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# Looking Forward

## July 2015

When I write these letters, I attempt to articulate our current view of the markets clearly and succinctly. To keep these letters as topical as possible, I often begin to draft them 45 days in advance so the information contained within is as relevant and timely as practical.

Accordingly, I began to write this letter in late May. I was fresh off a presentation on the "current" risks and opportunities in the credit markets. The overriding theme of my presentation was that for the first time in recent memory, we were seeing a decrease in correlation across global markets. Reflected in the geographic diversity of our current investments, our thinking was increasingly driven by idiosyncratic themes, spanning risk segments (secured/unsecured, performing/distressed). Yet, even with the lack of correlation across geographies, three key themes with universal relevance had emerged:

1. A tale of two tails.
2. The disappearing bank.
3. A sovereign and commodity macro mess.

By June 1, I had the outline mostly done and the letter well developed. But, just as I started to put it to bed, Greece entered into full economic collapse. So I rewrote. Along the way, China wobbled and – not unrelated – oil declined by 10%.[1] So I rewrote again. Now, Greece seems to have regained some sense of purpose, at least temporarily, as the European Union has recognized that abruptly kicking a member state out of the currency could be both an economic and humanitarian catastrophe. So after a few moments of drama, the risks and opportunities I started to write about a month ago have begun to play out as anticipated (and in the case of Greece and China—they are playing out in real time).

For much of the past year, we have told you that we are minding our time, patiently waiting for opportunities to develop. Our investments in both performing credit and special situations have focused as much on ***risk*** as they have on ***reward***. Until June, along the way it was a little lonely focusing on risks, as the market continued to rally and to benefit those focused more on the reward end of the continuum. Yet, we believe our patience is now paying off, both in performance and reduced volatility. More importantly, given our cash balances, the market cracks are presenting investable ideas that we can pursue.

People naturally seek patterns in life that repeat and are readily explainable within the framework of their world views. They often anchor on the hope and belief that tomorrow will work like today. As a starting point, while not a terrible assumption, it is one unlikely to drive recognition of real value opportunities and

1 Bloomberg.

niche investments, or the understanding that markets are facing something totally new. 2008 was unprecedented — yet, there seems to be a lot of mindshare going into predicting the "next '08" rather than evaluating the current state of the markets in the context not just of '08 but also of '05, '02, '97, '91, '89, '87 and so on to develop a framework of what the "next" 2016 will look like and how that informs one's view of 2020. While we do not predict markets, we do prepare for a variety of downside and upside scenarios. The key to success does not lie in lucky predictions based on limited data, but rather in recognizing market realities and adapting as necessary.

What we do believe is that today's markets are very different from 2008. Certain risks are gone, while a new set, which we fear are largely discounted, are coming to the fore.

2008 risks that are for the moment not driving the markets are:

1. Leverage in the system has been materially reduced.
2. Bank balance sheets are not bloated as dealer inventories are near 10 year lows and portfolio sales in Europe have begun to have a positive impact.
3. Risk of a bank failure is low.
4. Subprime mortgages are all but gone.
5. ABS CDOs are not only out of the darkness, but also all but gone.

New risks that we fear are being discounted are:

1. Europe's internal economic war.
2. Military adventures abounding around the world.
3. The strength of the US dollar.
4. Cheap money and high asset prices.
5. Liquidity in the fixed income markets posing real risk to the system.

Against that backdrop, the opportunities we are pursuing are geographically diverse, represent disparate segments of the risk continuum and are of a scale and scope different that we have seen in past cycles.

**<u>A Tale of Two Tails</u>**

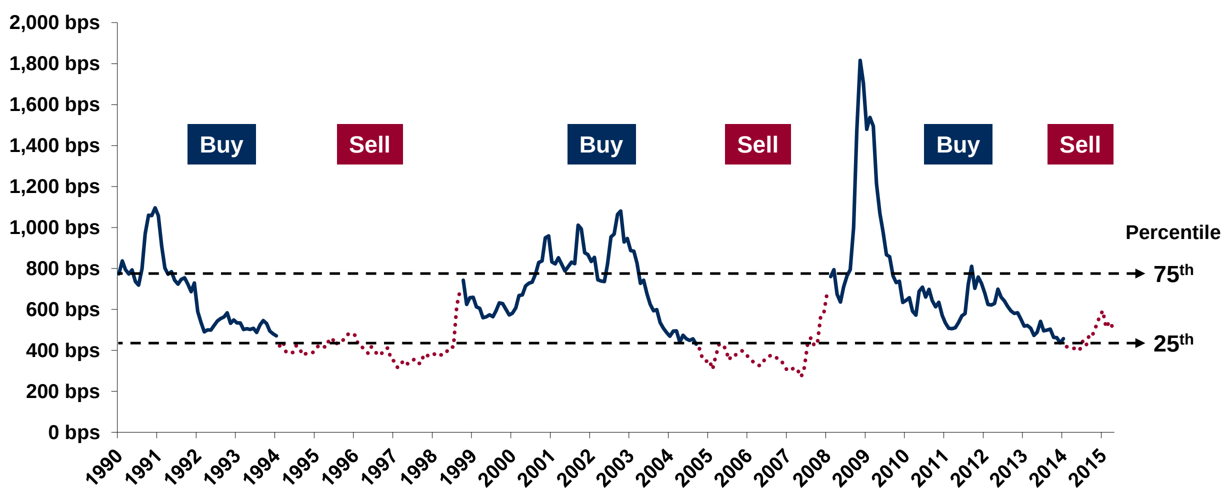
When asked if credit is cheap or expensive, my answer is a confident, "It depends." In the United States and, to some degree, Northern Europe, spreads are at median levels while current and expected defaults are well below median. That would tell you that in liquid, performing credit, you are generally getting a risk premium in excess of expected losses from defaults. Accordingly, from an income perspective, we see some decent value out there.

