DMS / 20 2000 - 2020 YEARS

GOVERNANCE. RISK. COMPLIANCE.

THE DMS MARKET REPORT

All is well in the investment world as I write this report - stock markets are hitting new highs, Brexit is going to happen and even the U.S. /China trade war is making progress. PE firms are rolling in money, debt defaults remain low and currencies and commodities are stable. So, what are the issues to consider in 2020? The heart of the matter is Central Bank control and loose monetary policy which is fueling the equity markets and letting the market speculators know the central banks will always bail out the market if it gets into trouble.

Private Equity and Private Debt are growing exponentially, and concern over this is muted as it is private and not public, so what's the problem? The funding via commitments and credit lines are increasing exposures, making these harder to monitor and many deals are inter-market and so do not have to justify public market scrutiny.

At the same time as Central Banks are intervening in the fixed income markets, their regulation cousins are increasing their oversight with the investment world via a mountain of rules and reporting processes.

Looking at this scenario, while increased regulation is good for firms like DMS, excessive regulation can be a problem for all, particularly if the interpretation of the rules starts changing. With that in mind I have included a section on UCITS regulation and how the regulators are beginning to tighten the rules around them.

DEVELOPMENTS IN THE PE MARKET

The main trend of increasing fund size continued throughout 2019. U.S. PE funds of at least $5 billion accounted for over half of all fundraising through the third quarter of 2019, a record for the past decade, according to PitchBook's 3Q 2019 U.S. PE Breakdown. This means there is no shortage of investors flocking to this asset class, particularly to buyout funds. A consequence of this trend is that exits are getting longer and many are focused on selling to larger platforms, therefore taking longer to build value. In Europe, however, multiples have not been as robust as in the U.S., reflecting the continued political uncertainty.

DMS PE FUNDS

All the private bank platforms overseen by DMS continue to see good growth with new funds being added almost quarterly. However, concern over getting the balance right is leading some to seek out lower risk profile GPs as well as GPs that have a good understanding of the relationship between private and public markets and what it takes to achieve a successful IPO. Technology and data mining are also playing a role here, where AI is helping find successful strategies to help transform target company investments.

Performance wise, private values in tech were obviously affected by the revaluation of WeWork and the fallout of this remains to be seen in the long term. PE Energy funds continue to suffer. Healthcare, real estate and credit continue to be favourite

sectors. An increasing number of funds however are leaning towards Impact Investing, yet the main problem is finding GPs that have a successful track record in this area.

DEVELOPMENTS IN THE PRIVATE DEBT MARKET

There are currently three macro trends in the private debt market:

1. lenders are highly focused on larger hold sizes and growing their asset base to provide single lender solutions to PE-backed businesses;

2. lenders are offering more debt products and continuously looking for gaps in the market and evolving their security types to address balance sheet gaps as an example, we are seeing more capital formation around "structured capital solutions" which are debt-equity hybrids used to finance stressed/troubled credits; and

3. focusing on unsponsored transactions to widen the opportunity set.

Large private debt funds are now entering into more direct competition with the syndicated markets (e.g. the Daisy Group financing by Ares) at the upper end, while at the other extreme there is also more liquidity available to the lower end of the mid-market. This space is less competitive, it attracts a pricing premium owing to the riskier profile of borrowers and is welcoming the product while banks seem to have less appetite. One of the key objectives for debt fund managers is to remain invested in credits they know and that have grown, instead of being refinanced on the first occasion. The result is that lender protections under loan documentation have become increasingly loose, private debt funds lending to the mid-market have generally retained the key leverage covenant rather than going entirely "cov-lite". In addition, some private equity managers indicate their portfolio monitoring is not solely focused on debt covenants. They assess performance on KPIs, which are more stringent and thus can provide a warning to management and shareholders.

In general, the market trend is higher risk aversion, with higher premiums and an increasing focus of direct lenders on the top of the credit risk structure. High multiples have also meant PE deals are now more equitized, due to the reluctance of credit funds to extend leverage.

DMS PRIVATE DEBT FUNDS

The DMS Credit funds mandate continues to grow with existing funds rolling out their next series. DMS helps put together often complicated master/feeder structures for these funds using the Irish ICAV as the conduit to comingle and pass through investors funds. New sectors for Private Debt funds such as Aircraft Leasing, Shipping and Special Situations mean DMS will use its structured finance division to manage these arrangements. New funds in non performing loans, CLO's and Special Situations are also increasing.

