PCA | PENSION CONSULTING ALLIANCE

VIEWPOINT

JUNE 2018

Contingent Funds: Positioning for the Credit Pivot

The view that we are late in the credit cycle seems almost axiomatic. The duration of the current economic expansion, the tightness of credit spreads, and uptick in covenant-lite issuance are often cited to prove that point – or are meant to.[1] Despite this, many investors remain hesitant to execute on a directional view that is inconsistent with a benign corporate credit environment. A handful of managers have responded—and we are seeing more funds come to market—with rules-based funds that are de facto call options on the "credit pivot," the move from a benign credit environment to one that is stressed/distressed. In these "contingent" or "dislocation" funds, as they are often called, Limited Partners ("LPs") cede the timing decision, capital is drawn and/or invested only after certain market-based triggers are met, and management fees typically are not paid on committed capital.

PCA believes that positioning for the credit pivot should be a key area of focus for investors today and that contingent funds may be a good fit for many institutional investors given current governance structures. However, the lack of industry standards around opportunity sets, vehicles structures, and fees makes manager selection critical. In this edition of *Viewpoint,* we highlight the investment rationale for contingent funds and share our thoughts on implementation, including a proposed beta-adjusted fee structure that better aligns General Partner ("GP") and LP interests.

TIMING MATTERS

Slow and steady is an axiom that most institutional investors have embraced. Due to plan's strategic asset allocations, the need for trustee education and detailed search processes, allocation decisions often take multiple months, if not longer. While generally rewarded for having a long-term horizon, LPs find it difficult to act quickly and take advantage of periods of market stress and/or allocate to cyclical asset classes based on timing. But, as is widely known, investors are often handsomely rewarded for investing into dislocations (Figure 1).

[1] The current economic expansion, which began in June 2009, is in its 108th month; the average for economic expansions is 37 months. High yield spreads are near their tightest levels (334 bps as of June 18, 2018) since before the Global Financial Crisis (246bps in May 2007). Seventy-seven percent (77%) of the outstanding U.S. leveraged loan market ($970 billion) is covenant-lite. Source: National Bureau of Economic Research (NBER), KKR; ICE BofAML US High Yield Master II OAS; Wells Fargo.

Figure 1 – Cumulative Returns During Market Dislocations (1996-2018) *

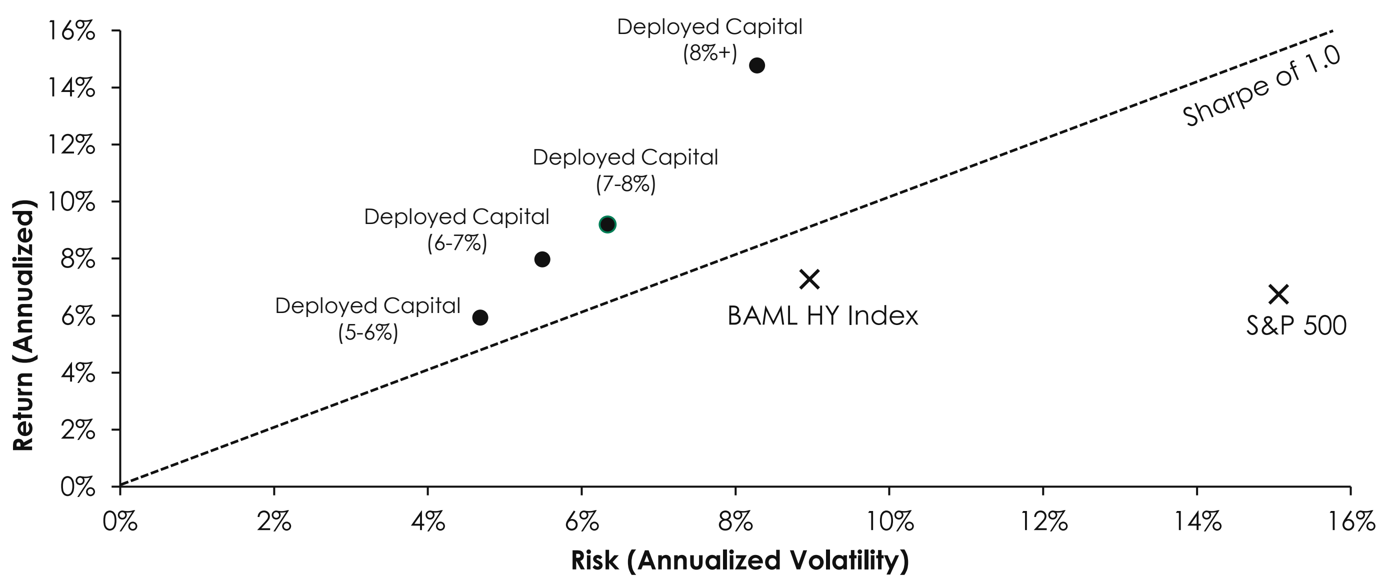
	24-month Holding Period	Peak to Trough
Telecom Bubble	49%	81%
Global Financial Crisis	92%	106%
European Sovereign Crisis	27%	39%
Energy Dislocation	29%	29%

