PERSPECTA TRUST

July 2016

Headspace

A colleague of mine turned me onto Headspace, a meditation app that helps teach mindfulness, early in the first quarter. The 'foundation pack' introduces the basics of meditation and mindfulness (which are different) – ten minute sessions focused on awareness of surroundings, sensory perceptions, and breathing. The idea is to create some space between you and the perceptions so as not to feel a *part* of them but rather an *observer* of them. A recent Times article[1] describes this mindfulness as "a higher order attention that involves noticing changes around and fully experiencing them in real time…[putting] us in the present, aware and responsive, making everything fresh and new again." The article goes on to relate mindfulness to visiting a new location – the state of being uncertain and unsure creates a heightened sense of awareness and interest in one's surroundings. I remember the first time I dined in the Piazza della Signoria (and the look on the waiter's face when I asked him why they didn't keep Michelangelo's David inside[2]) like it was yesterday, but subsequent visits have not left the same impression.

Mindlessness on the other hand is when "the past is riding herd over the present. We get trapped in categories created in the past, stuck in rigid perspectives, oblivious to alternative views."[3] As any follower of global financial press is acutely aware, the last month has focused on Brexit, the four-month old political phenomenon culminating with a "leave" vote on June 23rd. As a good friend and macro trader told me, for the trading community, it was about the biggest date / time – known event for the markets that he can recall over his twenty year career. Bloomberg was flooded with stories of trading firms bringing in cots, coffee, McDonalds, and other sustainment so speculators could make it through the trading night.

Despite the initial volatility caused by the surprise 'leave' verdict, equity markets have not only shrugged off the news but rallied to new highs. The ~5% decline in the S&P 500 in the two days following Brexit was followed by a ~5% recovery in the ensuing three days, leaving the S&P 500 nearly unchanged over the volatile five trading day session. So why did such a seemingly monumental market event lead to nearly no change in global equity markets?

Some of the reasons are clearer than others. First and foremost, there is plenty of wood to chop before the UK actually exits from the EU. The process for leaving the EU requires the departing member to invoke Article 50 of the Lisbon Treaty, which provides for a two year period to negotiate an exit that takes into account the departing member's obligations and future relationship with the union. Two years is a long time – for perspective, it took around a year from the time the Tories won the May 2015 election (hence tripping David Cameron's promise to renegotiate Britain's membership) and the referendum. Second, the referendum was more of a *political* than *economic* phenomenon. While the long-term investment implications *could be* significant and are an interesting thought exercise, trying to handicap them and forecast the potential impact is likely a waste of brain cells. Economic reality could trump (no pun intended) the political implications, ultimately leading to no material change in relations between economies. Lastly, it's possible that the British feel remorse over the vote once the likely (largely negative, in my view) consequences become more apparent. The election of Home Secretary Theresa May (a centrist who opposed Brexit) to succeed Cameron as prime minister could be the first green shoots of 'Bremorse'.

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[1] May, Matthew. *Achieving Mindfulness at Work, No Meditation Cushion Required*. **New York Times**, 4/23/16

[2] They do, in fact, keep David inside at the Accademia Gallery, but a replica is kept in the Piazza della Signoria where the original was originally placed and sat until 1873.