DMS REAL ESTATE FUNDS

Real Estate funds continue to grow, particularly in Ireland where one fund, where DMS retains the investment management, recently completed a successful trade sale of the largest commercial site in the country, demonstrating that a depth of understanding and the ability to move quickly ensured the investors generated a tidy return on their investment. Another of DMS' retained funds is currently acquiring nursing homes and looking at social housing investments.

Similarly, our European property funds are developing a portfolio of core assets that will either be bought out by another fund or engaged in an IPO.

Valuations tend to be the contentious area for the AIFM. Deciding what is the attributable value of development projects tends to be more of an art than a science and invariably the external valuer will be cautious and only consider current value, while investors, managers and potential buyers look at future value, meaning forward sales conditional on delivery are commonly seen. Often, as AIFM, DMS must arbitrate on this issue between the various stakeholders.

DEVELOPMENTS IN LISTED EQUITIES MARKET

Rising equity markets fueled by huge growth in passive ETFs, low interest rates and large tech platforms have caused a wider dispersion in intrinsic values. The underperformance of relative value strategies and growth strategies has never been more stark. There continues to be record dispersion in valuations with all the multiple (earnings) expansion occurring in the most expensive part of the market. This provides plenty of opportunities for Value traders but there are consequences and it is important that investors understand what the different investment styles mean. Value often means uncorrelated returns, longer investment holding periods and poorer liquidity profiles.

DMS EQUITY FUNDS

All DMS equity funds performed well in 2019. There were some tracking errors on ETFs due to Dividend Drag, Currency Hedging and Fees but otherwise performance was in line with expectations. Value Funds underperformed but were still positive. Asian Equity Funds had some higher volatility but generally had a very positive year.

DEVELOPMENTS IN LIQUID CREDIT MARKETS

Spreads in the loan market in general widened throughout the year, but with default rates remaining historically low, performance in 2019 was steady but not spectacular.

DMS LIQUID CREDIT FUNDS

DMS liquid loan funds found a new wave of opportunities this year in switching from European loans from European companies to U.S. loans from European companies. Pricing differences between the two markets allowed some funds to gain extra return without increasing their credit exposure. Similarly, the prominence of CLOs in this space mean that any rating of company's credit by the rating agency will lead to a re-weighting within the CLO basket. This often causes a loan to be substantially mispriced. There is a feeling in the market that rating agencies were caught sleeping at the wheel during the credit crunch and as a result are now a touch overreactive.

DEVELOPMENTS IN THE FUND OF FUNDS MARKET

Underperformance continues to be a constant challenge for these managers, while selecting the right pool of talent to stay ahead of the game is important. Machine learning, AI and Cryptocurrencies have become an increasing interest in this sphere.

DMS FUND OF FUNDS

DMS fund of funds performed well in 2019, in line with most industry benchmarks. The real challenge here appears to be reserving capacity with the right managers to meet investor needs. Many managers provide specialist mandates and have a combination of funds and managed accounts, both of which DMS can accommodate if required.

DEVELOPMENTS IN THE ALTERNATIVE LIQUID MARKET

2019 proved to be a successful year for many CTAs with most indices ending the year in positive territory. The big mover was U.S. interest rates where the easing of monetary policy saw yields fall up to September. After the equities fall in Q4 2018, many entered the year short, but quickly turned around as the rally continued. Energies provided significant volatility and in general commodities and currencies did not add a great deal.

DMS ALTERNATIVE LIQUID FUNDS

Most funds demonstrated positive performances, however, raising assets continues to be a problem in this area. Allocation to the sector in expectation of the sell-off in equities appears to have abated.

UCITS REGULATION

Liquid alternatives funds cover the world of UCITS in Europe. This structure has the advantage of providing the investor with the comfort that invested instruments need to be eligible for inclusion in a portfolio. In addition, many risk-based rules exist to ensure liquidity and manage risk. These rules are strictly enforced and reported should they be breached. DMS operates pre-trade monitoring where it has retained the portfolio management and also on some delegated mandates to ensure compliance. All UCITS funds have daily post-trade monitoring.