*BofAML HY Index

While hindsight is 20/20, investing into a declining market is difficult to do as investors often ask themselves whether they are trying to catch a proverbial falling knife and determining when to sell is equally daunting. With the view that identifying peaks and troughs is a role better served by investment managers rather than Investment Committees, vintage year diversification has been the default approach for most investors.

Contingent funds offer a different approach to this challenge, often using rules-based triggers to identify entry points.[2] Straightforward spread-based triggers (e.g., high yield spreads widening to 650 basis points) provide strong guideposts. As highlighted below, capital deployed into high yield when spreads were between 700 to 800 basis points, returned over 9% with a volatility of approximately 6% and jumped to nearly 15% with a volatility of 8% when spreads were greater than 800 basis points (Figure 2).[3]

Figure 2 – Historical High Yield Risk/Returns When Deployed at Different Spread Levels*



**Analysis from January 1997 to March 2018*
Source: Apollo Global Management LLC

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[2] Not all contingent funds are rules-based. Some provide full discretion to managers in terms of activation, while others employ a combination of rules-based triggers and judgement. Managers often employ a combination of multiple triggers.
[3] This assumes a 24-month holding period and a passive investment in the BofAML High Yield Index.

IMPLEMENTATION
While compelling in concept, the implementation of a contingent fund allocation is less straightforward. Challenges tie to opportunity costs, potential conflicts of interest, and fee structures as well as other considerations. These issues are addressed below.

Opportunity Costs
Core to the investment thesis of contingent funds is securing capacity with a best-in-class manager who is positioned to invest at the most opportune time. In order to do that, LPs underwrite the fund in the current benign environment and seek approval from their Investment Committees to make a commitment. As the fund is only "activated" when a pre-agreed upon trigger is hit, the opportunity may not materialize. While one could argue that all commitment style funds bear some degree of this type of risk, few are so pronounced – i.e., have the explicit risk of 0% capital being called.

We believe this risk – valuable Investment Committee time being spent on an opportunity that may not materialize – is best mitigated by investing in a contingent fund with a pre-existing manager as the time commitment of underwriting is less than it would be for a completely new allocation/manager. That said, if an investor is not already invested with a manager currently offering a contingent vehicle, we believe a new allocation (i.e., conducting a search for a new manager) is advisable. As outlined above, the return potential, on both an absolute and risk-adjusted basis, during elevated spread environments is compelling and worth positioning for, given the late stage of the credit cycle.

Potential Conflicts
While nearly all managers have well defined trade allocation policies, understanding what other pools of internal capital are competing for a given allocation and the liquidity structures of those pools is critical. Questions to consider include:

- Does a manager have a similar exposure across vehicles with different liquidity profiles?
- Do different vehicles have different fee structures?
- Who are the primary holders of this paper in the market, and what is their liquidity?
- Is the contingent fund a dedicated pool of assets with its own liquidity structure?

In general, it is best to avoid managers/funds where opportunity sets are similar across vehicles with different liquidity and where managers are launching longer locked funds that may have overlap with shorter-dated vehicles. While managers certainly can manage both finite life funds and open-ended structures without conflict, the opportunity sets should not meaningfully overlap, particularly where capacity is limited and capacity, even in liquid stressed high yield names, likely will be limited.

