

The Flexibility Premium

The Case for RP Select Opportunities Strategy



Executive Summary

- Volatile markets are defined by quickly-changing dynamics which put a premium on investment flexibility
- We believe unconstrained fixed income strategies, such as RP Select Opportunities, best meet the needs of investors facing the uncertainties of today’s environment
- RP Select Opportunities’ unconstrained design does not equate to outsized risk – instead the strategy provides the greatest breadth of opportunities to capture upside potential and avoid drawdowns

What Defines an Unconstrained Credit Strategy?

Unconstrained credit strategies are defined by their objective – to earn absolute returns and protect capital in all market environments. However, the name “unconstrained” is somewhat of a misnomer. **Many investors assume that managers are given carte blanche to take large risks with investor capital. At RPIA we view “unconstrained” as the exact opposite. This style of strategy translates to the largest investable universe through which a manager can find value in bond markets and protect capital.**

Strategy Designed For Ever Changing Market Dynamics

While fixed income is always treated as a singular asset class, we would argue that the market is actually composed of very distinct areas with unique risk-return profiles. This also means that where one finds value and risks in debt markets is constantly changing (as evidenced below). Considering how quickly the risk and reward in markets can shift, we believe that investors are best served by finding strategies which apply a level of flexibility that can accommodate the speed and variability with which risks and rewards make their way through fixed income markets.

Value and Risk in Fixed Income Markets are Always Changing

	Global Investment Grade	High Yield	Loans	Bank Capital	Preferreds	Floating Rate Notes	CrossOver	Hybrids
2018	-0.99	-2.08	0.44	-4.04	-4.25	1.50	-2.63	-4.56
2017	5.70	7.50	4.11	10.23	9.10	2.46	7.26	12.07
2016	6.22	17.13	10.16	3.74	1.94	2.06	10.67	7.11
2015	-0.24	-4.47	-0.69	4.29	5.47	0.47	-1.59	0.11
2014	7.60	2.45	1.59	10.74	14.07	0.79	6.52	9.09
2013	0.73	7.44	5.29	2.24	-0.17	1.35	2.08	9+.13
2012	10.92	15.81	9.67	18.39	18.64	4.87	13.17	30.52
2011	4.79	4.98	1.51	1.64	-1.16	-1.23	7.15	-5.48
2010	7.24	15.12	10.13	15.93	14.99	2.03	12.92	11.55
2009	16.60	58.21	51.62	31.97	45.01	9.48	38.23	37.67

Lowest Return | Highest Return

Source: Bloomberg
All index returns based on local currency.

Global Investment Grade = Bloomberg Barclays Global Aggregate – Corp. Bond Index

High Yield = Bloomberg Barclays US High Yield Index

Loans = S&P/LSTA Loan Index

Bank Capital = Bloomberg Barclays Contingent Capital Index

Floating Rate Notes = Bloomberg Barclays Floating Rate Note Index

CrossOver = Bloomberg Barclays US Crossover Bond Index

Corporate Hybrids = ICE BAML Global Hybrid Corporate Bond Index

Preferreds = ICE BAML Preferred & US Bank Capital Index

Utilizing Multiple Levers to Find Value and Protect Capital

In this paper we will discuss some of the levers that RP Select Opportunities uses to find value and manage risks against this ever changing backdrop.

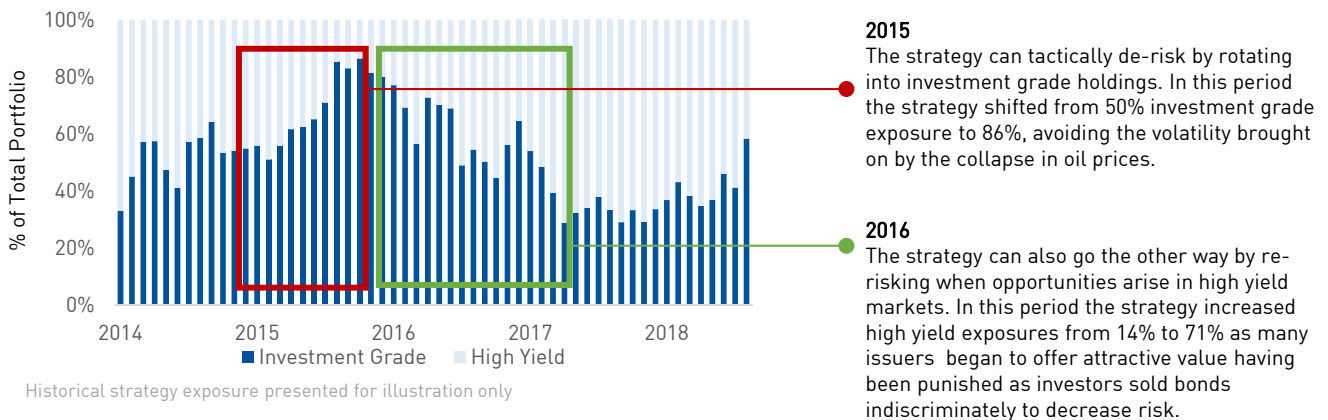
Multiple Levers to Find Value & Manage Risk in RP Select Opportunities Strategy



