# The Economy and Investment Opportunities in 2009 – the Good, the Bad, and the Ugly

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# Disclaimer

# An Unprecedented Year - 2008

- Financial paralysis and volatility
  - Failures of Bear Stearns, Lehman Brothers, AIG, Merrill Lynch, Citigroup
  - Extraordinary government capital infusions into banks in US and UK
  - Takeovers of WAMU, Wachovia, etc.
  - Government takeover of Fannie Mae and Freddie Mac
  - The end of the investment banking era as Goldman and Morgan become commercial banks
  - Government stakes in financial institutions could dramatically change how they operate and lower their risk appetites
  - Enormous strains on hedge funds and banks as they are forced to delever and redeem
  - Daily moves of 4% in equity markets have become commonplace – in earlier times there were years without such large moves
  - VIX ranging from 40% to 80%, up from 14% two years ago
- US and World economic growth slowing and turning negative as we enter a severe recession
  - Consumption demand fueled by consumer optimism, high asset values and cheap and available credit to borrow against them is over
  - Foreign economies slow along with US land US ed imports decline
  - Current forecast is for an actual decline in GDP in 2009
  - US Monetary stimulus is almost played out as in Japan
  - Only foreseeable relief would be from a fiscal stimulus such as major government infrastructure projects
- Housing, subprime and asset backed issues will take several years to work out
- New “surprises” coming:
  - Commercial paper markets are currently nearly non functioning (government on A1/P1 is helping)
  - Large concerns about counterparties’ abilities to post collateral in the face of exploding credit default swaps levels
  - Credit cards and auto loans
  - Intermediate and smaller sized banks are weak
  - Commercial real estate is marking time as rents and leases come under great pressure

