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What Got You Here, Won't Get You There: The Role of Opportunistic Credit in a Growth Portfolio

KEY TAKEAWAYS

- The paradigm shift from a 14-year zero interest rate policy (ZIRP) requires a new investing playbook as investors can no longer rely solely on growth strategies to generate returns.
- An over-reliance on growth strategies may be counterproductive in a growth portfolio, especially when taking into account the cyclical nature of the performance of growth strategies.
- Opportunistic credit strategies¹ can provide steadier cash flows by generating more consistent returns and distributing capital at a faster rate than growth strategies, allowing investors to fund their missions and capital call obligations on a continual basis, especially during downturns when other strategies are challenged.
- Lower volatility and low correlation to growth strategies can allow opportunistic credit strategies to serve as portfolio diversifiers throughout different market cycles.
- For investors focused on consistent, long-term growth, we believe opportunistic credit strategies are an important allocation in any alternative investments portfolio.

Most investors are charged with generating returns year in and year out to satisfy objectives from supporting the missions of endowments and foundations to meeting the payout requirements of pension plans and retirees. Even among allocators with longer investment horizons, few have the luxury of waiting out extended downturns without the need for some investment returns that can be monetized to keep their organizations running. The reality is that most investors require a fairly steady stream of cash flows to fund their missions and cannot withstand long periods of time without distributions from their portfolios.

HOW OPPORTUNISTIC CREDIT STRATEGIES CAN UNLOCK VALUE

Alternative investments have grown to become a core holding in investment portfolios for many institutions and ultra-high net worth individuals. As with any portfolio, diversification within an alternative investments portfolio is important. Investors should be wary of putting all of their portfolio risk into any single asset class or strategy.

Certain strategies are more cyclical, with extended periods of outperformance followed by extended underperformance. As an example, while growth equity and venture capital strategies had robust returns during the 1990s and 2010s, there have been other decades, such as the 1980s and 2000s, when investors made little to no money in these strategies.² This extreme cyclical nature makes it difficult to rely exclusively on these strategies to provide monetizable returns to cover ongoing

¹ Opportunistic credit strategies typically invest in a broad spectrum of credit and debt related investments across multiple geographies. Investments include but are not limited to traditional high yield bonds and bank loans, corporate distressed debt, non-performing loans, real estate, structured finance and dislocated industries (i.e., aviation, energy, shipping, royalties). Opportunistic credit (which may also be referred to as "credit opportunities") is a subset of private credit, which also includes strategies that invest in senior debt and in subordinated (mezzanine) capital. Source: Cambridge Associates LLC.

² Source: Cambridge Associates, Davidson Kempner Quantitative Research. Performance is measured as annualized internal rate of return (IRR) over 10-year horizons.

mission-related payouts or expenses in any given year(s). In fact, investors whose portfolios are concentrated in growth strategies may have difficulty funding capital calls issued by growth funds during economic downturns, due to the lack of distributions from prior vintages. This can create a negative feedback loop where investors have no cash flow from their underperforming growth vintages to invest in subsequent vintages that have the potential for outperformance.

We believe opportunistic credit can play an important role in an alternative investments portfolio as an all-weather diversifier because the strategy can achieve attractive rates of return even in market environments that hamper other strategies. Opportunistic credit strategies seek to unlock value in mispriced investments often associated with market dislocations or complex, distressed capital structures and out-of-favor assets where capital is scarce. Opportunistic credit funds can generate uncorrelated distributions, which provide investors with cash flow to meet capital calls and other spending needs throughout entire market cycles, including when it is needed the most. In other words, opportunistic credit can provide ballast to the portfolio when other strategies cannot.

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INVESTORS CAN ACHIEVE GREATER DIVERSIFICATION THROUGH OPPORTUNISTIC CREDIT

Opportunistic credit strategies have relatively low correlation with growth equity and venture capital, more so than overall private credit strategies. As shown in Exhibit 1, we calculate the correlation of returns between growth equity and opportunistic credit indices to be 43%, and the correlation between venture capital and opportunistic credit indices to be only 22%. Opportunistic credit strategies also have meaningfully lower volatility compared to growth strategies (see Exhibit 2).

