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DANIEL ZWIRN *of* ARENA INVESTORS

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It is a privilege to be sitting across the table from Daniel Zwirn, co-founder and CEO of Arena Investors, to explore the art of opportunistically investing across the entire credit spectrum—specifically, areas where conventional sources of capital are scarce. Dan is known for having founded and managed the business of D. B. Zwirn & Co., a \$6 billion alternative investment firm of which he was Managing Partner and Chief Investment Officer from 2002 until the end of 2007. D.B. Zwirn was one of the largest independent firms in the alternative credit space. Dan has invested in over 2,000 illiquid investments, accounting for over \$10 billion in special situation financing. In addition to being CIO and CEO of Arena, Dan is currently on the Board of Trustees of the Brookings Institution, the Barnard College Board of Trustees, and the Executive Board of the University of Pennsylvania's Jerome Fisher Program in Management & Technology. Dan, it is a real honor to learn from your experience and share your wisdom. Thank you for the opportunity.

Thank you for having me.

How has alternative credit evolved over the years?

Going back to the 1960s and 1970s, there were a series of different financial crises—even well into the 1980s. These crises were created by various forms of conventional financial institutions that got themselves into trouble, lending in a whole variety of different asset classes that didn't necessarily lend themselves to the kind of policies and processes of more conventional institutions—whether those were insurance companies, banks, mutual fund companies, or other types of independent finance companies.

The alternative credit business as we understand it today began in the privately negotiated situations involving insurance companies and S&L's in the 1980s, moved to mezzanine funds in the early 1990s, and also to certain areas within real estate coming out of the RTC crisis in the early 1990s. Ultimately, "alternative credit" drifted into a lot of activity that was done by the internal proprietary businesses of the investment banks by the mid-1990s, as well as a few independent specialized firms that evolved in the mid-late 1990s, many of which still exist today.

From where you sit, how do you characterize current credit markets relative to other periods that you've seen and lived through?

I think overall credit markets, in the way that most people look at them, meaning markets where there are publicly-traded bonds—whether it's the corporate bond market, the ABS market, or the mortgage markets—are really as priced to perfection and as tight as they have ever been. This includes the peak of 2007, the peaks before the move down in 2002, before September 11th, before the Asian Crisis in 1998, and even the fixed income issues that occurred in 1994.

We are at a very, very ebullient time across traded, or listed, credit markets. Particularly also in the wake of the 2008 crisis, a huge amount of credit risk has been assumed outside the conventional banking system, by a variety of firms that have evolved over the last 7 or 8 years. There were many strategies that seemed relatively esoteric 15 or 20 years ago, whether it's more conventional distressed debt or convertible bond arbitrage, or other hedge fund strategies that have really been priced in a way that doesn't reflect any type of underlying risk and became more conventional. So that which was more alternative at certain times over the last 10 or 20 years has become more conventional now. That which is truly alternative continues to evolve.

I think there are a lot of great opportunities in the markets today, but they require a lot of digging and they're far, far away from the liquid credit markets. In fact, the closer that liquid credit markets can be used to price risk in things that are not traded, the worse those obligations are priced. In some ways you need to be as far away from a perception of being an analogy to the liquid markets as you can get in order to get appropriately paid for the risk you're assuming.

To what extent has credit risk moved beyond the banking system?

In developed markets, central banks drove down yields. Issuance exploded, credits spread vs. risk-free declined, and there were a whole series of investors from bond funds to insurance companies or larger scale endowments and institutions, who wanted access to yield. There was and continues to be this desperate need for yield in portfolios.

A lot of capital is seeking investments within fixed income and credit that allow investors to meet their obligations—whether it's pension obligations or annual endowment draws or insurance obligations. A number of firms that were either not in existence, or were very small, a decade ago are now catering to these investors by accessing opportunities outside of the conventional banking system.

When you say 'alternative credit has become more conventional,' is that to suggest amateurs are beginning to enter the space?

There's certainly some level of crowding in these spaces. They say that lending is the world's second oldest business. Even before hedge funds or alternative investment firms became involved in this over the last many decades, a number of these different esoteric strategies, whether they're founded on traditional banking knowledge or not, get episodically more or less interesting. Strategy by strategy there is a tendency for cyclicity. And then, there's an overlay of cyclicity such that in certain instances the various strategies out there are themselves macro correlated.