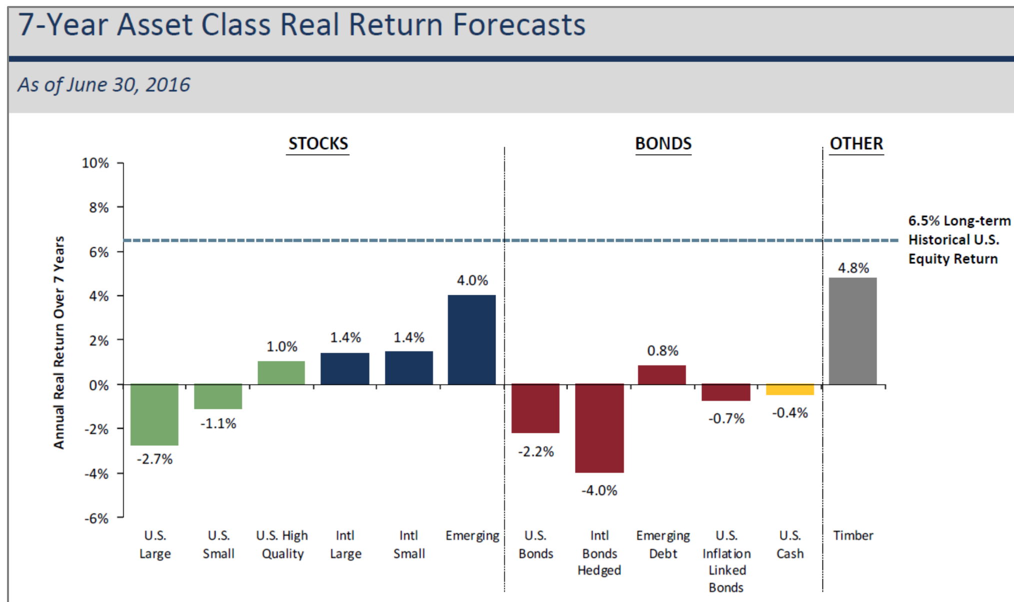
[3] May, *Achieving Mindfulness.*

Further, the quick decline and subsequent recovery is further evidence of the new market paradigm that started around 2009 and continues today. Seemingly negative surprises, whether they be earnings, jobs, Fed / government commentary, or Brexit, lead to a counterintuitive equity market reaction. Whereas the initial reaction to the Brexit surprise (5% market decline) would have likely led to further equity market declines as the impacts of trade, slower growth, and potential contagion were absorbed by markets, the new paradigm is for Brexit to signal a 'lower for longer' rates picture with increased likelihood for additional fiscal and monetary stimulus around the globe.

More specifically, in a recent post on Bloomberg, Mohamed El-Erian writes "For decades, three key beliefs structured our understanding of the economic and financial underpinnings of most advanced countries: that underlying structural forces had matured into understandable, transparent and very gradual drivers of change; that institutions were stable and well-functioning; and that these two solid foundations could withstand the vagaries of short-term political cycles…[this] framework, however, has proved both misleading and dangerous, particularly as it played down or ignored four important underlying developments: (1) the ever-increasing levels of debt and leverage needed to maintain the sense of economic and financial stability, however superficially; (2) greater and more distorting malinvestment in artificial rather than genuine drivers of growth and prosperity; (3) a worsening trifecta of inequality (income, wealth and opportunity), and (4) growing political polarization that fuels and is fueled by a widening distrust of the political establishment, business elites and expert opinion." The ability to be *mindful*, looking at developments with a fresh set of eyes instead of mindlessly adhering to rigid historical relationships, is perhaps more important in today's investment climate than at any time in at least the past decade.

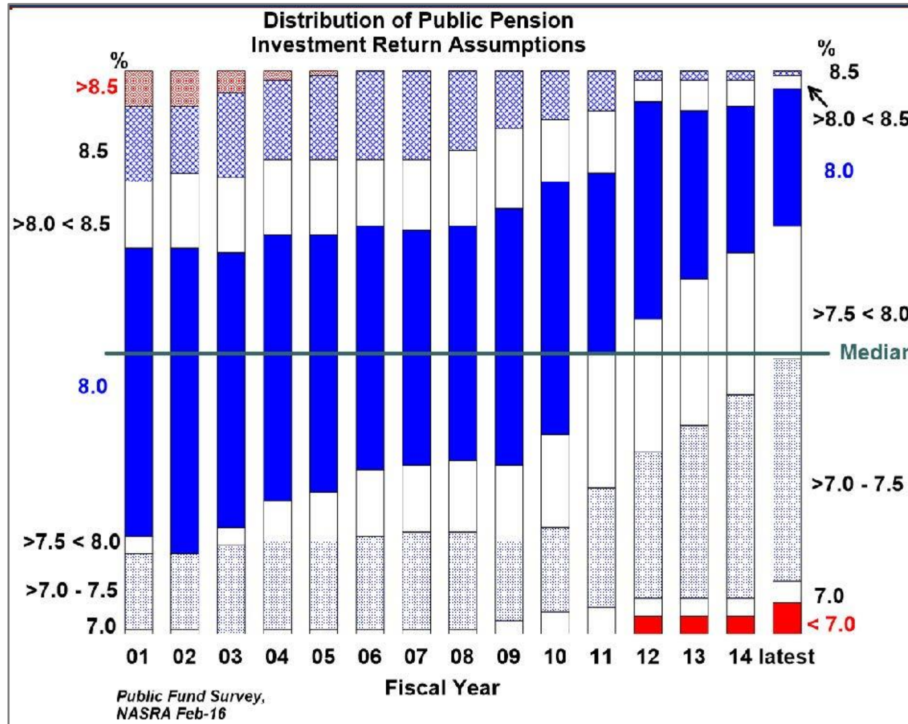
Data-Driven Returns

In a continued effort to be mindful, we look for timely opportunities where good *data* makes a compelling case that returns from a particular investment will fall within an acceptable range around a relatively high target. Targeted returns in the current environment are muted compared with history, as evidenced by GMO's much followed and typically conservative return forecasts:



Per GMO, the asset class with the *best* forecasted real returns over the next seven years (timber) is expected to yield a paltry 4.8%. You can also see how forecasted returns in the current environment compare with the long-term historical US equity return of 6.5%. While our internal return forecasts are slightly higher, it's fair

to say that most aggregate return forecasts are in the mid-to-high single digit range. As further evidence of declining return expectations, following is a chart from the National Association of State Retirement Administrators that shows both the median *nominal* return forecast (7.62%) as well as the change in distribution of *nominal* return assumptions for 127 plans measured over time:



Note that the solid blue section, which represents an 8% return assumption, has gotten smaller as a percentage of the total and gravitated towards the top-end of return assumptions, meaning that the average return assumption has fallen somewhat significantly over the last ~15 years. Further, a growing number of pensions are introducing sub-7% return assumptions for the first time in recent memory. Assuming inflation averages 1.6% over the next thirty years (which is currently implied by the US Treasury markets), real returns are expected to be around 6%. The goal, in our view, is to find opportunities for let's say a 10% real return over the mid/longer-term where we have confidence that our downside case is around the forecasted average of 5.5%. Easy to say, harder to do.

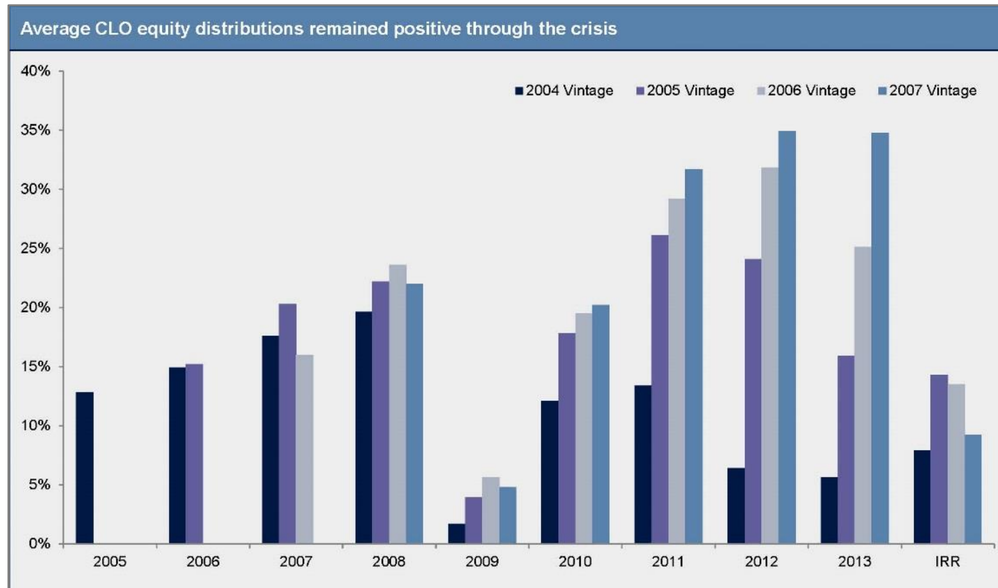
Purchase Options

Our search for data-driven 10% plus real returns is a slog but, a couple times a year, unearths opportunities that we think are truly differentiated. Oftentimes, those opportunities come to us through our network of seventy client families for which we serve as not only trustee or investment manager but also sounding board and potential source of capital. In the world of commercial mortgage backed securities (CMBS), the *fair value purchase option*, a term that most outside of the space have likely never heard of, is a cryptic feature buried within the ~400 page pooling and servicing agreement that governs a CMBS's activities. When a real estate loan that serves as collateral for a CMBS trust goes into default or nears default, it goes from the *master servicer* (entity in charge of collecting and distributing cash flows) to the *special servicer* (entity that controls workout process). Amongst other workout options, the special servicer has the right to purchase the specific defaulted loan from the CMBS trust *at a value that it determines*. In order to avoid obvious conflicts, the valuation needs to consider an appraisal, market conditions, other relevant information, and be

approved by an independent third party.[4] Despite these necessary checks and balances, by investing alongside a special servicer, you are effectively ring-fencing an actionable opportunity set. Further, the size of that ring-fenced opportunity set is significant – at the time of our commitment, our partner was the named special servicer on around $200 billion of CMBS trusts. Assuming that 10% of the underlying loans experience some form of distress, our ~$600 million pool of capital would have the first look on $20 billion worth of commercial real estate. Finally, by targeting vintage 2005-2007 securities with relatively high real estate valuations and lax lending standards, we increase the probability that the flow into special servicing is higher than the aforementioned 10%, thereby meaningfully increasing the opportunity set. Returns to date have been well ahead of our targets, and the opportunity set is just beginning to hit its sweet spot.