Exhibit 1: Correlation of Returns for Growth Equity, Venture Capital, Opportunistic Credit and Private Credit Indices

(%)	Growth Equity	Venture Capital	Opportunistic Credit	Private Credit
Growth Equity		86.1	43.0	59.1
Venture Capital	86.1		21.9	37.8
Opportunistic Credit	43.0	21.9		87.2
Private Credit	59.1	37.8	87.2	

Exhibit 2: Annualized Returns, Volatility and Sharpe Ratio for Growth Equity, Venture Capital, Opportunistic Credit and Private Credit Indices

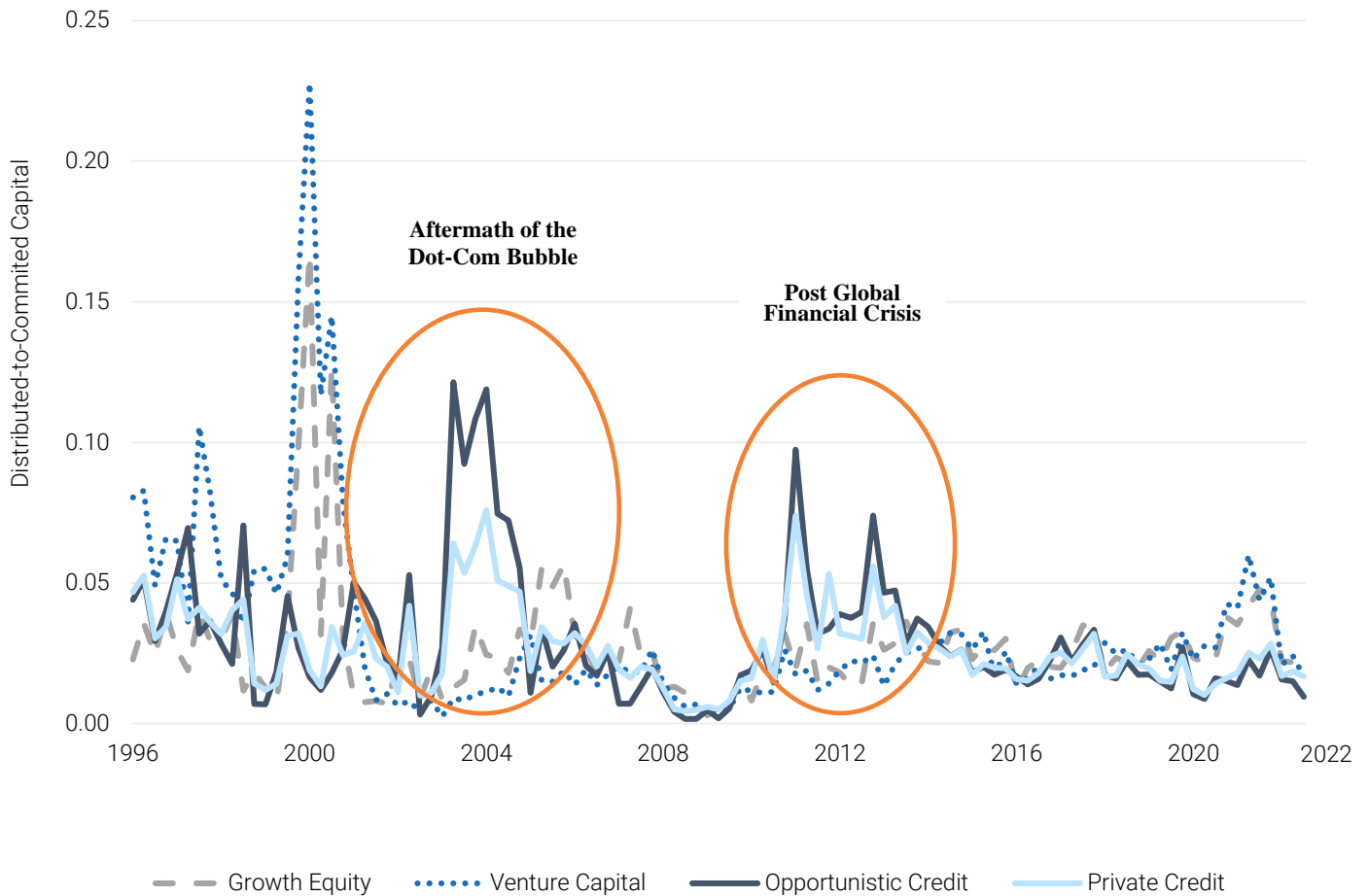
	Growth Equity	Venture Capital	Opportunistic Credit	Private Credit
Mean Return (%)	15.9	16.5	11.8	10.4
Return Volatility (%)	14.2	20.4	9.7	7.6
Sharpe Ratio	1.1	0.8	1.2	1.4