Investment Grade or High Yield? Not Quite Either

RP Select Opportunities can allocate across both investment grade and high yield markets dynamically as we assess relative risks and rewards in both markets. This variability is by design. **We do not solely focus on lower-rated issuers to produce higher returns at the cost of higher risk. Instead, the strategy will tactically shift between credit ratings categories to capture both yield/return in periods when credit markets are performing well and protect capital by shifting to investment grade sectors when credit markets are volatile.** With no restriction on these allocations, the portfolio manager can find value in all market environments, whether in periods when high yield looks “cheap” relative to fundamentals or when we prefer the relative safety of investment grade issuers.

Dynamically Shifting Exposures Between Investment Grade and High Yield



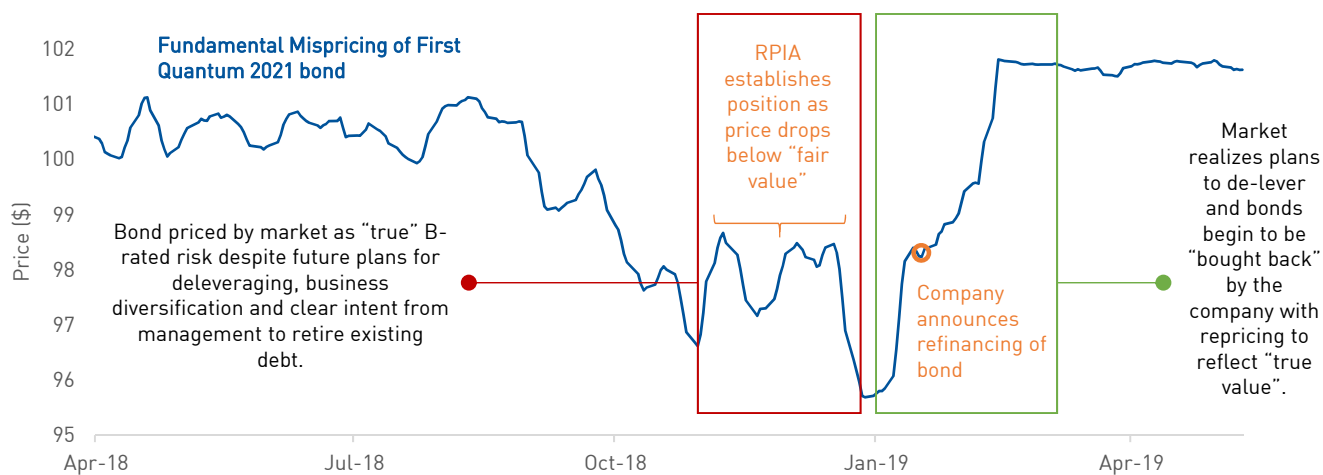
Discovering 'True Value' in High Yield

With the ability to tactically allocate between investment grade and high yield, RP Select Opportunities can quickly shift risk exposure based on market dynamics. However, the strategy will often maintain some portion of its holdings in non-investment grade issuers. This is because we view high yield markets as very inefficient. Unlike investment grade markets, the high yield asset class is extremely bifurcated, spanning a wide breadth of issuers – from those close to achieving investment grade metrics through to distressed companies on the verge of default. This compares to investment grade markets where correlations are higher with fewer opportunities to find relative value. **Because of this dispersion, high yield markets are often prone to high levels of mispricing which leads to compelling investment opportunities for those who can identify “true value”.**

