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Short Duration High Yield Manager Hedges with Russell 2000 with Successful Results

By Portia Richardson



Tom Krasner

Despite high yield credit spreads ballooning to 586 basis points in November, Miami-based Concise Capital Management managed to deliver an 11.60% year to date return by using a short duration (duration <2), small capitalization high yield strategy. In comparison, the Lehman Brothers High Yield Index eked out a 1.59% return. With \$12.5 million in assets, the emerging hedge fund has successfully

reduced volatility by hedging with the Russell 2000 index.

According to Tom Krasner, co-founder of Concise, the idea of using the Russell 2000 to hedge the high yield portfolio originated with research by Chris Garman, High Yield Strategist at Merrill Lynch. One of Garman's models forecasts the performance of the high yield market and the Russell 2000 based on the ratio of the relative strengths of the two markets. History confirms the correlation of the two markets during high yield corrections. Since 1997, Krasner counts 25 corrections in the high yield market. In every one of those corrections, the Russell 2000 has declined as well. High yield bonds are a hybrid security combining characteristics of fixed income and equity. Using the Russell 2000 as a hedge works especially well for Concise given its focus on small companies. When necessary, Krasner hedges using shorter-dated, slightly out-of-the-money put options on the IWM, the exchange-traded fund of the Russell 2000. The IWM puts provide an excellent hedge because they correlate to high yield credit spreads and protect the portfolio during market corrections.

This hedging strategy has contributed approximately 5% of the 28.5% return of the fund since April 2006. According to Krasner, it is difficult to project an annualized performance impact for the future. The fund begins every month with 140 basis points of net interest income before fees and targets uncorrelated returns of 1% per month after fees. The purpose of the hedge is to help preserve that income by reducing the volatility of returns and the correlation of the fund with other asset classes rather than by necessarily adding alpha.

A critical success factor, as with any high yield strategy, is avoiding defaults. The investment team conducts intensive credit research to identify short-maturity high yield bonds in smaller, under-followed companies. The focus on short-maturity issues derives from research by Edward Altman of New York University that shows annual default risk rising in the years after issuance through year three and declining afterwards. The emphasis on small capitalization issuers takes advantage of the relative inefficiency in the pricing of these bonds. The combination of the short-maturity, small-capitalization characteristics results in a high yield portfolio with substantially lower volatility than the high yield market. The lower volatility allows Concise to employ modest leverage without incurring undue risk.

In turbulent markets, one concern of investors is default. Krasner says, "Economic recession curtails liquidity. Our focus on short-maturity high yield bonds trades default risk for refinancing risk. Liquidity for refinancing depends on the availability of private equity and debt. During a recession we would expect to reduce leverage, improve the credit quality of the portfolio, and increase the hedge." Krasner further estimates the maximum capacity for his niche strategy as between \$400 million to \$500 million.

He is also in the process of fund-raising and growing his firm. He says of the process, "We are speaking to a variety of early-stage investors, funds of funds, hedge funds, and family offices. We are also talking to larger funds that may want to add a niche strategy to their existing fixed income products. Investors like the returns and the strategy but need us to grow assets. Moving from the friends and family stage to the institutional investor stage is our objective."

Krasner's one gripe is over the inefficient and time-consuming process of finding early-stage investors where the process feels much like raising venture capital. Krasner concludes, "Many institutional investors should be interested in our strategy but don't know about us." Recently, a family office seeded the fund with an initial investment of \$10 million and expects to make a subsequent investment of another \$10 million within six months. With the seed investment, Krasner believes Concise has reached the stage where institutional investors may start to take notice.

Glenn Koach has over 17 years of experience in managing short-term, high-yield funds. Mr. Koach co-founded Riverside Capital Advisers in 1984, a boutique institutional investment management firm specializing in short-term, high-yield securities, which grew to over \$400 million under management. The Riverside portfolio included, publicly traded seasoned securities for large nontaxable accounts such as, pension plans, endowments, and offshore funds, as well as private placements, tax liens, and structured settlements. He sold his interest in Riverside in 1997. Riverside sold the high yield business in 1999. As a corporate board director, Mr. Koach has guided several companies through difficult financial situations including, turn-arounds, workouts and bankruptcies. This experience gives him far greater insight into the under-pinning of high-yield offerings. In addition, Mr. Koach is an experienced corporate executive holding key positions with both public and private companies, including: CEO of Group Long Distance, Inc. (GLDI) and Vice President of Strategic Planning for Tribune Cable Communications. Mr. Koach began his career as Senior Tax Specialist for Peat, Marwick, Mitchell & Co. and was a CPA. Mr. Koach holds a Bachelor of Economics with a degree in Accounting from the Wharton School at the University of Pennsylvania.

Tom Krasner has spent over 15 years in distressed debt and high yield bonds. He has extensive experience in corporate restructurings, credit analysis, and portfolio management, including substantial hands-on involvement in the workouts of troubled companies. Most recently, Mr. Krasner was Executive Vice President at Harch Capital Management and was responsible for working out and restructuring distressed securities, high yield bonds, and bank loans for a \$600 million hedge fund. Between 1996 and 1999 Mr. Krasner was a Principal and Portfolio Manager at Riverside Capital Advisers, where he co-managed the short-term high yield portfolio with Mr. Koach. Between 1985 and 1996 he worked at John Alden Asset Management, a \$4 billion life insurance company, where he was responsible for the \$250 million private placement portfolio. In 2003 Mr. Krasner was appointed as Trustee by the U.S. Bankruptcy Court to administer the liquidating trust of Premier Operations. Mr. Krasner holds a B.A. (1983) in Economics/English/Mathematical Sciences and M.A. in Economics (1984) from Rice University and is a Chartered Financial Analyst (1990). Between 1996 and 1998 he was the President of the Miami Society of Financial Analysts. He currently is a Director of Institutional Deposits Corporation and has served on the boards of Birch Telecom, Doe Run Resources, FWT, Sterling Chemicals, and Trism.

Mike Borowsky has 12 years of credit analysis experience. Most recently Mr. Borowsky was Senior Credit Analyst with Standard Bank responsible for overseeing all US High Yield Bond exposure. Prior to this, he was employed at Dilmun Investments where he was a credit analyst covering the Steel, Auto Parts, Manufacturing, and Broadcasting sectors for both the company's proprietary portfolio and High Yield Bond CDO. Mr. Borowsky worked for six years as an investment analyst with Mackenzie Investment Management Inc. At Mackenzie, he was responsible for conducting credit analysis on High Yield Debt, Emerging Market Corporate Debt, and Investment Grade Debt across a variety of industry sectors. In addition, Mr. Borowsky has significant experience trading corporate debt securities. Mr. Borowsky holds a B.S. in Finance and Economics from Drexel University (1994) and an MBA from Nova Southeastern University (1998).