The information contained in Exhibits 1 and 2 has been calculated by Davidson Kempner’s Quantitative Research team, based on underlying aggregate and anonymous data provided by Cambridge Associates (“Cambridge”) that is used by Cambridge to calculate the performance of the growth equity, venture capital, opportunistic credit and private equity indices published by Cambridge. The information contained in Exhibits 1 and 2 has been calculated from the period of 1988Q4 to 2022Q3 and is based on the one-quarter pooled horizon internal rate of return (“Pooled Horizon IRR”) for each index, which is net of fees, expenses and carried interest. The Pooled Horizon IRRs are calculated as the rate of return that makes the combined net present value (NPV) of net cash distributions (assumed to occur in the middle of the quarter) and end-of-quarter NAV equal to the start-of-quarter NAV and is calculated on an aggregate basis for the quarter based on all of the underlying funds comprising the relevant index. Accordingly, the information contained in the tables is based upon quarterly returns and annualized. The timing and magnitude of fund cash flows are integral to the IRR performance calculation. Please see the Additional Disclosures at the end of this paper for further disclosure and important information regarding each index. Past performance is not indicative of future results.

COMPLEMENTARY DISTRIBUTIONS CAN PROVIDE MUCH NEEDED CASH FLOW

Opportunistic credit funds can oftentimes provide income or generate cash via distributions during periods when growth funds are unable to provide cash flow. Two noteworthy examples include the aftermath of both the dot-com bubble and the Global Financial Crisis, when distributions from opportunistic credit and private credit funds meaningfully outpaced distributions from growth equity and venture capital funds, as shown in Exhibit 3.

Exhibit 3: Time Series of Distributed Cash as a Percentage of Committed Capital (1996Q1 – 2022Q3)



The information contained in Exhibit 3 has been calculated by Davidson Kempner’s Quantitative Research team, based on underlying aggregate and anonymous data provided by Cambridge that is used by Cambridge to calculate the performance of the growth equity, venture capital, opportunistic credit and private equity indices published by Cambridge. The information contained in Exhibit 3 has been calculated from the period of 1996Q1 to 2022Q3 and is based on aggregate distributions for the quarter made by all of the underlying funds that comprise the relevant index relative to the aggregate committed capital of such underlying funds. The y-axis represents the ratio of aggregate distributions to committed capital, where 1.0x would indicate aggregate distributions for the quarter equal to 100% of aggregate committed capital. In calculating the distributed-to-committed capital, capital calls are not subtracted from capital distributions. Please see the Additional Disclosures at the end of this paper for further disclosure and important information regarding each index. Past performance is not indicative of future results.

