Camdor GLOBAL ADVISORS
MAKING THE COMPLEX SIMPLE
Investment Research

The Alternatives Macro Intelligence Report

Summer 2015

The Macro Outlook

Quo Vadis QE?

As policymakers fight complexity with complexity, liabilities remain stretched and asset prices boom in return. The financial system is becoming more fragile as dislocations are turning into cracks.

Sector Profile - Direct Lending

In a world hungry for yield, alternative asset classes are surging and direct lending is fast becoming the golden child. But hope is not a strategy and the terrain needs to be understood for those seeking returns. We present a travel guide.

Sector Updates

- **Private Equity:** A great 2015 with strong exits, but what about the excess of dry powder going forward?

- **Infrastructure Debt:** Everyone wants it. Unfortunately, no one can find it. Current emerging dynamics may pave the way to long term success.

- **Real Estate Debt:** As the banks have returned, pricing has followed suit. But pockets of opportunity still remain in Europe and in complex deals.

- **Hedge Funds:** At last some outperformance, but the long drought of returns is set to continue for most, even as more money rushes into the space. But dislocations are creating lucrative opportunities for some.

About The Report

The Alternatives Macro Intelligence Report is written and prepared by Camdor Global Advisors in-house team. It is has been primarily prepared for institutional investors and asset managers, in particular, those that deal with liabilities. The report contains informative views, explanations, data and analysis that are designed to help investors' understanding and inform their views of alternative asset classes.

In each quarterly issue, there will be an in-depth educational study of a specific alternative asset class, a macro overview examining current economic and monetary trends of relevance, and high-level sector analyses of other alternative asset classes.

Each alternative asset class, in this report, will be attributed a high level rating by CG Advisors. It is presented in the form of a traffic light, with green being a positive outlook and red a negative outlook. The reasoning is given in bullet points below the traffic light and in a written summary.

Camdor Global Advisors would be delighted to provide more information on this report, our upcoming quarterly issues and our wider suite of bespoke investment and risk advisory services.

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We also welcome any and all feedback you have on the report. Please send any comments or suggestions for content to **info@cg-advisors.com.**

Executive Summary

Macroeconomic Outlook

- Monetary policy has on the whole become increasingly more accommodative globally in 2015. Concurrently, the world is poised for the Fed's impending rate hike (the lone contrarian) but finding it impossible to predict. However, the increase in the quantum of weaker economic data has increased the probability of a delayed Q4 2015/early Q1 2016 rate hike.

- The supportive policymaker environment has led to a continued elevation of liabilities (for investors such as pension funds and insurance companies). It has also fuelled a succession of asset bubbles across most asset classes, as investors hunt for yield to meet liabilities and are happy to pay a significant premium for growth in a low to no growth world.

- Oil is an added stimulus which will trouble some countries but benefit many others. Prices have stabilized at a lower level and will feed through into demand over time. However, they also remove the upward pressure on wages and increase the risk of complacency.

- Emerging markets face growing pressure from debts taken on in recent years. Holders of dollar denominated debt (the vast majority) could be derailed as the currency continues to strengthen.

- A key tail risk not appreciated enough is the fragility of US growth. Economic data is mixed and wage growth is anaemic . The strong US dollar represents monetary tightening through the back door, which will impact corporate earnings in due course. Meanwhile, corporates are not investing, but rather using the record pools of cash and the availability of historically low debt at their disposal to fuel buybacks and dividends. The result is a stock market sustained more by financial engineering today rather than by fundamentals. This is a fragile market and economy at the mercy of sentiment, which policymakers would be wise to understand as they navigate future monetary currents and set policy.

Direct Lending Sector Profile

- Direct Lending is maintaining its fast growth as an asset class. In Europe and the US, non-bank lending is accelerating due to the search for yield, advantageous risk adjusted performance and regulations being imposed on banks.

- Especially in Europe, we will see the biggest shift from bank to non-bank lending. Regulators are helping with this movement through the stringent Basel III framework, which aims to deleverage banks and is creating a considerable funding gap in the lower middle market.

- Risk-adjusted returns are outperforming almost every other asset class, but there are also key risks to be understood.

- As the asset class organically grows, many new strategies are adopted by investors. Special sits investments and unitranche investments have dramatically increased in size.

- Many new funds are in the marketplace but only a few are credible. Team experience and a strong provable origination pipeline are key.

Sector Updates

- Private Equity – Performed well this year. Exit valuations are at all-time highs. The asset class looks precariously priced due to the overhang of dry powder, access of cheap debt and public equity markets appearing to be in bubble territory. There are some interesting areas, such as energy and zombie companies, in a rising rate environment.

- Infrastructure Debt – A key area of interest but with very limited supply to meet investor demand. Pricing has tightened significantly for attractive deals and origination is the key bottleneck. Mainly due to austerity as well as a mismatch between investor preference for cashflowing producing assets versus the development projects that are available. However, growing regulatory support could help close the gap. Individual deals also a growing area in the absence of a deep pool of experienced or credible managers.

- Real Estate Debt – Core market pricing has tightened as the banks have moved back. Pockets of Europe appear to be interesting as economic data improves with capital not flowing back into these areas. Distressed or complex value deals now emerging.

- Hedge Funds – The second quarter of 2015 has seen a divergence and outperformance versus traditional markets, after several years of underperformance and low returns. However, the supply of capital in the space is very large and accentuated by quasi-hedge fund strategies such as 'absolute return' funds, 40 Act funds, smart beta and so on. Does not bode well for future returns and implies more volatile returns. Some interesting areas of opportunity, notably merger arbitrage, bank disintermediation plays, activist strategies and long volatility strategies.

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Camdor Global Advisors Macro Outlook

"People can foresee the future only when it coincides with their own wishes, and the most grossly obvious facts can be ignored when they are unwelcome."

George Orwell (1903–1950)

Monetary Policy Overview

	Outlook
US	Tightening rhetoric of H1 2015 is giving way to a more mixed picture. Growing dovishness and the reappearance of some weaker economic data implies that the spigots will now tighten late in 2015, if not early 2016.
Europe	A slow recovery, divergent paths between north and south, and the spectre of Grexit means that monetary policy will remain very accommodative. QE is slated to continue till end Q3 2016 for now, but that could change if borrowing costs for Club Med begin to rise again.
Japan	Abenomics has still failed to reach its objectives by some way. For the foreseeable future, the dice continue to roll with very accommodative monetary policy and continued QE.
UK	Monetary policy set to remain accommodative. The economy is turning in better numbers and wage growth has picked up, increasing pressure on the Bank of England. However, the Atlantic flea remains far too sensitive to external factors such as Europe and far too exposed to financial winds of fortune (or ill) to risk a move till others have set the pace.
Emerging Markets	Monetary policy has begun to trend easier in response to slowing growth and the strengthening US dollar. Some such as China are also struggling with the side-effects of a leveraged financial system, as bad debts mount. Many countries have cut rates and unveiled other stimulative measures. Latin America is a bit of an outlier, with Brazil and Mexico pursuing tighter monetary policies.

Outlook For Interest Rates, Inflation & FX

	Interest rates	Inflation	FX direction
US	Unlikely to tighten before end 2015	Downward pressure	Strengthen
Europe	No interest rate rise in foreseeable future	Downward pressure	Weaken
Japan	No interest rate rise in foreseeable future	Downward pressure	Weaken
UK	No tightening before 2016	Picking up from very low levels, but unlikely to rise much	Mixed
Emerging Markets	Most countries cutting rates	Mixed	General weakening

Camdor Global Advisors Macroeconomic Outlook

Abenomics. Draghinomics. Investor shock and monetary awe. Negative yields. Lower for longer. The new normal. Bond bubbles? And tail risk trouble?

This is the stuff institutional nightmares are made of, particularly when you have liabilities. Unfortunately, this is also the evolving macroeconomic reality that these investors now inhabit and must navigate in the near and medium term.

As we reach the halfway point of 2015, global growth is showing signs of weakness and increased fragility. The assumed anchor for future growth – the USA – has suddenly found itself skidding as key economic data has come in weaker and GDP surprised to the downside. [Notwithstanding the blow-out May jobs report which may or may not auger a stronger Q2]. Meanwhile, other key countries – notably Europe, Japan and China – have reaffirmed their commitment to increased stimulus as the path out of the current morass. All told, 24 central banks globally have cut rates or unveiled monetary stimulus. The result is an increased dependence on policymakers and a further dragdown of yield, even as debt burdens across economies remain elevated or climb further.

> *“This rally in assets globally still has legs to run, even if the race may be long run.”*

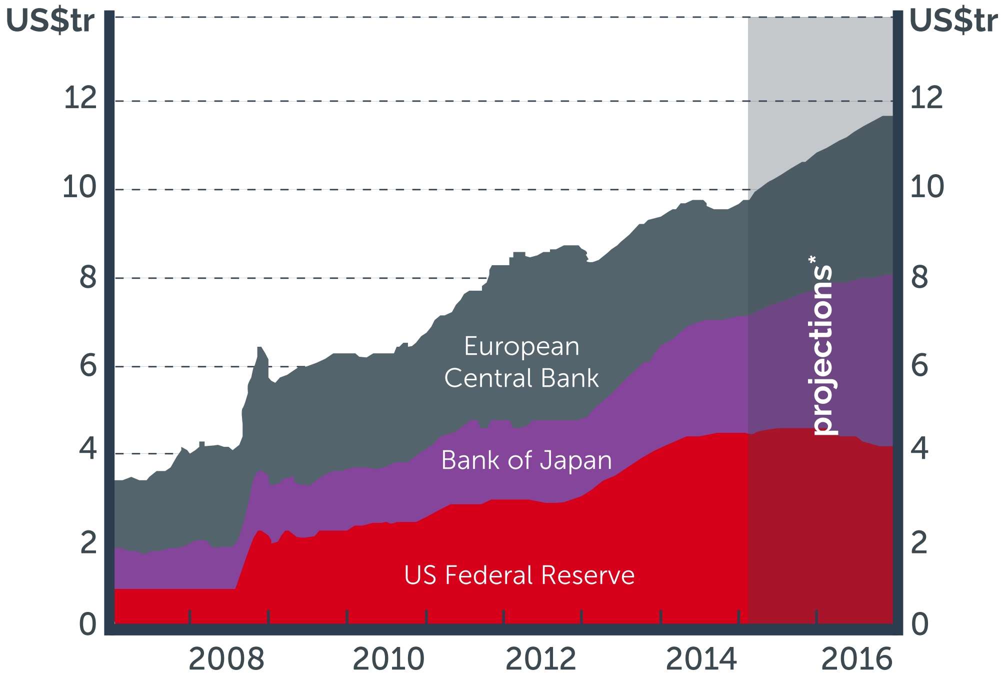
There are some glimmers of hope. The fall in oil prices means pain for some producers but added stimulus for many more others, who are consumers. The strengthening US dollar is a boon for developed countries, allowing them to devalue their currencies, create some much needed inflation and regain part of their economic competitiveness. For emerging markets, it is a more mixed picture with some benefiting while others suffer from the excess of dollar denominated debt acquired in looser times.

Institutional behaviour is increasingly driven by a rush towards yield and return. In a low growth world, people seem to be happy to pay almost any price for growth. This has led to talk of asset bubbles and much debate as to whether policymakers can manage any emerging excesses. In truth, both are hard to tell. A bubble is a bubble when asset prices detach from fundamentals. Unfortunately, in the current environment, the pricing mechanism has broken down, making fundamentals a theoretical point. This rally in assets globally still has legs to run, even if the race may be long run. Meanwhile, policymakers are facing an increasing dilemma between targeting financial stability and growth. That raises the risks of policy paralysis and credibility destruction should risks emerge.

QE & Quo Vadis
of interest rates & inflation

We live in a world of unconventional monetary policy, where economies cluster at the zero interest rate bound and the 'Big Three' central banks (the US Federal Reserve, European Central Bank and the Bank of Japan) have a combined balance sheet of about $10 trillion after years of stimulus.

Fig 1.1 Major Central Bank Balance Sheets



***based on central bank communicated intentions, assumes constant exchange rates**

Source: Bloomberg, RBA, Thomson Reuters

Based on current projections, that will grow by some 20% by the end of 2016. Importantly, this assumes the US will enter a period of tightening and gradually begin to shrink its balance sheet.

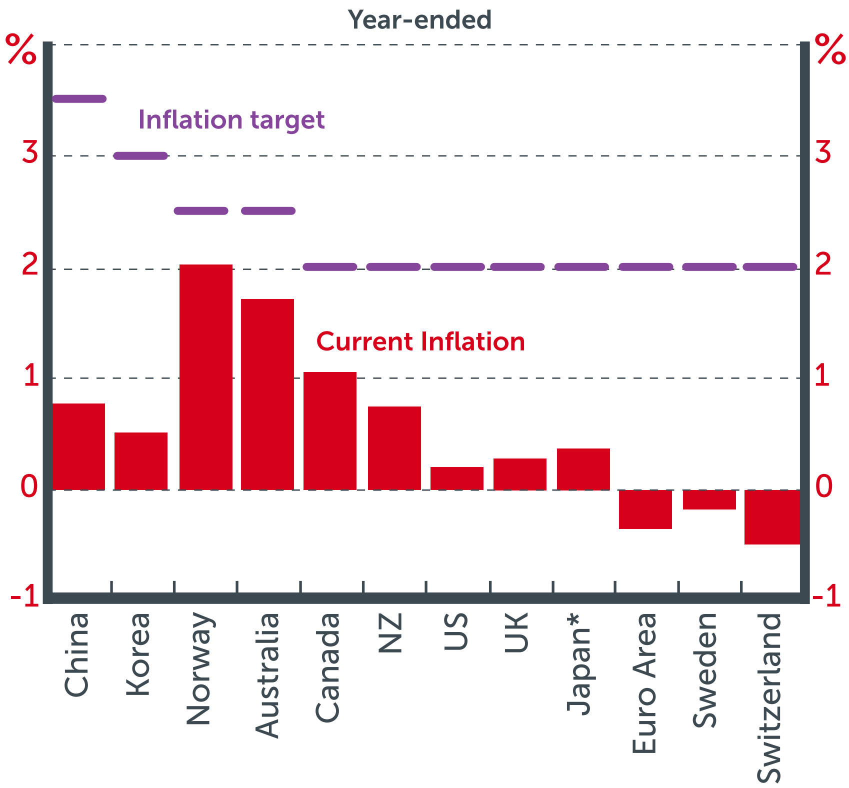
At the same time, debt burdens are high. Wage growth is anaemic at best. The concomitant social tensions are evident. And geopolitical tensions are making an unwelcome return to the global stage after the extended *entente cordiale* of the last 25 years.

The situation gets more complicated. With the exception of the US, the rest are struggling to maintain the facade of growth. Japan's bold 'Abenomics' experiment has failed to deliver on its ambitious promises so far and Europe is battling the demons of Greece once again. China's growth is slowing rapidly as its debt burden becomes destabilising, while growth in the other BRICS (Brazil, Russia, India and South Africa) is turning out to be mostly half-baked. Even where quantitative easing has had some success (chiefly, the US and UK), real wage growth has been tepid or worse, stagnant.

