Esoteric Assets: A Primer for Investors

Low True Correlation • Higher Alpha • Scalability

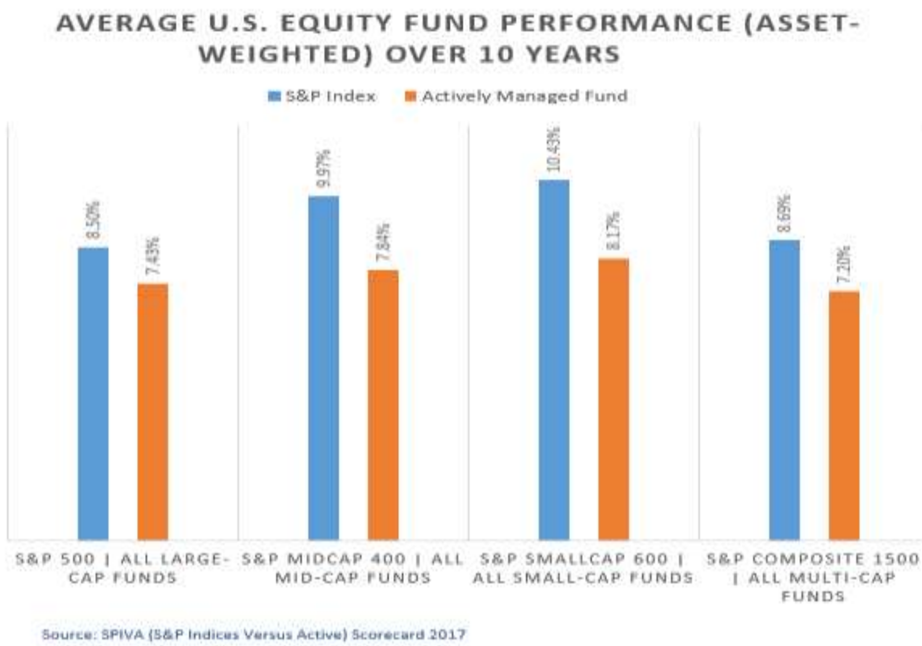
Financial markets are fairly efficient – they do not have obvious sources of excess risk-adjusted return – primarily because they are so competitive. But esoteric assets are less-competed assets, improving risk-adjusted return to investors.

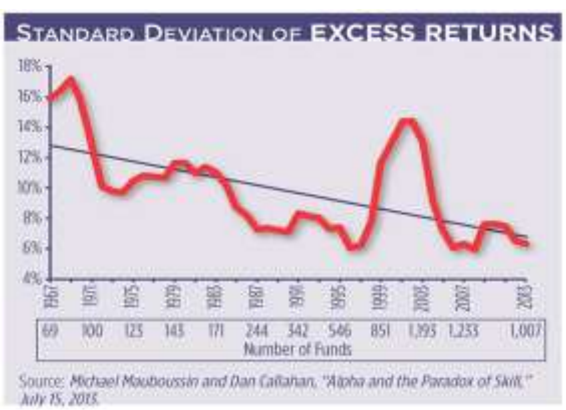
Competition for Assets Eliminates Risk-Adjusted Return

Taking a look at the US equity market over the last decade shows us that actively managed funds on average have underperformed compared to the market.

"…the majority of active equity funds underperformed over the longer-term investment horizons. Over the five-year period, 84.23% of large-cap managers, 85.06% of mid-cap managers, and 91.17% of small-cap managers lagged their respective benchmarks."

SPIVA (S&P Indices Versus Active)
Lipper Hedge Funds Database 2017





And the alpha or excess return is also decreasing.

No major strategy is insulated from competition; competition is high not only in stocks, bonds, derivatives, and currencies, but also in private equity, private debt, real estate, and venture capital. Even "niche" strategies suffer considerable competition. The key, therefore, to higher risk-adjusted return and durably lower correlations is to avoid competition.

What is an Esoteric Asset?

