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 (systematic or sustainable opportunities).
- Events may create price dislocations in security prices with no change in the fundamental value (event-driven opportunities).
- Opportunities occur in every asset class: stocks, bonds, real estate, commodities and currencies.
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

How does it work?

• All investments have risk.
• Having different investments with different risks is called “diversification.”
• With each strategy you should ask, “What are the risks?” and,
• How are those risks managed or mitigated?
Opportunistic Investing

General types of opportunistic investing:

1. **Event driven**—Unique, not repeatable, time sensitive.

2. **Sustainable**—Repeatable, systematic opportunities.
   - Direct lending (fixed income based)
   - Private equity secondaries (equity based)
Event Driven Opportunistic

Example of event driven opportunity #1:

- June to Sept of 2015—Oil prices drop from $113 per barrel to $47 per barrel.
- Oil stocks drop in price 17% in 3rd Q 2015.
- 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.
What is the risk?

- Oil prices don’t bounce back (commodity price risk) and 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.
Example of event driven opportunity #2:

- Valeant Pharmaceutical is criticized for acquiring drugs and raising prices by 4,000%.
- Mylan Pharmaceutical is criticized for raising price of EpiPens by 450% to $600 per pack.
- Drug company stock prices drop on fear of gov’t regulations that will limit drug prices.
- A company that specializes in “orphan drugs” for rare diseases gets two new drugs approved by FDA, with two others in pipeline, but their stock price drops anyway.
Event Driven Opportunistic

Event driven opportunity #2:

• The Orphan Drug company needs a loan to expand its production for the new drugs.
• Investors provide a senior secured loan for 8% plus stock warrants at 20% above current stock price.

What is the risk?

• Regulatory—New government regulations may limit prices/profits on the new orphan drugs.
Event Driven Opportunistic

Example of event driven opportunity # 3:

• A Business Development Corp (BDC) owns mortgage REITS as an investment.

• Due to mismanagement, it is forced to eliminate its dividend, loses its BDC status, and investors flee.

• The BDC’s stock price declines below the value of the underlying assets; the mortgage assets remain valuable and unimpaired.
Example of event driven opportunity #3:

- Investors buy a controlling interest of BDC and then sell the mortgage assets at market prices to a REIT manager who reinstates the dividend payouts.

What is the risk?

- **Sale price** of the mortgage assets are less than the amount spent to acquire control.
- **Interest rates** rise quickly, depressing the prices of the underlying mortgages.
Event Driven Opportunistic

Other event driven strategies:

- **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!)
Sustainable Opportunistic Direct Lending:

- Banks have successfully profited from making loans 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!
Sustainable Opportunistic

Direct Lending:

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.**
Your pension fund invests in loans already, they are just called **Bonds**.

- Bonds are loans to large corporations or to governmental agencies. The loans are large enough that they can be syndicated into securities that are publicly traded.
- Short-term bank loans to large corporations are also syndicated and sold in the public market place.
## Sustainable Opportunistic

### The Lending Business Segments:

<table>
<thead>
<tr>
<th>Segment</th>
<th>Revenues</th>
<th>Loan Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Corporate</td>
<td>$250 million+</td>
<td>Loans are syndicated into publicly traded bonds</td>
</tr>
<tr>
<td>3,691 public companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Large Private Companies</td>
<td>$50 million to $250 million</td>
<td>Loan are privately negotiated</td>
</tr>
<tr>
<td>65,000 companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Middle Private Companies</td>
<td>$10 million to $50 million</td>
<td>Loan are privately negotiated</td>
</tr>
<tr>
<td>366,000 companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Small Business</td>
<td>$500K to $10 million</td>
<td>Loan are privately negotiated</td>
</tr>
<tr>
<td>5.7 million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumers</td>
<td></td>
<td>Home equity lines of credit, car loans, and credit cards.</td>
</tr>
<tr>
<td>124.6 million households</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Large and middle private companies represent a $1.5 trillion loan market.
Sustainable Opportunistic

Who lends to each business segment?

• Large corporate loans (and government entities) issue publicly traded bonds, short-term bank loans and commercial paper.

• Large and middle market private companies
  – 70% of this market is private lenders (pension funds, insurance companies, etc.), less than 30% are banks.
Who lends to each business segment?

- **Small businesses and individuals**—Banks issue 90% home equity lines of credit and secured loans. The balance is issued by peer-to-peer lending platforms like Lending Club and Prosper. This segment is growing by $1 billion per year!

- Banks also sell or syndicate home equity loans, car loans and credit card debt as investment grade securities and sell the securities in the publicly traded markets. These securities are most likely in your fund’s bond portfolio right now.
## Sustainable Opportunistic

### Comparison of Middle Market Lending to Large Corporate Debt Securities

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

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.
Opportunistic Investing

Private Equity Secondaries:

• Investors purchase existing private equity interests, normally at a discount to the current portfolio value.
• Sellers include financial institutions, pensions, foundations, endowments, family offices.
• Deal flow was over $40 billion in 2015 with a 22% annual growth rate since 2005.
• Geographic distribution: 48% US, 37% Europe, 15% rest of the world.
Sustainable Opportunistic

**Private Equity:**
Attractive Risk/Reward Characteristics

<table>
<thead>
<tr>
<th>Time Period</th>
<th>5 Year</th>
<th></th>
<th>10 Year</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Equity Index*</td>
<td>9.5</td>
<td>10.6</td>
<td>9.8</td>
<td>14.4</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>11.6</td>
<td>12.7</td>
<td>7.0</td>
<td>16.5</td>
</tr>
<tr>
<td>Russell 2000</td>
<td>7.2</td>
<td>17.8</td>
<td>5.3</td>
<td>20.4</td>
</tr>
<tr>
<td>MSCI ACWI ex-US</td>
<td>0.3</td>
<td>15.0</td>
<td>1.9</td>
<td>20.5</td>
</tr>
<tr>
<td>Barclays US Aggregate</td>
<td>3.8</td>
<td>3.0</td>
<td>4.9</td>
<td>3.3</td>
</tr>
</tbody>
</table>

* 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.
Sustainable Opportunistic

**Private Equity Secondaries:**

- Known pool of diversified assets with multiple vintage years—Provides both sector and time diversification.
- 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.
Sustainable Opportunistic

Private Equity Secondaries

• What are the risks?
  – **Equity market risk**—Exit strategy is IPO or sale to economic buyers at current market multiples.
  – **Management risk**—Risk that the selection of the secondary funds is suboptimal and/or overpaying for fund interests.

• Risk mitigation:
  – Manager experience and assets are purchased at a discount from current asset values.
Opportunistic Investing:

- Can be event-driven or sustainable.
- Are typically contrarian investments.
- Are driven by structural mispricing of assets.
- Appear in all asset classes.
- Are generally illiquid (but not always).
- Have attractive risk/reward characteristics.
- Provide diversification in portfolios.
- Have the potential to increase plan returns.

How to succeed:
- Identify your fund’s goals.
- Be open minded.
- Know the liquidity needs of your fund.
- Understand the risks and rewards.
- Work only with experienced professionals.
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