Opportunistic and Multi-Strategy Credit

Interview preparation summary · PC track

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INT.CO.1.a · Flexible mandates and sourcing

Explain what flexible-mandate credit is, how it differs from a single-strategy fund, and why opportunities such as bank balance-sheet sales, risk transfers, forced selling and capital solutions arise.

An opportunistic or multi-strategy credit fund has a mandate wide enough to move across the capital structure, between public and private markets and across sectors and regions as value appears, where a single-strategy fund stays in one niche such as senior direct lending. The flexibility is only worth having if the fund can say why a given opportunity exists, because a return above the market is paid for something: providing capital when others cannot, taking a risk that a seller must offload, or bearing complexity or illiquidity. Typical sources are banks managing their balance sheets (selling loan portfolios, or sharing risk through significant risk transfers and synthetic risk transfers, where the investor takes a mezzanine or first-loss tranche of a reference portfolio and the bank keeps part of the risk so that its underwriting stays disciplined), forced sellers such as funds that hit rating or redemption limits, borrowers that are stressed but not distressed and need a rescue, bridge or refinancing solution, and dislocations in structured credit. Distressed investing has its own topic and is only one possible overlay. The usual mistakes are to treat flexibility as permission to chase yield, to assume a discount always means value when it may reflect real credit deterioration, and to forget that the mandate still carries limits. A strong answer names the seller or borrower, says what constraint drives them, says what the fund is paid for and says why the opportunity should not simply be competed away. Legal, regulatory and capital treatment of risk transfers is handled by counsel and advisers.

WORKED EXAMPLE: WHAT A RISK TRANSFER TRANCHE PAYS AND WHEN IT STOPS PAYING

A bank offers a mezzanine tranche of a 2,000m reference portfolio of corporate loans. The tranche attaches at 2% and detaches at 10% of the portfolio, and pays the investor a premium of 9.0% a year on the tranche amount. Assume a four-year life, no amortisation, premium on the original tranche amount, and ignore collateral income and tax. What is the tranche size, the premium over the life, and the cumulative portfolio loss at which the investor's total premium is wiped out by losses?

Answer: The tranche is 160m, pays 14.4m a year (57.6m over four years), and breaks even at a cumulative portfolio loss of 4.88%.

> **Interview tip:** Explain why the opportunity exists (the bank wants to free capital or reduce concentration), then give the attachment point, the thickness and a break-even loss in your first few sentences.

INT.CO.1.b · Flexible mandates and sourcing

Explain how a flexible-capital provider sources deals through banks, sponsors and advisers, and why speed and certainty of execution are part of the product and must be priced.

Much of the best opportunistic credit never reaches an open auction. It comes through relationships: bank portfolio management and capital markets teams that decide who sees a loan sale or risk transfer first, sponsors who need a fast answer for an add-on acquisition or a maturity, and advisers who run rescue and refinancing processes and want a lender that will deliver. What the fund sells in these cases is speed, certainty and flexibility as much as money. A borrower facing a deadline, such as a closing date or a maturity, values a lender that can commit quickly, accept a complex situation and fund on time, and it will pay a premium over a cheaper but slower or less certain alternative. The lender can price this by working out what the borrower's alternative really costs once the chance of failure is included, then charging part of the difference. Speed must not become carelessness: a fast lender narrows diligence to the few facts that decide repayment, such as the exit route, collateral value and ranking, runs advisers in parallel and conditions funding on security being in place, and it does not skip

those checks. Repeat business matters because sponsors and banks go back to lenders that delivered what they promised. A strong answer names the sourcing channel, the constraint of the counterparty, how the premium is justified and what diligence is still non-negotiable.

WORKED EXAMPLE: PRICING SPEED AND CERTAINTY ON A BRIDGE LOAN

A sponsor needs 90m within three weeks to complete an acquisition. A bank offers base rate plus 5.0% with a 1.0% fee, but there is a 40% chance that its approval will not arrive in time, and missing the deadline would cost the sponsor 15m in break fees. The fund offers a certain loan at base rate plus 8.0% with a 2.5% fee. Assume a one-year loan. Does the fund's price clear, and how much room does it have?

