FRONTIER ADVISORS

20 years

Frontier International

International research insights from Frontier Advisors

Debt, Alternatives and Innovation Research Team

Issue 13, May 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.

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.

Joey Alcock, Consultant

Michael Sommers, Consultant

Daniel Selioutine, Associate Consultant

Frontier Advisors

Level 16, 222 Exhibition Street
Melbourne, Victoria 3000
Tel +61 3 8648 4300

www.frontieradvisors.com.au

@frontier_adv

Mind the gap

In May 2015, members of Frontier's Debt, Alternatives and Innovation Research Team (DAIT) travelled to Europe. A focus of this trip was to meet with global managers we either currently rate or which we could rate in the future. Discussions with managers covered a broad range of themes and gave us a variety of perspectives helping to illuminate some of the issues and opportunities for investors to consider on the global stage.

Mind the markets gap...volatility, liquidity and interventions

There were several key market themes mentioned by a number of managers we met with on this recent research venture and, just like markets, all were interconnected. These themes included liquidity, regulations, market volatility, central bank activity and risk models.

Liquidity

Several managers acknowledged the increasing level of illiquidity in markets. One ex-IMF strategist explained that the IMF was very concerned about the weight of pension fund investments in markets relative to banks. Prior to Lehman's collapse, it would have taken an average six days to liquidate a credit fund; now it would take more than 50 days. This is because credit fund sizes have grown dramatically as a result of QE, and because banks no longer act as a market maker to the same extent due to regulatory influence.

Liquidity issues are not only confined to credit but are now observed at times in Treasuries, Gilts, Bunds and even the EUR/USD - the most liquid global market. Liquidity is there most of the time but any sign of a disorderly market leads to market gaps which are occurring more often than in the past. Interestingly, one experienced macro manager noted that while daily realised volatility had been relatively low for some time (albeit spiking recently), the intra-day volatility was the highest she had observed in her career which she believes reflects these liquidity issues.

Regulations

The actions by regulators to dramatically change the banking landscape (e.g. no proprietary trading, liquidity coverage ratios requiring higher-quality assets to be held, reduced leverage ratios and increased capital requirements) have been criticised in recent times for removing a key circuit breaker in markets.

One manager recounted discussions he'd had with a regional regulator regarding bank regulations. The regulator was happy with the new level of bank regulation (when wouldn't a regulator be happy with more regulations!) and that governments had been responsive to the proposals. However, there was dissatisfaction about the proposed regulations of the shadow banking areas (i.e. mutual funds) which were still not implemented.

Perhaps the most important proposed regulation, in our view, is for a larger cash allocation to dampen the liquidity risks of the sector (both from a trading and investor-redemption perspective).

The unofficial cynical view of the reluctance of these governments to implement these proposals was that the QE operations needed mutual funds to buy the bonds being issued as part of QE and so any extra-cash requirement would have impacted the efficacy of these operations.

This regulator admitted that perhaps it is "too late" to ask mutual funds to create a cash buffer and posed the question: "how would markets react to regulators asking a massive sector to store cash?"

Market volatility

How does this all come together? The increased regulations leading to banks operating within tighter risk limits change the way they operate. In the past, a key role of bank trading desks was to act as a market-maker which would include taking on proprietary positions when required. This ability to take on proprietary positions fostered a more liquid market, including providing a circuit breaker should any non-fundamentally driven market move occur. Now buyers and sellers must effectively be "matched" upfront, limiting liquidity and impacting prices. This in turn creates market gapping which has become more prevalent in recent times.

But these rapid changes in market conditions usually follow a period of low volatility, a condition that central banks have engineered with quantitative easing (QE). The latest instalment of QE is from the ECB. Its QE operations had led to a sustained decline in Bund yields to levels which had market participants confused given economic fundamentals (e.g. inflation expectations) could not justify such low yields.

Nonetheless, this is where an appreciation of different market participants can help. While this made little sense to some managers we met with who use economic fundamentals to value a trade, it made perfect sense to some macro traders who used market sentiment and momentum, in addition to fundamentals, as inputs to their trading decision.