> *"Inflation is conspicuously absent, and with it, any realistic prospect of deleveraging in real terms."*

These are not the foundations that policymakers hoped for when planning for recovery. Inflation is conspicuously absent, and with it, any realistic prospect of deleveraging in real terms. Even in the US, where growth has been sustained in recent quarters, the Federal Reserve has made it clear it is focused on unemployment reduction and wage growth as key determinants of genuine success. So far, there is very little evidence that these policies are delivering sustained results.

Fig 1.2 Headline Inflation & Inflation Targets



***excludes the impact of the consumption tax increase on inflation**

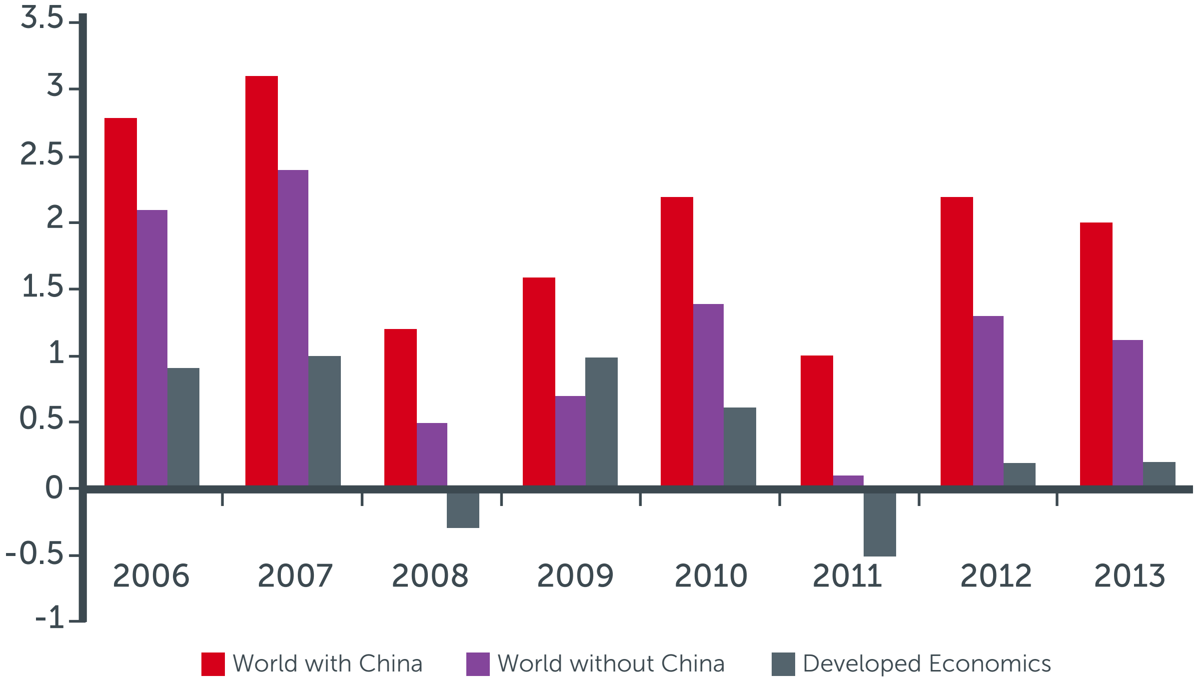
Source: CEIC Data, RBA, Thomson Reuters

Throw falling oil prices into this disinflationary environment and you ratchet up the stress factor for policymakers. Already, the rapid fall in oil prices has caused inflation to significantly undershoot expectations in 2015. Europe and the UK tipped briefly into outright deflation – the lowest since records began - earlier this year. Meanwhile, the wider risks to growth mount. Against the stimulus of lower oil prices, the IMF cited lower investment, market volatility, stagnation in Europe and Japan, and geopolitical events as risks that forced them to revise global growth projections lower by 0.3 per cent for the year.

At the same time, the upward pressure on real wages is lessened as falling oil prices have enhanced disposable income and dampened the conventional dynamics that push wages higher. Annual wage growth, already tepid over recent years once you remove China from the equation (see Figure 1.3), is likely to continue to disappoint, heaping further pressure on policymakers, although the latest UK data has given the first glimmer of hope on this front.

Indeed, policymakers are potentially caught between a rock and a hard place, as low wage growth projections has boosted jobs and reduced unemployment since 2008. Which do you prioritise?

Fig 1.3 Annual Wage Growth Globally (%)



Source: ILO

The natural reaction for policymakers is to postpone any tightening and reach for further monetary stimulus in an effort to stoke inflation and demand. The amount is simply proportional to their fear of deflation.

Quantitative easing – once unconventional – is now conventional warfare for those at the zero interest rate bound. Notwithstanding concrete results, Japan has renewed its vows of marriage to Abenomics. The ECB may have come late to the QE party, but Mario Draghi has unveiled his own ambitious €1.1 trillion programme of bond buying that original thinkers have christened Draghinomics. Even the US is under more pressure now to leave interest rates lower for longer and maintain an accommodative stance, thanks to the strengthening US dollar and recent tremors of economic and earnings weakness. Under these circumstances alone, as noted earlier, the balance sheet of the Big Three will grow by some 20 per cent to nearly $12 trillion by the end of 2016. This is a huge amount of monetary stimulus on top of the $500bn of 'fiscal' stimulus already provided by falling oil prices. The real danger, perhaps even likelihood, is one of hyper-stimulus.

Party Like It's 1999!
The crush for yield

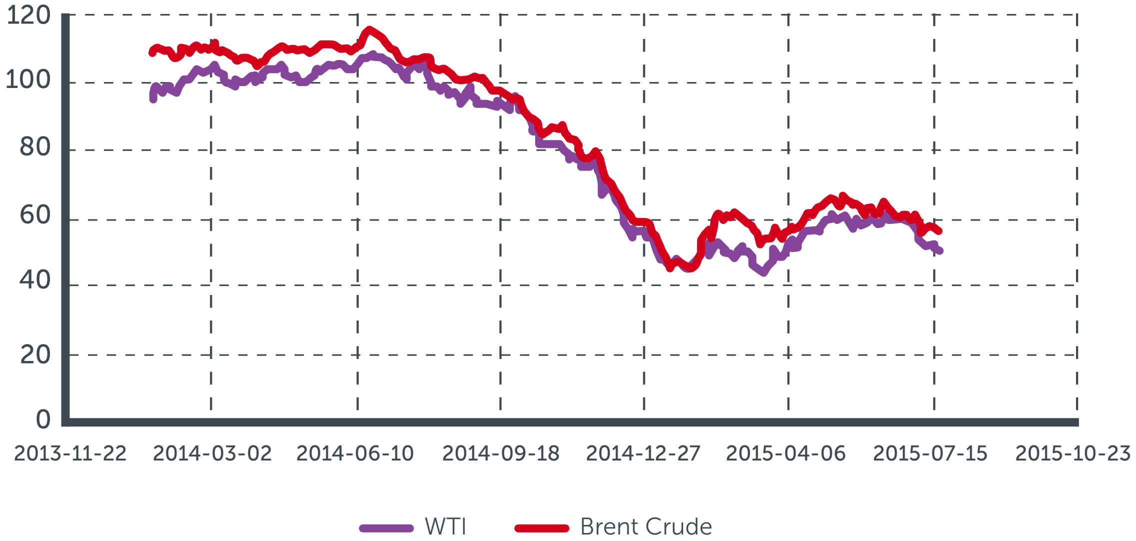
The only point of economic forecasting is to make astrology look respectable.

JK Galbraith

In the latter half of 2014, Wall Street analysts bent over backwards to prove Galbraith's adage right when it came to the price of crude oil.

In June last year, Reuters' monthly poll of bank analysts forecast Brent crude oil would average $104.8 a barrel in 2015. By October, that had dropped to $93.70 as the oil price declined. By December, as the decline turned out to be a step off a cliff, the forecast dropped to $74 – the largest downturn since the depths of 2008. Today, as BP and others talk of the new normal being $50, banks are rushing yet again to forecast into line.

Fig 1.4 Price of Oil Over the Last 18 Months



Price of Brent and WTI crude oil (in $ per barrel) over the last 18 months

Source: St. Louis Fed

In normal times, this is positive. Falling oil prices increase consumer real incomes, lower the cost of production for companies and reduce inflation. People end up with more in their pockets and demand rises. In short and pardoning the pun, it fuels growth and boosts GDP, the chief metric that policymakers live and die by.

But these are not normal times, given the dominance of unconventional monetary policy today. Indeed, we know we live in strange times when the prospect of lower oil prices has spooked many investors, and when the IMF gladly accepts the fillip provided by oil prices but still revises global growth downwards.

> *"The party is on. How we end and what the morning brings is another matter entirely."*

What does this all mean for asset class returns going forward, especially when coupled with the accomodative monetary picture outlined earlier? To answer, we need to unpick this complex landscape and understand both the direct impact of the last year and the unintended consequences.

To the first order, the decline in oil prices is a net positive.

The decline in prices today is due more to a glut of supply and less to a collapse of demand (though this has weakened globally). The reasons are varied, ranging from the pressing need for revenue for the likes of Russia to the worries at OPEC of being supplanted by new sources, such as shale. Both mean no one can afford to slacken on production in the short-term, as oil-producing nations seek to maintain market share at all costs.

The hit for exporters is large. Russia and Saudi Arabia, the most prominent examples, produce about 7 million barrels of oil a day. Today, this translates to a revenue drop of $420mn a day. They also need fiscal breakeven prices of $105-110 a barrel to balance their budgets. Against a backdrop of increased state costs, ingrained subsidies, fiscal deficits, weakening currencies, rising production costs and sanctions (for some), this is problematic for most oil producers. Those with significant reserves can hunker down and ride out the storm till supply reorients and prices rise. Those without have no easy answers.

But the world thankfully is dominated by oil consumers. For these, such as Europe and Japan, this is a significant boost to real incomes. Elsewhere, in emerging markets, oil consumption makes up 5.4% of GDP in China, for example, and 7.5% in India. Even in the US, where oil consumption is 3.8% of GDP, the shale revolution has only met half of that nation's energy needs, resulting in net benefits as prices decline.[1]

[1] Seven questions about the recent oil price slump, Rabah Arezki and Olivier Blanchard, IMF (22 Dec, 2014).

This is equivalent to a mammoth fiscal stimulus that will boost world GDP by between 0.3% and 0.7% in 2015, according to the IMF. In hard numbers, 2014 world GDP is $77.6 trillion, making this a global stimulus of somewhere between $230bn and $540bn.

That's a hell of a financial rocket, and therein lies the problem.

The best student parties seem to begin with a barrel. Lots of random unnamed bottles of alcohol (and the occasional mixer) are poured in and crudely mixed together to create a potent cocktail. Everyone imbibes copiously. No one says no. And the rest becomes very hazy. At least, until the punishing hangover the next morning, that is.

Today, we're putting together the frat party to end all frat parties.

Falling oil prices have a deflationary impact on consumer prices. In normal circumstances, central banks cut interest rates alongside to manage inflation. Today, precious few countries, such as India, can pursue that policy. The rest, particularly the developed world, have a problem. Their rates are already effectively at (and sometimes, below) zero, thanks to the trials and tribulations of recent years.

The (lower) quantum of stimulus to date and its distortion of the yield curve have proved powerful steroids to financial markets. Add in more, and you reinforce both the vicious crush for yield that has driven investors (particularly those with liabilities) into every asset class that promises a ghost of a return, and the moral hazard of the policymaker put option.

Meanwhile, the US dollar has strengthened in real terms, even as the euro, yen and others engage aggressively in competitive devaluation. That poses a potential brake on a sustained US recovery, fostering dovishness. It is also a source of stress in emerging markets, given the proliferation of foreign dollar denominated debt in recent years (some 75% of the $2.6 trillion outstanding debt). The resulting tremors will only reinforce the flight of capital to the developed world.

This is a repeat of 1999 but on a wider scale. Notwithstanding the jittery stock markets of recent months as concerns over Greece move to the fore, asset classes have generally seen brisk returns.

The fragile economic picture and embrace of stimulus *ad infinitum* by policymakers are a toxic dynamic for institutional investors with liabilities. The need to match assets and liabilities, coupled with the advantages bestowed by the vagaries of regulatory capital (where relevant), have made many firm adherents to the cult of fixed income over recent decades. But today, what was once a comforting contractual bulwark against uncertainty has become a crushing burden. Low yields exacerbate and arguably exaggerate liabilities. They also make it harder for assets to generate the cashflows needed to meet liabilities as well as generate shareholder returns.

At the same time, the focus on financial stability means that regulatory drag is increasing, further hampering returns. In the insurance sphere, for example, a March 2015 survey by the Insurance Investment Exchange found that 4 out of 5 insurers saw increasing yields, finding new fixed income substitutes and minimising regulatory drag as their key challenges in fixed income.

Thus, investor flows are strong as institutions hunt for yield and better returns on capital. In a world of low growth and unknown fundamentals, any prospect of strong returns excites a stampede. Importantly, as investors diversify increasingly out of traditional core areas such as public fixed income and equities into alternatives, the volume of flows threatens to create capacity issues, tightening spreads and squeezing returns. For example, there are $100 trillion worth of public fixed income securities and $70 trillion worth of equities today globally compared to just $3 trillion for hedge funds, $2.1 trillion for private equity and a mere $290bn for private debt.

This may be wonderful for asset managers, where fundraising periods have become quick and easy for established names, but it also points to problems for investors where deep due diligence, the key question of origination and a true understanding of new risks acquired are sacrificed on the altar of yield and growth. It also becomes easy for policymakers to erroneously conflate these growing asset bubbles with sustainable growth.

From a macro perspective, an enormous boom beckons across asset classes for the rest of 2015. There will be bouts of volatility as fragilities emerge, but the pressures to put cash to work and extract more yield mean that should one bubble deflate, the money will rapidly flow to other areas. It is a situation analogous to the pricking of the Japanese bubble in 1989, where capital fled into Asia birthing the Asian tigers of the 1990s and into the dotcom boom at the turn of the century. Unfortunately, it will also make it easy for policymakers to postpone deleveraging, delay much-needed structural reforms and enfeeble the economy behind the scenes. As longer memories may attest, the Asian tigers morphed into the Asian currency crisis of the late 1990s and we all still recall the spectacular demise of the first tech bubble.

The party is on. How we end and what the morning brings is another matter entirely.

Macro Tail Risk Focus:
Could the US fall off the growth freight train?

> *Analogies are tortured beings... but they have their uses.*
> Money Mania (2014)

In May 1937, the USA began a painful recession that lasted just over a year, ending in June 1938. Industrial production declined by almost 30%, manufacturing output fell by 37% from its peak, and stocks fell by more than 50%. It was the final chapter in the saga of the Great Depression, and indeed birthed the term 'recession' as an embattled worried President Roosevelt refused to use the word 'depression' once again.