- Esoteric assets are those assets that are not heavily trafficked and therefore there is less competition in terms of acquiring these assets. They are generally non-bid, non-flow, non-market, non-auctioned, and non-brokered. For this reason, they are often highly unconventional and illiquid.
- Esoterics can provide a refuge from the wide swath of asset classes (conventional or unconventional), which share at their core an erosion of alpha via sophisticated and relentless competition.

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Examples of Esoteric Assets:

- **Specialty Sovereign Receivables:** Payees of certain governments may be willing to sell their receivables at a discount. In this case, the receivables buyer takes sovereign risk but may be paid a large premium to take that risk in comparison to sovereign bondholders, who are arguably taking a similar risk but earn far less. For example, factoring a payment to an electricity utility from the Italian state may earn ten times as much as an Italian sovereign bond of similar duration. Only a small amount of this premium would be due to illiquidity.

- **Expert Legal Finance**: Limited access and arcane legal processes in smaller, foreign states provide significant barriers to in-court financing. Expertise can allow an investor to maneuver in these spaces to buy or to finance obscure judgments, court-mandated payments, or suits stalled at the stage of calculation of damages.

- **"Typical" Assets in "Atypical" Jurisdictions**: Even otherwise well-understood investments such as non-performing loans can avoid competition in jurisdictions which have little-to-no experience with them. Portugal, for example, has relatively little experience with NPLs.

- **De Novo (Invented) Assets:** Occasionally, an asset class is non-competed because it has not even been invented yet. As recently as ten years ago, there was no scalable source of financing for charter schools even though charter schools are public schools and therefore are municipal (state) credits. Today nearly $2 billion in financing has been provided to this new asset class, which now has institutional backing.

Esoterics as an Alternative for Generating Higher Returns by Avoiding Price Competition

How are Esoteric Assets different from niche investments?

Both niche and esoteric assets are unconventional. Niche assets, however, are still competed. Whether a film rights deal or a securitization of the earnings of a professional athlete, the niche asset will be seen by multiple bidders as brokers and other flow agents show the deal to interested parties, who are not hard to find. Similar to investors in more conventional assets, the investor who ultimately owns a niche asset is the one who paid the most for it. While niche assets certainly are entertaining to hold, there is no reason to believe they can escape the same competitive pressures that other assets suffer. In addition, niche assets generally do not scale, being small in size with many bidders looking to purchase them.

Why should an investor invest in esoteric assets?

Pros:

- **Low True Correlation**: Many investment strategies that lay claim to low correlations only exhibit this property in good times, when it is unnecessary and even unhelpful. In bad times, they reveal their true correlation, which can be unfortunately quite high. Since esoterics are originated and structured outside of markets, their true correlations can be very low: Esoterics, for example, performing before, during, and after the Financial Crisis of 2008.

- **Higher Alpha**: Without the pressure of competition driving price up to (and even beyond) fair value, esoteric assets can be bought at prices well below fair value. In addition, mechanizing the process of origination can create an operational business associated with the asset, providing an additional source of return.

- **Scalability**: For an asset to be in a market or flow state, it must be relatively refined. Therefore, refined assets are actually rare due to the work involved. But, as raw assets, esoterics are abundant, if hard to structure.

Cons:

- **Highly Illiquid**: As non-bid, non-flow, non-market assets, esoteric assets are perhaps the most illiquid of assets. There is no market offtake and little ability to sell in a stress scenario.

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- **Laborious Sourcing and Structuring**: Esoterics are non-flow assets; there is no easy sourcing of them despite their abundance. Further, as raw assets, each one has to be analyzed by an idiosyncratic and manual process, which is time-consuming and requires high human capital and potentially domain expertise.
- **Asset Novelty Risks**: Unlike standardized securities, esoteric do not exist in a well-understood legal regimes and can present novel legal issues for both investors and regulators. Even where legal issues are not presented, esoterics often present considerable operational and harvesting challenges. Finally, as novel assets, not all risks of a given esoteric will be well-understood at the start of the investment.

