Steering Clear of Liquidity Landmines:
The Anniversary of Third Avenue Focused Credit Fund's Demise

As 2016 comes to a close, we reminisce about some of the debacles that we have witnessed in the last year. One of the most noteworthy was that of Third Avenue Focused Credit Fund (TFCIX). While we acknowledge that Third Avenue's Focused Credit Fund is *not* a liquid alternative mutual fund, we believe that the issues surrounding the fund's downfall highlight some very important lessons for alternative mutual fund investors. The demise of Third Avenue's Focused Credit Fund that stunned investors and dominated the headlines this time last year simply could not be ignored given its broad-based ramifications in the investment world. It was a hot topic of discussion internally, as we have always been hyper aware of the consequences of declining liquidity in the credit space as a result of 2008. But what's more, it's a *mutual fund*, and its attempt to delay redemptions was highly unusual. It draws attention to lessons that we should all learn from, which is the importance of kicking the tires and looking under the hood to understand what one would own. You wouldn't buy a car without looking under the hood – why would you not do the same with your mutual fund investment?

A review of Third Avenue Focused Credit's historical 13F filings revealed that they were involved in fixed income securities that were generally rated CCC (Caa2 for Moody's) and lower – or were unrated altogether. In other words, these securities were low-grade debt of highly leveraged companies, and potentially highly speculative. Third Avenue Focused Credit offered daily liquidity to investors while its underlying investments were far more illiquid, and until this time last year, liquidity had only been tested in one direction. Our discussions with credit LP managers familiar with many of these holdings confirmed that Third Avenue had been in a slow motion unwind for several years as its struggles had been well-known amongst those in the fixed income world. Third Avenue Focused Credit's failure was simply not surprising to their fixed income peers, nor the manner in which it unraveled.

While the strategy thrived in a favorable economic cycle under normal market conditions (and led every day investors, thirsty for yield, flocking to the strategy due to its performance), as credit spreads at the end of last year widened significantly, Third Avenue found itself caught off guard as the high-risk asset class it was involved in came under significant pressure. Banks, active prior to the financial crisis in taking the other side of the trade, were largely absent as they have reduced their market-making activities as a result of new regulations. As the liquidity "rug" was pulled out underneath them, poor credit selection and concentrated exposure to a single issuer exacerbated the situation. For example, in its holdings through the end of July 2015 vis a vis its public 13F filings, TFCIX owned *a third* of troubled retailer Claire's Stores bonds' $320 million issue and similarly owned *more than half* of the iHeartRadio subordinated bonds' $250 million issue. Both carry a corporate family rating of Ca and Ca2, respectively, according to Moody's. Moody's definition of a credit instrument with a Ca rating is as follows; "Obligations rated Ca are highly speculative and are likely in, or very near, default, with some prospect of recovery or principal and interest". This provides some valuable context as to the uncertain nature of these issuers.

These position concentrations, given the underlying quality, are staggering and speak for themselves. As redemptions mounted, performance worsened as shareholders attempted to liquidate their holdings and Third Avenue was unable to meet liquidity obligations without severe ramifications in asset sale prices. As a result they engaged in a move that was highly unusual for a mutual fund – they placed the fund's remaining assets into a liquidating trust. This liquidating trust is the hedge fund equivalent of a "gate", which is an unspecified delay of redemptions that likely results in a lower net asset value than one expects. At the time, it was expected that the liquidation would take up to a year or more to complete. While investors have experienced such situations in hedge fund investments, this was never before considered possible for a daily liquidity mutual fund.

Furthermore, while overshadowed by Third Avenue's woes, distressed hedge fund Stone Lion Capital Partners also similarly suspended its redemptions, which has been a move that we frankly haven't seen since the financial crisis. And while it also similarly highlights a credit selection and portfolio management issue, it is important to clarify the distinguishing factor here; unlike Third Avenue, Stone Lion is a hedge fund where investors expect less liquidity. Third Avenue is not.

We don't sugarcoat the fact that credit selection and portfolio management were major components of Third Avenue's underlying problems that led to its downfall. However, it is important to note that Third Avenue on the surface executed its strategy in a way that was consistent with its stated mandate. That is, a deep-value strategy (typical of founder Marty Whitman's philosophy) focused on investing in high-yield bonds, albeit at the riskiest end of the credit spectrum. What was not appreciated by investors was just how its concentrated portfolio of speculative investments would perform in a stressed scenario where liquidity in the credit market begins to evaporate, as its strategy had never before been appropriately battle tested (the fund launched in 2009, post the financial crisis). More importantly, there was a material mismatch in the liquidity of the underlying instruments in comparison to the daily liquidity that was offered to investors – a basic lesson that is well ingrained in most hedge fund investors' minds from the global financial crisis of 2007-2008. The notion that Third Avenue could suspend redemptions for its mutual fund investors is staggering as it contradicts the very tenets of why one would own a mutual fund in the first place. In our view, Third Avenue managed the portfolio irresponsibly by not having the necessary safeguards and liquidity in place in order to meet potential redemptions in the event the fund significantly underperformed.

We don't mean to specifically pick on Third Avenue as we recognize that there were other funds that experienced similar capital impairment issues, and had these funds received similar redemption requests we would likely be seeing them in the headlines, too. However, the fact of the matter is the fund was mismanaged and highlights the importance of "kicking the tires and looking under the hood" in order to understand what it is that you are buying. On the private fund (LP) side of the business, Balter Capital Management is persistently evaluating the source of risk and return, and whether or not a manager's underlying holdings matches the liquidity that they are offering investors. Simply put, the asset and liability mismatch is one that we are highly cognizant of, as we have been around the block and have stressed that certain strategies that are simply not suitable for the '40 Act wrapper. Strategies based on aggressive exposure and concentration in highly speculative junk bonds represents one of them.

That said, investors should not be fearful of mutual funds or liquid alternatives, for that matter. Third Avenue's shortcomings stemmed from aggressive *long-only* exposure and concentration in highly speculative and illiquid fixed income securities – securities that in our view simply do not belong in a mutual fund. Further, investors also seemed to overlook the importance of evaluating a manager in a stressed scenario, a step that we believe is an imperative action when considering any strategy for potential investment. In our opinion, Third Avenue is a prime example of a mutual fund gone awry. Liquid alternatives similarly have daily liquidity, but that is where the similarities end and the differences begin, as the category we feel has unique attributes that we are detailing in a follow-up white paper. And while all liquid alternatives are not necessarily created equal, there is an obvious reason why most liquid alternatives have not engaged in the inclusion of illiquid fixed income securities in their portfolio. That is what the LP structure is for, providing protection for investors when utilizing strategies that take advantage of outsized dislocations that are highly leveraged, illiquid, or some combination of the two. We have always been major proponents of finding the correct fit for the strategy and the wrapper. Third Avenue Focused Credit simply should have never been offered in mutual fund form.

Nevertheless, there are clearly certain strategies that lend itself well to the liquid alternative mutual fund structure that include long/short equity and global macro. There are also strategies that are not suitable, particularly in certain areas of credit. We simply do not think there is a credible way to invest in distressed credit as the potential illiquidity brought on by stressed scenarios is not well supported by the liquid alternative mutual fund structure. In applying this across the mutual fund, liquid alternative and hedge fund worlds, we intentionally avoid managers trying to desperately force a square peg into a round hole, as history tells us time and time again that it simply doesn't work.

Additional information on the liquidation of the Third Avenue Focused Credit Fund can be found at www.focusedcreditfund.com.