Morgan Stanley

INVESTMENT MANAGEMENT

Hybrid/Opportunistic Funds Offer Differentiated Risk-Adjusted Returns In Challenging Markets

INVESTMENT INSIGHT | 2022

Traditional long-only public market investments are facing pressure from multiple forces ranging from rising interest rates and asset class correlations to inflation and economic slowdown, following years of success amid relatively liberal capital markets and suppressed volatility. The shift has prompted investors to reconsider how to rebalance and optimize portfolios and examine a variety of new approaches from asset type utilization to reviewing strategic and tactical allocations. This trend is causing a transition from liquid public markets to alternative private investments. Public equity markets have been offering increasingly narrow exposure across fewer long-standing names. Private markets supplement and complement that contraction. To a lesser degree, credit investors are entering private markets to achieve a truly diversified portfolio of yield, a migration that started with the zero interest rate policies during the global financial crisis and that has continued into the current rising rate environment, which favors shorter duration and floating rate instruments, among other investments. Investors who have preferred neatly categorized formal portfolio allocations are now questioning whether they should consider broadening their investment options, and in this paper we examine some of the opportunities offered through private hybrid/opportunistic funds to lessen the impact of current market challenges.

AUTHORS

DAVID FRECHETTE
Managing Director
Alternatives Distribution Management

PATRICK REID, CFA
Managing Director
Alternatives Distribution Management

Key Takeaways

- Current environment forcing a reconsideration of traditional asset allocation
- Hybrid funds may provide differentiated sources of return taking advantage of supply-demand imbalances
- Post-GFC specialized hybrid funds are benefitting from the flow of investments which historically may have been owned by the proprietary investment teams at investment banks
- Various market conditions may be favoring this type of investment style

Understanding Hybrid/ Opportunistic Funds

Hybrid/opportunistic funds encompass a wide range of asset classes and instruments aimed at decreasing portfolio volatility and reducing market beta. In general, these funds have more liberal mandates to invest across asset classes and to utilize specific instruments that may not fit into a current investment category or traditional investment mandate. While traditional investing may simplify portfolio allocations, the undercapitalized, underrecognized, un-catalogued, and under-pursued investment opportunities can offer the highest risk-adjusted returns. Hybrid/ opportunistic funds act as customized capital solutions providers to companies with unique liquidity needs. These funds are advantageous because they can invest across the capital structure and use a variety and combination of investment instruments to create unique risk-reward profiles.

Historically, these type of capital solutions were provided by proprietary desks at investment banks, which were able to offer flexible solutions and capital efficiently because their mandates were so broad. The banks themselves ultimately benefitted from these investments. Capital provision by proprietary desks ceased after the global financial crisis, when the banks reverted to their core banking businesses. Subsequently, these bespoke capital solutions are now offered to those with capital or liquidity needs by private funds, which enable their investors to benefit from this flexible investing style.

DISPLAY 1

Current Market Landscape

Conditions that Make Hybrid/Opportunistic Investing Attractive

Rare Opportunity

Hybrid/opportunistic strategies seek to achieve their objectives through nuanced investments that are often difficult to source, highly customized, bilaterally negotiated, and time sensitive. Many deals require differentiated analysis, detailed expertise of the industry or markets, and/or specialized structuring capabilities. Some are too small to attract attention from larger institutions, while other deals are limited to smaller communities of investors who know the niche markets and businesses involved. Specialized funds can earn a premium because so few capital sources offer mandates flexible enough to provide this capital or liquidity. Moreover, the expertise to create these investment solutions is rarified.

It is prudent for investors to seek areas of the market where the supply-demand balance is in their favor. Finding these supply gaps has historically driven enhanced risk-adjusted returns, especially when investments contain combinations of liquidity, complexity, and scarcity/ structuring premiums. Returns consequently tend to be alpha-oriented and less correlated to traditional assets, complementing portfolios by providing excess returns over traditional markets,

and other times providing differentiated returns and downside risk protection. There are always strategic opportunities for those with the skills and talent to see what others don't. In this case, investors are outsourcing this capability to dedicated, specialized teams with liberal mandates that are intentionally opportunistic.

