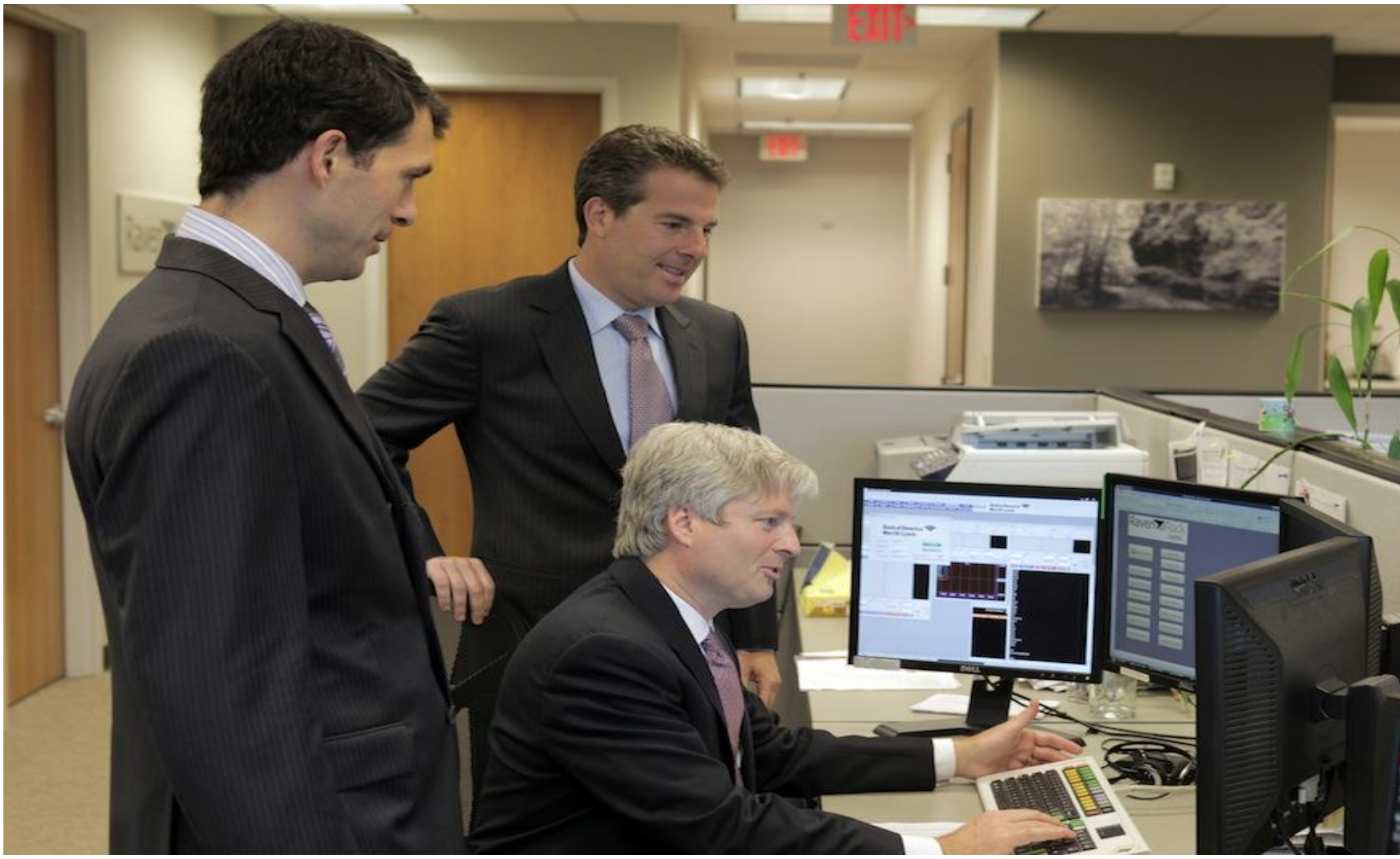
Profiting from market volatility

Why recent market turbulence isn't necessarily a bad thing



Arrow Capital Management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Comment

Managers: Guy Caplan, Bobby Richardson and Nate Brown, Raven Rock Capital

Fund: Raven Rock Credit Fund/Raven Rock Income Fund

Description: Bottom-up focus on corporate credit
Firm's AUM: US$440-million
Performance: 1-year: 9.38%; 3-year: 11.06% (Raven Rock Credit Fund, annualized, as of May 31, 2013)
Fees: Management 1.5% (A class); Performance 20%

The portfolio managers at Raven Rock Capital utilize a strategy that thrives on price volatility, so recent market turbulence isn't necessarily a bad thing.