Answer: Yes: the fund's extra cost is 4.05m against an expected failure cost of 6.0m, so the quote clears with 1.95m of room.

Interview tip: Say that you price the borrower's alternative including its chance of failure, then show that your premium is lower than the value of certainty.

INT.CO.2.a · Relative value and the cycle

Compare spread, yield and risk across loans, bonds, structured credit and private deals on one basis, adjusting for base rate, fees, price, expected loss and illiquidity, to say where capital is best placed.

Relative value is the core skill of a flexible fund, because it must compare things that are quoted differently. A floating-rate loan is quoted as a margin over a base rate, a bond as a yield or a spread to a reference curve, a structured tranche as a spread with a loss profile, and a private deal as a margin plus fees. The first step is to put every candidate on one basis, usually a spread over the base rate (or its equivalent after swapping fixed to floating), including upfront fees and any purchase discount spread over the expected life. A simple convention is margin plus discount or fee divided by expected life. The second step is to deduct expected loss, which is the probability of default times loss given default, to compare net spreads. The third is to compare a private deal with its liquid alternative: the difference in net spread is the illiquidity premium, which should be big enough to pay for being unable to sell, for the extra work and for the weaker information. When a sell-off makes liquid assets cheap, the premium can narrow or turn negative, and a flexible fund should then favour the liquid market or demand better terms. Compare like with like on structure and ranking, too, because a higher spread may simply reflect a lower rank. The usual mistakes are comparing headline coupons, ignoring fees and price, and treating the quoted spread as if it were all return.

WORKED EXAMPLE: HOW MUCH EXTRA DOES THE PRIVATE LOAN PAY FOR ILLIQUIDITY?

A fund compares two senior loans to similar borrowers. Loan A is liquid: base rate plus 4.0%, bought at 98.0, expected life three years, probability of default 1.5%, loss given default 40%. Loan B is private: base rate plus 6.5%, with a 2.0% upfront fee, expected life four years, probability of default 2.5%, loss given default 35%. The fund wants at least 1.5% of net spread over the liquid alternative. Does B qualify? Use margin plus discount or fee over expected life as the spread.

Answer: B nets 6.125% against A's 4.07%, an illiquidity premium of about 2.06%, so it clears the 1.5% hurdle, but it fails if B's default probability doubles.

Interview tip: State the convention you used, give both net spreads and the premium, then say what assumption would break the conclusion.

INT.CO.2.b · Relative value and the cycle

Judge where the credit cycle stands, decide when to be defensive or aggressive, pace deployment of dry powder, and explain how a flexible fund chooses where to put the next unit of capital.

A flexible fund has to decide not just what to buy but when. Late-cycle signs include spreads close to their long-run tights, loosening documentation (weaker covenants, larger add-backs), rising leverage multiples, falling interest cover, aggressive structures and abundant lender competition. Early-cycle or dislocated markets show wide spreads, tight documentation, falling prices, closed issuance and forced sellers. In the first case the sensible response is to raise the bar on structure and seniority, shift towards senior secured and liquid positions, slow deployment and hold dry powder, which is committed but uninvested capital. In the second it is to deploy faster into better-priced risk. Waiting has a cost, because uninvested capital earns only the cash rate, so the choice can be framed as a bet: waiting is worth it if the probability of a better entry point exceeds the break-even probability set by the carry given up and the extra return gained. A fund also has an investment period, but it should not lower standards to meet a deployment target. The decision for the next unit of capital is to rank

opportunities by return after expected loss, fees and illiquidity, adjusted for the capital and liquidity each uses and for how it changes portfolio risk, and then to choose the best addition within limits. Cycle calls are uncertain, so a strong answer commits to a view while saying what would change it.

WORKED EXAMPLE: IS IT WORTH HOLDING 300M OF DRY POWDER FOR A YEAR?