That said, within the riskier elements of performing credit, CCCs and second liens, we see signs of reaching for yield and spread. We have favored a barbell, offsetting our risk in these areas with hedges or cash assets.

It is also important to note that credit is very different than equity. A major component of return is the coupon, which makes timing price movements very difficult.

The chart below shows the returns of high yield bonds under two scenarios. One is buy and hold with market level defaults. The other is attempting to market time by buying only at wide spreads (75th percentile) and selling at tight spreads (25th percentile).

**High-Yield Spread and Investment Strategy Return, 1990-2015**




| Strategy | Annualized Return | MoM | % of Time in Cash |
|---|---|---|---|
| Always Hold | 9.0% | 8.9x | 0% |
| Market Time | 8.2% | 7.3x | 37% |

Data as of April 30, 2015. Source: Credit Suisse High Yield. Spread is STW. Market time strategy defined as holding high yield index until spread reaches 75th percentile and then moving to investing in 3-month Treasury bills until high-yield spread hits its 25th percentile.

As you can see, you are better off buying and holding rather than aggressively trading. In fact, over a 25 year period you would earn 80 bps higher annual return and 1.6 more turns on your money by holding rather than selling when the market was above the 75th percentile.

While the par market has value, there is a tail to the bell curve that represents a relatively deep pool of distressed opportunities. Representing a mere 6% of the market, high yield and loans trading at distressed levels actually total approximately $150 billion, an amount greater than in any other distressed cycle other than 2008.[2] This is partially driven by growth of the overall market. Different than we have seen in the past, the opportunity set is characterized by a variety of smaller industry-sensitive ideas, rather than the mega defaults (Lehman, CIT, Lyondell, etc.) that grew out of 2008. Furthermore, this data is for the US and Europe only. We have our teams working on individual distressed ideas from Spain to Singapore to New Zealand and everywhere in between.

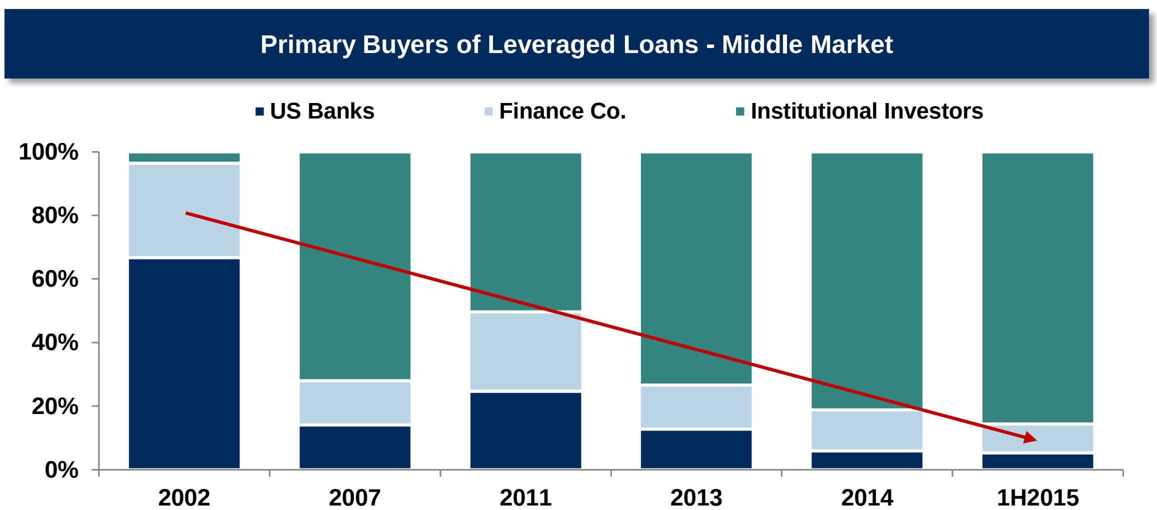
[2] J.P. Morgan.

