FOCUS

Covid-19 tail risk shows importance of true uncorrelated returns

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During SYZ's annual alternatives conference in January, CQS founder Sir Michael Hintze foretold the assembled group of influential investors an imminent pandemic could hit global markets.

This 'black swan' moment, he predicted, would create an asymmetric shock leaving far-reaching consequences for the world's economy and financial system.

Just weeks from his prophesy and we have witnessed Covid-19 shred global markets. Fragile valuations havebeen dismantled and portfolio diversification is againunder pressure. Meanwhile, global policymakers are scrambling to prevent economic contagion.

Marc Syz
CEO Syz Capital

MARKET PANDEMIC

While we did not expect a pandemic to arrive so soon, we were acutely concerned about valuations. In the weeks before the pandemic, our proprietary asset allocation model pointed to a late-stage economic environment. Many investors were entering or increasing exposure to a very stretched and overlevered private equity market. In both our traditional asset classes and alternative investment portfolios, our models were signalling a discrepancy between valuations across a range of risky assets and their return potential. This already prompted us to reconsider our asset allocation and risk exposures.

Our objective is to curate an investment experience in segments of private markets overlooked by most traditional investors because of size, complexity or inadequate duration.

Therefore, we dedicate our research capabilities to finding truly uncorrelated and better priced investment opportunities. One illustrative example of this process has been our exposure to litigation finance, where we finance legal claims, the returns of which are truly uncorrelated to capital markets.

Litigation funding is a fast-growing asset class, in which a third-party funder financially supports a claimant in a legal dispute. In exchange for this support, the funder requires either a multiple on cost or a percentage of future proceeds. The practice has its roots in antiquity. Athenians would act as third party to and champion cases. Apollodorus, a wealthy banker's son, was well known for buying shares of lawsuits and hired professional orators to write his court speeches.

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CLASSICAL PRACTICE

In more modern times, litigation finance was re-ignited in Australia in the late 1990s, quickly spreading to the UK, the US and other jurisdictions, including Brazil and Singapore. There are clear and growing market needs for third-party funding for accounting reasons, agency issues and cost savings.

The practice has allowed for David and Goliath stories to hit the headlines in recent years. For example, tiny British firm Miller won a huge payout from US construction giant Caterpillar, which was accused of stealing the secret to a vital piece of heavy machinery.

The asset class requires high expertise to enter, is resilient to market cycles and has a repeatable framework, allowing it to produce attractive and stable returns. The percentage of global law firms that are exposed to litigation funding has grown from 7% in 2013 to 36% in 2017. The UK is the most mature market for litigation funding, despite the US being the Targest. The US market is also the most competitive, due to claimants not being liable for defendants' costs and law firms fully assuming cases on their balance sheet.

Only a fraction of the litigation market is currently funded, indicating a global opportunity for catch-up. However, it is important to partner with experienced litigation funders that need to be hand-picked for their extensive network, proven track record, unique market access and structured execution capabilities. Diversification is also is key to any strategy, as the distribution of returns is leptokurtic, implying a great degree of higher and lower return outcomes.

Due to these dynamics similar to music royalties, as popularized by David Bowie during the 1990s, litigation finance represents the expansion of securitization into a new asset class frontier – and a new source of diversification. Litigation finance is uncorrelated to financial markets such as equities or fixed income, and will thus offer great diversification benefits in a portfolio context. The sector is also not correlated to the performance of the greater economy; market downturns generally lead to an increase in lawsuits, hence deal flow.

UNTAPPED OPPORTUNITY

The market is largely untapped, with few cases ending up in heavy competitive processes. Hedge funds and other forms of purely financial capital do not have the expertise to fund single cases, as deep relationships with law firms are required, as well as human capital,
efficient due diligence process and expertise.

While demand is growing fast, funders are in a good position to take advantage of abnormal returns for the foreseeable future, making litigation funding an asset class very similar to private equity or private debt strategies 10-15 years ago. At the heart of our investment process lies an imbedded rigorous risk management strategy. This enables us to better identify both indigenous and exogenous risks via our proprietary models and indices to recognize these signs early.

Our constant portfolio reviews and macro overlays, coupled with the views of our expert partners, enable us to protect our discretionary portfolios as well as the ones we advise for our clients. Through this, we are able to mitigate significant downside risk in what some would consider unpredictable events, which can impede overall performance in the long term.

In an era of low growth, uncorrelated returns are becoming increasingly elusive. Investors need to broaden their reach if they are to achieve strong longterm risk-adjusted returns. In this environment, more esoteric asset classes such as ligation finances are providing important sources of diversification.