Much has been written and debated about the causes of 1937, but increasingly, it is clear that a potent cocktail of fiscal and monetary tightening from 1936 onwards played a dominant role. Indeed, statistical analysis suggests that monetary and fiscal policy accounted well for its severity[2] if not all of the cause.

History does not repeat, but it does offer us cautionary tales to guide the future. And today, the Federal Reserve would do well to consult its archives widely and glean the full facts of the case, as it seeks to raise interest rates and wean an addicted financial market off monetary methadone.

> *there are undeniably bubbles across a whole range of asset classes, but now is not the time to prick them.*

Financial markets have been dominated in recent months by the debate and uncertainty over when the Fed will raise rates. The Fed signalled its intentions clearly in December 2013 when it announced the gradual wind-down of its bond-buying programme. The move triggered a series of 'taper tantrums' around the world, particularly in emerging markets, as financial markets woke up to the spectre of a world devoid of stimulus.

[2] The recession of 1937 – a cautionary tale, Francois R Velde, Economic Perspectives, Federal Reserve Bank of Chicago, 2009.

But nearly 18 months on, stock markets have regained and reached new highs in many countries around the world. The world appears to have accepted the inevitability of tightening and learnt to live with it.

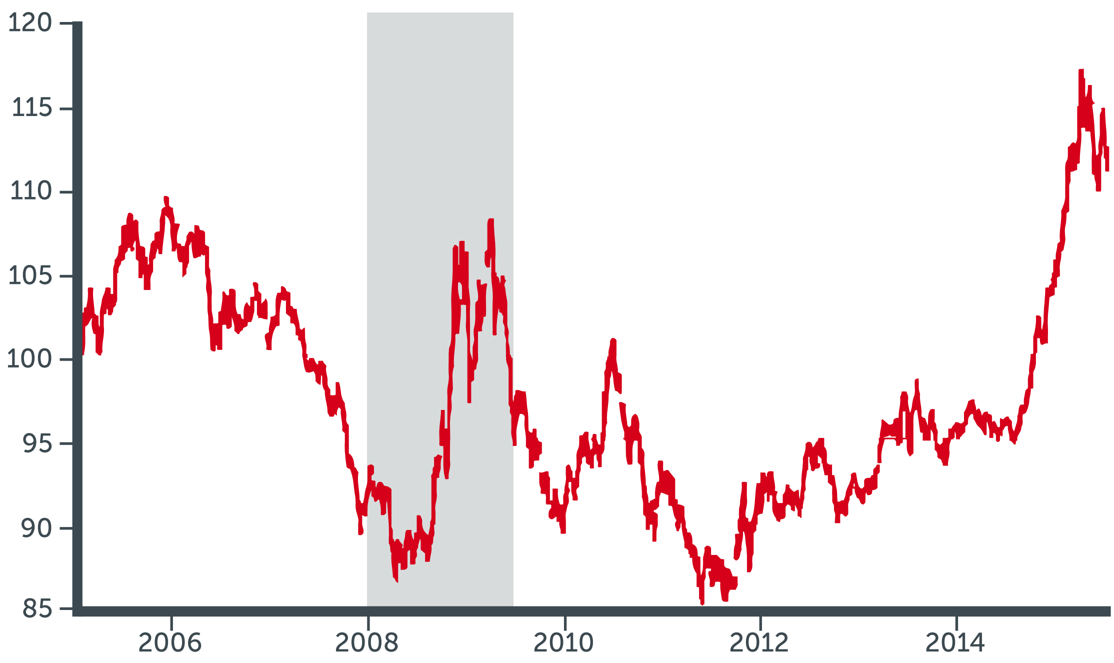
Importantly, from the Fed's perspective, the US economy appears to have recovered and is growing once again. Yes, the first quarter of 2015 was weak but that has been put down to transient factors such as the fall in the price of oil hitting producers and the severe winter weather conditions across the US.

Policymakers such as Dennis Lockhart, president of the Atlanta Federal Reserve, talk of the Fed being on course to raise rates most likely in Q3. Markets concur, though recent weakness in data coupled with the focus on unemployment as the key driver of policy change has led us to see December as being more likely.

There is, however, a problem with the above narrative. The facts do not fit.

The US has already entered a period of monetary tightening and is now almost a year into the journey. This is not thanks to rate rises, but rather tightening by proxy because of the strengthening US dollar against all major currencies.

Fig 1.5 Trade-Weighted US Dollar Index: Major Currencies, March 2005 = 100



Shaded areas indicate US recessions

Source: St. Louis Fed

Over the last year, the dollar has strengthened by almost 20% against major currencies such as the euro, yen and swiss franc. In fact, it is now the strongest it has been in over a decade.

This tightening has major implications – both internationally and domestically – creating a minefield of policy missteps.

To the first, it is important to stress that the Fed is the world's central bank, not just for the US. The strength of the US dollar enforces tightening across the world, thanks to its status as the global reserve currency.

In particular, in emerging markets, the taper tantrums may have subsided but the stresses are increasingly painful by the day. The proliferation of dollar-denominated debt in these regions means that they are facing a rapid divergence between their debts and their ability to service those debts with domestic earnings. It is estimated that almost three-quarters of the outstanding debt of $2.6 trillion is dollar denominated. That is an asset-liability mismatch of global proportions.

Alongside, it should be noted that the falling oil price is a limited salve for many countries. Ignoring producers, the falls are generally smaller when viewed through the lens of domestic currency. The lag for the stimulative effect of more disposable income to feed through into consumer behaviour also means that it brings no benefit in alleviating the short-term stresses they face. Indeed, if anything, the additional income may simply end up as precautionary savings by populations worried by an uncertain future, further hampering growth.

No economy is an island. The US may have decoupled in terms of data but it has not in terms of trade. These fragilities in the world economy risk sharp slowdowns in global growth and contagion back into the US in the event of continued tightening. Alongside, as money flees to safer havens in the developed world such as Europe, they will find the pressure of strengthening sapping their own efforts at recovery.

In the absence of growth, stimulus remains the only option for most. And, as noted, 2015 has seen an unprecedented unveiling of stimulus globally. To date, some 24 central banks have cut rates or engaged in unconventional monetary stimulus in an effort to ignite growth. This has unveiled a vicious circle of competitive devaluations all round that have further strengthened the dollar, leading to the accentuated rise observed.

The domestic effects of all this cannot be ignored and only accentuate the above tensions.

The Fed has a domestic mandate focused on price stability and unemployment. The international effects of a strengthening US dollar translate into strong deflationary forces. Japan and Europe are now exporting by the armoured truckload the one thing they have an abundance of.

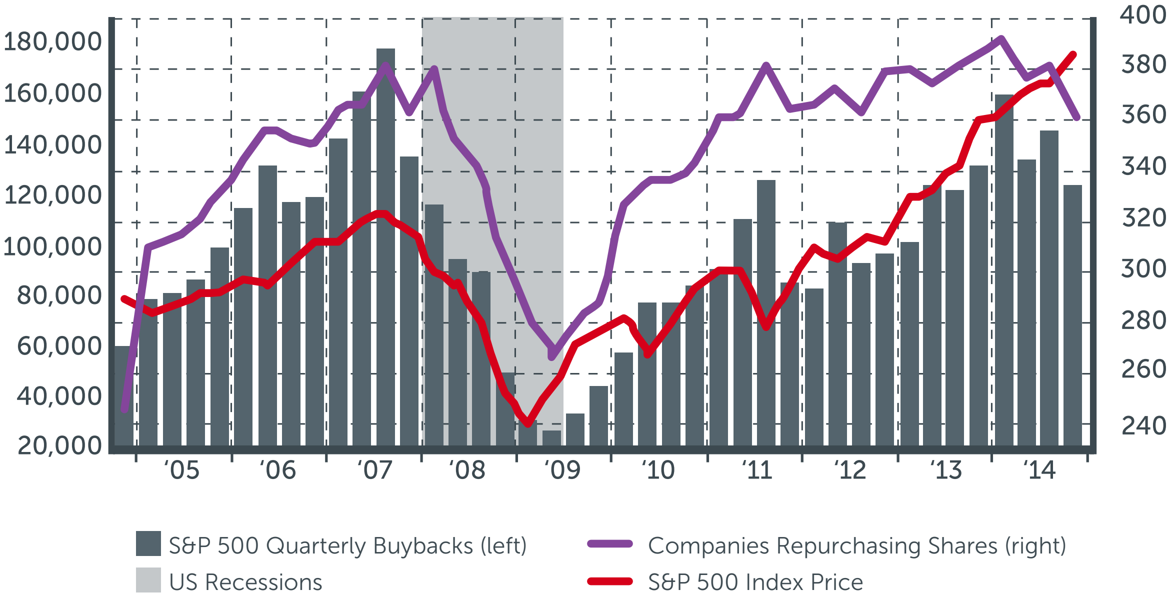
Already, the headline PCE rate sits below 0.5%, which does not bode well for the inflation policymakers desperately want to help erode the debt overhang from the last crisis. Wage growth, already weak, faces further pressures in this environment. The importance of this cannot be understated. Consumer debt burdens have been rising again the last few years and in the absence of wage growth, the ability to service them will again become stretched.

Despite the above, hawks will point to the numerous asset bubbles being created today as supporting the need for tightening. They are right as there are undeniably bubbles across a whole range of asset classes, but now may not be the time to prick them.

US overseas earnings are already lower thank to the strong dollar, and likely to surprise further to the downside this year, despite the lowered expectations of analysts as the dollar continues its march. Domestically, the economy is still fragile, with the latest productivity and manufacturing numbers showing signs of weakness rather than robust growth.

Meanwhile, the record stock markets are a product of financial engineering today, rather than a reflection of profitability. QE has compressed rates to all-time lows which in turn has forced the hand of many investors into equities. Secondly US corporate cash balances are at record levels (see Figure 1.6), but they are not being used for investment any longer. Rather, they have been used to fuel buybacks and dividends in an effort to reward shareholders.

Fig 1.6 **Quarterly Share Repurchases ($mn) and Buyback Yield (%)**



Source: FactSet Fundamentals

American companies spent $903 billion on share buybacks and dividends in 2014. This year, that number is expected to exceed $1 trillion. To put that in context, equity mutual fund and ETF flows have been less than a tenth of that.

Indeed, the stagnation in recent years indicates that recent growth has come not so much from earnings as from multiple expansion and the technical pressure of such sustained buying. None of this indicates a strong corporate sector going forward, capable of handling further monetary tightening.

Pricking the bubble rudely is not the answer.

There is already tightening occurring, as noted above, and its slowing effects on the US and global economies have yet to fully feed through. In 1936-37, the incremental steps towards tightening had no discernible impact at the time but their cumulative impact was punishing. The Fed would be unwise to repeat the exercise today, especially given the global spillover effects and bare cupboard of policy. They can also ill afford to also sacrifice their credibility, particularly given the advent of forward guidance and macro-prudential regulation as the policy buzzwords of the future.

2008 may be receding in the rear-view mirror, but confidence is still fragile and contagion an even bigger problem today. In short, the Fed would be well advised to wait, judge the facts and step carefully through this minefield.

Credit Markets Tracker

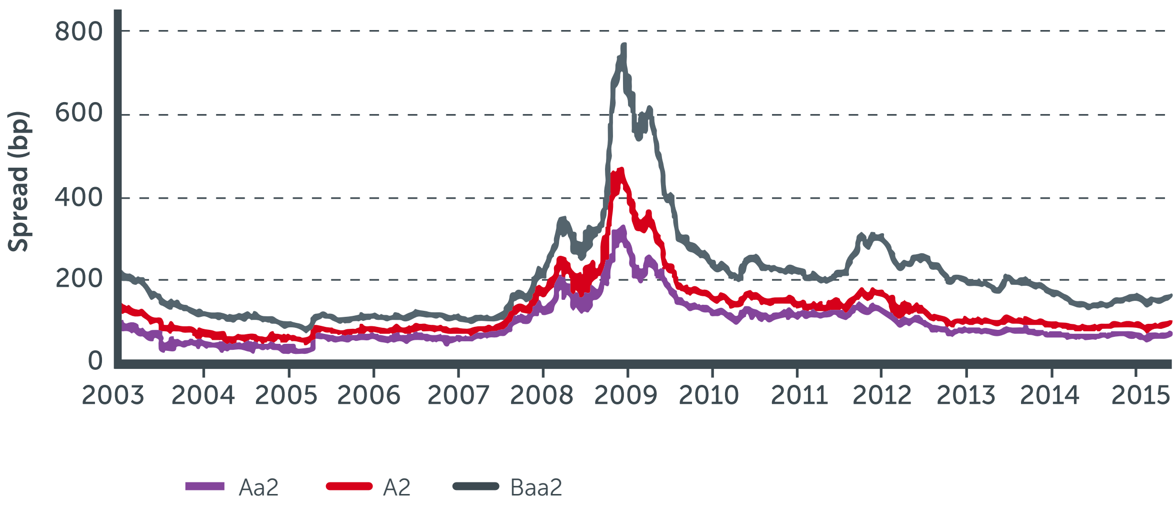
Bonds

Year-to-date, investment grade spreads have tracked wider while high yield spreads have tightened. Investment grade spreads have recently trended wider. Primarily as investment grade bonds have sold off in sympathy with the sell-off in government bonds in June. The spurt of weaker than expected economic data in the U.S. in April and May also have contributed to the spread widening as has record issuance in both the U.S. and Europe.

On the high yield front, U.S. high yield spreads have declined from 564bps to 508bps year-to-date. There has been a similar decline in European high yield spreads, which likely reflects the continued high demand for yield in Europe given the very low levels of government bond yields.

High yield bonds have also benefitted from the recent albeit muted recovery in the price of oil, as energy-related credits make up around 20% of the U.S. high yield universe.