The Central Bank of Ireland has recently emphasized the requirement for investments to be both eligible and suitable. Liquidity, post the Woodford UCITS debacle in the UK, has become an increasingly contentious area. Many UCITS managers also used the 10% "Trash Bucket", i.e. the part of the fund utilised for less liquid and non-listed instruments in order to give them some flexibility and enhanced returns. The regulator is coming down hard on this and many instruments that were allowed previously are now being discouraged. These include; Contingent Convertible Bonds (CoCo), Collateral Loan Obligations (CLOs), Contract for Differences (CFDs), US Exchange Traded Funds (ETFs) and anything that does not have reasonable liquidity to enable redemption needs.

Liquidity in determining suitability is going to come into sharper focus when the European Securities Markets Authority "ESMA" stress testing comes into force in September 2020. Most managers will use their historical redemption profile and match that against the average investment position volumes to determine liquidity. Mitigating factors such as the number and size of the investor base of the fund plus the provision of gates or discretionary mandates may allow them to argue that the funds liquidity profile is fine.

HOW TO DETERMINE LIQUIDITY?

In the extreme case, if the fund has daily dealing and no gates possible, the funds needs to have full 100% liquidation of all investments within a day. As the dealing NAV extends out to two weeks, (the maximum allowed between dealing days for a UCITS fund), the investment liquidity can also be extended. If gates are imposed, say 10%, then investment liquidation period can be further extended.

TRASH BUCKET

Many UCITS managers use up to 10% of the funds exposure to hold illiquid instruments. The expectation from regulators is that these instruments need not be illiquid but "less liquid". What this means in practice is that these instruments will probably be the last to be liquidated but they must be able to meet the 100%

redemption. No historical redemption profile or mitigating factors will be considered, meaning that when considering what securities will go into a trash bucket, for a daily dealing fund with 10% gates, it would have to be realizable in 10 days.

If an instrument is consequently viewed by the regulator as ineligible or unsuitable, the manager may have to compensate for any loss incurred, so it is important that this is correctly managed.

STRESS TESTING

In addition, in September 2020, ESMA stress testing will be introduced. This means that both the investor redemption profile and the investment instruments profile will need to be tested. If full redemption is always expected, which is the formula that DMS adhere to, then there is no risk here but stressing instrument liquidity could become an issue.

CLOSET INDEXING

Closet indexing has been described by ESMA as a practice whereby asset managers claim, according to their fund rules and investor information documentation, to manage their funds in an active manner while the funds are, in fact, staying very close to a benchmark and therefore implementing an investment strategy that requires less input from the investment manager and charge management fees in line with those of funds that are considered to be actively managed.

Following the Central Bank of Ireland's recent thematic review of UCITS Index funds, DMS has carried out extensive testing and a review of its UCITS funds to ensure they are not closet index funds.

There were three tests used:

1. Tracking Error Volatility ("TEV") – The TEV obtains the difference between the movement of the UCITS and the movement of the index and measures the volatility of that difference. UCITS with lower TEV are more likely to be potential indexing funds.

2. Beta – The line of best fit between the movement of the UCITS and index is obtained using a linear regression. Analysis of the line of best fit is performed to see if the UCITS move in line with the index.

3. R2 – Is also linked to the line of best fit, R2 is the variation in the UCITS explained by the variation of the index.

In carrying out the review, the CBI determined that the following criteria would establish if a UCITS met the threshold to identify potential closet indexing funds (the "Central Bank Closet Indexing Threshold"), namely:

- Tracking Error <3.5%
- Beta 0.9 – 1.1
- R^2 >0.9

DMS ALTERNATIVE LIQUID FUNDS – UCITS

DMS has many UCITS Funds and is constantly managing this evolving process. Our view is that the industry will need to understand that the regulators will become increasingly aggressive in the area and only the most vanilla of strategies will be allowed to remain as a UCITS fund. This means we have needed to develop procedures in order to monitor and track more closely the funds that are higher risk of breech. We have also been engaging more closely with our clients to help them understand how these trends are developing.

CONCLUSION

There is no doubt that despite higher equity markets, the geopolitical tensions such as U.S. China trade war, U.S. Election and Brexit are causing concerns within the investor market. However, responses by regulators and central banks remain equally important from the fund industry perspective. Regulations continue to drive many of the DMS client solutions and access to Europe, particularly from the U.S. seems to many to be harder than ever. Ironically, in the drive to create a single-market, events appear to be spinning it in the opposite direction.

We look forward to keeping you updated on future market trends as we add to this series on a regular basis and we hope that you found the material both valuable and thought-provoking.

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