Finding these instances of mispricing comes with a caveat. Investors must take the time to fully understand the credits in which they invest. **However, managers able to do in-depth fundamental research can often uncover high yield issuers who have a clear path towards a higher rating (through plans to de-lever and/or improve the functioning of their core business) but whose pricing does not reflect these realities.** Therefore, discovering “true value” is best served by moving beyond standard metrics for assessing the quality of an issuer. To this end, we often consider “official” credit ratings as lagging indicators that do not properly capture the forward-looking risk inherent in owning bonds of certain issuers. This point is most acute in high yield securities. In this space many issuers often carry a lower rating than warranted by their improving fundamentals and others are often rated much higher than implied by future prospects for the company. This makes building a portfolio based on “official” credit ratings an inefficient way to allocate capital. Instead, at RPIA we find “true value” opportunities through deep-dive credit research including financial statement modeling, meetings with management and constant re-testing of our core investment thesis. This work is done by our dedicated credit research team where each individual has industry specialization. Their in-depth work also ensures we are consistently monitoring risk to ensure we are always “getting paid” for taking on that risk. This also means we can avoid or short those issuers which do not accurately compensate us through yield/return.

This focus on “true value” creates a high yield allocation that is tilted towards higher quality bonds – mainly those which have shown a clear path towards achieving a higher rating and/or moving up within the quality spectrum. Because we often focus in this area our high yield exposure will generally exhibit lower volatility and drawdowns versus broad high yield markets.

In-Depth Credit Research Can Uncover “True” Value That is Mispriced by Markets



Source: Bloomberg
Examples are provided for illustrative purposes only

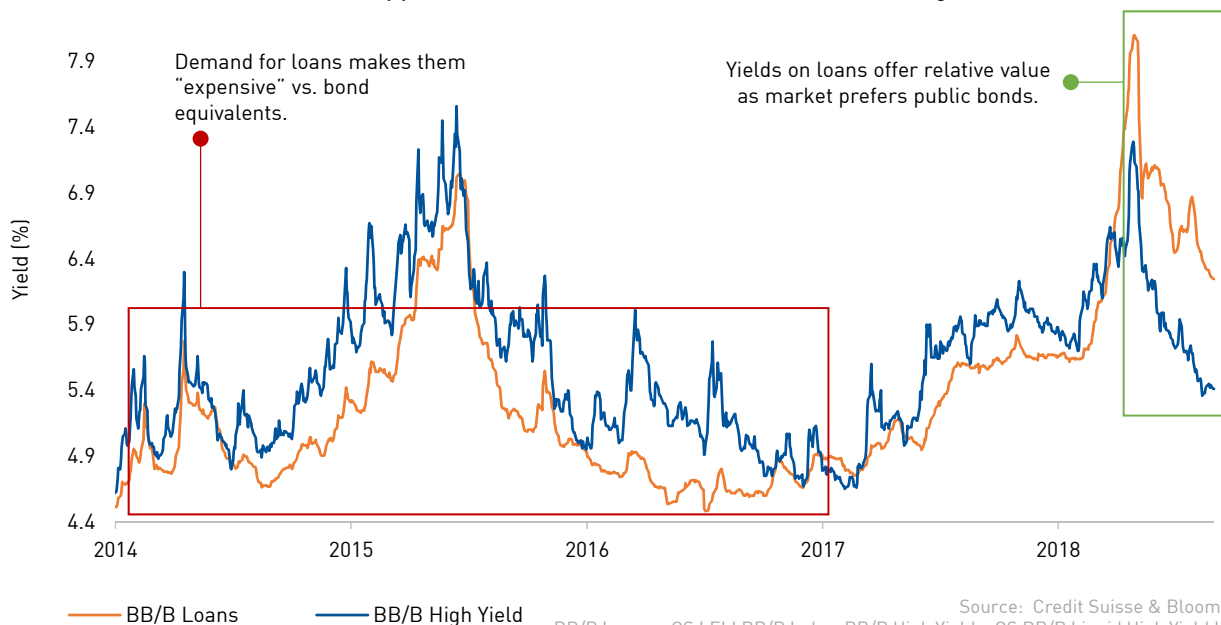
Relative Value in Loans

Outside of traditional fixed income markets, RP Select Opportunities is also able to exploit relative value opportunities in the loans market. Due to the strategy's unconstrained framework, we can express positions through multiple instruments, one of which is a choice between a public bond or a loan equivalent. **This flexibility results in a portfolio which often rotates between public bonds and loans depending on which asset class provides the most relative value and characteristics that fit our targeted risk levels.** For example, because loans often have floating interest rates we find that when market participants are concerned about rising interest rates, loans tend to be "expensive" relative to their public bond equivalents and vice-versa when expectations are for lower interest rates. RP Select Opportunities often finds value by "taking the other side of the market", investing in loans during periods when consensus is pricing them "cheaper" to their relative risk and avoiding/shorting when demand has made loans too expensive.

