INCREASING BOND MARKET ILLIQUIDITY IS ADDING RISK TO YOUR PORTFOLIO

IT'S TIME TO CONSIDER FIXED INCOME ALTERNATIVES LIKE PRIVATE DEBT

IT'S NOT THE BOND MARKET YOU ONCE KNEW

By Kenneth Masters & Richard de Silva

When two of the world's most respected bond gurus independently identify the same potential shocks coming to the fixed income market, it's worth taking notice—if not action.

Bill Gross of Janus Funds and Howard Marks of Oaktree Capital Management are hall-of-famers in the investment management world. Both have gone public in recent weeks predicting that the corporate bond markets are in for a rough ride due to conditions created by the Federal Reserve's zero interest rate policy.

We agree with their short-term prediction. We also believe that the implications for long-term portfolio allocation are profound for both institutional and family office investors.

Why have two industry titans turned their backs on the markets that made them rich and famous? For three good reasons that have to do with structural changes in the U.S. corporate bond market: 1) reduced liquidity, 2) low yields, 3) mispriced risk across credit quality.

> Howard Marks and Bill Gross believe the corporate bond market is getting less liquid and risk is improperly priced. Bonds as an asset class are likely to be more volatile going forward.
>
> The key questions for investors: How should they respond to fundamental changes in the marketplace? And, should private debt be in your portfolio?

"Because BB,B and in some cases CCC-rated companies have been able to borrow at less than 5%, a host of zombie and future zombie corporations now roam the real economy."

- Bill Gross, Janus Funds

"Liquidity can be transient and paradoxical. It's plentiful when you care about it and scarce when you need it the most."

- Howard Marks, Oaktree

NO. 1
REDUCED LIQUIDITY

The current corporate bond market is not as stable and liquid as it once was. The bond market today is almost as rambunctious and unpredictable as the equity market. Basel III and Dodd-Frank regulation after the 2007 financial crisis forced banks to step back from market-making operations and proprietary trading. Hedge funds, retail mutual funds and bond ETFs filled the void.

As a result, the arbiters of the new bond market have liquidity mandates that force them to sell to meet daily or monthly redemptions from their investors. They can't simply ride out the inevitable market fluctuations and tend to accentuate moves acting as price followers who sell low and buy high. Despite this shift, which otherwise might have stifled the growth of the bond market, corporate bond issuances over the past years have clocked a record pace fueled by low rates.

BASEL III & DODD-FRANK
A BIG DEAL

Just how significant were the regulatory changes? Structural changes for banks at three levels: balance sheet economics, disappearing branch networks and the elimination of trading.

The Basel III rules, adopted by the Federal Reserve in 2011, significantly strengthened bank capital requirements for "too big to fail" banks by increasing cash reserves and decreasing leveraging. The unintended consequence of these rules is significantly reduced lending to lower middle market and small businesses. Banks are now required to hold at least 7% of equity against risk-weighted assets. Prior to Basel III, it was only 2%. For unrated debt including loans to small and medium-sized businesses,[1] banks must hold up to 5 times more in Tier 1 Capital than for rated public debt to larger companies.

And for the biggest banks which account for 95% of the industry, Basel III requires those institutions to maintain double the ratio of Tier 1 Capital to Total Exposure. Banks therefore avoid unrated bespoke middle market loans and focus heavily on the syndicated loan market, where the loans range from $100MM to $1 billion in size. Banks prefer to lever their balance sheets 5 times more for readily available syndicated loans and bonds than reach for better risk-reward opportunities in the middle market.

The local bank loan officer has virtually disappeared as the number of banks in the US fell from 15,000 to 5,000 over the past 30 years, driven by consolidating branch networks and consumer mortgage origination. Adding to the problem is the Dodd-Frank legislation, signed in 2010 which has put additional costs and compliance pressures on community banks forcing them to engage in further consolidation.