Fees
We recognize that the resources required to execute contingent funds are significant and further recognize, as one manager highlighted, that contingent funds involve "renting our best ideas for a period of time." As such, we support incentive fees, provided that there is a proper alignment between GP and LP interests. Unfortunately, most funds currently in the market fail to do so.

As previously highlighted, investors bear the binary risk of underwriting the opportunity and not getting invested, while managers enjoy the benefit of having executed subscription agreements, so they are able to invest at the optimal time. Investment managers also are able to market their capabilities based on an assets under management number that reflects these commitments, which again, may not be invested. Additionally, as mentioned above, the beta-driven returns available in the liquid credit markets following dislocations are significant and could be passively accessed using rules-based triggers for an all-in fee of likely less than 0.25%. While we believe that managers can add significant value relative to a passive investment, we also do not want investors to pay an incentive fee on beta.

In turn, we recommend that managers adopt a beta-based hurdle rate of *the annualized return of the BAML High Yield Index (or a comparable index) over the investment period of the funds with a catch-up*. We believe this beta-based hurdle rate reflects the significant tailwind available to managers and aligns incentives.

<u>Other Considerations</u>

While most contingent funds focus on corporate credit, approaches vary widely. Some focus on providing liquidity to tradeable credit markets (e.g., high yield and leverage loans) during a period of stress, while others focus on ramping into influence-oriented/non-control and for-control distressed. Yet other funds are focused on more idiosyncratic opportunities outside of corporate-based collateral, including reperforming loans (mortgage credit) and equipment leasing. Not all contingency funds are drawdown structures. Some are open-ended, fully ramped opportunistic portfolios; the contingency funds secure capacity in the event of a dislocation. All approaches have merit, and the appropriateness ties to an investor's objective and comfort with a given manager as well as other considerations best addressed at the individual client level.

Assuming an investor is considering a drawdown structure, how the allocation is factored into a pacing model analysis is a further consideration. The treatment needs to consider whether the investors is over- or under-allocated to private markets as well as other considerations and is best done based on a LP's individual circumstances. Sizing similarly would be an individual decision. A further consideration ties to the management of unfunded commitments. While all drawdown capital structures have unfunded commitments, the binary nature of contingent funds adds a further complication for investors, one that is best addressed based at the individual LP level.

RECOMMENDATION

PCA believes that positioning for the credit pivot (i.e., the move from a benign credit environment to one that is stressed/distressed) should be a key area of focus for investors today and that contingent funds are a good "call option." Contingent funds allow LPs to secure capacity with best-in-class managers who are positioned to invest at the most opportune time and address many of the corporate governance issues that make it difficult for most institutional investors to move quickly when allocating capital. Manager selection, however, is critical as contingent funds are nascent vehicles that present unique implementation challenges. Moreover, most fund fees do not reflect these challenges or the favorable beta environment that is inherent in this opportunity. In this *Viewpoint* we suggest a proposed beta-adjusted fee structure that better aligns GP and LP interests and highlighted some implementation considerations.

We welcome the opportunity to further discuss additional implementation considerations and the broader appropriateness of contingent funds with interested investors.

ABOUT THE AUTHOR

MARY BATES is a Principal in the Private Markets group at PCA. Prior to joining PCA, Mary was the Director of Credit Strategies at Silver Creek where her responsibilities included leading the firm's consultant relations effort, serving as a product specialist and underwriting private credit managers. Prior to joining Silver Creek, Mary spent over eleven years at Hewitt EnnisKnupp where she most recently served as a Senior Research Consultant on the Liquid Alternatives team, focused on credit-related hedge funds. While at HEK, Mary worked with some of the largest institutional plan sponsors in the industry on their hedge fund programs, advising on portfolio construction, manager selection and program design. She also was a key team member of the manager selection phase of the Public-Private Investment Program (PPIP) of Troubled Asset Relief Program (TARP). Prior to joining Hewitt EnnisKnupp, Mary began her career at Lehman Brothers where she was an analyst on the emerging market debt desk. Mary holds a B.S. in Business Administration with a concentration in finance from Indiana University.

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