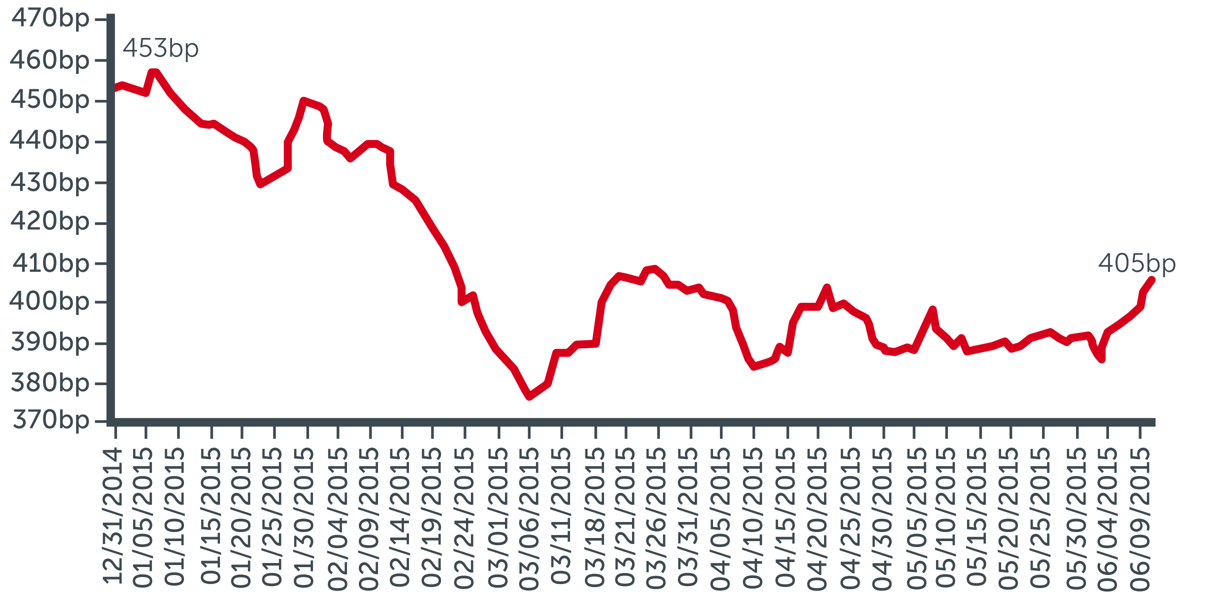
Fig 1.7 Five Year Median Spreads - Global Data (High Grade)



Source: Moody's

Fig 1.8 YTD Average Spread of US HY Issues

Fig 1.9 YTD Average Spread of European HY Issues



Leveraged Loans

Year-to-date, leveraged loan discount margins both in the U.S. and Europe have experienced similar declines of around 50bps compared to those we have seen in the high yield bond market. In the U.S., the decrease has primarily been driven by an imbalance of supply and demand as leveraged loan issuance is down close to 30% from the previous year while CLO issuance is at record levels, putting a solid floor on the price of loans. In Europe, it is likely the drive for yield as well as strong CLO issuance which have given loans a strong bid year to date.

Fig 1.10 YTD Discount Margin (3yr) of US Leveraged Loan Issues

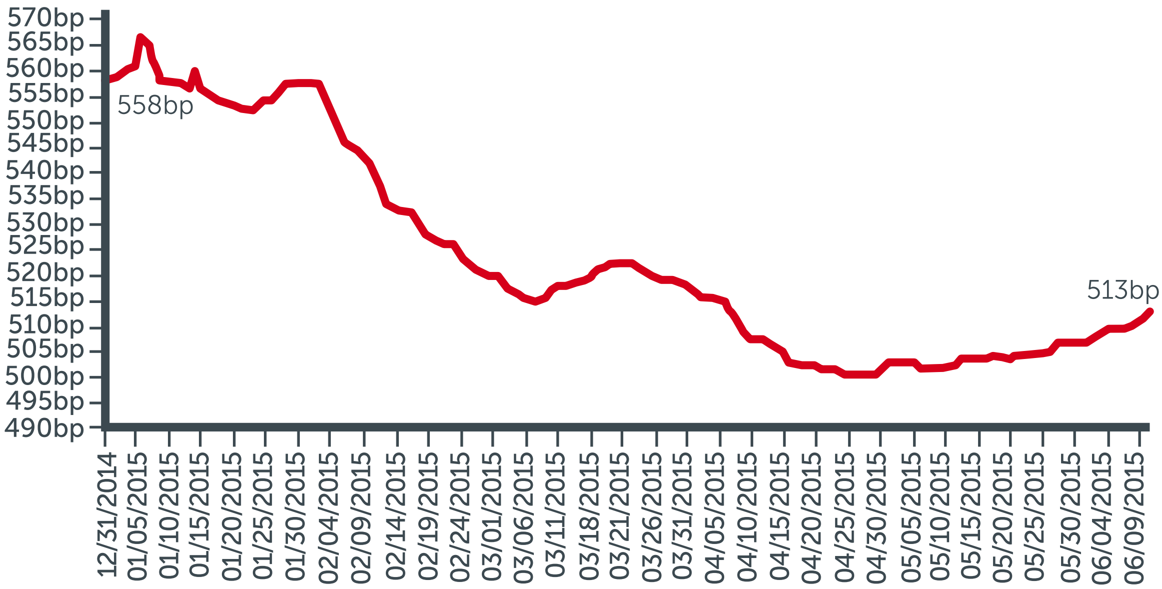
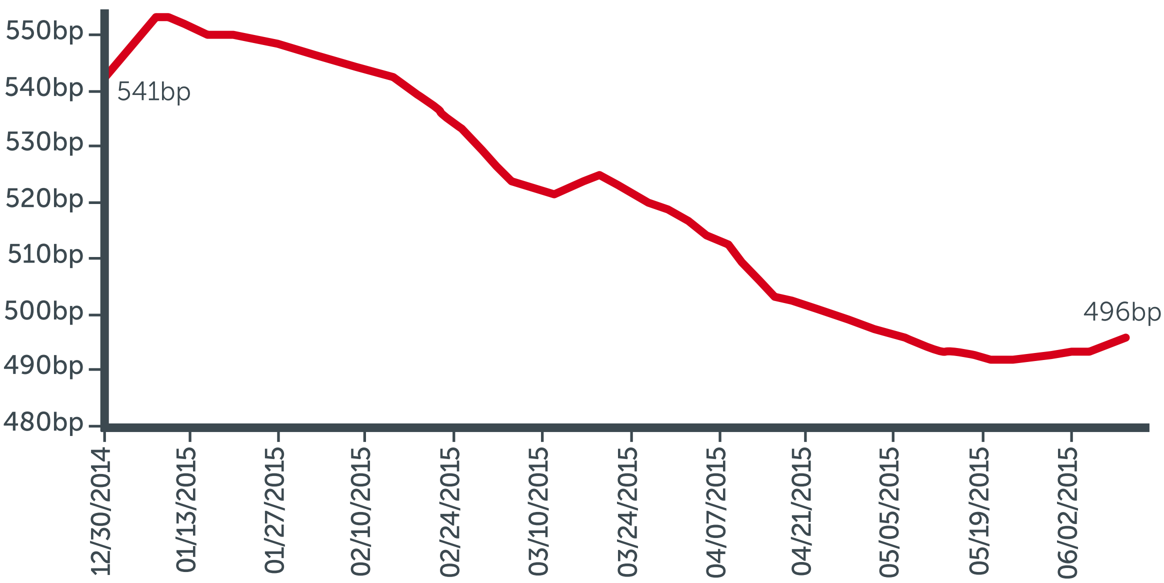


Fig 1.11 YTD Discount Margin (3yr) of European Leveraged Loan Issues



Direct Lending Sector Profile

Direct Lending Executive Summary

Camdor Global Advisors is positive on the potential for direct lending strategies to deliver good risk adjusted returns over the coming years. The direct lending sector is large and expanding in both North America and Europe, with Europe poised to see the strongest growth over the next five years. The main factors driving this growth are increased regulation of banks and mandated higher capital ratios which have curtailed corporate lending, particularly to smaller companies. Within Europe, the impact has been much larger as banks made up a significantly higher proportion of all lending pre-crisis. The combination of ongoing deleveraging and the increased focus on financial stability will continue to cause European banks to shrink their corporate loan books even further.

Managers should be able to attain high single digit to low double digit returns with low volatility and downside risk because of the strong structural protections provided by senior secured loans. This is attractive relative to the most relevant public comparable, which is the syndicated loan market where the pricing is Libor plus 400 to 500bps. The increased return is partly from the illiquidity premium and partly from increased credit risk due to smaller borrower sizes.

The fixed income nature of the sector means that it is a compelling substitute for institutional investors reaching for additional yield. Where there are regulatory constraints – with insurers, for example – we expect that an internal model could justify a relatively low capital charge as compared to other alternative investments, thanks to the security and low loss given default ratios.

Our main caveat is the large number of direct lending funds being raised today, especially in Europe, and the lack of experience and track records for many of the managers. Origination is also an area often overlooked by investors, yet is the most important criterion for producing strong sustainable returns. We believe selecting the right manager with the right strategy and a strong origination capability is the key to a successful investment

Sector Description

Direct lending is a sub sector of the much more broadly defined category of private debt. Private debt encompasses a number of quite different strategies including mezzanine debt, distressed debt, infrastructure debt, real estate debt and of course direct lending. Some asset managers will also label their syndicated or more lightly syndicated loan fund products as direct lending.

In our view, however, direct lending in its purest form refers to a private, bi-lateral loan between a fund and a borrower, which is typically a small to mid-size company. Direct lending funds target borrowers that have EBITDA[1] between $1 million (or the Euro or Pound equivalent) and $40 million with loan sizes ranging from $5 million to $200 million. Fund managers will sometimes syndicate out a portion of the larger loans to other funds or even banks with which the manager has relationships. Loan sizes below $5 million are generally too small for the significant diligence costs, legal costs and funds' time needed to close a transaction, while companies with over $40 million of EBITDA are typically able to access the syndicated loan market or the high yield bond market which provide cheaper funding than a direct lending fund.

Direct lenders provide financing directly to borrowers in the form of senior secured loans, which are secured by a 1st priority lien (or claim) on all the tangible and intangible assets of the borrower. The focus of the direct lender is usually on the cash flows of the business that will be used to service the debt. This involves a thorough assessment of the borrower's business including market position, industry trends, value of the service or product offering, competition, management and financial metrics such as profit margins, capital expenditures and return on assets. However, there are also direct lending managers who focus more on asset-backed lending in special situations. These lenders will be more focused on the value of the borrower's tangible assets as for one reason or another current cash flows cannot support the needed level of borrowing, but are asset rich. As explained later on, this type of lending generates higher returns for the fund.

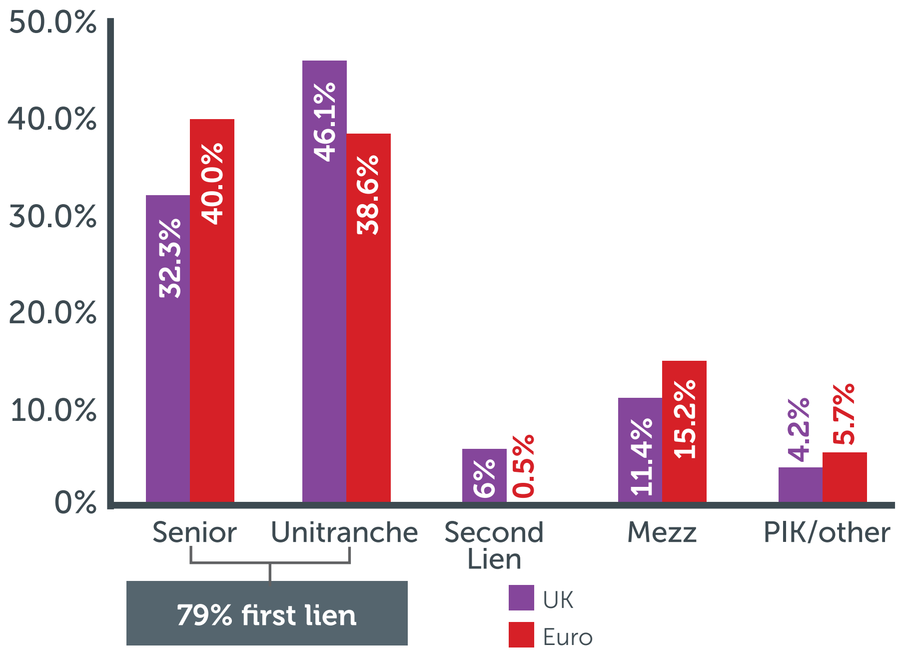
[1] earnings before interest, taxes, depreciation and amortization – a widely used benchmark for profitability and debt capacity

Direct Lending Strategies

There are two major senior secured lending strategies. The traditional and more conservative strategy is the senior secured bank loan, in which the fund will lend an amount roughly equal to the amount of leverage that a typical bank would lend. If the borrower wants additional leverage in this strategy, the company can go to a separate provider of subordinated or mezzanine debt who will add another layer on top of the senior loan.

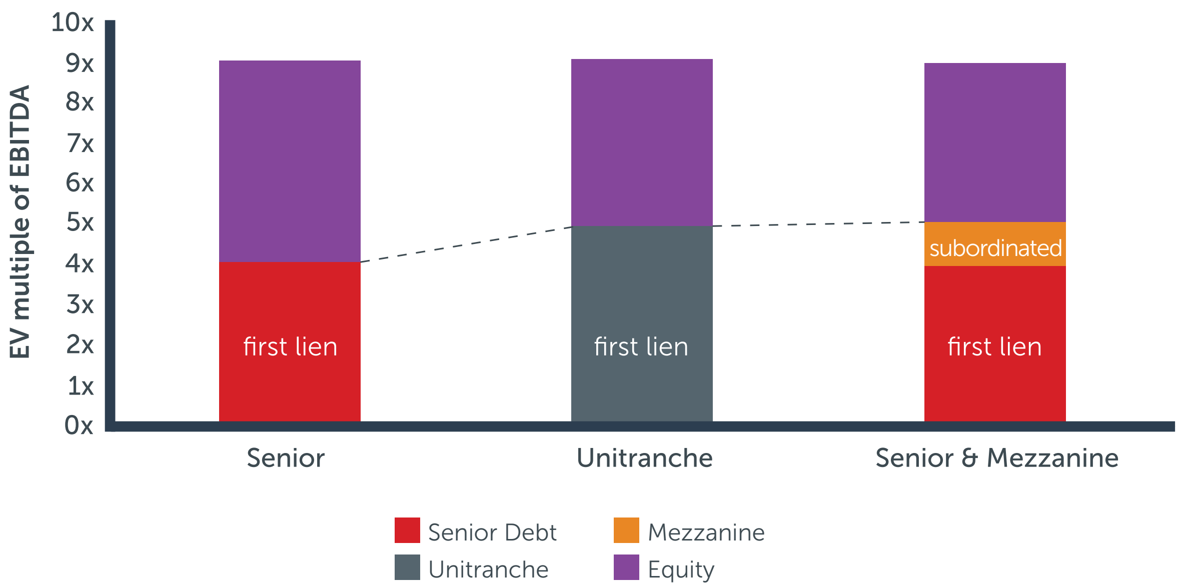
The other major strategy is the unitranche structure which has become more popular recently to both fund managers and borrowers. The unitranche structure is senior plus mezzanine/subordinated debt combined into one tranche with blended pricing. This benefits the fund as it increases both the size of the loan and the pricing, and it benefits the borrower by not having the complexity and potential intra-creditor conflicts of a mezzanine/subordinated tranche. While the unitranche strategy will increase returns, there is clearly more risk in this strategy than the traditional senior bank loan given the higher level of leverage.