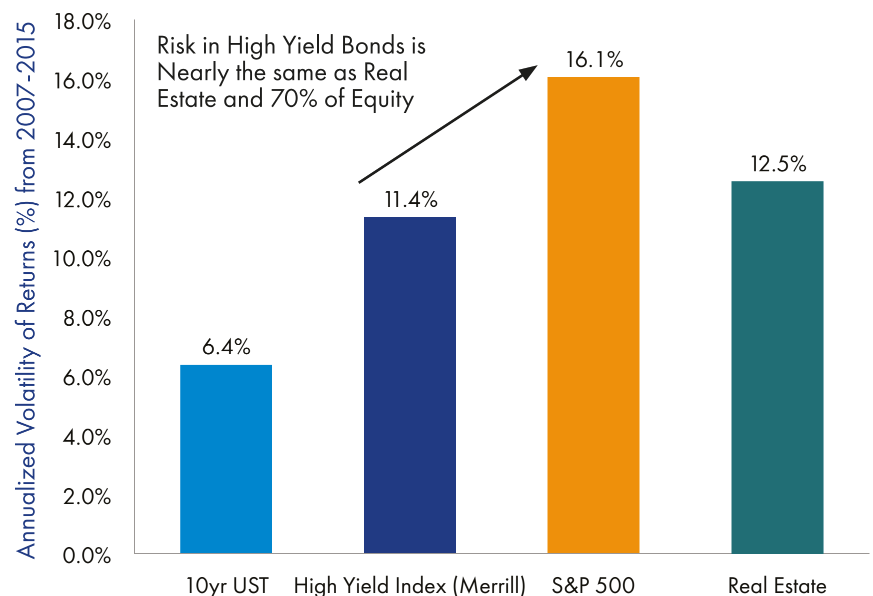
Finally the Volker rule passed with Dodd-Frank prohibited banks from engaging in proprietary trading activity. This led to the dismantling of large proprietary trading desks at major banks, which engaged in both private equity and private debt activity.

[1]KPMG: Basel III: Issues and Implications, 2011. http://www.kpmg.com/global/en/issuesandinsights/articlespublications/documents/basell-iii-issues-implications.pdf.
Padgett, Sarah; The Negative Impact of Basel III on Small Business Financing; July 13, 2013.

NO. 2
LOW YIELDS

Corporate bonds, even in a slowly rising rate environment, are unlikely to deliver returns at historical levels of performance and will probably remain correlated with equities as they have been since 2007. The long-held adage of allocating bonds as a percentage of your portfolio according to your age (i.e., if you're 75, you should be 75% in bonds) no longer makes sense in a market where bond yields are below 5%.

RISK BY ASSET CLASS:
ANNUALIZED VOLATILITY ACROSS ASSET CLASSES, 2007-2015



NO. 3
MISPRICED RISK

Pricing and risk across bond quality have been distorted by the massive universal demand for yield. The spread (or the relative measure of risk) between Treasuries and high-yield bonds has narrowed substantially compared to 20 years ago. There's no reason to believe that high-yield bonds carry lower risk today than they did previously, but you don't get paid a premium for that risk any longer. Yet hedge fund and individual investors continue to buy high yield mutual funds and ETFs for incremental yield and the possibility of liquidity.