Given the search for yield by more conventional institutions and the ever-growing size of the institutions that are funneling that money into the markets outside the banking system, spreads have inevitably continued to compress: things that would've been deemed to be relatively more esoteric or interesting years ago have become very crowded. It's not to say necessarily that those providing the capital are amateurs. There could be people who are very experienced but who are just man-

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aging many, many more billions of dollars than they ever have before such that no matter how talented they are, the number of things where they can, as an example, invest \$100 million or \$200 million or \$300 million at a time in a credit investment are relatively finite.

As smart as they are, they can't make that spread be appropriate to the risk they are taking. There are a number of investors who have been very successful and who have thriving, growing asset management businesses who've pushed to find places for that capital to fill the void.

How do you think cyclicalities in alternative credit is different, or similar, to more traditional markets?

I think at the very extremes, like we saw most recently in 2008, everything becomes correlated or certainly large amounts of that which exists in the fixed income markets becomes correlated. However, I think that much more interesting is the fact that each and every one of these various forms of idiosyncratic, esoteric credit strategies that we look at have their own cyclicalities, sometimes correlated with other forms of esoteric credits, sometimes not.

As an example there's a good argument related to sub-prime auto in the United States. It's relatively difficult to differentiate as an originator in that marketplace and in the wake of the crisis a huge amount of capital entered that space. Securitizations got increasingly more efficient such that at this point one could argue that we're perhaps in the beginning of a new peak of sub-prime auto. At the same time, as an example, marketplace lending or unsecured consumer lending are at the relatively early stages of opportunity, because over the last several years, for reasons mostly associated with the regulatory environment, they couldn't grow in the way that subprime auto did. You see different opportunities becoming more or less appealing and there's always an overshoot in those areas, back and forth, so we find ourselves sometimes in the second or third trip through a given area.

Another example is energy. We started investing in energy when prices went down. This is not to say that we had a view on prices, because we have no idea where oil and gas prices will go—in fact, I'm not sure if it's been proven that anyone has been able to do that systematically as an expertise. However, when prices move down markedly in a relatively short period of time, inevitably there are investors who are caught short, having explicitly or implicitly made a price-bet, many of which are banks or bank-like institutions that have issues. In the mid-late 1990s when oil was \$9 and gas was \$1.40 per mcf, I started buying distressed obligations in that area, and then began lending on an original issue basis because banks no longer wanted to be involved. Then, as 2000 came around and a group of energy traders led by Enron and other similar companies entered the marketplace, it became less logical to do that lending and we became less involved. A few years later, as the overshoot occurred, we ended up buying the portfolios of some of those investors and realized, again, that the opportunity to lend had presented itself. By the late 2000s, banks and others re-entered the market making it less appealing. In the last 1.5 years, prices went back down again, banks got short again, and we re-entered the market and began lending at very favorable advance rates against very modest asset levels, such that at no time were we ever taking a price bet.

These things just kind of come and go and if you are positioned in a way such that you're not, as an institution, compelled—either because of a particular mandate or other truly non-economic reasons—to do things that don't make sense, you can be in a position to comfortably say 'no' when they become less logical which, at least up until recently, has become the time in which the banks come in.

It remains to be seen, given a potentially new regulatory environment, the degree to which banks will re-enter and begin lending again. They really have been out of the market for anything even remotely out of the ordinary for many years now.

With enough experience, does history begin to rhyme?

I certainly think it does. I think there are many booms and busts within esoteric credit strategies, which tend to be somewhat in-sync with human nature within each of those areas. Ultimately, there are a lot of incentives that are built into a lot of the structure—market participants try to scale credit origination well past the time when risk has been appropriately priced.

As an example, less well remembered now, is 2006 and 2007. When middle market lending was becoming markedly less interesting, even before the crisis, there were a whole group of alternative credit funds at the time referred to as “ABL funds”—many of whom blew up when the crisis came. They weren’t banks, they were alternative firms. They were supposed to theoretically be able to do things that banks couldn’t.

It turned out that they made a lot of mistakes that banks themselves did. So inevitably there will be overshooting, there will be retrenchment by banks and non-banks providing opportunities for investors who can be on the other side of that overreach.

