INVESTMENT PERFORMANCE SERVICES, LLC

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Opportunistic Investing

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2017 Survey of Capital Market Assumptions

(Net of Fee) Market Returns

Equity	10-Year Horizon
US Large Cap	6.46%
US Small/Mid Cap	6.90%
Non-US Equity -Developed	6.99%
Non-US Equity -Emerging	8.00%

Fixed Income	10-Year Horizon
US Treasuries	2.27%
US Corporate Bonds - Investment Grade	3.24%
US Corporate Bonds - High Yield	5.06%
Non-US Debt - Developed	2.18%
Non-US Debt - Emerging	5.30%

Alternatives	10-Year Horizon
Real Estate	6.18%
Hedge Funds	4.92%
Commodities	4.05%
Infrastructure	6.67%
Private Equity	9.00%

Source:
Horizon Actuarial Services, LLC -2017

Opportunistic Investments Agenda

- Explain what they are
- Describe the structure & characteristics
- Identify risk factors
- Illustrate benefits
- Discuss how they make money

What are Opportunistic Investments?

Idiosyncratic or catalyst-driven (unique; not repeatable) investment opportunities that **seek to exploit a market or price dislocation**

What is Opportunistic Investing?

- Purchase of assets from <u>owners motivated to sell when there are few willing or able buyers</u>

- Opportunities occur in every asset class…
  - Stocks
  - Bonds
  - Real Estate
  - Commodities
  - Currencies

Managers who invest opportunistically typically have broad global reach, expertise in specific market niches, and deep industry relationships/networks.

General Types of Opportunistic Investments

- **Event Driven** - Unique, not repeatable, time sensitive

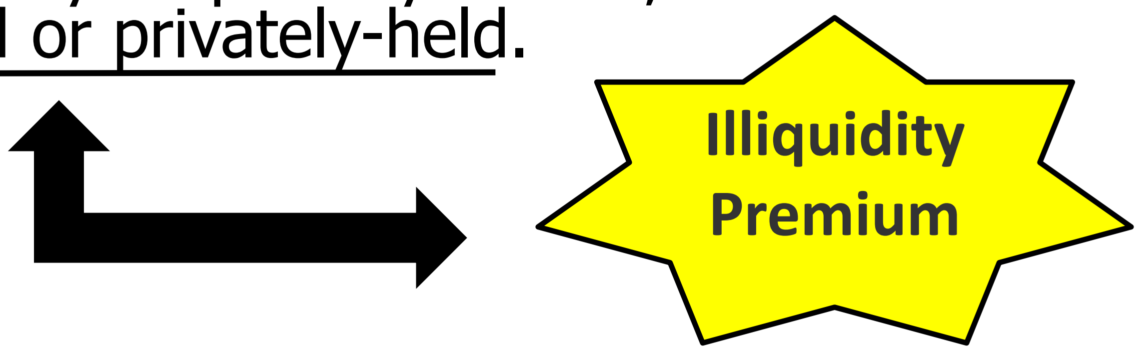
- **Sustainable** - Repeatable, systematic opportunities

Fixed income based → **Direct Lending**

Equity based → **Private Equity Secondaries**

How Does Opportunistic Investing Work?

- Astute and nimble investors can profit from **buying assets at a substantial discount**.
- The ultimate contrarian investment strategy; often involves **buying out-of-favor assets**.
- Some strategies are complex, some are simple.
- Some assets may be publicly-traded; most assets may be <u>illiquid or privately-held</u>.



Characteristics of Opportunistic Investments

- **Return Objectives**

  - Range 8-10% (net of fees) for credit strategies
  - >10% (net) for strategies utilizing equities

- **Securities**

  - Mix of illiquid, private, over-the-counter
  - Public debt and public equity

- **Quality**

  - Dominated by high yield & distressed debt
  - Low levels of investment grade

Characteristics of Opportunistic Investments

- **Term**
  - Closed-end / self-liquidating
  - Trend toward more open-ended vehicles
- **Pricing/Liquidity**
  - Monthly pricing, quarterly liquidity (with notice)
  - Minimal/no requested liquidity if self-liquidating
- **Benchmarks**
  - Absolute return oriented /IRR targets
  - Manager comparisons are not always relevant

Other Factors to Consider

- Simple vs. Complex (minimally understood assets)
- Globally-focused vs. U.S. only
- Long-only vs. Hedging
- Diversified vs. Concentrated
- Leverage

Opportunistic Investment Structures

- **Vehicles**
  - Usually limited partnerships
  - Closed-end or open-end
  - 5 to 10 year term ; self-liquidating

- **Annual Fees**
  - **Management**
    - Typically range from 75 bps -135 bps
  - **Incentive**
    - Usually 10% with a hurdle rate 6-8%
    - Possible high water mark

Events that Create Opportunities

- **Shareholder Activities** – Forced corporate asset sales restructuring, spin-offs
- **Litigation** – Product defects, asbestos, fraud
- **Litigation Finance** – Fund the legal costs of lawsuits and share in the settlement
- **Bankruptcy** – Reorganizations, spin-offs, asset sales at distressed prices
- **Management/Regulatory Changes** – Forced asset sales; Dodd-Frank’s banking reform reserve requirements!