"VaR Shock"

Just as fundamentals could not explain the Bund yield's sustained fall, nor could they explain the sudden reversal of the Bund in late April which saw yields surge 70 basis points from a low around 10 basis points in a matter of a few days. There was no fundamental catalyst. Instead, this had followed a period of low volatility driven by the ECB's QE operations. All that was needed was for one key market participant to head for the exit before others chose to do so in an exit stampede. This was classic frantic trading activity which a number of managers believe was exacerbated due to illiquidity.

The buzz with managers and banks we met with was the impact that Value at Risk (VaR) models at banks, hedge funds, fund managers, risk parity funds and CTAs had on creating the spike in Bund yields that occurred in late April/early May. Owing to the way it is calculated, VaR can be quite sensitive to market volatility. Banks and fund managers use this metric as a risk controller and so reduce trading positions when market volatility spikes.

Conversely, it will also lead them to take on bigger trading positions when market volatility is relatively low. Therefore, VaR-driven investors increased Bund (and other bond) allocations as volatility progressively fell following the ECB's QE implementation.

The Bund reversal forced these same market participants to sell to ensure they remained within their VaR limit. In so doing, a feedback loop was created whereby selling created volatility which necessitated more selling to bring a portfolio back within its VaR limit. Critically, this was a mathematical tool driving frantic investor behaviour.

©Frontier Advisors

However, this isn't exactly a new phenomenon. Managers mentioned the market has seen these types of VaR shocks before (although they seem to be more prevalent in recent times) including Japanese Government Bonds (2003 and 2013), "Taper Tantrum" of mid-2013 and US Treasuries in October 2014. Each shock follows a similar pattern of sanguine market volatility storing up the condition for a sudden spike in volatility which was not caused by any fundamental driver.

These VaR shocks have been relatively short-lived and have not had a discernible medium-term impact on returns. However, each occurrence leads market participants to become ever more concerned with the risk of illiquidity in the future precisely when markets will need it. One tail risk manager (and of course that skewed negative view of the world needs to be borne in mind) believes the next market shock will be bigger than the GFC simply because of the extreme illiquidity that will occur now banks will not be there to help soften falling markets. In our view, while these may be short-term shocks, investor portfolio returns may be impacted in the medium to longer-term if decisions are made outside of their control which have long-lasting structural impacts on markets and economies (e.g. Lehman Brothers being allowed to default).

Currently, the prospect of a disorderly evolution of Greek debt discussions (referred to in the media as a "Graccident" whereby a Greek exit out of the Euro happens which most market participants do not foresee) is one such possibility which could have medium-term ramifications, most notably for the Euro, European equity markets and the peripheral bonds of Spain, Portugal and even Italy.

Mind the funding gap…shadow banking

Shadow banking. Alternative lending. Bank replacement. Whatever the name tag, for some time, Frontier has been monitoring the opportunity set in the financing "gap" arising from the withdrawal of banks from segments of the capital markets, especially in those considered more risky, such as mid-market corporate.

Our European research trip was therefore a good chance for us to get a feel for the degree of persistence in this theme by speaking with some of the fund managers which have been able to take advantage of this gap over recent years. We also canvassed the views of some of the large local banks to gain their perspective.

Looking back to our trip to Europe around one year ago, we had observed many divergent views with respect to what lay ahead for the region in terms of economic growth, the Eurozone political situation, and the potential actions of the European Central Bank (ECB).

Since then, in the face of continued insipid economic growth and concerns around deflationary risks, markets did receive some tangible support with the announcement by the ECB in January this year that it would significantly expand its asset purchase programme as part of its continuing efforts to stabilise asset pricing in the region.

So, with the ECB now embarking on its own version of Quantitative Easing (QE) and injecting cheap liquidity into the European economy, we were curious to find out whether this had led to banks returning to their old haunts, particularly the mid-market corporate and asset-backed spaces.

The answer appears to be "no", or at the very most "not yet" and the factors holding them back are being considered by some fund managers to be more structural than cyclical.

Certainly, regulation of the European banking system remains a key constraint on banks undertaking activities such as lending to smaller and medium-sized businesses. The requirements around capital adequacy to back bank loans to higher risk corporates for example are still considered by the broader banking industry to be too onerous or restrictive to warrant re-entering this market. One fund manager observed the banks preferred to use their now increased access to cheap debt financing to undertake low margin carry strategies rather than look at higher margin lending.