Loans also often sit more senior in the capital structure, typically above public bond equivalents, which makes them inherently less risky and a viable way to reduce risk while still capturing attractive yields. In addition, many issuers have become 'loan-only' issuers which means that certain, high quality company debt can only be accessed through loans as they no longer issue public bonds. The ability to invest in loans alongside traditional bonds means the strategy's investable universe is incrementally larger than traditional bond funds.

RP Select Opportunities employs a nimble approach to the relative value equation between bonds and loans by buying the instruments which offer the best value-versus-risk and rotating between the two as market dynamics change. For this reason we focus only on liquid, broadly syndicated loans which allow us to apply our active style to this section of the market without taking on undue liquidity risk.

Relative Value Between Bonds and Loans Means Better Opportunities to Earn Excess Returns and Manage Risk



Investing in the Grey Zone of Hybrids and Bank Capital

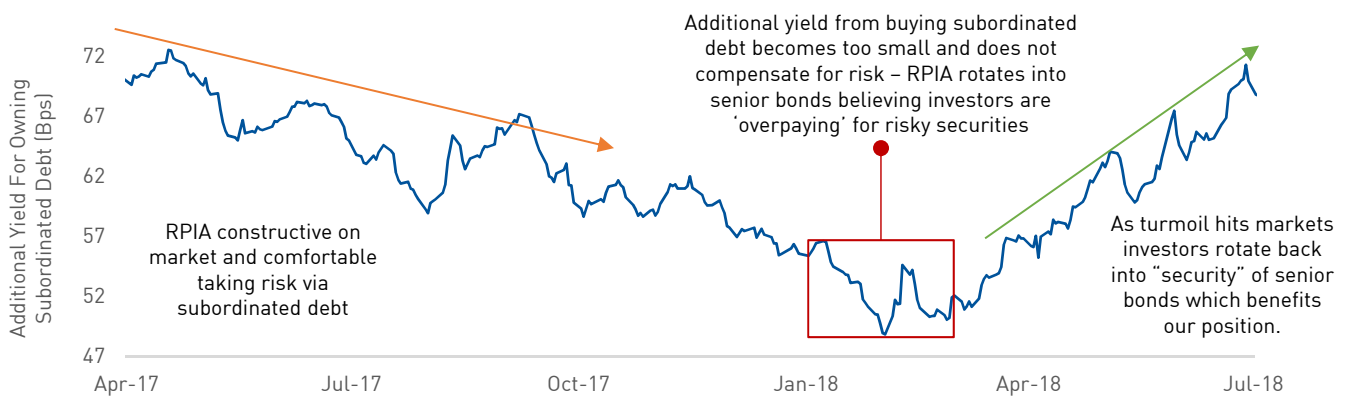
Another key part of RP Select Opportunities "go anywhere" philosophy is our ability to invest in instruments which are bond-like in nature but have features which make them unique from plain "vanilla" bonds. These instruments (which include contingent capital, preferred shares and corporate hybrids) are often complex structures that make it hard to accurately price the underlying credit risk of this instruments.

RPIA has a long history of investing in these types of securities. Because these instruments are not commonly understood we often find that this area of the market exhibits many inefficiencies that provide opportunities to earn a higher yield than would be implied by the underlying risk. On the other side of the equation, because we are able to accurately price underlying risk we can also tactically avoid instruments which do not offer enough compensation relative to these risks or even short securities that we believe are overly expensive. Similar to our argument for high yield, the complexity of these instruments leads to persistent opportunities for both long and short positions as many market participants do not fully understand the risks underlying the bonds they own and thus are pricing them incorrectly.

The flexibility in hybrid investing also applies to bank capital whereby a manager can invest in a single bank issuer through a multitude of capital instruments which have a wide array of risk profiles. Global financial issuers often have a debt capital stack which includes many different types of debt instruments - from secured debt to senior unsecured obligations and subordinated debt with some tied to regulatory capital requirements and others that have both equity and bond-like features. This means that even when a manager is constructive on a financial issuer they have many choices in terms of how to express this view. More importantly, their choice of instrument can significantly change the risk profile of their portfolio.