Potential Benefits of Opportunistic Investments

- **Increased Diversification**

  - Low or negative correlations to stocks & bonds
  - Low duration (minimal interest rate risk)

- **Attractive Risk/Return Characteristics**

  - Absolute return targets
  - Relative to other asset classes in portfolio

- **Potential to Increase Plan Returns**

  - Broad exposures to new asset classes
  - May offer capital protection in event of market ⬇

Potential Drawbacks of Opportunistic Investments

- **Potential for Illiquidity** - Capital may be “locked up” for a significant amount of time

- **Investment Complexity** - Investments may be difficult to understand

- **Operational Complexity** - Capital calls and cash distributions over time

Potential Drawbacks of Opportunistic Investments

- **Market Risk** - Extreme price movements, credit spreads, interest rates, etc
- **Strategy Risk** - Investment idea simply is not successful
- **Manager Risk** - Poor execution; lack of skill
- **Structural Risk** - Liquidity or trading restrictions
- **Regulatory Risk** - New legislation, regulations, or government intervention

How Does Opportunistic Investing Work?

With each strategy you should ask…

Event Driven Opportunistic

June to Sept of 2015

- Oil prices drop from $113/barrel to $47/barrel
- Oil stocks drop in price 17%
- Oil **bonds** drop in price 40%-60%

- An oil pipeline company has long-term fixed rate contracts, not related to oil prices.

➡ **Buy** pipeline bonds at $45 and wait for market to realize the company is not impacted by oil prices.

Event Driven Opportunistic

What are the risks?

- Oil prices do not recover (**commodity price risk**)
- The market does not care if the bonds are dollar good or not and bond prices remain depressed.

Risk Mitigation

- Hold the bond to maturity with a 12% yield.

Sustainable Opportunistic Direct Lending

The Cardinal Rule for Successful Lending:

- The borrower has the <u>**ability**</u> to repay the loan, i.e., they have the cash flow and/or assets,
- The borrower has the <u>**integrity**</u> to want to repay.

If both are present, you have a performing loan,
If <u>either</u> is not present, you have a defaulted loan.
Everything else is paperwork!

Sustainable Opportunistic Direct Lending

Your Pension Fund invests in loans already, they are just called **Bonds**.

- Bonds are loans to large corporations or to governmental agencies.
- The loans are large enough that they can be syndicated into securities that are then publicly-traded.

Direct Lending Business Segments

Large Corporate 3,691 public companies	Revenues of $250 million+ Loans are syndicated into publicly traded bonds
Large Private Companies 65,000 companies	Revenues of $50 million to $250 million Loan are privately negotiated
Middle Private Companies 366,000 companies	Revenues of $10 million to $50 million Loans are privately negotiated
Small Business 5.7 million	Revenues of $500K to $10 million Loan are privately negotiated
Consumers 124.6 million households	Home equity lines of credit, car loans, and credit cards.

Large and Middle Private Companies represent a $1.5 trillion loan market

Who Lends to Each Segment?

- **Large Corporate Loans** (and government entities)
  Issue publicly traded bonds, short-term bank loans and commercial paper.

Most likely in your Pension portfolio right now!

Who Lends to Each Segment?

- **Large & Middle Market Private Companies**

  70% of this market is private lenders **(pension funds, insurance companies, etc.)**, less than 30% are banks.

Direct Lending is "banking" without the overhead!

Sustainable Opportunistic Direct Lending

Comparison of Middle Market Lending to Large Corporate Debt Securities

Characteristic	Large & Middle Market Direct Loans	Large Corporate Syndicated Bank Loans	Short Duration High Yield Bonds	High Yield Bonds
Market Size	**$1.5 trillion**	$694 billion	$757 billion	$1.9 trillion
Description	**Senior Secured Lending**	Senior Secured Lending	Unsecured lending to below investment grade corporations	Unsecured lending to below investment grade corporations
Loan to Value Ratio	**Up to 65%**	Up to 70%	Up to 75%	Up to 75%
Rate Risk	**Floating**	Floating	Fixed	Fixed
Loan Duration (Yrs)	**2.5**	2.5	2.2	3.8
Liquidity	**Low**	Medium	High	High
Expected Return	**8-11%**	4-6%	4-6%	4-6%

Sustainable Opportunistic Direct Lending

What are the risks?

