

## PRACTITIONER'S POINT



Santo Volpe co-founded Eden Rock Capital Management, a hedge fund business specialising in asset-based lending. He is a member of the investment committee of Heather Capital Limited

### Risks and rewards of investing with a "niche" asset backed player

#### How would you as a practitioner define a "niche" player?

I would define a "niche" player as someone who has access to a particular and specific competitive advantage. In asset-based lending ("ABL") the manager will usually have a unique competitive advantage to originate deals within his/her particular area. "Niches" can be characterized as either geographic or collateral-specific or both. For example, someone may have access to finance timber receivables in Oregon. This is obviously a very "niche" opportunity with respect to both geography and collateral

#### How did you end up being one?

By being in the right place at the right time. Though it is a cliché, it is true. ABL as a hedge fund strategy is a fairly recent development. As an early investor in ABL prior to this, and given that most of the ABL managers are North American-based, the fact that I was based in Europe allowed me to identify certain niche lending opportunities.

#### Drawing from your experience: what would you say are the handicaps of being a niche player? And the rewards?

The major handicap is that one's investor base is going to be limited. As a niche manager one should expect a niche investor base. Though the trend is changing, the vast majority of hedge fund investors, mostly institutions, are unlikely to consider a very niche strategy with probably limited capacity. Though the number of investors who seek niche opportunities is growing, they still

represent a small portion of the global hedge fund investor base. The reward is the other side of the same coin. The niche ABL manager is immune to the cyclical trends of allocations on the part of institutions. This can often result in massive capital flows in and out of various strategies. Niche, non-correlated ABL hedge funds are unaffected.

#### Would you say capacity (AuM) is a constraining factor?

Definitely yes. By definition anything niche is going to be of a limited and highly specialized nature. It is unlikely that any hedge fund with more than USD \$1 billion of assets can be classified as truly niche - unless they have a monopoly, which, in the long term is unsustainable.

#### Niche players are more likely to deliver "uncorrelated" returns to other asset classes – but if they lack adequate diversification within "their niche" they could actually ramp up the risk – what has your experience been?

I don't really know how it is possible to diversify within a true niche. In ABL, "ramping up the risk" implies lax lending procedures, high loan-to-value ratios and/or loose documentation. In my experience, investors should understand precisely what their risks are. Diversification in a niche ABL portfolio is not always a risk-mitigating factor. Numerous examples can be cited.

#### With the new generation of "fund replicators" – can one expect to remain a "niche player" and still maintain the current level of fees?

That depends on the niche player's ability to maintain that competitive advantage. Anyone can try and replicate a fund, but their ability to succeed ultimately depends on what their added value is. Simply offering a reduced fee is not enough. ABL managers earn their fees because they have an edge in origination or special access to certain deals. Fees will come down if access to those deals becomes wider spread. But then, can one call it "niche" at that point?

#### What does it take to "preserve" a niche?

No single person, manager, firm, etc. can "preserve" a niche. That's up to market forces and good old supply and demand.

#### Do you believe it is possible to isolate "pure alpha"? Do you believe it exists?

In order to have Alpha you need Beta. Alpha and Beta are part of the Capital Asset Pricing Model. ("CAPM") ABL returns are non-correlated to the capital markets because they have nothing to do with the capital markets. Because of this "de-correlation" it is difficult to apply the CAPM. Therefore, the measure of Alpha needs to be discounted. Similarly, people often use the Sharpe Ratio, or Sortino Ratio, or other ratios to measure risk v. reward. Those ratios depend on standard deviation. Standard deviation has nothing to do with risk. It is a measure of volatility. Again, as with Alpha, one needs to rethink one's approach of applying traditional investment metrics to ABL.

**Comments, remarks...** I must point out that in my replies to your questions, I was referring to what one would call ABL as opposed to ABS (Asset-backed securities). ABS is a trillion dollar market with high levels of liquidity. It is the biggest fixed-income market in the world. When referring to ABL we mean private loans with no securitized secondary market. ABL returns are not correlated to the market because there is no market.

There has been an impressive flow of hedge fund capital into ABL in the last two years. Investors are attracted by the low level of correlation and the consistency of the returns. However, chasing returns is no reason to invest in ABL. A thorough understanding of the underlying risks is necessary and the methodology for measuring those risks should be applied appropriately. On the global perspective the outlook for ABL as a hedge fund strategy is promising. Hedge funds only represent a miniscule portion of the global ABL industry. We will see more hedge funds emerge, each with their own specific niche.

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