

ASSET FINANCE

Systematic Absolute Return's (SAR) Survey Findings



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Fabrizio Ladi, a managing partner and member of the fund's investment committee discusses some of the recently released survey's findings...

From your perspective as an allocator in the asset finance space, what has been the most surprising survey revelation

We are pleased with the level of responses received and with the interest shown by the 58 survey participants. We were also pleasantly surprised to see how aware and well informed the respondents were. Participants included institutional investors as well as sophisticated investors from the US, Canada, Australia, Switzerland, the UK and other EU member states.

From an asset finance perspective, how do you define tail risk? How do you manage and mitigate this risk in your fund? Do you believe investor concerns in this context are unfounded?

When compared with other hedge fund strategies, there is no real difference in how tail risk is defined for the asset finance space. A closer look at the tail events in certain option arbitrage strategies, tend to show a similar profile - high Sharpe ratios, no negative months, uncorrelated returns - until a tail event strikes. To make my point, it is the cause(s), not the structure of the outcome that tend(s) be the real differentiator.

A change in accounting standards (the introduction of the new Financial Accounting Standards Board (FASB) fair value rule slated for late '07) or the defaulting of a large loan in a portfolio, or a change in rating standards, are all examples of potential causes that could trigger a tail event in an asset finance hedge fund.

Hence we believe the steady, low volatility return profiles of asset finance funds do not reflect truly, the risks that are embedded in the asset finance portfolios. These risks are usually operational and not market risks. During our evaluation process, whether on-

going or initial, we focus on the operational and valuation aspects. We therefore focus on how portfolios are priced; on how the collateral is valued and what recovery rate is expected in case of default. This last aspect is very important in the context of asset finance funds. If the loans are appropriately backed by hard assets - we may experience some volatility in case of a tail event - but the funds will, over time, foreclose on the assets that backed the loans and recover value. Usually due to over-collateralisation, recovery rates tend to be high. This also calls for well honed negotiation and structuring skills to ensure that the fund is always in a privileged position to claim assets.

We believe investor-concerns with regards investing in asset finance are well founded - but that they are actually no different from those applicable to other niche strategies: It is not advisable to invest in any unique strategy without understanding fully the risks involved.

30 % of the survey's respondents considered ABL as the most important strategy. Why do you think ABL strategies emerged as the most favoured in this pool?

Yes, within the respondent sample, ABL was most preferred amongst the asset finance strategies. It was followed by PIPEs, ABS and ABI. At the tail end of the sample were CDO's and MBS.

In our opinion the steady, uncorrelated, positive returns offered by ABL strategies, explain the survey participant's preference. One must also bear in mind that these strategies are comparatively easier to understand than the others that feature in the survey sample.

I feel comfortable stating that, investor understanding and their comfort level achieved in investing in ABL strategies is comparable with that achieved by long short (L/S) equity strategies. No wonder 70% of the hedge fund money is invested in L/S strategies - despite the high and expensive beta involved.

Drawing on your experience: are PIPE strategies "divisive" ... why or why not?

In our survey, PIPEs ranked second at the mean preference level, it was also the most disputed and polarised strategy among participants. While 22% assigned PIPEs a high preference level of "1", 33% assigned it the least preferred score of "5". This, despite the size of this market and even though individual

deals are getting larger, and that the operational quality of the players is improving. The space remains relatively small and is very competitive, with managers often fighting for deals amongst each other.

In addition to the headline risks, PIPE strategies may be exposed to some hard to quantify regulatory risks, as well as possible conflicts of interests between the fund managers and its investors. PIPEs are therefore "out-of-bounds" for some investors.

We are also aware that some allocators find the returns so appealing, that they invest in PIPEs and report their positions as convertibles arbitrage to avoid the headline risks.

Once again it is paramount to understand the valuation and liquidity of a PIPE manager's portfolio before assuming that risk.

The risk/reward potential offered by MBS and ABS relative to other AF strategies?

MBS and ABS provide a different risk reward profile to other asset finance strategies owing to the liquidity that some of these securities enjoy on the regulated markets that serve them. Obviously some can be very volatile and sensitive to changes in ratings and credit spreads. It was interesting to note that MBS emerged as the least favoured strategy even though the survey was carried out before the sub-prime woes struck.

Key challenges faced in constructing an efficient portfolio in the asset finance space

The key challenge is the valuation of the portfolios; it is paramount that the allocator has access to expertise to understand fully the practices and methods used to calculate the fair value of the assets that constitute each single portfolio.

This features in your recent newsletter: "If it be not now, yet it will come: the readiness is all". why did you choose this quote?

This statement is relevant to investing in any strategy, not only to asset finance; for we believe it is never the obvious risks that undo assets managers but the ones we can not see or even imagine. We acknowledge this and hence it finds reflection in our style of asset management.