- **Loan defaults increase**, reducing returns or creating losses.

Risk Mitigation

- Break-even would require loan defaults to rise from current levels to higher than the interest rate being charged.

- Loans are floating rate, little interest rate risk.

Sustainable Opportunistic Private Equity Secondaries

- Investors purchase existing private equity interests, normally at a discount to the current portfolio value.
- Sellers include financial institutions, pensions, foundations, endowments, family offices.
- Deal flow was over $40 billion in 2015 with a 22% annual growth rate since 2005.
- Geographic distribution: 48% US, 37% Europe, 15% rest of the world.

Sustainable Opportunistic Private Equity Secondaries

Annualized Returns and Standard Deviation								
Time Period	**3 Year**		**5 Year**		**7 Year**		**10 Year**	
As of 12/31/2016	**Return**	**Std. Dev.**	**Return**	**Std. Dev.**	**Return**	**Std. Dev.**	**Return**	**Std. Dev.**
Private Equity Index*	**8.8**	**6.9**	**11.2**	**7.2**	**11.5**	**9.5**	**8.6**	**13.1**
S&P 500	**8.9**	**6.8**	**14.7**	**9.1**	**12.8**	**12.9**	**7.0**	16.4
Russell 2000	**6.7**	**13.0**	**14.5**	**12.8**	**13.2**	**17.4**	**7.1**	20.4
MSCI ACWI ex-US	**-1.8**	**10.2**	**5.0**	**11.9**	**2.9**	**15.3**	**1.0**	20.3
Bloomberg Barclays - U.S. Aggregate Index	**3.0**	**3.5**	**2.2**	**3.2**	**3.6**	**3.3**	**4.4**	3.4
Bloomberg Barclays - U.S. High Yield Index	**4.7**	**6.4**	**7.4**	**5.7**	**8.1**	**6.4**	**7.5**	12.2
HFRI Fund of Funds Composite	**1.2**	**3.7**	**3.4**	**4.0**	**2.4**	**4.6**	**1.3**	6.8
NCREIF ODCE Equal Weighted Index**	**12.3**	**1.3**	**12.2**	**1.1**	**13.3**	**1.9**	**5.6**	8.8

* Hamilton Lane All Private Equity with volatility de-smoothed. Geometric mean returns in USD. The Hamilton Lane All Private Equity Index tracks the performance of all private equity strategies including direct buyout, venture capital, credit, other special situation strategies and Secondaries.

Sustainable Opportunistic Private Equity Secondaries

Private equity has shown the ability to deliver attractive performance over long-term periods…

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Upper Quartile	12%	15%	17%	17%	18%	16%	16%	18%	18%	14%
Median	7%	10%	12%	10%	12%	12%	10%	11%	8%	-2%
Lower Quartile	3%	4%	7%	7%	7%	7%	5%	5%	-4%	-23%

…but manager selection and vintage year diversification are key determinants of an investor’s performance.

Significant dispersion exists among vintage years and the top-performing and bottom-performing managers.

Sustainable Opportunistic Private Equity Secondaries

- **Known pool of diversified assets with multiple vintage years** - Provides both sector and time diversification.
- Immediate cash flow; **no “J” curve.**
- Illiquid investment – **5-7 year term** vs. primary private equity funds with10-20 year term.
- **Predictability** - The potential for outsized returns may be reduced, but so is risk of outsized loss.

Sustainable Opportunistic Private Equity Secondaries

What are the risks?

- **Equity market risk** – Exit strategy is IPO or sale to economic buyers at current market multiples.

- **Management risk** – Risk that the selection of the secondary funds is suboptimal and/or overpaying for fund interests.

Risk Mitigation

- Manager experience and assets are purchased at a discount from current asset values.

Key Takeaways

Opportunistic Investments

- Can be Event-Driven or Sustainable
- Are typically contrarian investments
- Are driven by structural mispricing of assets
- Appear in all asset classes
- Are generally illiquid (but not always)
- Have attractive risk/reward characteristics
- Provide diversification in portfolios
- Have the potential to increase Plan returns

Key Takeaways

How to Succeed with Opportunistic Investments

- Identify your Fund's return goals and acceptable risk level.
- Be open minded.
- Know the liquidity needs of your fund, as these are all illiquid investments.
- Understand how each strategy works, their risks and rewards.
- Work only with experienced professionals in each strategy.