LARGELY UNCORRELATED DISTRIBUTIONS CAN CREATE DIVERSIFIER EFFECT

An alternative investments portfolio with meaningful allocations to opportunistic credit can benefit from the fact that distributions are largely uncorrelated from those of growth equity and venture capital strategies (see Exhibit 4). We believe such uncorrelated distributions can provide more consistent cash flow, which is critical for investors who have ongoing expenses and missions to support.

Exhibit 4: Correlation of Distributed to Committed Capital for Growth Equity, Venture Capital, Opportunistic Credit and Private Credit Indices (1996Q1 – 2022Q3)

(%)	Growth Equity	Venture Capital	Opportunistic Credit	Private Credit
Growth Equity		76.4	8.6	21.9
Venture Capital	76.4		0.1	12.9
Opportunistic Credit	8.6	0.1		85.5
Private Credit	21.9	12.9	85.5	

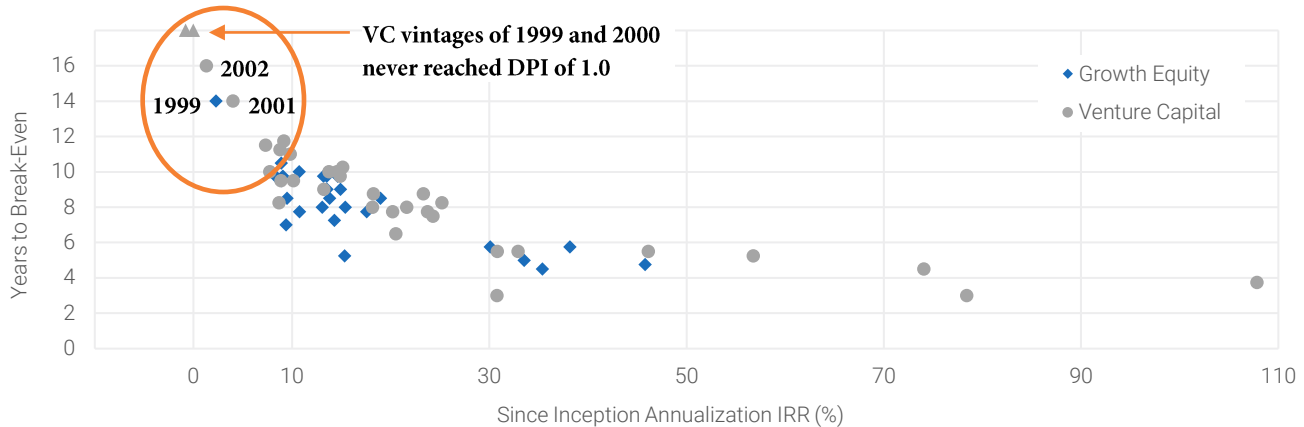
The information contained in Exhibit 4 has been calculated by Davidson Kempner’s Quantitative Research team, based on underlying aggregate and anonymous data provided by Cambridge that is used by Cambridge to calculate the performance of the growth equity, venture capital, opportunistic credit and private equity indices published by Cambridge. The information contained in Exhibit 4 has been calculated from the period of 1996Q1 to 2022Q3 and is based on aggregate distributions for each quarter made by all of the underlying funds that comprise the relevant index relative to the aggregate committed capital of such underlying funds. In calculating the distributed-to-committed capital, capital calls are not subtracted from capital distributions. Please see the Additional Disclosures at the end of this paper for further disclosure and important information regarding each index. Past performance is not indicative of future results.

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STARVED FOR CAPITAL WHEN INVESTORS NEED IT THE MOST

Because growth strategies take longer to return capital to investors during fallow times, investors are often starved for capital when they need it the most. Using a metric which we refer to as “years to break-even,” defined as the number of years since inception that it takes a fund to reach a Distributed to Paid-In (DPI) ratio of 1.0, we show the correlation between the since-inception annualized IRR and how long it takes investors to receive cumulative distributions equal to aggregate capital called (see Exhibit 5). The lower the IRR, the longer it takes for both growth equity and venture capital funds to reach their years to break-even. Certain venture capital vintages, namely 1999 and 2000, never reached a DPI ratio of 1.0.