Windows of opportunity open and close without warning and having a dedicated hybrid strategy allocation could be extremely valuable, reducing the risk of mistiming or lacking available capital. Often, the advantage of the hybrid model is flexibility accompanied by execution expertise. Consider it a complexity premium with a willingness and capacity to structure and tailor a deal to alleviate risk without sacrificing premium. Hybrid funds tend to be very bottom-up focused and less disrupted by traditional market movements. Hybrid/opportunistic strategies respond dynamically, moving with conviction, judgment, and discipline to capture opportunities that less-equipped investors miss.

Why Now?

Currently, investors are evaluating portfolio allocations in the light of changing markets dynamics that impact their mix of alpha (specific or idiosyncratic risk) and beta (market risk, volatility, and shifts in supply and demand). Our colleague at Morgan Stanley Wealth Management[1] wrote presciently about considerations around directional-only passive beta risk at the start of 2022 and the need to take a more considerate approach to identifying differentiated active sources of return. By design and objective, hybrid/opportunistic investing falls squarely into this camp.

Efficient markets hypothesis (EMH) suggests that markets price in all available information to create accurate valuations. In a perfect market, there are no transaction costs, information is free, and investors are rational and share expectations, thereby creating efficient markets. Within the world of hybrid/opportunistic investing, we see several factors at play that undermine market efficiency. With the growing range of available investments, increasing volatility, and constraints around information exchange, transparency, and access, certain areas of the market, particularly the private markets, offer an edge to skilled investment professionals. Especially during times of heightened stress or volatility, certain managers may achieve attractive differentiated results. Many traditional and alternative investments can provide a form of diversification, but correlations are abnormal and can spike in times of stress. Hybrid funds are diversified across asset classes, with some, such as royalties, remaining uncorrelated even among themselves. These true non-correlating properties, along with contractual protections in the structuring of some deals, may generate attractive true non-correlated returns.

Before we delve more deeply into some of the specific investments considered by hybrid/opportunistic funds, it's useful to provide some context for the current investing climate. Most significantly, the supply-demand dynamic between capital seeker and provider is shifting toward supplier.

Structuring Alpha

In the current environment, capital needs are at a premium and the capital provider may have heightened influence in their ability to negotiate pricing and structure optionality around the transaction to obtain enhanced contractual downside protections. Some of these structures result in differentiated returns, or structural alpha, for the capital provider.

Weakening M&A Cycle

The supply of capital is typically much tighter following a protracted period of robust mergers and acquisitions and deal activities. In a typical M&A cycle, deal volumes and values initially decrease in keeping with an economic downturn, often prompted by external events. In this environment, hybrid/opportunistic funds can be the provider of capital capable of plugging a liquidity gap at attractive terms for the capital provider.

Staying Private Longer

Less regulatory oversight, inflation, recession fears, and broad market volatility are among the many reasons why some companies delay initial public offerings. The IPO market has significantly slowed in 2022, and many companies that went public in recent years are now trading below IPO prices, suggesting that public markets are demanding more maturity for new issuers. Also, within private markets, there is heightened sensitivity around traditional private equity rounds of financing. Due to current market conditions, companies worry that a "down round", (financing in which a company sells shares of its capital stock at a price per share that is less than the price per share it sold shares for in an earlier financing), will be perceived negatively. Companies are looking at different ways of structuring their financing to shore up capital. This opens significant opportunities for hybrid/opportunistic investors with liberal mandate requirements enabling them to structure investments attractive to both parties. Moreover, many growth companies are pivoting hard from spending to bolster top line growth. Traditional private and public capital markets are unable to provide the capital they need.

Transaction Speed, Certainty, and Confidentiality

Sometimes companies prefer to transact privately, with a limited set of capital providers executing transactions quickly and efficiently. Hybrid/opportunistic funds offer the flexibility, access, and expertise to achieve these goals with certainty and speed regarding structure, terms, and rates.

[1] Passive Investing: The Right Strategy for 2022? | Morgan Stanley by Lisa Shalett, Chief Investment Officer, Wealth Management. January 4, 2022.