Within RP Select Opportunities we often rotate throughout a bank’s capital structure based on market dynamics – preferring more senior bonds to lower overall risk and extending into subordinated debt when we are comfortable taking on more risk. **By investing across the capital structure, we are also able to maintain exposure to issuers that we fundamentally like but can alter the strategy’s risk profile in times of market stress by rotating into more senior positions in the capital stack (all while maintaining exposure to the bank issuer which we are constructive on).**

Rotating Between Senior and Subordinated Debt Can Actively Change Risk Profiles



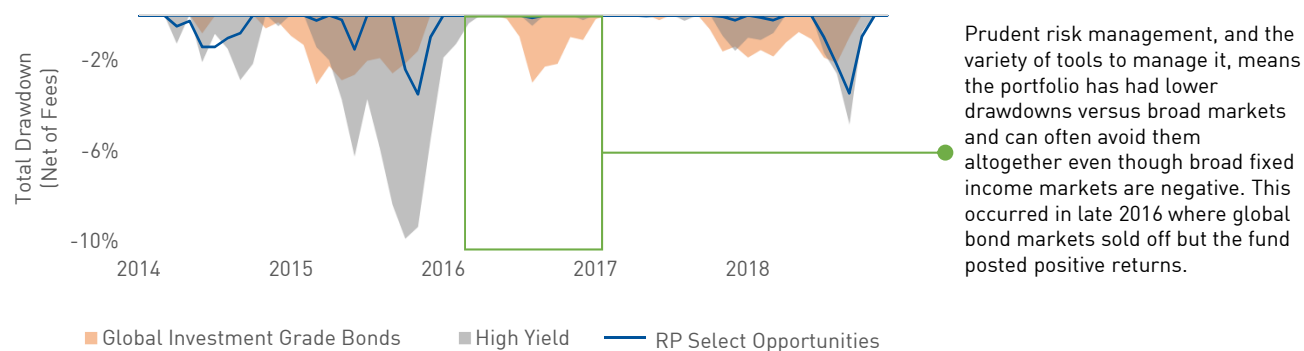
Source: Bloomberg
 Spread difference between Bloomberg Barclays US Senior Financials Index less US Subordinated Financials Index
 Examples are provided for illustrative purposes only

Hedging Away What We Don't Want

Outside of the multitude of levers the strategy has to generate returns, we also designed RP Select Opportunities with the added flexibility to hedge risks that we believe are un/undercompensated, leaving us with only the risk exposures we want. This includes removing interest rate risk from the bond portfolio (a risk which often dominates traditional fixed income solutions) and reducing market beta so that the performance of the strategy is less reliant on the general ebbs-and-flows of broad fixed income markets.¹ We achieve this in several ways including index credit default swaps (which provide protection against the general negative moves in both investment grade and high yield markets), shorting of individual bonds (which provide positive performance at times when other core conviction positions may be underperforming) and shorting of other instruments which track broad markets such as fixed income ETFs (which cover a variety of global credit markets and unique sub-asset classes). **The use of dynamic hedging across all these options allow us to produce a return profile above major indices but with much less volatility and drawdown risk.**

¹ The risk that comes with owning a passive exposure to broad fixed income markets (systematic risk)

Dynamic Hedging Translates to a Changing Risk Profile With Less Downside Risks



Source: Bloomberg
Global Investment Grade = Bloomberg Barclays Global Aggregate – Corp. Bond Index, High Yield = Bloomberg Barclays US High Yield Index
Examples are provided for illustrative purposes only

Conclusion

RP Select Opportunities has many levers through which it can earn excess returns and manage downside risk. **The unconstrained format means that the strategy can change its positioning quickly which best matches the fast-paced nature of today’s markets where value and risk can move quickly from one section of the market to another.** RP Select Opportunities was built to be unconstrained in all avenues, whether by capitalizing on market inefficiencies to earn excess returns or by better protecting capital through a wide variety of hedging tools. RP Select Opportunities is built specifically for today’s environment in which there is true premium on flexibility.

Please feel free to contact the Client Portfolio Management Team with any further questions on how investors can utilize RP Select Opportunities in their portfolio.

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