I believe Jeff Bezos once commented that he focuses on what he knows does not change. What are some elements that don’t change, that you know to be constants?

One constant is the nature of enterprises and entrepreneurs, and humans generally, to overreach. Inevitably there are people who have a dollar and really want to risk that dollar so that they can have two dollars. Or, really want to risk that dollar in order that they can buy something. Whether that’s a billionaire who wants to be worth \$2 billion or a subprime customer who wants a larger television, the notion of overreach continues to present itself time after time after time.

In what we do, we are not unlike a casino. If you’re a casino you don’t have a view as to whether the cards are going to go one way or another, you want the gamblers to keep coming. We want to be the casino for those gamblers who have assets, whether they have a corporate asset, consumer asset, real estate asset, or structured finance asset, who want to bet those assets, or hypothecate those assets, to do other things. If it turns out that they win, we’re delighted for them. If it turns out they lose, we’re going to take that collateral and we’re still going to be fine. We’re happy to present the opportunity for people to bet on themselves in that way, and we continue to see the nature of borrowers to be relatively consistent through all cycles and all times.

Please help us better understand who can access traditional credit, and who cannot?

That box changes over time. Certainly up until very recently there had never been a tighter box, when you’re talking about access to conventional forms of credit. To be fair, the existence of this box does not at all speak to the intellect of the people providing credit within depository institutions. When you’re in a position where you have to massively scale the practice of credit underwriting, by definition, you have to cre-

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ate a relatively rigid set of rules so that there is some sort of consistency in how you look at credit across a whole different series of assets on a large scale basis. Inevitably, that creates opportunities where there are exceptions that can be taken advantage of—if you are housed in an institution that is not trying to scale at that level and therefore doesn't have to be governed by those rules.

We tend to focus on situations where we can be on the other side of these conventional rules. To that end, when you think about the credit box, and who can access credit or who cannot, what we tend to see is an incredibly tight box. Again, across corporate, real estate, structured finance or consumer assets where the 'have's' keep accessing more and more and more credit, they should do so because credit has been systematically underpriced for them. Ironically, this has actually added to a disparity that certain people decry as inappropriate. For the 'have not's'—no matter how much intrinsic reason that they should be able to access capital, there is simply no price that they can pay in order to access conventional credit. We have built a business servicing the 'have not's' across all areas.

If you could elaborate a bit further, what specific skills are needed to succeed in alternative credit versus the traditional credit?

I think, as a general matter, the ability to be very, very narrow and very deep in esoteric areas is critical. What we tend to do is try to be thoughtful about partnering with people who have, as an example, twenty-five years of nothing but lending to energy assets, or twenty-five years of nothing but lending in subprime auto. Creating partnerships with people like that is key to understanding what we do. We need to be absolutely and very precisely aligned in our interests with those partners such that at no point can we each be unhappy and happy at the same time, respectively. We're both either happy or we're both unhappy; we are hyper aligned in our interests. Accessing this kind of narrow expertise in a way that it is playing for your own team, and doing so on a variable cost-efficient basis, is something we spend a lot of time thinking about. As you are trying to aggregate reasonable amounts of more esoteric credit, the ability to be very focused on technology and systems and the infrastructure necessary to maintain control of

all those assets is also vital. We spend a huge amount of time thinking about how to simplify the process by which those assets are held on our books, and managed, and controlled, and surveilled, because these things can quickly get out of control, as we've seen in the crisis—if they are not appropriately monitored and with others focused on in a very detailed way.

How does credit risk for those who cannot access traditional credit compare against credit risk of those who can?

I think, ironically, when you take into account the return you can receive from the 'have not's' and adjust that for the relative tendency for the 'have not's' to perform less well than 'haves' on that basis it's arguably, or frequently, safer to lend to the 'have not's' than to the 'haves' because the return that you can get from lending to the 'haves' is so slight because of their perceived tendency to repay that it may not be enough to mitigate losses you're going to experience when lending to them. On the other side of that equation, what you can receive in interest or other compensation from putting capital into the hands of the 'have not's' can frequently put you in a position to be more than compensated for the inevitably greater absolute amount of loss experience you might find among a pool of 'have not's' versus a pool of 'haves.' That notion evades many more conventional sources of credit.