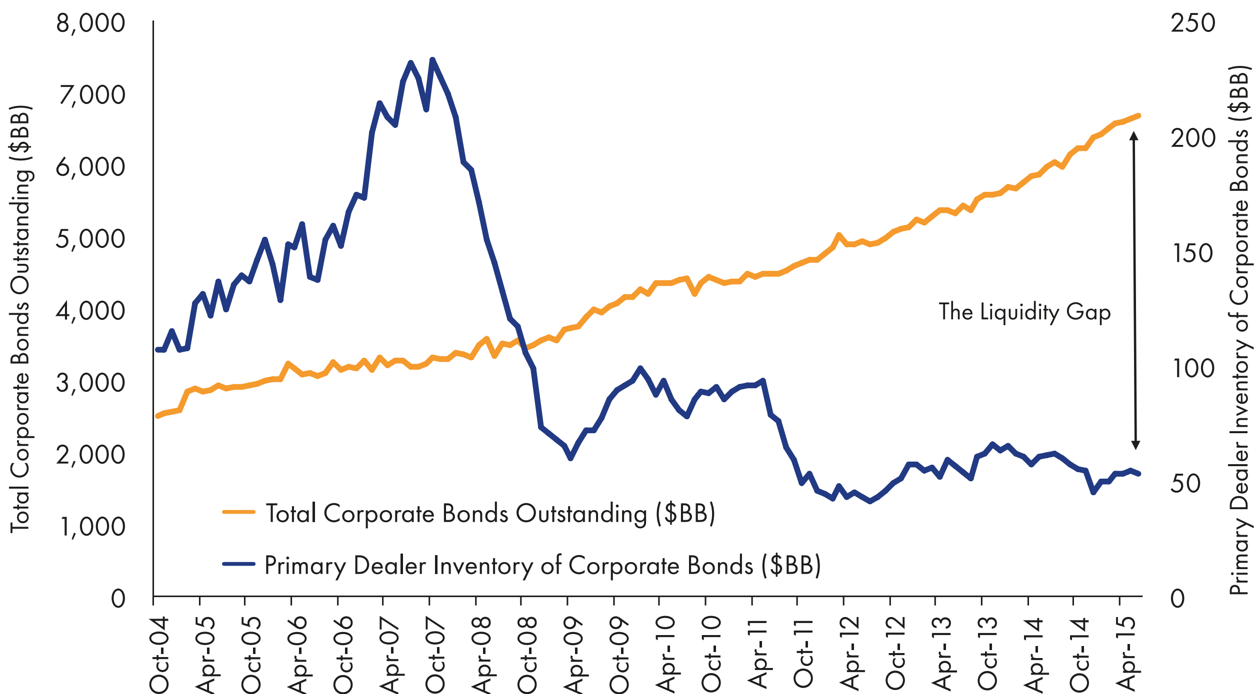
RETHINKING THE BASICS: PRIVATE DEBT

A FIXED-INCOME ALTERNATIVE

If you accept our premise that corporate bonds are vulnerable to major liquidity constraints, and don't generate sufficient income for the accompanying risk and volatility, you undermine the main premise behind most portfolios.

Portfolio theory seeks to reduce risk and maximize return through diversification across asset classes. By investing in equities, fixed-income and alternatives, investors in a well-constructed portfolio theoretically generate non-correlated returns, meaning that when stocks are tanking, fixed income should be less affected.

MARKETS GROWING WITHOUT MARKET MAKERS:
A STRUCTURAL CHANGE IN THE CORPORATE BOND MARKETS



THE KEY QUESTION, THEN, IS HOW INVESTORS SHOULD PROCEED?

We don't think investors should abandon the fixed-income market. Instead, they need to think out of the traditional portfolio box by shifting some portion of their public debt allocation into private debt. This change involves trading off the possibility of short-term liquidity for lower risk and higher returns.

Lateral invests in the debt of private, lower middle market companies with strong assets, proven cash flows and well-defined growth plans. We provide our investors with double-digit yield from debt service, plus substantial upside from the equity positions we take in our companies. We believe this type of alternative fixed-income product offers a significant advantage in this market—current income, principal protection and capital appreciation.

In other words, returns comparable to private equity with limited principal risk, significant uncapped upside and low volatility.

	Public Debt	Private Debt
Target Net IRR	4-6% (BB)	15-20%
Structure/Control and Recovery	Variable; Large Syndicates	Senior; Secured by Capital Stock Pledge
Risk Parameters	Cashflow	Collateral
Term	7 Years	24-36 Months
Information Access	Limited	High
Size of Financing	>$100MM	$5MM-25MM
Borrower's Capitalization	Private Equity-Backed Private or Public	Owner Operated, No Private Equity

THE BOTTOM LINE

Bill Gross and Howard Marks have rung the alarm bell. If your portfolio relies heavily on bonds for liquidity and steady income, you should understand that the zero rate environment of the past few years has rendered your allocation methodology obsolete.

Investments in public corporate bonds are not what they used to be. Consider resetting your portfolio allocation to prepare for potential shocks in the fixed income markets if you believe, as we do, that the Fed will raise rates slowly over the next few quarters.