**The Disappearing Bank**

One outgrowth of the 2008 crisis that still affects the markets profoundly is the new definition of what it means to be a bank. Sadly, the plethora of much needed regulation seems to have missed the mark, at least partially. Rather than providing better market liquidity, improved lending operations and stability to markets, they do just the opposite. The trends from where we sit are quite simple to see:

1. *Banks lend less, trying to syndicate more.*

   Against this environment of bank retrenchment, we have found interesting investments globally in both the senior and junior private lending arena. Sankaty has been investing in the space since 1999 and, until recently, found it to be an attractive, niche segment. Beginning in 2008 and accelerating during the past 3 years, private lending has become an important and growing segment of the capital markets. The chart below shows the dramatic shift in the middle market area from traditional bank lenders to institutional or fund investors.




Data as of June 30, 2015. Source: S&P LCD Quarterly. US Banks includes securities firms. Excludes non-US banks.

This trend is not confined to the US. We have private lending operations globally. In fact, we recently established pools to invest in senior direct loans in the US and Europe, and dedicated country specific pools in Ireland and Australia.

There is a great deal of debate as to whether the private lending trend is good or bad. We believe it is good for the system and for economic growth. Funds are able to provide more flexible and customizable capital than traditional banks can. Furthermore, smaller companies are inherently riskier, and therefore institutions that invest locked up capital are better able to weather the volatility inherent in capturing this market segment's excess returns.

The downside to this trend is first and foremost the relative depth of the fund market versus traditional bank balance sheets. While it may seem like a lot of private money has flowed to this market, it pales in comparison to the amount of bank capital that has exited the space. The result of this supply/demand imbalance must suggest some element of excess spread to those able to make these loans, at least in the short-term. Where long run "fair value" ends up, only time, default experience and ultimate investor experience will tell.

2. *Banks don't own assets the same way and fail profoundly in their role as market makers.*

   The table below provides a simple, yet extremely troubling, summary of an important market reality. During the last decade, the market for high yield loans and bonds has more than doubled while the inventory or trading books banks hold has declined by over 66%.

| | 2005 | 2008 | 2014 |
|---|---|---|---|
| **U.S. Market Size:** | $725B | $1,100B | $1,900B |
| **U.S. Dealer Inventory Size:** | $155B | $75B | $50B |
| **Ratio:** | 5:1 | 15:1 | 38:1 |

Data as of December 31, 2014. Market size data per JP Morgan and LCD. Dealer inventory size data per Morgan Stanley.

When this chart came out, some banks disputed the content, suggesting the size of the decline in inventory is lower because of a decline in structured products. But one thing is clear — trading liquidity in all areas of fixed income has gone in the wrong direction.

Practically a week doesn't go by without some article about limited trading liquidity, mutual funds owning such large positions in deals as to render them illiquid, or about the backlog in loan settlements at banks. We do our best to mitigate these phenomena by aggressively pursuing trade settlement, knowing the holders of the securities we are buying, and generally holding cash and AAA securities as a buffer in times of volatility.

While this trend is not generally good for the markets or economy, it does create buying opportunities on both the par and distressed side for investors with patience and capital. Fortunately, we believe we are one of those investors.

3. *The global trend (rather than US) is still toward delevering.*

   There is an often quoted saying in economics that "things take longer to happen than you think they will, and then they happen faster than you thought they could." This couldn't be truer than in the case of European loan sales. In 2008, one would have thought the whole continent would be for sale in '09 and '10. Yet it took years for the banks and market to find an equilibrium point. We did not do a major portfolio acquisition until 2012; yet, since then have purchased 11 portfolios with a face value of $5.9 billion. These have represented some of our highest returning investments, and we think Europe is midway through the sales process, at best. The chart on the following page shows the current levels of remaining NPLs across Europe.

| | Stock (€B) | Traded (€B) |
|---|---|---|
| Italy | 184 | 8 |
| Spain | 173 | 21 |
| United Kingdom | 107 | 22 |
| Ireland | 98 | 31 |
| Greece | 90 | 1* |
| Netherlands | 55 | 4 |
| Cyprus | 29 | Unknown* |
| Portugal | 20 | 1* |
| Romania | 8 | 1* |
| Other | 416 | 2 |
| **Total** | **1,180** | **91*** |

Data as of December 31, 2014. Traded levels correspond to full year 2014 actual and estimates (estimates marked with *). "Other" includes Germany, France, Russia, Poland, Austria, Turkey, Denmark, Hungary, Ukraine, Czech Republic, Sweden, Norway, Slovakia and Finland. Source: PwC (Portfolio Advisory Group, Market Update Q1 2015) and Sankaty calculations.