It's perhaps not appropriate to call people 'amateurs,' but I think it is appropriate to call people 'newcomers'—as a veteran, what mistakes do you sometimes see newcomers make?

There are situations where people who are steeped in credit analysis from the perspective of security selection may not pay as much attention to the fact that these assets are living, breathing things that need to be surveilled in an incredibly intense way. Just because someone has the means to repay doesn't mean they may be in the mood to repay, and so they need to be frequently reminded, very frequently, in a very focused way, that they owe that money. In a way, a loan or a private arrangement between the borrower and the creditor may not act in the same way, naturally, that a bond might. Similarly, there may be situations, certainly that I have experienced over many years, where there may be jurisdictions that may look and feel kind of like the United States—there are

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certain jurisdictions, as an example, in Europe, where one intuitively might say: “Well, this must work relatively similarly to the United States” and it turns out it doesn’t work as if there’s any material rule of law at all. I’ve had situations in Germany or Belgium or Italy where creditors don’t necessarily have the rights they thought they did, or if they do have their rights, in order to enforce them it may take many, many years longer than they ever dreamed it would take. Adjusting for that, and the uncertainty that it creates, is something that you learn over time—and unfortunately typically only by experience. Another tenet that we live by is that we like to get very diversified because no matter how much experience we have in any of these things, no matter how many years we’ve focused on it, still anything can happen in any one of these situations, when you’re swimming among the ‘have nots.’ There’s nothing that negatively affects our judgment, in my experience, more than being overly exposed to any one thing because when that sideways event happens, hopefully even at its worst, it shouldn’t affect the overall enterprise that you’re trying to build to provide credit—so you can completely, dispassionately, deal with whatever kind of unexpected events may occur.

Elaborating on the observation that you only learn certain things with time, with experience, what are some insights you have now that you wish you had decades ago when you first started?

I think there are situations that one can encounter in these investments where, while you may be wholly dispassionate in your analysis of the situation, particularly in cases where things don’t go as everybody planned, the degree to which partners and counterparties can act against their own economic interest can surprise you. Over time, when people feel very passionately about their asset, even when it’s not theirs anymore, or certain types of service providers that we saw in the crisis who forgot that they were serving customers, and suddenly what we thought was a customer-vendor relationship became a counter-party relationship—some of the broad variety of ways that people can react to extreme issues probably was more extreme than I would have guessed 20 years ago.

I’d love to ask how you practice patience, and how you communicate patience to your clientele?

I think there are some really exceptional investors out there who I certainly admire, people like Seth Klarman or Howard Marks, who have been able to either go to extreme levels of cash at certain times or work with their investors to access capital at very particular times where there are lots of opportunities to pursue—and keep their investors patient when there are fewer opportunities.

As a business, what we’ve tried to do is to say: “How do we build patience into our enterprise?”—as opposed to relying on me or any other individual here on an a priori basis to determine when it’s time to be patient. The way we have done that is to think about relative-risk versus absolute-risk. By doing a very large number, or looking at a very large number, of different types of opportunities at the same time, we can choose to go in and out of different opportunities based upon the appeal of their relative return per unit of risk. If you have vastly more opportunities to explore than dollars needed to act on them, then the opportunities themselves show you where to put your capital, or more importantly where not to act. That allows us to move capital effectively, to be patient. Not because we’re saying: “We’re just going to do nothing”—not that we wouldn’t if every single thing that we’ve looked at was relatively unappealing—but to rather say instead: “I’m not going to do this anymore because I have these other 5 things

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that are much more appealing.” The way we do that without, if you will, ‘breaking the bank’ as an enterprise is to create variable cost-efficient access to a large group of experts with very particular capabilities who are strongly aligned with us. Our ability to then take all those people, and all of the ideas, and all of that advocacy, and dispassionately look at the return per unit of risk available in these various things allows us to, effectively, be patient. Patience is built into that process, as opposed to simply being a matter of personal discernment by me or anyone else.

As a firm founder, how do you navigate the value of inactivity, when sometimes doing nothing is the best choice for your clients? And when inactivity is optimal, how do you communicate this to your clients?