Fig 2.1 Deal structure overview



* For the purpose of the deal tracker, we classify senior only deals with pricing L + 650bps or above as Unitranche. Pricing below this hurdle is classified as senior debt

Fig 2.2 This is a simple breakdown of the capital structure of a business



Source: The Deloitte Deal Tracker

Both senior loan and unitranche strategies benefit from many structural protections. Obviously the 1st lien tranche has a priority claim on the collateral and is the safest part of the capital structure. The loan agreement will also contain financial maintenance covenants that compel the borrower to maintain a certain level of debt service coverage. These covenants are tested on a quarterly basis and if not met, the lender can declare a technical default. This gives the lender a higher level of default interest payments and greater influence over the management of the company, as the loan can ultimately be accelerated, potentially triggering a forced sale of the collateral or other remedies. As a result of the priority claim and the lender's ability to quickly force action at the borrower, recovery rates on defaulted 1st lien loans are high, averaging 60% to 70%. This gives the strategy significant downside protection.

Funds also target different sectors and geographies in the direct lending market depending upon their core competencies, experience, personnel and return targets. For example, some funds target specific geographic sectors such as Germany or Spain where local knowledge, language and networks are key to deal generation, and knowledge of the country's legal system as it relates to lending and bankruptcy are crucial to minimizing risk.

Another differentiator is target size of borrower. Sourcing deals for companies with less than $5-10 million of EBITDA requires different channels and contacts than sourcing deals from larger companies for example. Dealing with smaller, less sophisticated borrowers also requires a different skill set. Loans to smaller borrowers will also have a different return profile because with fewer assets and smaller market positions they are inherently more risky. Loans to this lower end of the market should show higher returns with the boost coming from equity-like profit participation (perhaps in the form of warrants) to compensate for the added risk.

One more differentiator is the type of situation into which a fund will lend. The vast majority of loans will be normal course of business loans such as refinancings, financing capital expenditures or working capital, or financing an acquisition. But managers with the requisite expertise can also target special situation loans where the company is stressed or over-leveraged and needs more risky rescue financing.

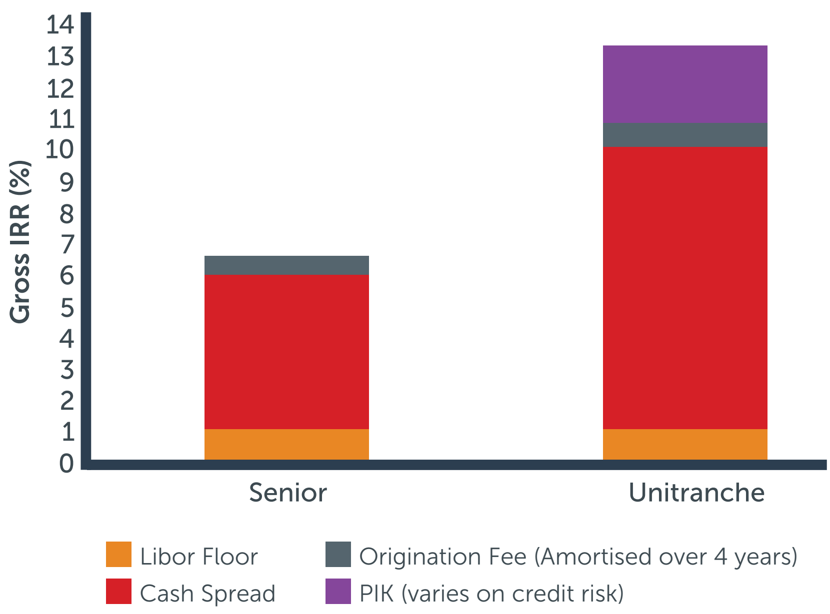
Expected Returns

Direct lending strategies typically target net unlevered returns in the 6% to 15% range. Where the specific fund will be targeting depends on the mix of the above strategies employed. Those targeting traditional senior bank loan strategies will be at the lower end of that range and those targeting unitranche, special situations or smaller borrowers will tend to be towards the higher end of the range.

Returns are primarily generated through interest payments, composed of Libor[1] plus a spread, on the loan which are augmented by origination fees, monitoring fees, default interest and exit fees. Conservative, large-borrower lending strategies should be able to generate gross IRRs in the upper single digits to low teens assuming coupons of L+400 to L+800 and 2-3 points of origination fees, plus exit fees and monitoring fees. This compares well with the leveraged loan market at L+400 which has higher market volatility.

In addition, special situations and loans to smaller borrowers can receive higher coupons and equity-like kickers through profit participations, boosting IRR's to 15% to 20%.

Fig 2.3 **Estimate breakdown of returns**



Source: Camdor Global Advisors

[1] London Interbank Offered Rate

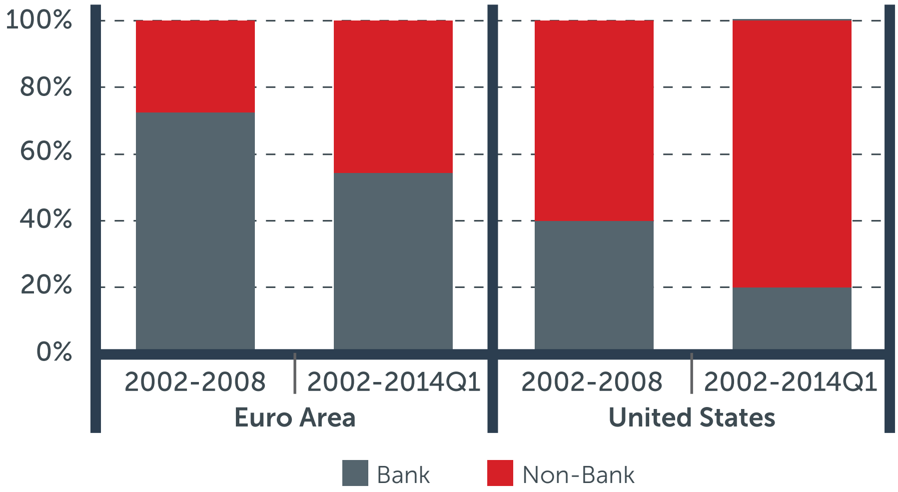
Today's Outlook on Direct Lending

Direct lending funds are almost exclusively focused on North America and Europe, and have been growing steadily since the financial crisis. Direct lenders have operated in the U.S. for decades, largely thanks to the reshaping of the debt landscape that took place in the 1990s following the Savings and Loans crisis. Pioneers like Cerberus Capital Management, Ares Management and Highbridge Capital all successfully operated pre-crisis by filling a lending niche that traditional banks did not, by focusing on the more complex financing situations where timeliness was key. These organizations and others like them developed reputations for sophisticated analysis and fast turnaround times, as well as aggressive enforcement. These strategies produced low double digit returns over time with very low volatility.

Post the financial crisis, however, there has been dramatic growth in non-bank direct lending on both sides of the Atlantic (see figure 2.4) as tougher global regulations try and make banks safer, in turn making it more expensive for them to lend. The Basel III rules, for example, encourage banks to hold more capital against their loan books. (Basel III stipulates a loans/capital multiple at just over 12 times, with total capital set at a minimum of 8% of loan books. Certain European countries have gone further and have set lower multiples at 8 times. To illustrate this dramatic decrease in leverage - pre-crisis, some banks were up to 40 times leveraged on a 'look through' basis).

As a result, European banks are expected to shrink their balance sheets by up to €2tn, or about 7 per cent of their assets, according to the International Monetary Fund. Much of this decrease will be from running off their loan books but also from asset sales. Another example is the U.S. Fed's recent stricter scrutiny of highly leveraged loans. Partly as result of the Fed's actions, U.S. leveraged loan issuance is down over 30% so far in 2015 from the prior year. Many of these financings have found their way into the high yield bond market but deals that are too small for the bond market have found their way into direct lending funds, which are becoming a larger and more permanent fixture in the U.S.

Fig 2.4 Funding of non-financial corporations in the euro area and the United States (shares in accumulated debt transactions)

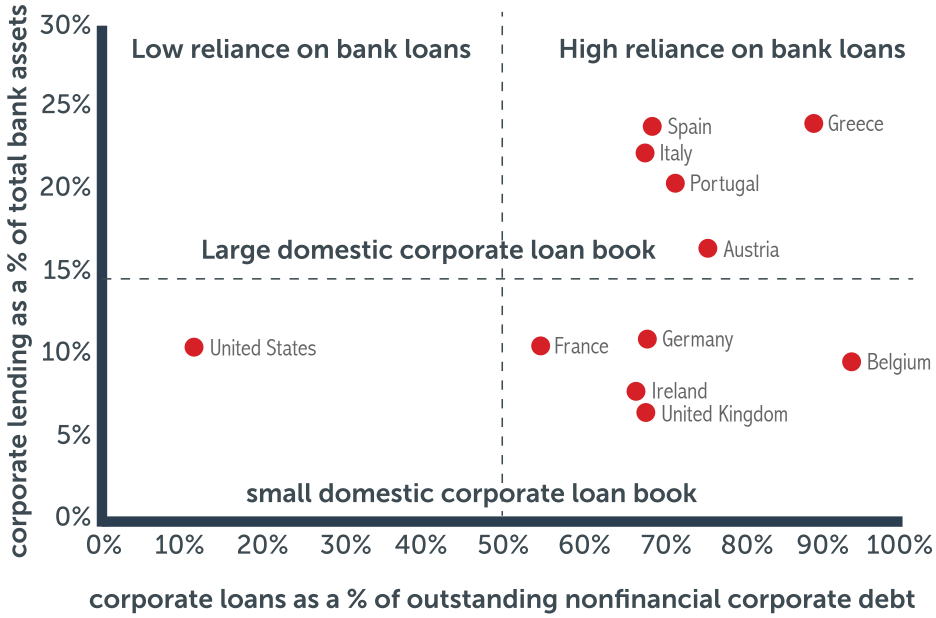


Source: Based on Cour-Thimann and Winkler (2013), with updated data from Eurostat, ECB, Federal Reserve System.

As we can see, while direct lenders in the U.S. have been a part of the lending environment for many years, in Europe it has been a more recent development. Banks have traditionally dominated corporate lending in Europe, evidenced by the much higher percentage of bank assets relative to GDP in Europe (350% of GDP) versus the U.S. (80% of GDP). European lenders, many of them state supported in one way or another, have traditionally supported their local businesses with cheap bank financing. Post crisis, as a result of tougher regulations and from the capital deficits caused by the crisis, European lenders have been pulling back from their traditional domination of corporate lending, and direct lending funds have begun to fill in the slack.

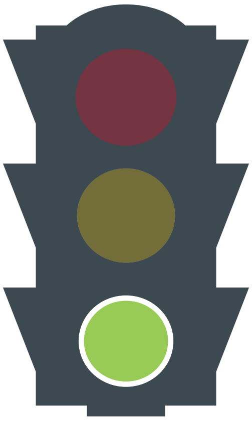
Europe's SMEs are heavily over-dependent on bank loans as a source of financing, especially comparable to the US, as evidenced in figure 2.5 below. (Banks in peripheral European countries are facing the highest deleveraging pressures as they typically have large corporate and SME portfolios). This recent drop in supply of credit by the banks is being filled to some extent by emerging non-bank lenders, primarily direct lending funds. As well as the drop in supply from banks, there is likely to be an uptake in demand by borrowers over the coming years and there are doubts that banks will be willing, but more importantly, able under new regulatory laws (particularly Basel III) to lend to the SME's. Additionally, it should be noted that in recent years, the numerous banking bailouts in Europe have led to a convergence between sovereigns and their banks. Many banks across Europe have begun to shrink from the periphery to their core markets in response to shifting political priorities and restrictions. The resulting mismatch from all these factors between the supply of and demand for credit has created a large "financing gap" for non-bank lenders to fill.

Fig 2.5 Reliance on bank financing by non-financial corporations (in%)



Source: IMF (2012), based on data from ECB, Eurostat, Federal Reserve, Halver Analytics

Camdor Global Advisors View



Deal Flow/ Origination

- Abundance at the lower middle and SME end of the market
- Demand for credit increasing
- Currently dominated by sponsor deals, though non-sponsor dealflow is improving

Deal Pricing

- Larger core market deals are more competitively priced due to banks returning
- Smaller end pricing more robust

Macro/Secular Dynamics

- Basel III regulations are creating structural opportunities for non-bank lenders
- Borrowers are more willing to go to non-banks for capital
- Low yield environment continues to drive investor capital into the space

Camdor Global Advisors is positive on the potential for European direct lending strategies to deliver good risk adjusted returns in the coming years, especially when compared with what the liquid credit markets have on offer today. The disintermediation of banks in the Eurozone by bond markets and non-bank lenders is a slow but continuing process.

It is also a structural shift in the landscape akin to when the US debt landscape was rewritten in the 1990s by the Savings and Loans crisis. Going forward, non-bank lenders and the shadow banking sector are going to become a significant proportion of the landscape in Europe. European borrowers are becoming more comfortable with dealing with non-bank lenders. In fact, according to surveys, many mid-market companies actively want to diversify their funding away from an over-reliance on banks and see the new breed of direct lending funds as good long-term partners. In other words, this is not a 2-3 year dislocation but a fundamental shift that will play out over next decade and longer.

In our view, strategies that target small to mid-market borrowers that have complex financing needs or are more of a "story" credit will be the most successful, as these are the types of credits that traditional banks have much less interest in serving. Good quality, larger borrowers still attract traditional lenders and it is hard for a direct lending fund to compete with their lower cost capital. In addition, the larger multi-billion dollar funds recently raised by global asset managers in response to investor demand and flows tend to target the larger loans brought to them by more conventional middlemen such as banks and brokers. The competition for these types of deals is intense.

We are more positive on niche strategies that target a specific region, smaller borrowers, or special situations and have the personnel, origination networks and expertise to source and structure these deals. The knowledge of specific regions in Europe is a vital tenet for a manager whether it relates to a sourcing network, knowledge of the legal system or knowledge of the banking system (that we saw previously in figure 2.5) can vary consideraby from country to country.