The Chapel Hill, N.C.-based firm invests in a wide spectrum of credit qualities and across issuers' entire capital structures, primarily high-yield bonds, convertible bonds and leveraged loans.

The Raven Rock Income Fund, which is offered through Toronto-based Arrow Capital Management, and the Raven Rock Credit Fund for U.S. institutional clients, are run using two sub-strategies.

The first is a directional credit portfolio, where the managers take individual long or short corporate bond positions.

"Credit is an attractive spot within fixed income," portfolio manager Guy Caplan said. "Credit has favorable fundamentals and lower interest rate risk than sovereigns and municipals."

The high-yield sector tends to be shorter duration, which is one reason the managers are particularly optimistic about this market segment.

"The quality of corporate balance sheets indicates good risk/reward characteristics for the asset class," co-portfolio manager Bobby Richardson said.

The other side of the portfolio utilizes a relative value strategy, trading one instrument in a company's capital structure against another.

The biggest component of this strategy is currently in convertible arbitrage, where a position's equity market exposure is neutralized by hedging a portion of the shares that the bonds are convertible into.

"This is a way of getting long equity volatility," Caplan said.

The managers, a group that also includes Nate Brown, say the real alpha generator is their ability to shift between directional credit and relative value credit. "You typically have equity volatility when credit spreads are moving wider," Richardson said.

There hasn't been much equity market volatility until recently, so the convertible arbitrage side of the portfolio hasn't been a strong contributor. However, the managers have raised their exposure to this strategy to about 50% of the fund in the past month, up from roughly 40% earlier.

BUY

Milestone Aviation Group Ltd. (8.625% senior notes, due in 2017)

The position: Bought at issue late in 2012

Why do you like it? This helicopter-leasing firm focuses on civil customers, rather than the military.

"Large helicopters are in great demand due to all the deep water oil and gas exploration going on," Richardson said, highlighting the multi-year waiting list for purchases.

"Fixed-wing aircraft leasing is a very large and established business that can be somewhat cyclical. But we feel there is much less competition in helicopter leasing, and asset values are more stable.

Biggest risk: A collapse in oil prices would hamper helicopter demand.

Cobalt International Energy Inc. (2.625% convertible bonds, due in 2019)

The position: Among largest convertible bond holdings

Why do you like it? This oil and gas exploration company has some large positions in high-profile pre-salt plays in West Africa and the Gulf of Mexico.

Richardson noted Cobalt has about a dozen significant wells that will produce results in the next year.

"Because these fields are so large, each well has the potential to move the stock significantly," he said, adding each well could be worth as much as US$1-billion.

Biggest risk: Many dry holes.

Neff Rental LLC (9.625% senior secured notes, due 2016)

The position: Bought at issue more than a year ago

Why do you like it? Neff, like many companies in the equipment rental business, got banged up when U.S. construction essentially came to a halt in 2008. It filed for bankruptcy and emerged with a clean balance sheet late in 2010.

The rental equipment market has improved along with the U.S. economy and Richardson noted Neff has been able to pay down debt and reduce its leverage to about 3x.

"The company has solid asset coverage given the value of its equipment fleet versus the amount of debt outstanding," the manager said.

Biggest risk: Economic weakness causes a slowdown in construction.

SELL

Connacher Oil and Gas Ltd. (8.5% second lien notes, due 2019)

The position: Short

Why don't you like it? Richardson points out this integrated oil and gas producer has substantial leverage, limited cash and will need to heavily spend on capital expenditures in order to improve its production profile.

"They have the reserves, but they're not a very efficient operator," he said. "At the very least, we feel that first lien debt could be issued in front of these notes to push them further down the capital structure."

Potential positive: Very high oil prices.