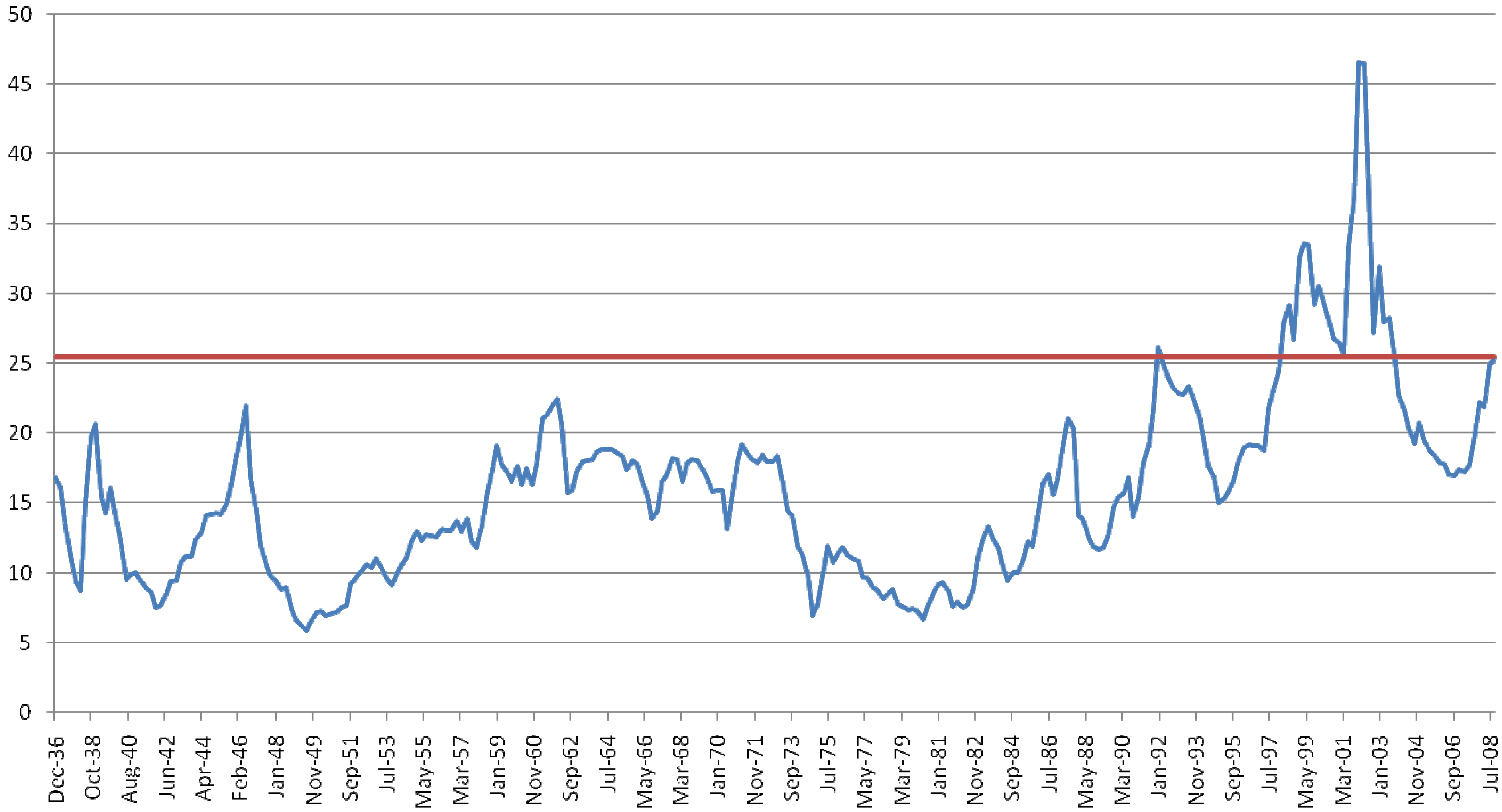
# Going Forward - A Simple Perspective

- Will the recovery be U shaped, V shaped and will it take 6 months, 1 year, 2 years, or a Japan like 10 years?
- Macro: GDP = C + I + (X – M) + G
  - C = consumption (its gone)
  - I = investment – why invest if no one is going to buy what you produce
  - (X – M) = Exports less imports – but foreign economies are in worse shape than we are
  - G = government expenditure and it's all that's left
- It depends on the extent of government stimulus
- We've used up monetary stimulus – rates are low enough
- The financial sector plan is still a work in progress
- Suggests a long U shaped bumpy road ahead

# What will the Stock Market(s) Do?

- Nobody knows – the key question is the extent to which the market has already factored in pessimistic forecasts
- My view is that the market is far too optimistic
- As the attached P/E chart shows, the forward looking P/E is on the order of 25 – hardly cheap and, in fact, close to all time highs
- That is ridiculous
- It is difficult to see what the good news will be in 2009

# S&P 500 P/E
# Trailing ( - ) and Forward ( - ) from 2/12/09



# The Asset Purchase Programs – Fixing the Financial System

- TARP
  - original amount $700b
  - as of January 23, 2008 about $300b had been disbursed:
    - about $200b for capital purchase program – direct infusions into banks for senior preferred stock and warrants (Tier 1 capital)
    - $20b for automobile industry
    - $80b for targeted failing institutions
- Targeted efforts, e.g. CP, have helped unfreeze the top of the market but liquidity requires the secondary market
- TALF (term asset backed securities loan facility)
  - Federal Reserve will lend up to $200b on newly originated consumer and business loans on a non recourse basis
- That leaves the huge overhang of existing asset backed securities to fend for themselves

# The Stimulus Package (G) – A Drop in the Bucket

- The stimulus package - $850b
  - Hardly enough
- It largely replaces expenditures that the states and municipalities would have made anyway; just treading water
- Tax cuts and exhortations to spend to a population that is poorer and may fear for their jobs are unlikely to have a propensity to consume
- World War II and not Roosevelt got us out of the Great Depression – 4-5 million people went to work for the government and we made 100,00 airplanes in one year
- We need a high speed train from Boston to Miami and another one from Seattle to San Diego
- We need 50 nuclear reactors – if France can supply 80% of its electricity with nuclear we could do the same

# What Will Happen to the Banks and their Assets?

- I don't know
- What should happen?
- Effectively through TARP and the capital infusions the government should make it official – (temporary) nationalizaton the 'N' word
- The government should wipe out current stockholders and take over the troubled banks including the biggest
- It should bifurcate the assets and liabilities into a good bank/bad bank
- The good bank would attract private capital and would hold good assets and appropriate liabilities – it would be spun off as soon as possible
- The bad bank would hold the bad assets and many of the unguaranteed liabilities and the government would pick up much but not all of the shortfall and would – RTC like – auction off the bad assets
- I do know this: bad assets will be sold off

# Challenges/Opportunities

- Crises and challenges bring opportunities
  - multifamily housing after the S&L crisis
  - high yield bonds after the S&L crisis
  - arbitrage & credit strategies after the LTCM collapse
  - micro-cap equities after the Internet bubble
- The forced deleveraging of financial institutions and hedge funds combined with the illiquidity of the markets and the loss of credit has left good and even high quality assets greatly under priced
- Throughout 2008 it has been too early to invest in many so called undervalued assets and it is still too early for vast sectors, e.g., equity and equity related commercial real estate