Volatility

Capital needs are exacerbated in periods of heightened volatility, as supply-demand gaps widen. During moments of volatility and market disruption, several circumstances occur:

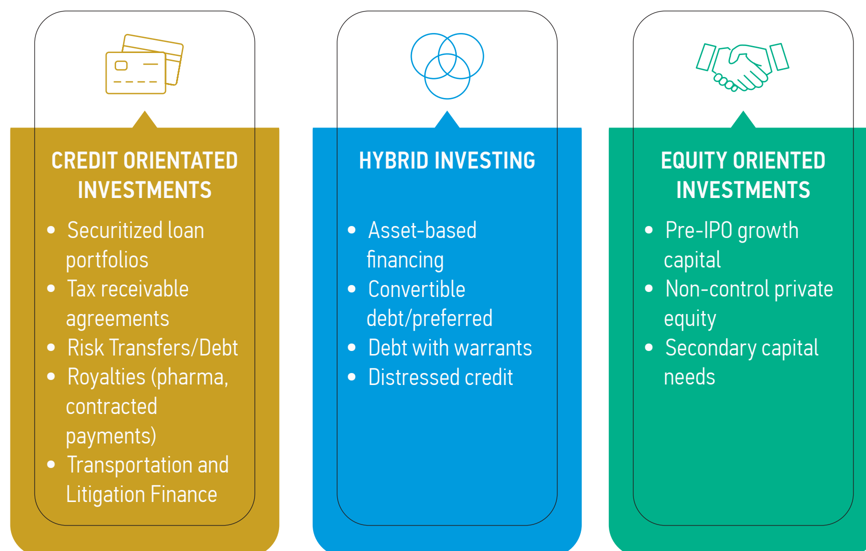
1. Issuers' need for capital may increase and/or accelerate through cash flow constraints, or the business plan requires additional capital
2. Sources of capital may become more expensive, harder to find, or dry up
3. Regulatory constraints are imposed (prop desks are restricted from participating)
4. Tourist investors (institutions that don't typically have roots in venture capital) re-focus on primary areas of investing or retrench as noted below
5. Liquidity constrained investors seek liquid assets

Retrenchment

During periods of market exuberance, investment firms may stretch beyond their comfort zones into other areas in a bid to boost returns through differentiation. Over the past few years traditional hedge funds have leaned into more private growth-orientated investments, but in times of stress, there is typical retrenchment back to core mandates. Pullback often creates opportunities for investors with flexible mandates who are dedicated to the space.

DISPLAY 2

Flexible mandate enables opportunistic funds to structure unique and tailored capital solutions



Conclusion

Hybrid/opportunistic funds are unconventional and invest in opportunities that require expertise and sourcing. These investments can be episodic, hard to access, and complex, but they can generate attractive differentiated risk-adjusted returns. Current market conditions create more opportunity for hybrid investing gains. **Understanding the overall objective of hybrid/opportunistic funds requires evaluating the profiles of potential investments and why they may suit the current environment. Offerings include payment-In-Kind (PIK) instruments, warrants, royalties, and tax receivable agreements (TRAs).** Hybrid/opportunistic investments may provide a unique diversified return source with low correlation from traditional investments that investors cannot capture on their own.

IMPORTANT INFORMATION

Diversification does not eliminate the risk of loss.

The views and opinions and/or analysis expressed are those of the author or the investment team as of the date of preparation of this material and are subject to change at any time without notice due to market or economic conditions and may not necessarily come to pass. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date of publication. The views expressed do not reflect the opinions of all investment personnel at Morgan Stanley Investment Management (MSIM) and its subsidiaries and affiliates (collectively "the Firm"), and may not be reflected in all the strategies and products that the Firm offers.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors or the investment team. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific strategy or product the Firm offers. Future results may differ significantly depending on factors such as changes in securities or financial markets or general economic conditions.

This material has been prepared on the basis of publicly available information, internally developed data and other third-party sources believed to be reliable. However, no assurances are provided regarding the reliability of such information and the Firm has not sought to independently verify information taken from public and third-party sources.

This material is a general communication, which is not impartial and all information provided has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

The Firm does not provide tax advice. The tax information contained herein is general and is not exhaustive by nature. It was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer. Each Jurisdiction tax laws are complex and constantly changing. You should always consult your own legal or tax professional for information concerning your individual situation.

Charts and graphs provided herein are for illustrative purposes only. **Past performance is no guarantee of future results.**

The Firm has not authorised financial intermediaries to use and to distribute this material, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this material is appropriate for any person to whom they provide this material in view of that person's circumstances and purpose. The Firm shall not be liable for, and accepts no liability for, the use or misuse of this material by any such financial intermediary.

