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Peer Insights REPORT

Q&A with Matthew Moniot
Chief Investment Officer, Elanus Capital Management

Principle Series:

Peer Insights Review sits down with Elanus Capital, a global opportunistic credit firm, for an exclusive look into their investing and the state of financial services.

Matthew Moniot, a former PM at Omega, Lehman and Millennium, and Tino Kamarck, former President of Radian Asset Assurance and Chairman of the U.S. Export-Import Bank, founded Elanus in 2010, to take advantage of regulatory capital relief transactions – structured credit deals that help banks mitigate specific credit risks. While their original mandate was a product of the distress and dislocations created by the financial crisis of 2008 – 2009, Elanus has expanded over the past four years and is now active in niche, opportunistic structured and cash credit markets.

Q: Why did you set up Elanus Capital in the middle of the global financial crisis?

A: Tino Kamarck and I founded Elanus Capital in order to extract market opportunities created by the global financial and European banking crises. Tino was a credit insurance executive and I had a background as an economist, trader and analyst. Three major factors led us to believe we could generate very high risk-adjusted returns. First, global bank capital requirements were increased both in terms of quality and quantity. Second, bank risk weights had risen due to credit deterioration. Finally, the traditional avenues for banks to manage credit risk – credit insurance – were impaired. As such, banks needed to sell risk and had no functioning markets.

Q: In light of the new paradigm financial firms find themselves in, what type of opportunities are you focused on?

A: We are focused on growing our credit risk management platform to allow us to provide risk mitigation in multiple forms. Further, we are exploring the growth of non-traditional capital securities markets. But most importantly, we are transitioning to a much more "neutral" exposure. We believe that a long period of relatively elevated credit risk lies ahead. We think there will be winners and losers both in the non-financial corporate space and in financials. The era of a rising tide floating all boats seems well and truly at a high ebb given the extremely high levels of corporate, financial and household leverage present around the world.

Q: Can you explain how increased regulation actually provides new opportunities?

A: Investors have had a very difficult time adjusting to the new environment for financials. Most appear to assume that financials will return to the profitability of the pre-Crisis era; that is not going to happen. Regulators are quite clear that they see a new paradigm in which trading businesses are burdened with extremely high levels of capital such that they destroy shareholder value. Of course, this is not immediately apparent and management are loath to admit this to shareholders as they have yet to articulate any new strategic vision. As management dither, business leaks out of the regulated sector into the non-bank financial space. There are opportunities galore here, but they are difficult to source and scale. Additionally, there are substantial capital structure arbitrage opportunities within the financials sector as investors adjust to a new paradigm of risk and reward throughout the capital stack.

Q: How has the regulated global financial industry evolved over the past decade?

A: The single most important change relates to the treatment of capital. Prior to the crisis, it was accepted wisdom that capital could be aggregated in a single entity and used to support multiple operating subsidiaries around the world. This is the famous "double counting" of capital. Universal banks, therefore, had a major advantage as they could hold a small fraction of capital, relative to their total risk, than their smaller, less diversified peers. Beyond capital, the "Vickers Report" in the UK, the Liikanen Report in Europe and the Volker Report in the US all articulated substantial systemic reforms including ring-fencing trading businesses from guaranteed deposits, resolution mechanisms and curbs on compensation. Additionally, derivatives businesses have been completely re-regulated leading in many cases to markets effectively ceasing to operate.

Q: Does the need for outside capital pertain only to banks?

A: While the need for external capital is most acute in banking, it is also present in the insurance and non-bank financial businesses. That noted, only banks have traditionally internalized most of their capital. Insurers typically use significant amounts of reinsurance and non-bank financials typically sell subordinated securities out of securitization programs. Banks on the other hand, up until the crisis, managed capital by manipulating their models to reduce the amount they needed and by lowering the quality of capital in order to reduce its cost. That game is over. Nonetheless, banks still must operate businesses that consume large amounts of capital, such as commercial lending.

Q: What is your primary investment thesis for the firm?

A: We believe that highly diversified credit risk portfolios, of the sort found in financial services firms, are much more defensive than investors understand. Further, we think that the structured credit markets are substantially less efficient than cash markets. Finally, we know that investors have yet to appreciate the capital structure anomalies present in the financial services industry. Combining these three critical factors, we have generated good risk-adjusted returns.

Q: What are some current myths surrounding financials?

A: Until the crisis, investors thought that 1) financials could not fail and 2) that 15-20% returns on equity was "normal." 2008 proved both assertions astoundingly misguided. Today, investors mostly believe that financials will return to mid-teens returns. They will not. At the same time, it is widely accepted that banks, especially, are incredibly sophisticated and unstable entities. They are neither. Even the world's best banks are fairly poorly managed. Capital and funding expense allocations are a relatively recent phenomenon. Imagine any other business not associating COGS to various departments. It's unimaginable. Yet it is a relatively recent advance for many banks.

Q: Why are financials at a high level a great investment?

A: Financials are credit risk warehouses. Managed appropriately, they are arbitrage vehicles. They borrow for less than Libor and lend out well above it. Properly scaled and diversified, they produce highly defensive returns. There is only one caveat – since they are highly geared, it is incredibly important that they do not push the envelope with respect to risk. In the quarter century up to the financial crisis, bank and insurers became enamored of the high returns on capital associated with the capital markets and they started a long process of incorporating those businesses into their own. The flaw in the strategy, however, lay in the misunderstanding of risk management and accounting for trading assets. When I started in the business, Mother Merrill used to trumpet the fact that they turned their balance sheet every five days. By 2007, 2/3 of Lehman Brothers' balance sheet was cement. The only way to turn those assets was to repackage them in structured securities, which took months even in a liquid market. When that market ground to a halt, there was no cash market into which to sell. And so Lehman suffered a monumental liquidity crisis.

