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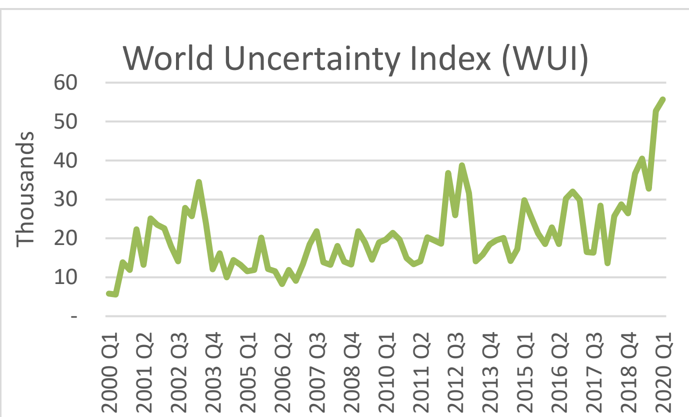
Tactical Hedge Fund Allocation

Seeking Security and Opportunity During Times of Uncertainty *(2 of 2)*

By: Gregory Neal

In *Tactical Hedge Fund Allocation (part 1)*, we discussed using a tactical allocation strategy to increase diversification during uncertain times such as the recent nationwide shutdown. We now want to address the flipside of tactical allocation – **opportunistic hedge fund allocation and strategies.**

As the U.S. and the rest of the world is beginning to reopen, the future is fraught with ambiguity. No one can tell you what's coming next – The *World Uncertainty Index*, created by two senior officials at the International Monetary Fund, is at its highest level in history, with a 52% (as of 3/31/20) increase from this time last year.



Source https://worlduncertaintyindex.com

With this increased level of uncertainty there must be opportunity, and at the risk of sounding overly simple, the first step in investing in these opportunities is finding an attractive set of investments.

Finding Unique Opportunities

New investment ideas can come from numerous sources, but we find that managers on the ground, closest to the action, usually have the best insights. In order to find what you are looking for, it will require many conversations with your current managers, prospect managers, and even completely new managers.

As we speak to managers each day it becomes more and more clear that there are many mispricings across equity and fixed income markets. Now it's just a matter of choosing the opportunity and manager that is right for you.

What We Are Seeing

We're seeing dislocation across several markets, but I want to specifically highlight the **"Fallen Angels"** or corporate bonds that were downgraded from investment grade to high yield during Q1 through to today.

Many of the **attractive high yield opportunities** prior to the global pandemic were companies in challenged industries such as retail and energy, and prospects were limited to good companies with sub-optimal asset or bad balance sheets. However, during the month of March the situation entirely changed, permeating virtually all corporate industries.

We also saw the percentage of the High Yield Index constituents trading at distressed prices (>1,000 bps credit spread) increased from 8.1% to 32.0% during the first quarter.

Numerous Fallen Angels are among that 32% – Going from investment grade to junk and a spread of greater than 1,000 bps in such a short time seems unlikely. In such a short time period this feels more like emotional trading and mispricings in the market. I'm sure some bonds are priced correctly, but I think if you can find a manager that knows the space well, they will be able to take advantage of these large mispricings.

You've now spent the time having the conversations and researching the ideas; you're reasonably sure you've found an appealing opportunity set. What do you do next?

Make the Investment

You need to find a way to invest. If the idea came from a manager that you're already working with and know well. This makes the allocation process as easy as it can be.

But what if the investment is with a new manager you've done limited research on, or an unknown manager altogether? How do we ensure access to the opportunity before it disappears? How do we make the allocation in a way that increases control and mitigates risk?

I see three main ways to access opportunistic investments:

1. Direct Investment
2. Separately Managed Accounts
3. Co-Investment Vehicles

Direct Allocation

Most institutional investors understand what is required when making a direct allocation to an existing fund. This may be the best option for some, but I think in most cases it includes additional complexity and investment strategies and exposures that will not fit within your portfolio.

Separately Managed Accounts

The second option is to use separately managed accounts or SMAs. Using an SMA structure allows you to access the opportunities as well as increase control over other exposures existing in the manager's portfolio.

Co-Investments

The last option is partnering with the manager and investing in a co-investment structure. This formation gives you direct access to the investments you want, without the exposure to the rest of the manager's portfolio.

We're living in uncertain times, with historically low interest rates and reduced return expectations over the next ten years. To me, seizing opportunity is more important than ever. Who knows when the next one will come along? Tactically allocating to opportunistic hedge fund investment ideas will allow you to realize those opportunities quickly and efficiently.

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