Sales of NPLs have recently averaged around $150 billion a year. At that pace, taking into account normal cash flow and sales, we would expect three to five years more of material trading activity.

**The Sovereign and Commodity Macro Mess**

Against the specific micro opportunities I have described, the two big ifs to consider are macro/sovereign issues in Europe and Asia and global commodity price collapses especially impacting US oil.

On energy, much has been written, little of which has been accurate. Given oil prices are at least in part driven by the actions of a cartel, predicting supply and demand has been nearly impossible. The price movements of the last year certainly reaffirm that. That said, to conclude that the space is uninvestable is wrong as well.

What we attempt to do in the energy space is take a long view and buy assets that have recoverable value below the prevailing strip price of oil. Furthermore, addressing the space requires a dedicated team and an ability and willingness to hedge. Finally, generally focusing on well-level economics rather than just basin-level economics is key to preserving capital.

Our energy investments to date have focused on low cost of production, high IRR fields that work at low levels on the oil strip. We have also focused on being a senior capital provider in situations we have followed for a long time in fields where we have first-hand knowledge. While we were early to some situations, our instinct to adapt and not go "all in" ever, let alone early, has generally served us well and left us with capital to deploy when and if we feel it appropriate. Portfolio discipline dictates not getting too big in the space, because securities will correlate at the end of the day. While we have some small separate accounts in the space, we have chosen not to raise dedicated energy funds. When we see good opportunities, we will buy them in our core funds where we have plenty of room.

On the sovereign side, we are following the events in Europe/Greece and Puerto Rico, but have not participated in the securities of those countries. Through our history, we have found pricing sovereign risk nearly impossible and increasingly difficult to hedge. Implicit in sovereign investing is a belief one can predict government actions with some degree of precision. Some institutions specialize in these risks, or have strategies that can withstand these types of binary risks. That is not us.

We do look in those situations for short duration, high cash flow and tangible investments. Currently, the only investments we have in any of the headline geographies is one investment in a portfolio of buildings in greater Athens purchased from a non-local bank that was exiting the geography. While events in mid-June caused us some concern, the investment continues to perform in line with expectations. Our thesis was and remains that in times of high uncertainty, people prefer to own land and buildings over cash in a bank they don't trust.

More broadly, the fact that Greece is in trouble, Puerto Rico has gotten worse than most anticipated and China is providing epic support for its equity markets, does undeniably suggest world growth has some major headwinds. That one is pretty obvious. A secondary risk arising mostly out of the Greek Drama is the potential impact of a populist movement in a single country or an entire region. With an upcoming election in Spain and the UK's vote on EU membership in 2016, we will be mindful of the impact of these movements and more creative in imagining the possible contagion effects they can have. Our hope is policymakers will as well. Decisions should be made based on practical realities, not ideologies. To paraphrase a common analogy, the moment the patient is in the emergency room with a heart attack is not a good time for the doctor to lecture on the virtues of diet and exercise.

**Finally**

The last risk I see is one that the team tells me makes me sound like the cranky old uncle, but I think is nonetheless important to consider. Seven years out from 2008 and nearly a decade from the run up, there are a lot of people sitting in important positions at banks, trading desks and funds for whom that dislocation is as distant a memory as the Great Depression. If you didn't see it, experience it and witness the rational and irrational actions that emerged from it, you may lack an important experience that should inform your actions in the next selloff. While there is no immediate action step here, it is something of which we consider when gauging market activity.

What does all this mean? Quite simply, it is a bit of back to the future. The strategic play here is not as simple as "buy bank loans" in 2008. That said, while the system is more stable, especially the banks, the opportunities are truly bespoke up and down the risk spectrum and across the globe. Our base case positioning is:

**Liquid Credit:** Stay senior and safer, but recognize there is plenty of income to earn if you do your job and avoid defaults.

**Private Lending:** Find places to be the capital provider where banks have exited or are constrained. The senior market is certainly deeper, but selective opportunities do exist in junior privates in the US, Europe and Australia.

**Distressed:** Pursue corporate opportunities in the United States, portfolios in Europe and special situations (private loans and portfolios) in the Asia Pacific region.

What we won’t do is chase tight markets, take comfort in what others are doing, and try to “put money to work.” The challenges we face are weighing conservatism versus fear and patience versus inaction—but that is what you pay us for and it is a responsibility that motivates us every day.

If you have any questions about the markets or our approach, please let us know.

Sincerely,

Jonathan Lavine
Managing Partner and Chief Investment Officer
Sankaty Advisors, LLC