Where are the returns coming from?

- The primary driver of excess return is a lack of competition for the asset. Without competing bidders, esoteric assets can be bought cheaply.
- Esoteric assets are highly illiquid and hence some of the difference in return can be attributed to Illiquidity premium. Typically, this can be measured through rough proxies.
- Both sourcing and structuring barriers require high human capital and domain expertise to condition an otherwise raw asset into an investable one.

What Are The Risks Associated With Esoteric Assets?

While esoterics have lower exposure to systematic factors of risk, they have higher exposures to nontraditional risks. Still, investments in esoterics can help investors move away from risks they are overloaded in to risks that they have relatively little of, improving their overall risk profile.

Illiquidity	Investments are in esoteric assets which might not be easily sold; self-liquidation is the usual exit. **Mitigants:** Self liquidation. Creating a market for a de novo asset class.
Asset Novelty	Novel transactions and assets are subject to latent risks; safeguards and exits must be built for situations which may otherwise appear unlikely or impossible. **Mitigants:** Highly structured relationships with expert local managers
Legal Issues	Many illiquid transactions depend fundamentally on the existence of certain rules; rules can change and with them the alpha capture opportunity. **Mitigants:** Though there is no clear mitigant, this is a diversifying risk exposure.
Secrecy	Discovery of the asset by others increases competition. **Mitigants:** Undertake significant measures to protect trade secrets and sourcing.
Sourcing	There is no method to mechanize or to guarantee deal flow or capital deployment; the Investment manager uses proprietary methods to develop a significant alpha-generative pipeline. **Mitigants:** Esoteric assets are generally abundant
Platform risk	Transactions may depend on the performance, competence, and incentives of expert counterparties. **Mitigants:** First loss, contingent back-ended manager participation

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Who Are The Investment Managers In This Space?

Orthogon Partners has located itself at the most exotic end of the spectrum, having taken assets to two different supreme courts (Germany and Brazil) and even invented an asset class (charter school receivables). Orthogon has also funded organizations ranging from religious orders to women's shelters. It is a "pure play" esoterics manager.

Investors looking for managers who are more conventional will find a number of choices. Increasing how "vanilla" an asset is increases its accessibility though it also reduces the potential for outperformance. Most funds here will have unconventional assets mixed into their more conventional portfolios.

	Geography/Country Focused Funds	Global Funds
"Pure Play" Funds		• Orthogon Partners
Non "Pure Play"	• Morgan Rio Capital Management, LLC (Latin America) • ESO Capital (Europe) • Roundshield Partners (Europe) • Jive Asset Management (Brazil) • Atalaya Capital Management LP (primarily US)	• Fortress Investment Group LLC - Drawbridge Special Opportunities Fund • Värde Partners • CarVal Investors • Cordillera Investment Partners (FoF)

What about investing directly?

- Esoteric assets are raw assets. They have not been refined by brokers, agents, finders, or other sources of "flow". As such, they require considerable subject matter expertise, labor, and patience.
- Of all major strategies, esoterics are the least efficient to insource as it requires diverse knowledge and experience to perform even simple investment operations; insourcing esoterics require significantly more effort than would be required to insource traditional strategies such as real estate, private equity, private credit, and venture capital.
- While insourcing avoids an external fee to a manager, it creates internal costs in labor, time, and development that would likely far exceed what a devoted manager would charge, and at greater risk as well. Investors with specialized expertise in an area (whether esoteric or not) can gain significant advantage from investing directly, but those who do not already have expertise in complex investments may find the effort to be more trouble than it is worth.

Special Thanks to:

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Orthogon Partners seeks to generate excess returns from less-competed ("esoteric") assets which have reduced dependence on credit, business, market, rate and other factors of systematic risk. Orthogon's investments in esoteric assets are intended to provide superior returns over broad market conditions with realizations targeted within a five-year period.