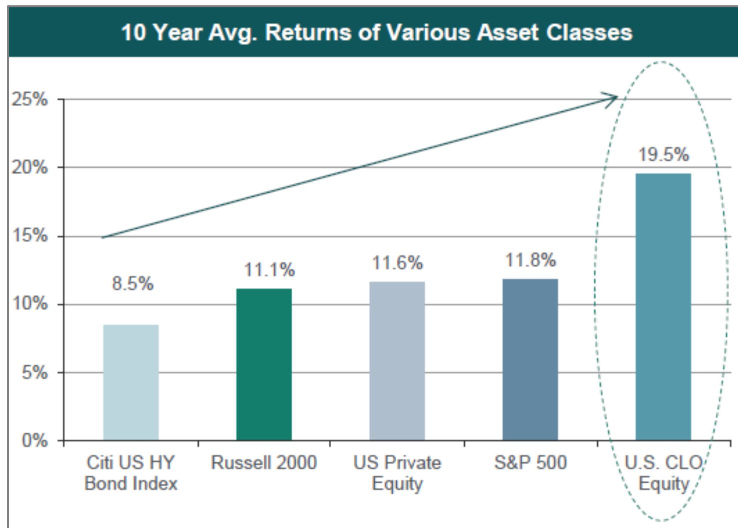
Structured Credit

Another area of focus has been collateralized loan obligations or CLOs. The arcane world of structured credit has many less than favorable connotations following the financial crisis of 2008. Some investors have abandoned the asset class completely. Like any broad asset class, however, it is important to parse the underlying collateral, structures, and return drivers to identify value and find opportunity – ‘fixed income’ and ‘real estate’ generally could provide attractive opportunities whether an investor is looking for 4% returns or 24% returns depending upon where within those broad asset classes you look. Accordingly, residential mortgage backed securities (RMBS) that packaged sub-prime and alt-a mortgages were one way to invest in structured credit pre-crisis; another way would be to invest in CLO equity positions, backed predominately by first lien corporate credit. While the housing decline and associated decimation of the sub-prime RMBS market are well documented, CLO performance might surprise you. Following is a chart that shows cash-on-cash returns to CLO equity investments around and during the crisis:[5]



[4] Commercial Mortgage Securities Association, 15th Annual Convention, June 8-10, 2009
[5] THL Credit

Note that, during arguably the worst time to invest in structured credit / CLOs, cash flows to equity remained positive, and IRRs remained above 6%. More generally, historical CLO equity returns compare favorably to those of private equity and most other asset classes, as shown in the following chart from Citi:[6]



Recent changes to the CLO market provide more investor opportunity and protection than during pre-crisis times. CLO '2.0', which came about post-crisis, generally creates CLO securities that are smaller, have a higher percentage of first lien senior secured loans, shorter reinvestment and non-call periods, and more restrictive indentures. Finally, regulatory changes have made large banks and other traditional buyers apprehensive about holding CLOs, thereby reducing traditional demand and improving potential returns. While we don't expect to earn 20% on new CLO allocations, in light of a dearth of liquid investment opportunities, CLO seems a good place to look for the time being. Further, it fits our data-driven, 10%+ real return target while providing reasonable downside protection.

Conclusion

It's a tough market. As we've written about in the past, the global monetary experiment that's seven years running has created an infinite number of anomalies vis-à-vis historical market regimes and investing cycles. The US presidential election will likely cloud the capital markets with more uncertainty as we progress through the summer and fall. Fortunately, we continue to find opportunity and navigate through difficult markets. Those that read our fourth quarter investor letter would have been well served by increasing allocations to both master limited partnerships (MLPs) and high yield corporate debt, which have handily outperformed most equity and debt markets since our recommendation at the beginning of the year. We'll continue to be mindful, aware, and nimble as we seek good returns in tough markets.

Please let us know if you have questions, and thanks as always for your continued support.

Anthony J. Annino
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[6] Citi Global Structured Credit Strategy. *CLO Equity: The Past and Peek into the Future*. 3/20/15