This material may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this material in another language, the English version shall prevail.

The whole or any part of this material may not be directly or indirectly reproduced, copied, modified, used to create a derivative work, performed, displayed, published, posted, licensed, framed, distributed or transmitted or any of its contents disclosed to third parties without the Firm's express written consent. This material may not be linked to unless such hyperlink is for personal and non-commercial use. All information contained herein is proprietary and is protected under copyright and other applicable law.

DISTRIBUTION

This material is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

MSIM, the asset management division of Morgan Stanley (NYSE: MS), and its affiliates have arrangements in place to market each other's products and services. Each MSIM affiliate is regulated as appropriate in the jurisdiction it operates. MSIM's affiliates are: Eaton Vance Management (International) Limited, Eaton Vance Advisers International Ltd, Calvert Research and Management, Eaton Vance Management, Parametric Portfolio Associates LLC, and Atlanta Capital Management LLC.

This material has been issued by any one or more of the following entities:

EMEA

This material is for Professional Clients/Accredited Investors only.

In the EU, MSIM and Eaton Vance materials are issued by MSIM Fund Management (Ireland) Limited ("FMIL"). FMIL is regulated by the Central Bank of Ireland and is incorporated in Ireland as a private company limited by shares with company registration number 616661 and has its registered address at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland.

Outside the EU, MSIM materials are issued by Morgan Stanley Investment Management Limited (MSIM Ltd) is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

In Switzerland, MSIM materials are issued by Morgan Stanley & Co. International plc, London (Zurich Branch) Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland.

Outside the US and EU, Eaton Vance materials are issued by Eaton Vance Management (International) Limited ("EVMI") 125 Old Broad Street, London, EC2N 1AR, UK, which is authorised and regulated in the United Kingdom by the Financial Conduct Authority.

Italy: MSIM FMIL (Milan Branch), (Sede Secondaria di Milano) Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy. **The Netherlands:** MSIM FMIL (Amsterdam Branch), Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. **France:** MSIM FMIL (Paris Branch), 61 rue de Monceau 75008 Paris, France. **Spain:** MSIM FMIL (Madrid Branch), Calle Serrano 55, 28006, Madrid, Spain. **Germany:** MSIM FMIL (Ireland) Limited Frankfurt Branch, Große Gallusstraße 18, 60312 Frankfurt am Main, Germany (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Denmark:** MSIM FMIL (Copenhagen Branch), Gorrissen Federspiel, Axel Towers, Axeltorv2, 1609 Copenhagen V, Denmark.

MIDDLE EAST

Dubai: MSIM Ltd (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158).

U.S.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

ASIA PACIFIC

Hong Kong: This material is disseminated by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this material have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this material shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This material is disseminated by Morgan Stanley Investment Management Company and may not be circulated or distributed, whether directly or indirectly, to persons in Singapore other than to (i) an accredited investor (ii) an expert investor or (iii) an institutional investor as defined in Section 4A of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"); or (iv) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. This publication has not been reviewed by the Monetary Authority of Singapore. **Australia:** This material is provided by Morgan Stanley Investment Management (Australia) Pty Ltd ABN 22122040037, AFSL No. 314182 and its affiliates and does not constitute an offer of interests. Morgan Stanley Investment Management (Australia) Pty Limited arranges for MSIM affiliates to provide financial services to Australian wholesale clients. Interests will only be offered in circumstances under which no disclosure is required under the Corporations Act 2001 (Cth) (the "Corporations Act"). Any offer of interests will not purport to be an offer of interests in circumstances under which disclosure is required under the Corporations Act and will only be made to persons who qualify as a

"wholesale client" (as defined in the Corporations Act). This material will not be lodged with the Australian Securities and Investments Commission.

Japan
This material may not be circulated or distributed, whether directly or indirectly, to persons in Japan other than to (i) a professional investor as defined in Article 2 of the Financial Instruments and Exchange Act ("FIEA") or (ii) otherwise pursuant to, and in accordance with the conditions of, any other allocable provision of the FIEA. This material is disseminated in Japan by Morgan Stanley Investment Management (Japan) Co., Ltd., Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

Explore our site at **www.morganstanley.com/im**

© 2022 Morgan Stanley. All rights reserved.

CRC 2522979 Exp. 11/15/23 10305884_KC_1022
US