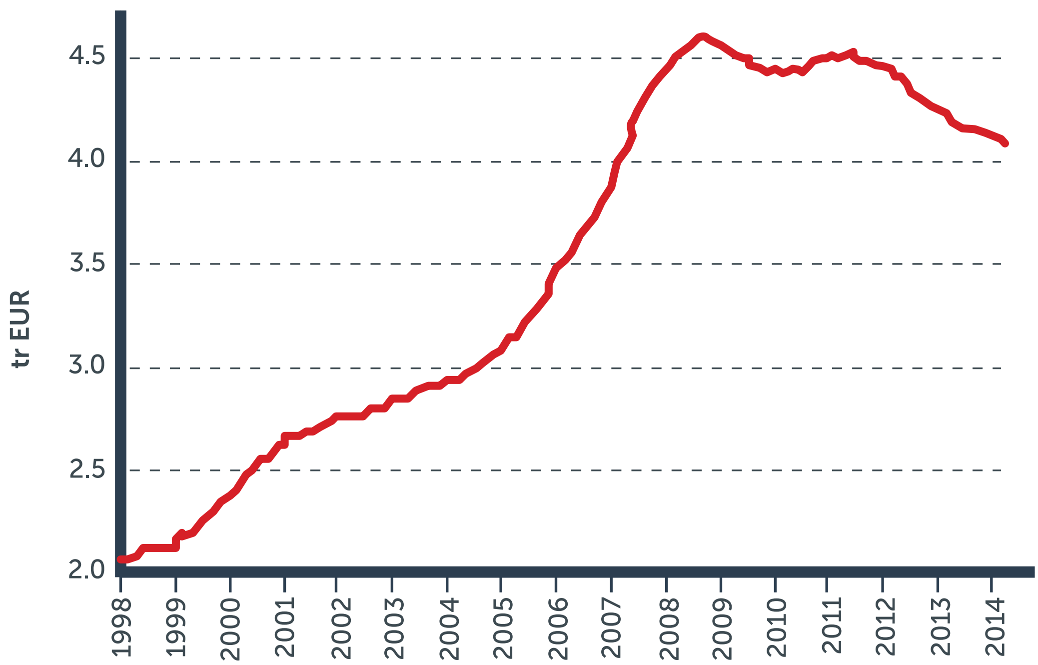
As we have seen, European SME's are in most need of financing as they have been most at risk to deleveraging by the banks. We feel this is a relatively untapped sector of the market with very few managers operating at the 'S' end of the SME market.

The main caveat to our positive view is the sheer amount of funds being raised in European direct lending strategies today. Camdor estimates there are currently around 35 direct lending funds active in the market who have raised a total of €27 billion, much of which has not been invested yet. There are an additional 30 funds currently in the market trying to raise around £21 billion.

Our concern in the near term at least is that the current level of financing opportunities in Europe is not large enough to support the direct lending capacity being raised, particularly given the lack of proven origination capability for many players. Our research has also uncovered anecdotal evidence that European banks have recently become more aggressive again in the prime deals, as robust asset markets have allowed them to sell down non-performing assets at better than expected prices and replenish their capital base. We think, however, that over time, as disintermediation continues, the opportunity set will increase and be able to fill up the capacity. For example, the IMF believes that there will be €2.8 trillion of debt capital required by non-financial corporates in Europe over the next four years, with Basel III rules not slated to fully kick in until 2019.

Secondly, even with the signs of banks moving back into certain sectors, it is de minimis compared to the scale of pre-2008. As we can see (below in figure 2.6) lending to non-financial corporations in Europe has been on a steady decline since 2009 and still has to bottom out.

Fig 2.6 Outstanding loans to non-financial corporations in the euro area



Source: EIF, based on data from ECB

Our other concern is the number of first-time and inexperienced managers entering the sector. A number of teams have been put together and brought to market to take advantage of the large and growing interest in this space by investors. Many, however, have strong leveraged finance backgrounds but lack the commercial banking experience needed to exploit the pockets of opportunity outlined above. We feel that a number of the first time managers will struggle to deploy their capital in attractive deals as they do not have strong, proprietary origination platforms and could under-price riskier loans. The majority are biased towards private equity sponsored deals, resulting in a common origination mechanism with little differentiation. Consequently, crowding risks are emerging as well as a possible mini-bubble where supply may well exceed demand, eroding returns and weakening covenants in time.

For this reason, we believe that a world class origination capability is probably the most important skill set for a manager to possess today. We would look for managers that have a large network in place, of brokers and middlemen, having direct relationships with financial sponsors, and that have a proven track record of originating private loan transactions.

Lastly - as investors often see direct lending in parallel, or even as a substitute, for public fixed income, we believe that importance should be placed on a fund's annual distributions (effectively a coupon). Although it is hard to estimate what the correct yield should be (as direct lending funds differ from one to the next, in terms of where they lend in the capital structure) we believe investors should target a cash yield of around a minimum of 4%-6% annually (preferably distributed quarterly) for a senior secured direct lending fund with a target IRR of 8%-10%.

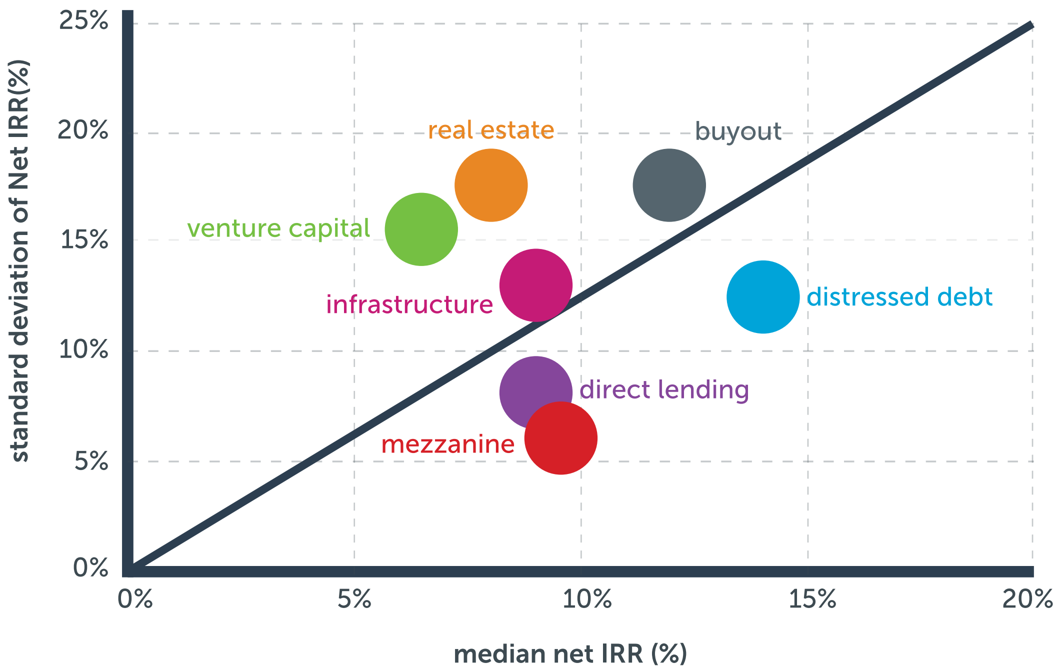
To conclude, there are many vital facets investors need to understand and analyze when looking at direct lending managers and their funds. Of most importance to us are:

- The manager's deal network and sourcing capabilities
- The historical performance and/or pedigree of the manager
- Proven flexibility to find good value deals across a spectrum of different markets
- A strong focus on fundamental credit quality work coupled with a deep understanding of commercial realities in different sectors and geographies
- A tight focus on covenants and ongoing proactive monitoring

Risk and Return

Direct lending strategies have historically performed extremely well on a risk adjusted return basis. According to Preqin's analysis of 2001 to 2011 vintage direct lending funds, the median net IRR to investors was 8.9% while the standard deviation (of net IRR) was only 8.4%, resulting in a risk-adjusted return ratio that compares very favorably to other alternative strategies, including other private debt strategies. The below graph (figure 2.7) illustrates this, comparing return to standard deviation of return for a range of asset classes. Those strategies that do well on a risk adjusted return ratio appear in the lower right (lower standard deviation of IRR and higher net IRR).

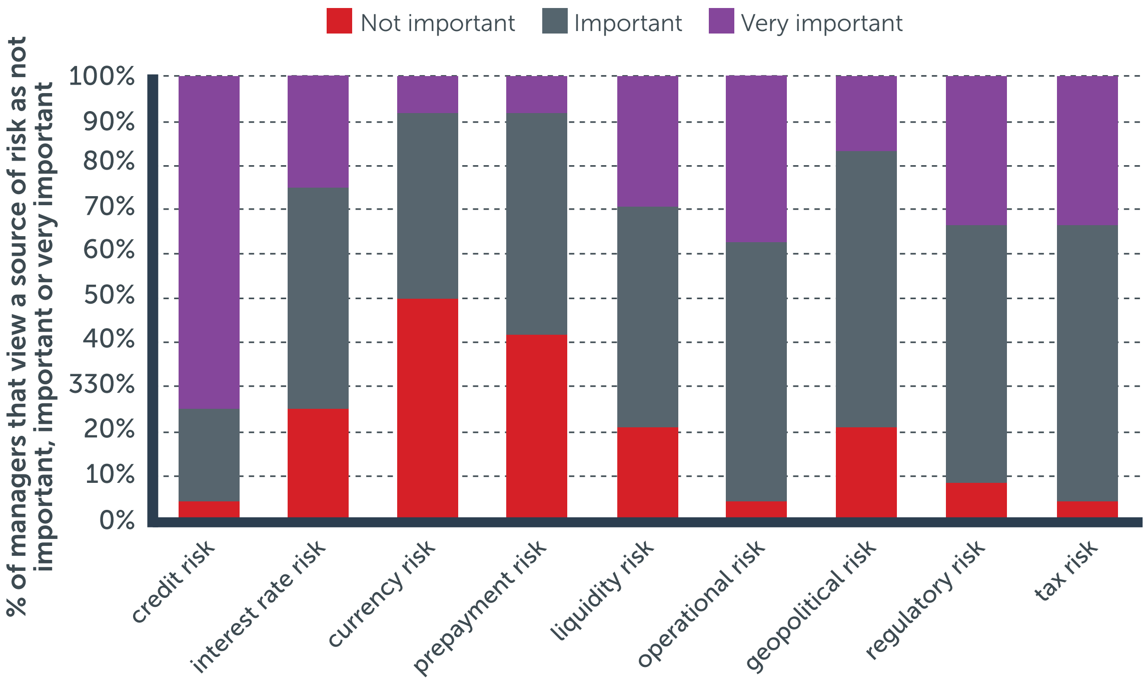
Fig 2.7 Risk and Return Profile



Source: Preqin and Camdor Global Advisors

Risks of Investing in Private Debt

Fig 2.8 Manager perceptions of risks in private debt



As with all asset classes, there are many risks associated with private debt. Some are associated with alternative investments in general (e.g. illiquidity) and some are specific to the intricacies of private debt. AIMA conducted a study of fund manager perceptions of risks (figure 2.8) and the importance they hold. Although we agree with these findings we also believe there to be many more to consider, as an investor, investing into a fund. Notably, it is important to understand that unlike public fixed income, where many terms and processes are standardized, private debt deals are very bespoke. That results in advantages in eeking out additional returns and security but also creates risks if adequate attention is not paid to every aspect. For example, key risks include:

- Counterparty risk
- Documentation and covenant risk, given the bespoke nature of the terms and agreement
- Complexity risk
- Lack of eligibility for collateral
- Information asymmetry risk, given the limited public information and limited comparables
- Refinancing risk at maturity
- Illiquidity risk as the secondary market is very limited and often on a deal by deal basis

Regulatory Constraints

For some large pools of institutional capital, notably insurance companies, regulatory considerations and treatment will be a key part of the allocation process. Even where there is no explicit regulatory capital to consider, the growing focus on holistic asset-liability management and mapping of risk factors makes the below analysis relevant for others, such as pension funds. Lastly, for all others without clearly quantified liabilities, these investor dynamics are important to understand as they impact the technical flows and capacity of these strategies.

As noted earlier, the current uncertain macroeconomic environment has fuelled an enormous compression of yields, that has resulted in ballooning liabilities, notably for pension funds and insurance companies. As these liabilities are typically of longer duration than the assets held, the net impact has been a rise in the mismatch between assets and liabilities, and a growing pressure to find adequate cashflows to replace the shortfall.

Alongside this, sweeping regulatory changes in the insurance market are having an enormous impact on the way insurance companies act and behave. In particular, in Europe, the incoming Solvency II regulation will uncover balance sheet volatility across the board, encourage board level debate of all risks and impose an increased requirement to fund sufficient capital to protect policyholders' interests. Pension funds are not immune either, given recent noises about the need to implement some form of regulatory capital framework for these also.

As yields march ever lower and with the advent of Draghinomics (and European QE), the longer-term picture in the eyes of many institutions is one of further tightening of spreads, potentially for 2-3 years. Already, large parts of the sovereign universe in Europe are now at negative yields. The implication is a huge growth in the diversity of the fixed income universe, and a need to generate more return even if the capital required is more, as returns on capital decline. In short, we are seeing a move amongst insurers from an approach that focused on minimising capital to one that will seek to maximise the return on capital.

Within this environment, private debt is amongst the most attractive of alternative asset classes. Its fixed income characteristics make it a viable higher-yielding alternative to public fixed income portfolios especially as pockets of opportunity there (e.g. high yield) have tightened significantly. It is not surprising then that so many funds are raising currently, given the appetite.

From an instrument perspective, direct lending may be viewed as a short duration bond. It is typically floating rate, therefore, has no interest rate risk. In some cases, the Libor component may even have a floor below which it cannot go, providing therefore a partial deflation hedge as well. In almost all cases, the bond is callable, i.e. it may be refinanced or repaid early (subject to agreed penalties), and has optionality in the form of equity warrants. The bonds are typically unrated, though a rating could be created by using some form of internal rating model.

Within the Standard Model, the prescriptive simple formulaic approach of Solvency II, direct lending holds up well. Though the stresses applied per year of duration may be high, the short duration means that the overall capital charge is typically 12-20%, resulting in an attractive return on capital once the higher yield is taken into account.

In many countries, however, larger insurers are going down the route of creating an internal model. This is a direct consequence of their strong desire to manage their risks on a far more proactive basis and pick up subtleties within the portfolio that Solvency II does not address within its standard formulation. Under this approach, private debt potentially becomes even more attractive. It has clear portfolio diversification benefits versus the core fixed income book; the additional security gained through improved covenants, relative position in the capital structure and active monitoring may be used to argue for lower capital charges; and credit may also be taken for the improved recoveries in case of default.

There are some complications, particularly for life insurers, such as for example, the matching adjustment, which requires fixed cashflows for the duration of the instrument. However, where insurers want to use direct lending instruments in these pools, structuring solutions are possible to create the required cashflow profile. Other key constraints are the ability to create the appropriate internal models given the lack of relevant resources and expertise, as a detailed understanding and modeling of the material risks is critical to win regulatory approval.

In general, insurers who understand and can demonstrate that the risk of these higher capital consuming assets can be fully or partially mitigated (e.g. through internal models, careful construction or by efficient use of derivatives) should be able to enhance the return on capital further and, therefore, benefit from the diversification benefit of allocating to a broader set of asset classes, geographies and sectors. Over time, we expect many other insurers will go down this route as well as they acquire increased sophistication and realise the efficiencies of capital that can be achieved through this approach.

Cash Flow Profile

Direct lending funds have net cash flows that follow a similar profile to that of private equity funds. In other words, for the first few years of the fund's life, net cash flows are negative as the manager calls down capital to make investments. As the loans are illiquid and the term of the loans is generally 2 to 5 years, distributions generally don't start until year 2 and peak in years 4, 5 and 6. Cash flow breakeven comes around year 5 to 7 which is two or three years earlier than a typical private equity fund. Importantly, however, a number of funds are structured to pay a quarterly cash distribution/dividend out of the current interest they are receiving from their borrowers.