# The Alternatives Industry pre and post 2008

- Pre 2008
  - Managers focused on particular strategies and expertise evolved into mega managers who do mega deals
  - Capital relatively unconstrained
  - This was a fundamental departure from the original model
  - Alternative investments historically produced superior returns for institutional investors
    - risk adjusted returns were high
    - correlations with equity markets and other assets were low
- Post 2008
  - High correlation amongst asset classes
  - Enormous withdrawals from alternatives and industry shakeouts
  - Shaken investor and manager confidence
  - Many funds underwater and many not surviving

# A Tactical Theme for Successful Investing in 2009

- Invest in cash on cash returning assets that have strong principal protection on the downside
- Have security of principal as a the major concern but not liquidity
- Invest in assets that are most impinged by reduced liquidity
- Do not be concerned with mark to market
- Focus on niche assets that are overlooked, neglected or not in adequate supply to attract the bigger investors
- If the market does improve they will prosper but don't make investments that rely on a market improvement to give a good return

# Exploiting the Opportunities

- Create long-horizon portfolios of niche securities whose prices have been most impacted the lack of liquidity in the markets and by liquidity-based selling
- Focus on assets with substantial intrinsic principal protection
- Look for strong cash returns whether or not pricing recovers to normal ranges
- Implement through separate accounts (where possible), run by managers with significant experience
- Possibilities for co-investment
- As markets thaw and growing numbers of institutional investors increase allocations to distressed credit strategies, significant price appreciation may result for earlier investors

# Implementation Implications: Manager Criteria for All Asset Classes

- Smaller managers but experienced and seasoned
- Between $200 million and $2 billion under management
  - enough to maintain a critical mass of personnel and systems
  - adequate fees to cover costs
- Small because their strategy has limited capacity and not because they are unsuccessful or simply because they are new
- Focus on performance
- Niche specialization but nimble
- Inverse relationship between the size of a fund & the number of investment opportunities that it can access per dollar of assets
- Managers who can implement targeted strategies in separate accounts and with negotiated fees

# The Alternative Classes and Examples of Strategic and Tactical Opportunities

- Hedge funds
- Real estate
- Private equity
- Venture Capital

# Hedge Funds

# Hedge Funds in 2008

- Hedge funds are shell shocked
- Redemptions
  - Selling into a falling market
- Underwater relative to their high water marks
- Madoff and funds of funds
- Going forward hedge funds and investors will have to rethink

# Hedge Funds in 2008

- 2008 saw a major reversal of prior years' favorable hedge fund trends
  - factors adversely affecting most hedge funds
    - negative returns to broad equity and credit exposures
    - large declines in liquidity of many securities in many markets
    - unprecedented spikes in volatility and credit spreads
    - significant changes and reversals in government policies regarding intervention in distressed companies and rules governing short selling
  - such factors have led to extreme negative performance for many hedge funds

| Dow Jones Hedge Fund Index 2008 Performance | YTD %Chg |
|---|---|
| Convertible Arbitrage | -49.8 |
| Distressed Securities | -36.9 |
| Event Driven | -27.7 |
| Merger Arbitrage | -7.7 |

# Redemptions

- Redemptions from hedge funds were substantial in 2008
  - some investors redeemed as a result of poor hedge fund performance
    - many hedge funds previously sold as “absolute return” vehicles have disappointed investors
    - many large funds of hedge funds had attracted hot money which departed after negative returns
  - other investors redeemed in order to fund cash needs of other less liquid investments
  - redemptions combined with negative performance have caused 28% decline of hedge fund assets in 2008
  - further redemptions to come, as various large funds blocked year-end redemptions

- In order to fund actual and anticipated investor redemptions, individual hedge funds were forced to liquidate positions to raise cash
  - because of overall leverage in hedge funds, more positions needed to be liquidated than the amounts of cash needed to be returned to investors
  - commonalities across many portfolios held by individual hedge funds meant many hedge funds were on the same side of liquidation trades in order to raise cash
  - largely in-phase liquidation of positions to meet redemptions resulted in crushing downward price moves of many securities held by hedge funds
  - Negative feedback cycle was created:
    - bad performance => increase redemptions => increase liquidation of positions => even worse performance…
    - may last until hedge fund redemptions moderate, as hedge funds are dominant, same-side investor in many securities

# Implications for the Hedge Fund Industry

- Hedge fund landscape is changing rapidly
  - many smaller funds will cease to exist
    - negative performance and high water marks limits possibility of performance fees
    - firms will have difficulty keeping investment talent
    - investors not likely to allocate funds to small, losing hedge funds
  - institutionally-friendly model of largest funds of hedge funds now strongly in question
- The shortfall from their high water marks will challenge the viability of many firms
- Hedge fund performance will be difficult so long as large redemptions (or expectations of them) persist
  - difficult for many hedge funds to generate strong performance against the tide of redemption-based liquidations
  - important to understand the extent and implications of further liquidations by large hedge funds who put up gates in order to slow redemptions
  - whether or not investors remain with large funds of funds will also be a key factor, as large funds of funds have been a major source of previous redemptions