Exhibit 5: Duration vs. Performance for Growth Equity (1989-2014 vintages) and Venture Capital Funds (1981-2014 vintages)



Low-performing vintages take much longer to break even. In extreme cases, some venture capital vintages (1999 and 2000) never reached a DPI of 1.0; i.e., their “years to break-even” was infinite, as indicated in the circle above. The information contained in Exhibit 5 has been calculated by Davidson Kempner’s Quantitative Research team, based on underlying aggregate and anonymous data provided by Cambridge that is used by Cambridge to calculate the performance of the growth equity and venture capital indices published by Cambridge. The information contained in Exhibit 5 plots for each vintage for the relevant index the number of years needed for such vintage to reach a DPI of 1.0 (as shown on the y-axis) and the since-inception annualized IRR for such vintage as of September 30, 2022, beginning with the first reported vintage for such index through the 2014 vintage. The information contained in Exhibit 5 has been calculated on an aggregate basis for all the underlying funds within each vintage that comprise the relevant index. Please see the Additional Disclosures at the end of this paper for further disclosure and important information regarding each index. Past performance is not indicative of future results.

A PROFOUND PARADIGM SHIFT FROM A 14-YEAR ZERO INTEREST RATE ENVIRONMENT

The 14-year grand experiment with a zero interest rate policy (ZIRP) ended in March 2022, when high single-digit rates of inflation finally forced the Fed to raise interest rates. Over a period of 12 months, the Fed raised rates nine times to its current target range of 4.75% to 5.00%. While the global pandemic and the Russia-Ukraine War contributed to the sharp rise in inflation, we believe its root can be traced to ZIRP, coupled with a tremendous amount of stimulus spending by Western governments before and during the pandemic. As the Fed walks a tightrope between fighting inflation at the risk of recession and higher unemployment, signs point to the beginning of an extended inflationary period.

A NEW INVESTING PLAYBOOK FOR A LOW GROWTH ENVIRONMENT

If history holds here, investors are experiencing a profound paradigm shift that requires a new investing playbook. Fourteen years of ZIRP has had a significant impact on the composition of capital structures. Business decisions that were predicated upon low financing may no longer work with current financing spreads while companies that have business models that do not support the amount of debt they carry will need to be restructured. We expect this process to play out over the next several years. Moreover, under ZIRP, many investors have also used leverage to amplify returns on equity. If the paradigm shift portends an inherently low growth environment, a new playbook will be required for these investors to generate consistent rates of return.

WHAT GOT YOU HERE, WON'T GET YOU THERE

The past decade of robust returns from venture capital and growth equity strategies may have led investors into believing that these strategies will always provide the performance they seek. Investors should be mindful that what has proven successful over the past 10 years may not work as well over the next 10 years. It is worth noting that the venture capital and growth equity funds of the early 2010s were excellent vintages – but they were only available to investors who had the capital to invest and/or the ability to ride out the same strategies' preceding underperforming vintages.

We believe opportunistic credit has generally performed well in higher rate environments. More importantly, we believe that allocating to opportunistic credit strategies today could provide investors with cash flow in the near-to-medium term, which would in turn enable investments in growth strategies in a timeframe that could prove beneficial well into the future.

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ABOUT DAVIDSON KEMPNER

Davidson Kempner Capital Management LP is a global investment management firm with more than 39 years of experience and a focus on fundamental investing with a multi-strategy approach. Davidson Kempner has more than \$38 billion in assets under management and over 500 employees across seven offices: New York, Philadelphia, London, Dublin, Hong Kong, Shenzhen and Mumbai. Additional information is available at: www.davidsonkempner.com.



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Tony received a J.D. from Columbia Law School and an M.B.A. from the Columbia Graduate School of Business Administration. He earned an A.B., cum laude, from the School of Public and International Affairs at Princeton University.