Fees and Expenses; Fund Terms

Most of the funds have structures comparable to those seen in the private equity industry with a 3-5 year investment period and a 6 to 8 year life with extension options. Given the lower expected returns from direct lending funds, however, fees are generally lower than that seen in private equity funds, with management fees in the 1.25% to 1.75% area and incentive fees of 15% to 20% of profits over a hurdle which will be calibrated to the expected return of the strategy.

Managers and Fund Raising Trends

According to our research there are about 35 active direct lending funds in Europe today with total AUM of around €27 billion. Some of the larger and more active funds include Alcentra, Ares, Ardian, Bluebay, GSO, Hayfin, Highbridge, ICG, Proventus and Czech.

In addition, there are currently around 30 funds currently in the market looking to raise a total of around €21 billion. Some of the larger managers out fund raising include Ardian/AXA, Bluebay, Chorus, Crescent, CVC, European Capital, 3i, Pemberton, Permira, ICG and GSO/Blackstone.

Please contact us for additional information and analysis on direct lending funds currently in the market.

Sector Updates

Private Equity

What has happened in the market?

- Private Equity has experienced a bumper year on a number of different fronts this year. Exit valuations, asset prices and dry powder have all soared on the back of a low interest environment and an improving economic outlook.

- The last year has been a great time to be a PE seller. Low interest rates, increased liquidity and bullish public equity markets has resulted in a surge in exit valuation prices. Unsurprisingly, given the amount of liquidity created by QE, we have seen an increase in the amount of IPO exits by PE funds (See figure 3.1). The aggregate value of buyout exits has increased 70% year on year from 2013 to the end of 2014 (the most recent seen data on Q1 of 2015 has seen a further increase of 10%).

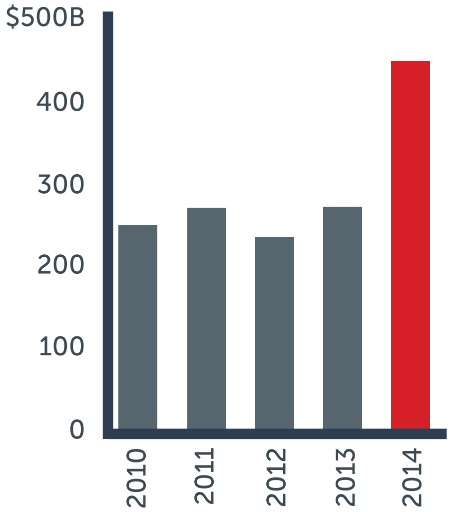
- On the flip side, these same market forces (low interest rates and cheap debt) that have created this bullish sellers' market have resulted in a precarious buyers' market. Propelled by superabundant global capital, asset prices have and will remain chronically high in the near future. This is heaping pressure on GPs to find and execute 'good value' deals in this hyper competitive market. These high valuations have been accentuated by the amount of dry powder on the books of GP's. The result is a huge increase in secondary buyouts and even tertiary buyouts, as asset managers trade portfolio companies with one another in the hope of extracting further efficiencies.

- 'Shadow capital' is the capital institutional investors invest in PE deals through alternative methods to the conventional investment as a passive investor in a PE fund. These alternative methods are typically co-investing alongside a GP or investing directly into deals by themselves. As institutional investors increase exposure to PE, they have been growing and developing their teams. We expect this to be the catalyst for a continued increase in shadow capital. Shadow capital has the ability to have a profound effect on the industry in three ways: 1) It drives down expenses for the investor, in turn this could cause GP fees to go down. 2) Institutional investors will start competing with GPs on the same deals which will further saturate an already competitive market. 3) LPs will place more of a premium on GPs creating alpha otherwise LPs will come to the conclusion they can invest themselves with the same returns. (See Figure 3.2)

- Fundraising - As the amount of exits increase typically we expect to see fundraising increase albeit it with a marginal lag as LP's look to recommit capital to the GP's. This should always be a sign of caution for an investor because, as already noted, we may be reaching the top of the cycle and therefore it should not be an automatic reaction to re-up with the GP. It is important to assess the macro and idiosyncratic outlooks for different industries and sectors.

Fig 3.1 Total exits over last 5 years

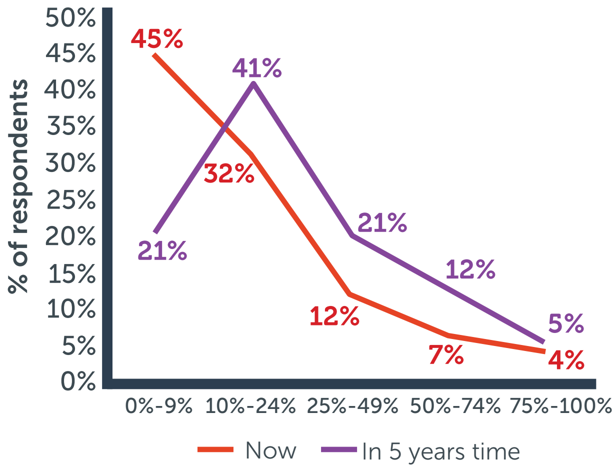
Global buyout exit value



Source: Bain & Company

Fig 3.2 The increase in LP shadow capital over the next five years

Proportion of LPs' exposure that is/will be direct - now and in 5 years' time



Source: Coller Capital

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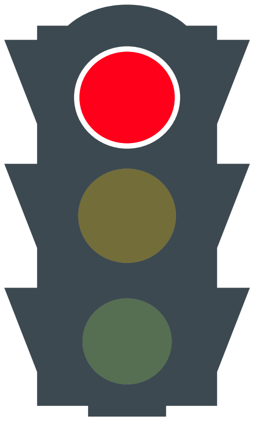


Deal Flow/ Origination

- Competition from strategic and corporate buyers
- Same portfolio companies increasingly being churned between managers, with diminishing value being added

Deal Pricing

- High valuations from the abundance of capital and excess dry powder
- High stock market valuations driving up asset prices
- Rising rate environment will provide further opportunities

Macro/Secular Dynamics

- Appears to be at the top of the cycle
- Energy and other real assets look relatively cheap whilst providing an inflation hedge/ distressed

Our high-level outlook on private equity is one of caution. While we believe that there are some interesting strategies within the mix, certain assets look dangerously inflated at what appears to be the top of the market cycle. The overpricing is due to the preponderance of cheap debt, dry powder, high comparable stock market valuations and strategic competition, as corporates look to use their huge cash reserves. Therefore, while the underlying assets and overall economy are not in a distressed state, the rich prices being paid will squeeze returns on investment going forward. We strongly believe due to the market conditions that the key focus should be on manager selection, particularly those managers whose strategies have an attractive capital supply/demand dynamic and where investments are strongly protected on the downside due to macro, industry and idiosyncratic dynamics.

There are also some interesting sectors. Energy, for example, has experienced a significant downturn but the oil price looks to have stabilized after the sell-off. In this environment of lower energy and commodity prices (likely a medium-term scenario given Chinese tremors and the rise of Saudi America), many companies are suddenly finding themselves over-leveraged and with attractive assets that are too expensive to hold. That creates distressed opportunities, particularly for those willing to ride out the secular commodity cycle. Additionally, despite the dominance of deflationary pressures, inflation is the key goal of policymakers. The risk remains of a sudden elevation as the medicine works too well, making energy as well as the broader real assets category a cheap and long-dated inflation tail hedge.

Over the coming year, the growth of the PE industry will be strongly dependent on when and how fast central banks (critically the Fed) hike interest rates. This will curtail the availability of cheap debt and has implications for the extended bull run on equities. Over the medium term, it will also expose zombie companies, kept alive by low servicing costs and 'extend and pretend' strategies from lenders, creating both distress as well as opportunity.

Infrastructure Debt

What has happened in the market?

- Public debt markets – As described by the the iBoxx £ Collaterised AA 15+ Maturity Index - a good proxy for social housing bonds and other secured, long-dated infra bond - had a spread of around 140 bps at the end of May, only slightly tighter than where it started the year. Low supply of issuance coupled with large demand from pension funds and insurers have kept spreads low while increased social housing sector risk due to government buyback policies has made some investors wary.

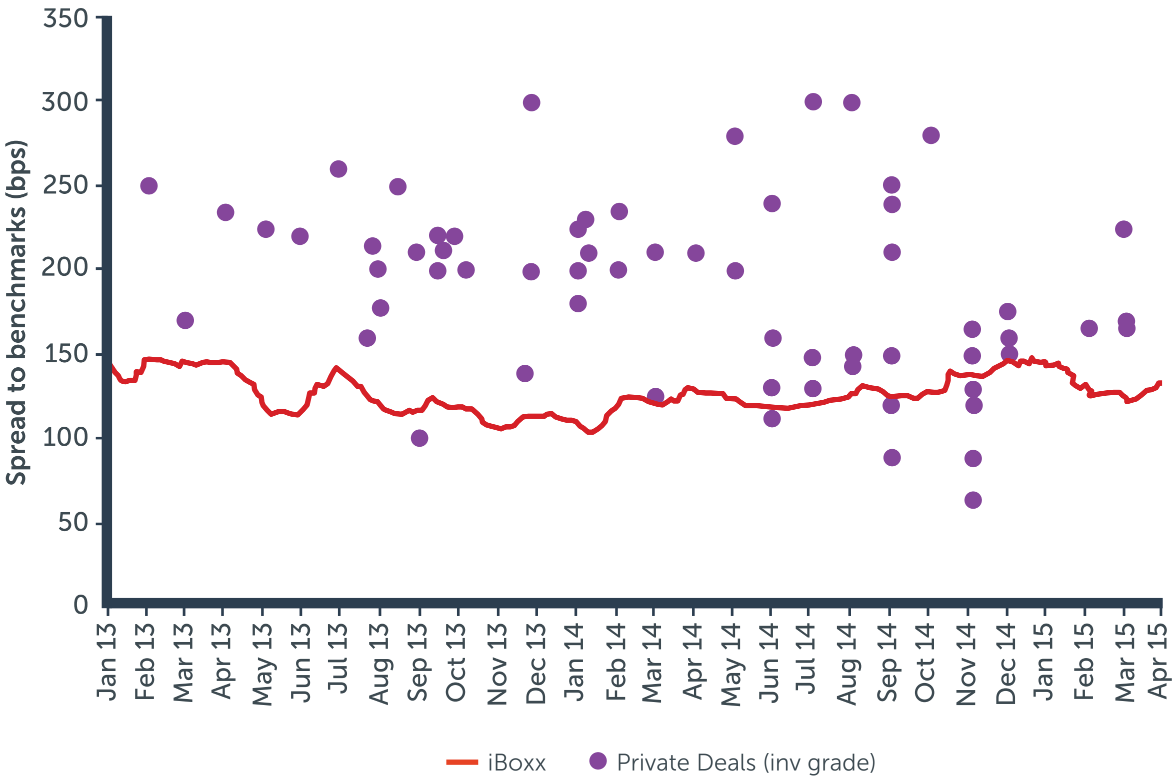
- Private debt markets. Similar to public debt markets, private debt markets are seeing demand for the asset class out strip the supply available from new infrastructure projects. The allure of infrastructure debt remains strong. Pension funds and insurers continue to allocate and in many cases up their allocations to the asset class for very valid reasons including 1) low investment grade type default rates; 2) very high recovery rates in the order of 80-100% given a default which is higher than even 1st lien secured loans; 3) the ability to earn an illiquidity premium; 4) the ability in some cases to invest in long duration debt; and 5) the ability in some cases to achieve inflation-linked returns.

- In North America and Europe, around 20 infrastructure debt funds have raised close to €20 billion since 2012. There are currently another 17 debt funds in the market looking to raise over €16 billion, according to data from Preqin.

- However, the supply of new infra debt has not been enough over the last year to meet investor demand. Large new infrastructure projects in both the U.S. and Europe have been in short supply. Political deadlock and budget austerity are primarily to blame. Additionally, institutional investors have been unwilling to sign up to new projects with development risk, preferring existing ones that are already cashflow producing. Areas that have seen a lot of activity tend to be small and niche such as the renewables sector which has benefitted from governments concerned with climate change. Student housing in the UK is another sector which has seen favourable development dynamics, though is now saturated with institutional capital.

- As a result spreads on private infra debt have come in somewhat over the last 6 to 12 months. (See chart over page)

Fig 3.3 Spreads of Selected Private Infrastructure Debt Deals



Source: iboxx € Non-financials A15+ and Macquarie Bank

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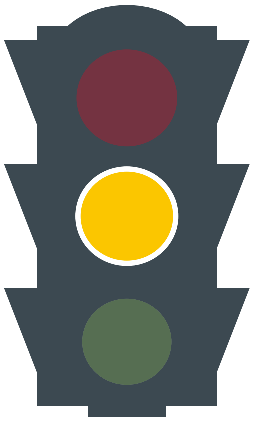

Deal Flow/ Origination

- Limited deal flow of interest to investors
- New projects hard to get off the ground

Deal Pricing

- Margins have compressed elsewhere but market is not overvalued yet
- Pricing has tightened significantly for high quality deals due to strong demand

Macro/Secular Dynamics

- Large unfulfilled demand for infrastructure
- Monetary stimulus may give way to fiscal stimulus
- Regulatory support

We are cautious on the infra debt sector in Europe and the U.S., which is where most institutional investors are interested in investing. In the private debt markets, a large amount of capital chasing relatively few deals has compressed margins. Having said that, the benefits of infra debt towards matching long-dated liabilities and the illiquidity premium still on offer continue to make the space of interest. Increasingly though, it has become difficult to put money to work given the deal competition and relatively lack of scale in the supply. Many managers have struggled to originate deals in sufficient size or quality. We recommend a conservative allocation to the sector and would look for fund managers with the resources, experience and name recognition to source and win deals, particularly in niche sectors such as renewable, and where they are able to fund small to mid-size deals. We also recommend looking more actively at the recent trend towards individual deals being brought directly to market. Whilst these need more due diligence and structuring, they also represent a rare source of origination. Lastly, we note that the secular dynamics in the long run are supportive. Many governments are now considering fiscal stimulus to augment monetary stimulus, which may remove some of the development risks associated with new projects. Additionally, there is considerable lobbying pressure to loosen regulatory capital requirements on both long-dated debt as well as infrastructure equity (particularly for insurance companies).

Real Estate Debt

What has happened in the market?

We base this brief outlook predominantly on Real Estate Debt in the European market. From a value standpoint we believe that Europe offers more of an opportunity comparative to the US, which has already seen considerable growth and capital flow back in from the banks.

- Real Estate lending has seen robust growth since 2012. According to Cushman & Wakefield there was a 55% increase in lending origination across Europe in 2014 (new investment lending, new development lending and refinance lending). With the banks returning to the core markets, alternative lenders will have to start targeting more niche opportunities.