# Hedge Funds as Managers in 2009

- Once clarity on redemptions increases, hedge funds to be favored will include:
  - CDO and mortgage specialists: managers who can identify extreme risk/reward among particular CDO and mortgage tranches and have no legacy problems
  - capital structure arbitrage and convertible bond arbitrage: extreme cross sectional variation and volatility have increased opportunities for long/short trading within capital structure of individual companies
  - financial services debt and equity specialists: extreme moves and volatility of financial services company valuations create opportunities for managers with skill differentiating between companies within industry
  - CDS specialists: managers experienced with trading and hedging CDS exposure who can exploit current high levels of implied default risk and unburdened with legacy positions
  - distressed debt managers: as actual default rates increase, more opportunities for investing in distressed debt will be created
  - micro-cap equity managers: many stocks in this area now trading at or through cash levels
- Managers in above areas will ultimately benefit from
  - high cross-sectional volatility of such securities' prices
  - increases in liquidity
  - broad recoveries in credit spreads and equity prices
- Less emphasis on the crowded 'stat arb' space: avoid 'medium' frequency quant funds

# Investment Opportunities

- Unusual opportunities have been created in securities that have been held largely by hedge funds who have been liquidating positions to fund redemptions
  - securities being sold in order to fund redemptions (or as part of financial institutions' efforts to deleverage), not based on a manager's opinion on the underlying economics
  - most hedge funds and bank trading desks have been on the same side of many such trades (few natural buyers for other side of these trades at present)
  - prices of various types of securities which have been driven down mostly by forced liquidation offer compelling value for investors who can now deploy capital with longer horizons than the liquidating investors who are facing redemptions
    - structured products
    - residential mortgage backed securities
    - asset-backed securities
    - convertible bonds
    - preferreds
    - high yield bonds
    - municipal securities
    - micro-cap stocks trading at or through cash levels
    - closed-end funds

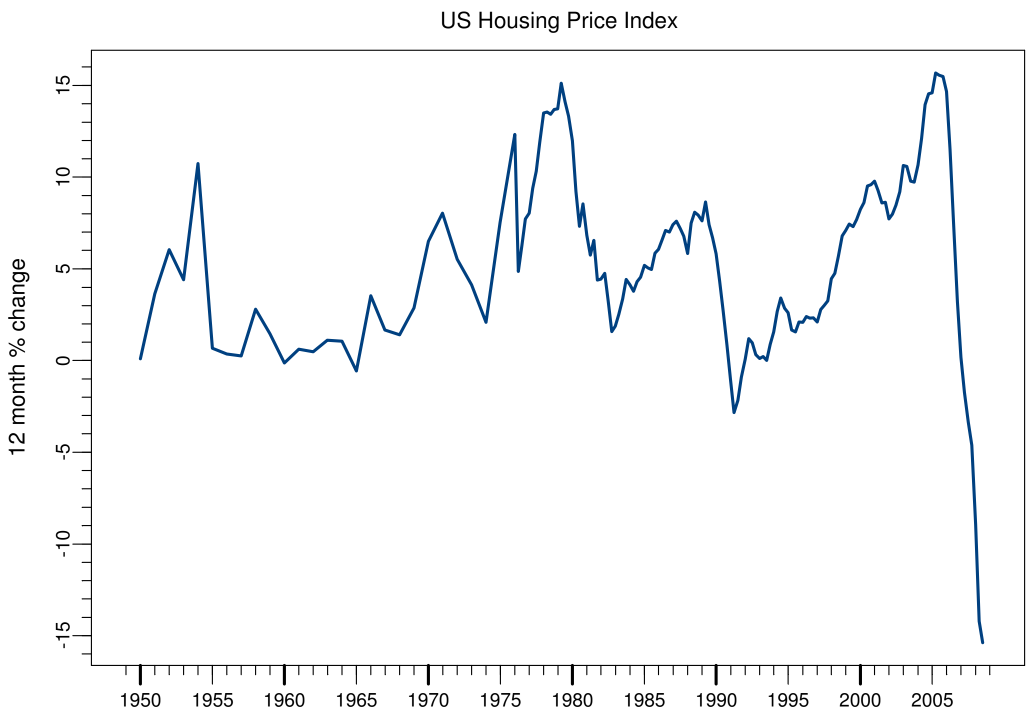
# Real Estate

# Real Estate in 2008

- Commercial real estate is moribund
  - there are no private deals
  - equity real estate is waiting for the rush of bad news
  - leasing risk
  - refinancing risk
- It is too soon to be investing in commercial real estate; the pain coming will dwarf what we have seen to date
  - long term contractual relationships (i.e., leasing and financing) are delaying the day of reckoning