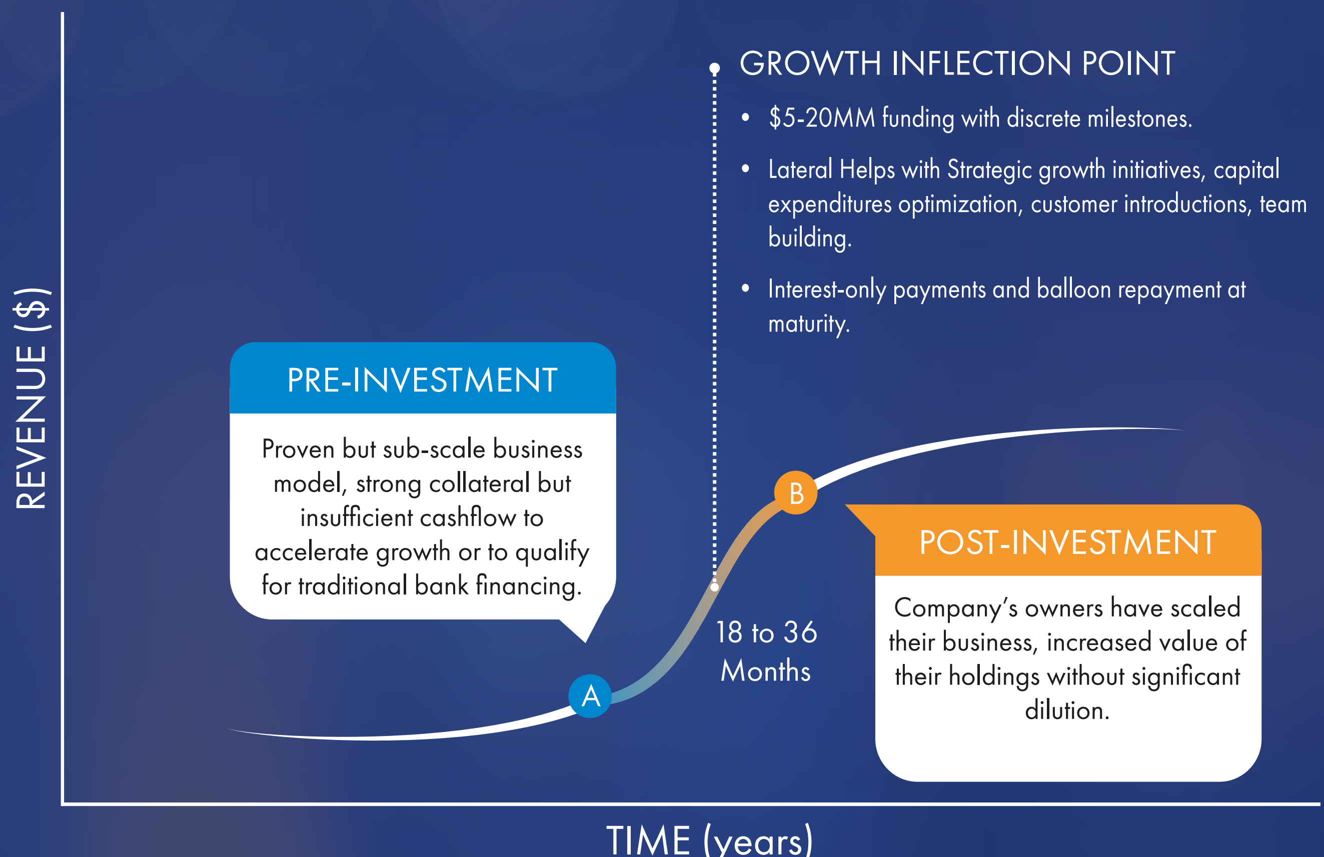
WORK WITH
LATERAL INVESTMENT MANAGEMENT

Lateral Investment Management provides senior secured short-term financing to non-sponsored, lower middle-market businesses, with $10MM-100MM in trailing 12-month revenues. The Fund targets gross returns that are significantly higher than fixed income and private equity benchmarks, with low principal risk, low volatility, and low correlation to the public markets.

We believe this opportunity to generate superior returns results from long-term market disruptions in the U.S. banking system which have reduced access to growth capital for lower middle market companies. The demand for capital far outweighs the supply to this segment.

Lateral provides short-term credit financing to owner-operated or family-owned middle market companies as an alternative to the formulaic limits of bank debt or the dilution of private equity.

- Downside protection, targeting a minimal loss rate while focusing on business building and exit management through value based underwriting and opportunistic exit strategies. The Fund minimizes principal risk by investing in highly collateralized loan positions that are typically short in duration (36 months or less) and senior in the corporate structure to protect both principal and base returns.
- Value-based underwriting: Emphasis on asset-based industries and collateral in the form of hard assets or contracted revenues.
- A short-term “inflection point”: Well-defined opportunity to accelerate growth by 50-100% through geographic expansion, product extensions or acquisitions



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