- Real estate debt funds have seen a 25% increase in capital commitments over the last year, raising a total of $20bn globally according to Preqin.

- Not to the same dramatic extent, but as with direct lending, the 3 years after the 2007-2009 financial crisis saw a retrenchment of the banks in real estate lending. The following three years have seen the banks moving back into this sector as balance sheet pressures ease, as evidenced by the compression of margins and higher LTV rates. We estimate prime lending in Europe is currently around the 60-70% LTV range, with margins in London around 2-2.5% and Germany tighter at around 1.5-2%.

- Europe's top three markets (France, Germany and the UK) have maintained strong growth over the last year. Most notably though, there has been an 80% increase in tracked lending in certain southern European countries (specifically Italy and Spain). There has been similar growth in periphery Eurozone countries - we expect this to be an area, along with more esoteric deals (e.g. in smaller cities outside key centres such as London), that alternative lenders target as the banks price them out of the core markets.

Fig 3.4 Real estate investment in Europe, Q1-Q3 2014 billion

Source: Real Capital Analytics

Figure 3.4, showing Real Estate investment in Europe. Measured in billions it is clear to see the vast amounts of capital Germany, the UK and to a certain extent France have compared to the rest of the Eurozone. We expect the other European markets to close the gap in terms of investment.

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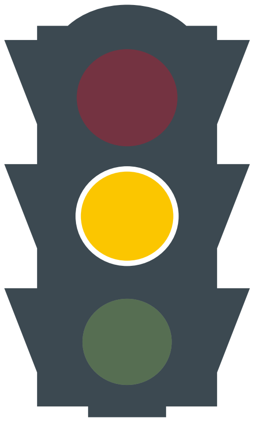


Deal Flow/ Origination

- Abundance of deals available
- Some issues with origination where competition is intense

Deal Pricing

- Core markets have seen a compression in margins and offer limited value
- LTV rates around 60-70% for prime lending in European core markets
- Some deals emerging in complex value space

Macro/Secular Dynamics

- Banks back operating in core market deals
- Still considerable value in peripheral Europe and some niche areas

CG Advisors is cautiously optimistic for the Real Estate Debt asset class in the near future. Similar to many of the other alternative asset classes, there appears to be large swathes of capital flowing in. However, we think there are pockets in certain sectors and geographies where there is considerable value available and limited competition. Although the distressed trade is disappearing, there are still major dislocations in

European markets, especially in southern Europe, Ireland and Turkey. Finding value in the US is difficult, as the market has recovered quickly and there is a lot of capital chasing the same deals. The deals that are emerging are those in the distressed or complex value space. Consequently, portions of that capital is reallocating to Europe which in turn will further tighten margins on this side of the Atlantic.

We expect margins to continue to compress and see a competitive floor be reached in the core markets, where banks are going to be more of a threat to alternative lenders. Therefore, we expect to see them shift into more niche markets, though this is not necessarily a negative connotation. As we see tentative shoots - although brief - of an economic recovery in Europe, we could see a funding gap created in these niche markets as the banks are not inclined to return yet or are able to from a regulatory and political standpoint.

Hedge Funds

What has happened in the market?

Hedge funds are a very heterogeneous group of strategies and indeed, for the last decade, almost every new niche strategy has often called itself a hedge fund as a means of quickly gaining legitimacy, short-circuiting the investor education loop and justifying higher fees. For the purposes of our analysis, we define hedge funds as the following:

- Strategies that at their core play at the short end of the illiquidity curve, with liquidity profiles ranging ranging from daily to a year. There may be small pockets of deeper illiquidity within the portfolio, but this should be the exception rather than the rule.

- Strategies focused on sustained higher risk adjusted returns. This may be through any of or a combination of identifying trends, dislocations, arbitrages, behavioural biases, unique structures, other business cycles etc. Careful identification and elimination of risks is also a key component. A large subset focus on absolute returns but increasingly, there are strategies such as activist equity, commodities focused and insurance linked strategies whose return profile is anything but absolute return and embeds their own idiosyncratic return cycle.

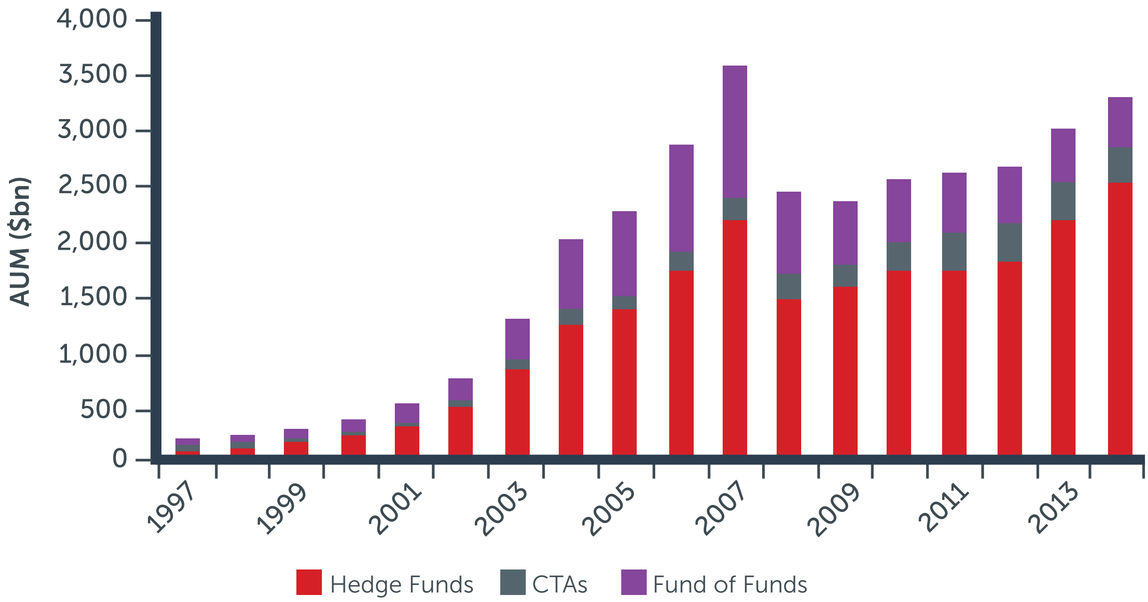
In later reports, we will unpack in more detail but for here, we note some key trends of relevance to investors:

- Hedge funds as a breed have seen poor returns in recent years, with the Credit Suisse Broad Hedge Fund Index returning 7.8% per annum since the end of the last financial crisis in March 2009 – significantly less than long only markets. Falling risk-free rates and tightening yields have reduced nominal returns, while rising correlations to other asset classes and the unpredictable uncertainty created by policy have eroded real returns. In 2015, however, hedge funds have once again begun to outperform major indices as the near-all asset bull market of the last six years begins to show jitters in the light of China, Greece, Fed tightening and other financial flashpoints.

- There are some pockets of opportunity, particularly with niche strategies and where the broader market dynamics are supportive. For example, merger arbitrage strategies stand to benefit from the excess of private equity dry powder as well as the need for corporates to deploy their growing piles of cash. The latter dynamic also means there are potentially rich pickings for activist strategies.

- At the same time, flows continue to be strong, thanks to investors looking for sustained growth and diversification in a low to no growth world. Despite the large falls in AUM in 2008 triggered by poor performance and scandals such as Madoff, investors have forgiven the industry since. Hedge fund strategies are now at record AUM. Managed futures strategies (which employ systematic models to capture trends) are also at record highs, though poor performance has led assets to plateau in the last 2-3 years. Only the funds of funds have suffered and continue to bleed assets as investors abandon the model and it falls out of favour. However, despite this, the whole hedge fund complex will still overtake its peak of 2007 by the end of 2015 and the flows should accelerate as investors once again prioritise liquidity and consider hedge funds to offer some sort of protection against future volatility. These flows are also accentuated by the large amounts of capital flowing into 'absolute return' and 'smart beta' funds that promise some element of higher risk-adjusted returns but at lower cost, bridging the gap between traditional long only and hedge fund strategies (more on that below).

Fig 3.5 Total Assets Under Management for Hedge Funds, CTAs and Funds of Funds (1997-2014)



- Worryingly, the flows are dominated by the largest hedge funds, with the oft repeated stats being that 90% of flows go to the top 10% of managers. This risks both a compression of returns as they struggle to deploy capital efficiently and a growth in crowding risk, as investors herd into common positions by proxy.

- While we expect relative outperformance to continue going forward, we also expect to see hedge funds continuing to struggle to deliver the high levels of performance of pre-2007, especially compared to other alternative asset classes with better capital supply / demand dynamics. The large amounts of liquidity in the markets have led to rising correlations across the board and many funds are struggling to adequately deploy capital without taking on greater levels of (unrewarded) risk. Those that have prioritized risk management and minimizing the downside will continue to find that the resulting lack of nominal out-performance is a potential business risk.

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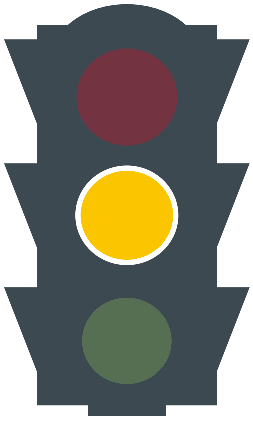

Deal Flow/Origination

- Significant amounts of capital but relatively few good trades to be done
- Niche opportunities emerging thanks to dislocations
- Risk management critically important, but can also restrict returns to the detriment of the business

Deal Pricing

- Many asset classes are richly valued, making returns harder to extract and more dependent than ever on market sentiment
- But some areas of value, e.g. commodity trade finance, merger arbitrage etc.
- Liquidity a growing embedded risk again

Macro/Secular Dynamics

- Policymaker uncertainty to be an ongoing theme, which will continue to suppress returns and present tail risks
- Excess of capital leads to rising correlations across most strategies
- Some trends are supportive, e.g. the disintermediation of the banks, excessive levels of corporate cash
- Rise in volatility could benefit distressed and long volatility managers

CG Advisors is neutral on the hedge fund asset class in general. First, the excess of capital across the industry means that there is too much money competing for too few opportunities. Second, the need to justify fees and provide adequate returns to satisfy impatient investors also means that many managers have taken on high levels of exposure and dialed back their risk management, leaving them exposed in case of any future jitters or downturns. Third, the multiple asset bubbles across the world and continuing accommodative monetary policies have led to high correlations between different strategies, making it hard to 'hedge' out or out-skill external influences.

This is a market for picking strategies and managers carefully to generate and more importantly, to realise returns. Beyond the idiosyncratic risks of each sub-strategy and manager, investors now run additional macro and liquidity risks that need to be carefully analysed and understood. There are pockets of opportunity around, particularly where strategies are either subscale and therefore, nimble; and/or where they are supported by broader market dynamics. We highlight some strategies that interest us in particular currently:

- Merger arbitrage: This should benefit from the excess of PE dry powder and the pressure on corporates to make use of their cash piles as they look to grow through acquisition in a low demand world.

- Activist strategies: These again benefit from the need for corporates to use growing cash piles as well as the need to sustain shareholder returns. There are risks as these strategies have little downside protection but they stand to make the best of a volatile equity market, particularly as earnings falter.

- Bank disintermediation plays: Strategies such as commodity trade finance and supply chain financing have an attractive opportunity set. The disintermediation of the banks, as noted, has created dislocations in the supply of credit to key parts of the global economy, creating a huge demand. However, the limited supply of capital available to meet this creates an attractive supply/demand dynamic, that should generate consistently decent (if unexciting) returns.

- Long volatility strategies: Volatility will be higher going forward, whether in a good (tightening) or bad (loss of credibility) world. Therefore, strategies that are intrinsically long volatility should have an attractive asymmetric risk-return profile. This should be confused by the way with volatility arbitrage funds, who are exposed very much in the opposite direction thanks to their levels of leverage.

There are many other niche strategies that are emerging, which bear careful analysis. As with others, understanding the dynamics, the experience and suitability of the team, and the pipeline of deals is critical to success. Some, for example, have already been swamped with capital to the detriment of returns, such as for example, the ILS (Insurance-linked securities) space, where pricing has softened while risks have not. Lastly, it is worth noting that in recent years, the lines have become blurred between traditional asset classes and hedge fund strategies. The focus on liquidity has led to the advent of 'liquid alternatives' and systematic replicators that attempt to capture diluted elements of the above, creating a bridge of untested foundations between traditional and alternative worlds. More cynically, the push to generate higher revenues has also played a large part, both from traditional managers looking to sell high margin products and from hedge fund managers looking for a larger asset base generating more predictable cashlows (in the form of management fees and a diversified product base).

This trend bears careful analysis as it represents additional competing flows of capital and herd behavior. Further, these risk creating liquidity risks as many of these strategies are unproven in adverse market conditions and when investors choose to withdraw capital rather than invest. The latter is particularly true of absolute return bond funds, given the dramatic falls in bond liquidity since 2008.

The Team

The Camdor Global Advisors Team

Dr Bob Swarup - Principal

Bob is Principal at Camdor Global Advisors and a respected international expert on financial markets, investment strategy, alternatives, ALM and regulation. He is also co-founder of the Insurance Investment Exchange, the leading forum for insurers globally to debate investment issues and trends. Bob formerly ran alternatives and was Chief Risk Officer at Pension Insurance Corporation, a leading UK-based pension buyout firm. He is a Fellow of the Institute of Economic Affairs; a senior Visiting Fellow at Cass Business School; and on the Editorial Board of the Journal of Alternative Investments. He holds a PhD in cosmology from Imperial College London and an MA from Cambridge. Bob has written extensively on a range of topics, most recently the internationally acclaimed bestseller Money Mania (Bloomsbury, 2014) on two millennia of financial crises and the lessons to learn.

Daniel Schrupp - Principal

Dan is principal at Camdor Global Advisors. He is seasoned investment professional and a former insurance company senior executive. Prior to Camdor Global Advisors, Dan was Chief Investment Officer at Lucida plc, a UK insurer focused on the pension buyout and bulk annuities markets. Dan successfully led Lucida into alternative credit asset classes including leveraged loans, private debt, ABS and infrastructure debt. Prior to Lucida, Dan was a Senior Portfolio Manager at Aozora Bank where he managed a $4.5 billion portfolio of U.S. and European leveraged loans. Dan has a bachelor's degree in economics from Yale University and a Masters of Business Administration from the Tuck School at Dartmouth College.

Anthony Kerr – Senior Associate

Anthony arrives to Camdor Global Advisors from a private equity background. He was previously with Forbes Private Capital Group, a US capital raising firm specializing in the private capital markets. Anthony worked as an analyst specializing in niche private equity and alternative credit. Anthony was based in Europe, his role included; all phases of the due diligence process and winning mandates for the firm. Anthony has passed his IMC (level 4) and is working towards his CFA unit 1.

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