# Real Estate: The Environment

- House price declines are reaching unprecedented post war levels – US nationwide is rivaling worst of California in 1980s



# Real Estate: What is Happening

- The real estate credit market contraction that began in early 2007 is deepening and has spread to the commercial sector
  - available commercial mortgage leverage has decreased from 90% to 60% LTV
  - commercial mortgage spreads over Treasuries have increased from 90 bps to 400 bps
  - the market for new issue CMBS has disappeared (TALF may have an impact)
  - back to the future; CMBS collapse is putting life insurance company lenders back in business
- ‘A slowly moving train wreck’
- Defaults are rising and compounded by a slowing economy
- Still early – many ‘vulture’ purchases are now having significant problems as values have dropped further – suggests equity opportunities in late 2009 and 2010
- Equity REITs are off 50% from their highs, but if they are about 50% equity and 50% debt they imply the underlying properties are only off 25% of their values – a clear underestimate

# The Perfect Storm is Coming

- The perfect storm
- Tenants both retail and commercial are under stress and putting owners and landlords under pressure to alter lease terms
  - retail in malls want to switch from fixed payments to percentage of (diminished) sales
  - office tenants are exploring other opportunities demanding better terms for renewals and looking from A to B buildings
  - FIRE (finance, insurance, and real estate) industry and law firms which support them which is the backbone of signature metropolitan properties (e.g., New York, Boston, Chicago, Dallas, San Francisco) are contracting rapidly
- Refinancing bullets coming due will be nearly impossible for most owners
  - a property with an original value of 100 and an A list of tenants now has an A/B list and a market value of 60
  - the bank wants its original mortgage at, say, 75 paid off and will only issue a new mortgage for 45 (75% of 60)
  - the owner/developer has to come up with the difference

# Private Equity

# What we (should have) Learned about Private Equity in 2008

- What happened to Private Equity in 2008?
- From 1989 to 1998 private equity averaged about 46%/year
- In that same period the market rose about 17%/year
- With 4.5:1 leverage applied to the market returns would have been about 59%/year (4.5 x 17% - 3.5 x 5%) which leaves about 12%/year as the average (2 and 20) PE manager's fee to get to the same 46%/year as private equity
- How did private equity do in 2008?
- Since the market fell by 37% the same logic would say that unlevered private equity would be down 37% (if it was levered like the market) and, depending on leverage, it could be worthless – in other words, private equity underperformed the markets

# Private Equity 2009

- Traditional PE dead: no leverage, no exit
- PE firms morphing into “distressed “ investors
- Approximately $1.1 trillion in junk debt outstanding
- Estimate of 30+% of leveraged PE deals will become distressed
- Opportunities in senior secured debt: selling at 65 cents
- PE firms buying discounted debt in deals where they own the equity: trying to influence the restructuring, minimize the damage
- Firms may buy debt as a way to own the equity after bankruptcy
- PE firms may make direct investments thru convertible preferred as part of a re-structuring

# PE and Distressed Opportunities

- Skeptical of PE firms that are now "distressed"  or "vulture" investors
- Secondary PE interests available at increasingly large discounts as existing investors struggle with capital calls and their own liquidity needs ( UVA fund, Harvard ), but key items like adverse selection (cherry picking), quality of data, vintage year, sponsor actions require careful analysis
- There are opportunities in reorganizations for experts in debt structures and bankruptcy
  - DIP loans, exit financing, prepacks, and bridges – low risk good returns; traditional players ( GE, Citi, B of A ) not in the market
- There are opportunities in the junk debt market
  - Fallen angels: good business caught in tough times
  - Restructurings: good business that was over levered
  - Goners: bad business, over levered, should be liquidated
  - acquire defaulted debt to control a creditor class with "blocking power" over a corporate reorganization to receive a disproportionate interest in a reorganized company
  - structured deals: CLOs and CDOs
  - smarter and safer with whole loans than in synthetics

# Venture Capital

# Venture Capital Prospects

- Has yet to return an initial $1 investment over the past 10 years
- No reason to think this will change in 2009 and in the foreseeable future
  - still too much capital in venture funds
  - relative to too few good opportunities
  - a bet on a return of the IPO markets at strong multiples
- Not enough exit from the industry yet to support a contrarian approach – just too many superior alternatives

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