I think that, as I said, usually it is not doing nothing, it’s doing different things. For that to be the case we need to communicate, upfront, the fact that we’re going to look at what may appear to be a relatively wide variety of things so that we’re not in a position where we are advocating for an activity that no longer is compelling because, as we said, our view is all of these different esoteric strategies become episodically uninteresting, and so we have to be in a position where we can very quickly and comfortably not do one or any of them, at the time that they become uninteresting.

An even more interesting question, beyond how do you communicate that to your investors, is how do you communicate that to your own staff—to your own fellow professionals? What we try to do is say that we are hiring for a particular set of capabilities; many times we think that set of capabilities will be useful to a person throughout a cycle, but we have had many situations where someone said, “This thing I’ve been spending my last 2 years on is uninteresting, so what am I to do?”

To which we will say, “We didn’t hire someone to do that strategy, we hired someone who was a commercial actor. If the thing that you’re focusing on is not able to find a place on a return per unit of risk basis in our portfolio, then, as a commercial actor, you need to find something that leverages your capabilities and creates something that creates value for our portfolio.”

We’ve described this notion as a “Darwinian funnel of opportunity” where, again, the risk-return of all the different things we’re looking at simultaneously shows

itself to us. That goes for things that our own employees are doing on a day-to-day basis. I’ve seen people with a variety of different types of expertise transition and leverage their capabilities into other things. As an example, I’ve had colleagues who had been great in the traded asset-backed securities markets, then credit spreads have tightened and they’ve said: “Well, these underlying assets are compelling, if we can just find a way to access them—without doing so through securities or securitizations, maybe there can be an appealing way to invest.” They’ve recreated that same type of appealing risk/reward outside of the securities markets in negotiated situations. Or, I’ve had people who are very good at relative value within the equity securities business who have then said: “The kind of risk that I’m looking for can be found in a different type of arbitrage, or a different type of geography, and I’m going to go and leverage my capabilities, the capabilities I already have, to that new opportunity because I think I might be able to find appropriate return per unit of risk in that.”

Never being content with “this is the least worst-opportunity, so we have to do it” is critical and empowering people to go outside their normal field of endeavor, to find where the best stuff is, becomes critical in order for that to happen—and then to communicate that approach to our investor base, so that they’re not surprised when we go from 30% outside of the United States to 80% outside of the United States, because that’s where the spread is. We’re going to continuously look at ALL the opportunities that present themselves, and communicate the way we look at things and do things, such that there are no surprises for any of our stakeholders—so that when we’re going after that kind of optimal return per unit of risk nothing stops us from doing so.

If there’s awareness of excess in the automotive lending space—is it optimal to avoid the space entirely, or to preemptively look for opportunity, or to wait and re-act should an event transpire? How do you think through, where you sit, the next step after spotting a cyclical excess?

I would say whenever something becomes overheated we are always thinking about how to position ourselves for when the game starts again. If we see an area where there has been gross over-issuance at terms that don’t make sense, at spreads that don’t make sense, leverage via securitization that doesn’t make sense, we might

then say to ourselves: “How do we make sure that when these bonds come for sale, at the right level, we’re ready? When this collateral comes out, are we ready? Do we have the right partner who knows how to evaluate that collateral? Do we have the right partners who know how to dispose of that collateral?” Certainly you can see yourself having those thoughts within the subprime auto area right now and saying: “If auto loans again look like they did 6 or 7 years ago, are we in a position to take advantage of that?”

What areas would you suggest one study, in further detail, to become a more intelligent investor?

There’s certainly no magic to it. There’s nothing, in my view, more valuable to think through as an investor than the investments of great investors. There are things to be learned, even today, from all of the Buffett letters and the writings of Benjamin Graham. I think all of those things are applicable today. Also, there are aspects of psychology and philosophy that can be studied that give insight into human behavior.

As we conclude, which areas of need do you choose to devote your personal time and capital?

For me, I really love the pursuit of learning and knowledge, and the employment of reason—organizations that are devoted to making things clear, devoted to study, devoted to enlightening, are really things I can be passionate about. That’s where, for me, I’ve spent most of my personal bandwidth outside of work and family—and almost all of my non-profit activity.

Dan, thank you for teaching us; it’s great to learn from you and thank you for your time.

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