1.9	20.5
Barclays US Aggregate	3.8	3.0	4.9	3.3

* Hamilton Lane All Private Equity with volatility de-smoothed. Geometric mean returns in USD. The Hamilton Lane All Private Equity Index tracks the performance of all private equity strategies including direct buyout, venture capital, credit, other special situation strategies and Secondaries.

Private Equity Secondaries

What are the Risks?

- **Equity market risk** – Exit strategy is IPO or sale to economic buyers which are anchored to current stock market valuations.
- **Management risk** – Risk that the selection of the secondary funds is suboptimal and/or overpaying for fund interests.

Risk Mitigation:

- Manager experience and assets that are purchased at a discount from current asset values.

Opportunistic Investment Funds

- Usually Limited Partner structure
- Offered by firms that specialize in certain area
- May be limited life “vinatge year” fund or “evergreen” fund
- Will have diversification (multiple investments)
- Have limited liquidity; withdrawals over several years
- Annual management fees plus incentive fees

How to Succeed with Opportunistic Investments

- Identify your Fund’s return goals and acceptable risk level.
- Be open minded.
- Know the liquidity needs of your fund, as these are all illiquid investments.
- Understand how each strategy works, their **risks** and **rewards**.
- Work only with experienced professionals in each strategy.