Tony is a member of the Board of Trustees of Princeton University and a member of the Board of Directors of PRINCO, the investment manager of the Princeton University endowment. He also serves as a member of the Board of Trustees and on the investment committees of The New York Public Library and New York-Presbyterian. He is a member of the Council on Foreign Relations.

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Certain of the information contained in this paper is based on aggregate and anonymous data provided by Cambridge Associates ("Cambridge"). For purposes of calculating the information presented in Exhibits 1-4, Davidson Kempner's Quantitative Research team used aggregate and anonymous underlying data provided by Cambridge (including quarterly cash flows and net asset values) that was pooled across all vintages for reporting funds for the relevant index. The starting quarter of available data and aggregate number of underlying reporting funds for each index is shown in the table below:

Index	Starting Quarter	Number of Funds
Venture Capital	1981Q1	2943
Growth Equity	1986Q3	821
Private Credit	1986Q2	595
Opportunistic Credit	1988Q4	306

For purposes of the information presented in Exhibit 5, Davidson Kempner's Quantitative Research team used aggregate and anonymous underlying data provided by Cambridge (including quarterly cash flows and net asset values) that was broken down by vintage for the reporting funds for the relevant index. With respect to the underlying data broken down by vintage, vintages with fewer than 3 funds were redacted by Cambridge and excluded from presentation in Exhibit 5. This resulted in the 1986-1988 vintages being excluded from the Growth Equity fund data for Exhibit 5.

It is important to note that the indices are unmanaged and reflect aggregate data of underlying funds that report to Cambridge. An investor cannot and did not invest in any index. While all four indices have global coverage, as illustrated above, the number of underlying funds that comprise each index, and the length of history for each index, varied substantially, which could have a material impact on the information reported herein. Accordingly, the data provided by Cambridge is necessarily subject to certain assumptions, qualifications, limitations and biases, including survivorship bias. Further information is available upon request.

Below are the definitions used by Cambridge's research team to classify each underlying fund into one of the four separate indices discussed in this paper:

- **Venture Capital** – Funds that specialize in sourcing, funding, and building young, innovative companies. Investments made by venture capital funds typically range in stage from seed ("new ideas") to late (growing, more established companies) and focus on industries such as technology and healthcare.
- **Growth Equity** – Funds where 50% of capital is deployed / intended for companies that exhibit organic revenue growth in excess of 10%, are profitable or have a clear path to profitability, and have no technology risk and limited market risk. In addition, the fund manager intends to be first and likely last institutional investor, acquires a minority ownership stake, is the sole or largest institutional shareholder, and employs low to no leverage at the time of investment.
- **Private Credit** – Consists of Credit Opportunities (Opportunistic Credit), Senior Debt and Subordinated Capital (Mezzanine) funds:
 - **Credit Opportunities (Opportunistic Credit)** – Funds that invest in a broad spectrum of credit and debt related investments across multiple geographies. Investments include but not limited to traditional high yield bonds and bank loans, corporate distressed debt, nonperforming loans (NPLs), real estate, structured finance, and dislocated industries (i.e., aviation, energy, shipping, royalties).
 - **Senior Debt** – Funds that provide senior secured loans for companies seeking to finance acquisitions, add-ons, restructurings and/ or bridge loans. Senior loans offer a level of downside protection through priority of claim on assets in the event of bankruptcy in addition to embedded covenants. The loans typically have floating rate coupons priced off LIBOR and benefit from LIBOR floors and/ or upfront origination fees. These investments may offer a lead role in refinancings with the ability to influence.
 - **Subordinated Debt** – Funds that invest in securities that lie between equity and secured debt. These investments are most often made to finance a buyout but can also be used in place of growth equity. Along with the typical interest payment associated with debt, mezzanine capital will often include an equity stake in the form of warrants attached to the debt obligation or a debt conversion feature identical to that of a convertible bond.