Beyond the specific regulatory pressures limiting bank activity in the mid-market, other anecdotal observations from managers included ongoing public pressure on European governments to keep a firm lid on banker salaries. With the bigger risk-takers at banks traditionally receiving the biggest bonus cheques, this pressure on salaries has proven to be a drag on the incentive for bankers to take risk at an individual level given the lack of payoff. Thus an exodus of sorts has occurred as a result, with staff leaving banks, which subsequently lose the personal relationships they once had with borrowers. Indeed, many ex-bankers are moving over to the funds management industry working on deals they used to work on at a bank prop desk. And this is a continuing trend.

Even so, the mid-market lending space as an example has continued to become more competitive with more fund managers seeking to exploit this dynamic, so the need to be selective on deals and have the necessary sourcing, credit assessment, deal structuring, and operational capabilities remains very important to generate an attractive risk-adjusted return. It is not wholly clear whether a particular segment of the mid-market is more attractive to these types of opportunistic managers than another.

We find managers that have the capability to select the most attractive segment of a company's capital structure, whether it be senior-secured loans or sub-investment grade structured loans, when assessing a deal to be highly appealing.

But for now, it appears investment managers continue to have a reasonably attractive hunting ground in the European mid-market space. One potential issue on the horizon however, is the looming possibility of bank-like regulation of the investment management industry – watch this space!

Mind the funding gap…differential pricing

A key focus point on this trip was to assess the recent influx of "simple" products from a number of trend following managers (typically called CTAs) looking to tap into the fee conscious Australian market. CTA managers seek to generate positive returns by identifying and investing in trending markets across a spectrum of tradable asset classes (equities, bonds, commodities). Such strategies are typically quantitative in nature and rely on trends continuing after their initial investment (CTAs perform poorly when trends unexpectedly reverse).

Frontier met with six of the biggest names in CTA quantitative strategies to get a feel for what is available in the market and on what terms. As a general observation, we think that the 2 and 20 fees quoted for a number of flagship CTA offerings appear excessive relative to quantitative strategies in other sectors; although some – but not all – of this difference reflects the esoteric nature of the underlying exposures as well as the purported superior trade execution capabilities of the managers. Nevertheless, 2 and 20 is a hard sell for Australian investors and strategies for lowering this level were on the agenda.

The simple products we discussed were emphasised as solid standalone offerings in their own right. The superficial difference was that they had no exposure to a sizeable number of less liquid markets and instruments. The logic was sensible; these markets were the most complex, most expensive to trade and most capacity constrained exposures; so it made sense to remove them to reduce product costs.

This has indeed reduced headline fees to more palatable levels, bringing some of the "simple" CTA offerings in line with other opportunistic investments; however fees remain materially higher than traditional asset classes like equities and bonds.

Buyer-beware: the devil is in the detail

Our further probing discovered that in addition to removing illiquid, expensive markets; a number of managers reduced the complexity of what was left in their "simple" strategy. There was a clear undertone of differential pricing throughout our meetings and in one instance, we observed a manager that had diverted resources to undertake new research into alternative methods of implementing their existing investment ideas instead of simply porting signals from their flagship product. This was a clear attempt at making the two products different enough to justify what were materially different fees. We can appreciate why managers may be tempted to do this; lest investors in the flagship decide that the tradeoff between the uncertain expected benefit of illiquid markets does not justify the certainty of higher fees.

For investors considering these products, we suggest they know the details of the more complex strategy so they can better assess what you are giving up in the simpler strategy. Indeed, it became clear to us that a number of managers had not considered marketing their more expensive product in Australia, creating a real risk that this crucial detail would be lost in translation – unless one knew to ask!

©Frontier Advisors

About Frontier Advisors: Frontier Advisors is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

Frontier does not warrant the accuracy of any information or projections in this paper and does not undertake to publish any new information that may become available. Investors should seek individual advice prior to taking any action on any issues raised in this paper. While this information is believed to be reliable, no responsibility for errors or omissions is accepted by Frontier or any director or employee of the company.

Frontier Advisors Pty Ltd ABN 21 074 287 406 AFS Licence No. 241266