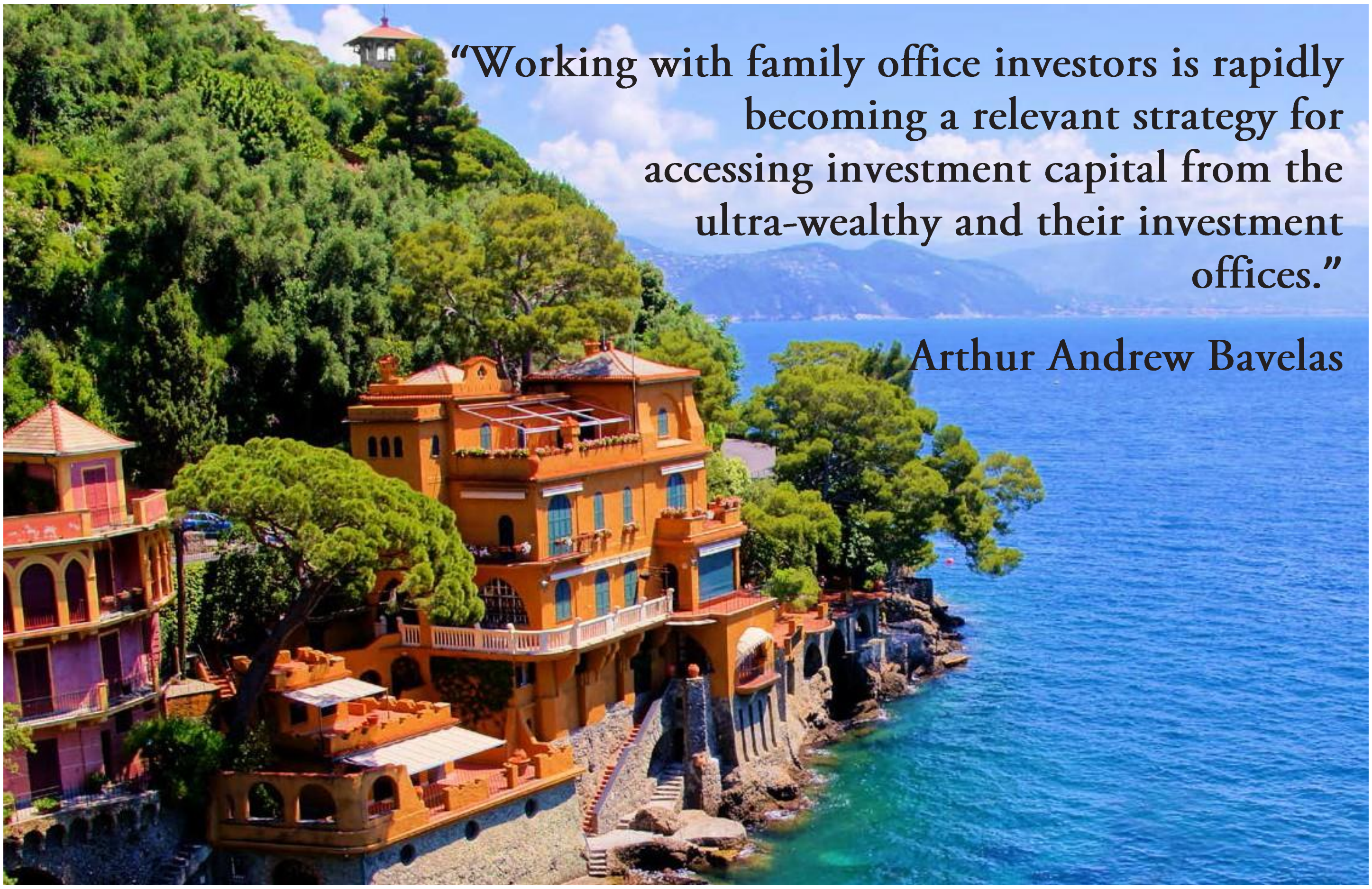
Q: How does Elanus differentiate itself among the industry?

A: We invest in the structured and alternative credit markets. We think there are many well informed investors in our peer group. But we do not believe any of them have the depth of knowledge both of financial services and of corporate credit analysis, especially from the "short" or hedging perspective, as we do. We believe that applying our skills in these markets is a significant advantage. For instance, we are active in trade finance, a niche segment of the credit markets and one where Tino Kamarck, having run the U.S. Ex-Im Bank for eight years, is highly knowledgeable. Additionally, our deep understanding of the banking universe has informed our sourcing and structuring of transactions that have withstood substantial issuer strain without causing our investors loss.

Q: Why is it attractive for family offices to invest in emerging managers such as yourself as opposed to larger ones?

A: Smaller investors are more focused. They are unburdened by status quo. They have no hierarchy of traders chasing finite capital or phalanx of bureaucracy to navigate before making decisions. Additionally, they are often founded around a compelling thesis that larger investors refuse to acknowledge because they do not see the near-term ability to monetize the strategy relative to their existing revenues. If you can manage $10bn and generate 8%, why walk away to manage $100mn at 20% returns? Or even 30%? Smaller, younger firms do not have revenues, strategies, or stale theses to defend. Finally, and undoubtedly most importantly, there are virtually no scale benefits to LPs or shareholders of funds. Scale only benefits managers.

For more information, please go to www.elanuscapitalmanagement.com and to contact Matthew, please email mmoniot@elanuscapital.com.


"Working with family office investors is rapidly becoming a relevant strategy for accessing investment capital from the ultra-wealthy and their investment offices."
Arthur Andrew Bavelas