A fund has 300m to deploy. Spreads are tight. Deploying now earns an expected 8.5% a year for four years. Waiting holds cash at 4.0% for one year and then invests for three years at 12.5% if a dislocation arrives, or at 8.5% if it does not. Use simple annual returns without compounding. What probability of a dislocation within the year makes waiting break even?

Answer: Waiting breaks even at a 37.5% chance of a dislocation within the year; above that it is worth holding the dry powder.

Interview tip: Frame the cycle call as a break-even probability, say what evidence you would use, and say that you would phase the deployment.

INT.CO.3.a · Fund construction, returns and terms

Construct and risk-manage a flexible credit portfolio at fund level: set concentration and correlation limits, decide what to hedge, use leverage prudently, match portfolio liquidity to the liquidity promised to investors, and run stress tests.

A broad mandate means the portfolio can drift into crowded or correlated positions, so fund-level limits matter more than they do for a single-strategy fund. Typical limits are by issuer, sector, region, strategy sleeve, ranking and the share in illiquid or hard-to-value assets, with extra attention to correlated exposures such as two borrowers owned by the same sponsor or exposed to the same customer. Interest-rate risk is usually hedged where the fund's target is a spread over base rates and fixed-rate positions would otherwise add price risk the fund is not paid for, and currency risk is hedged back to the fund's currency; credit risk is managed through selection and sizing, with hedges such as index protection used only for specific, understood purposes. Leverage at fund level (a credit facility or subscription line) raises income but also magnifies price falls and creates margin or covenant risk, so it is capped and sized against the liquidity of the assets. The central structural risk is liquidity mismatch: the fund must not promise investors more liquidity than its assets can supply. A liquidity sleeve sized to stressed redemptions, notice periods, gates and side pockets protect remaining investors from forced sales at poor prices. Stress tests combine shocks, such as wider spreads, higher rates, defaults and redemptions at the same time, and report the effect on net asset value, income and liquidity. A strong answer names the limit, the risk it controls and the action it triggers.

WORKED EXAMPLE: LIQUIDITY COVERAGE OVER TWO QUARTERS OF REDEMPTIONS

An evergreen fund has a net asset value of 1,000m, of which 250m is liquid credit that can be sold close to par within a month and the rest is private and structured assets. In a stress, investors request redemptions of 15% of net asset value each quarter. Ignoring performance and assuming redemptions are met from the liquid sleeve, what is liquidity coverage in each of the first two quarters?

Answer: Coverage is 1.67x in the first quarter and 0.78x in the second, which shows the liquid sleeve runs out and a gate or larger sleeve is needed.

Interview tip: Explain that the problem is the second quarter, not the first, and that fair treatment of remaining investors is the reason for gates.

INT.CO.3.b · Fund construction, returns and terms

Attribute a flexible fund's return to carry, spread capture and trading gains, bridge gross to net returns, and explain drawdown and evergreen structures, side pockets, gates, fees and the risk of style drift.

A senior direct lender earns mostly carry, the contractual margin and fees, so its return is steady and its losses come from defaults. A flexible fund earns carry too but also spread capture (price gains as spreads tighten or as a discounted position pulls to par) and trading gains from relative-value moves, and it can suffer mark-to-market losses in a sell-off even where no default has happened. Attribution separates these, because carry repeats while capture and trading depend on the cycle and on skill. Gross return becomes net return after management fees, fund expenses and any performance fee, which is typically a share of the return above a hurdle, so the investor's net figure is lower than the gross figure by the fee load. Structure follows asset liquidity. A drawdown (closed-end) fund calls capital as deals are found and returns it as they are realised, which suits illiquid and special-situation positions. An evergreen (open-ended) fund offers periodic redemption, which needs a liquidity sleeve, notice periods, gates and side pockets, where a side pocket holds an illiquid or hard-to-value asset apart from the main pool so that it is realised for the investors who held it. Fee design should align incentives: fees on invested or net asset value,

a hurdle, a high water mark or clawback, and valuation that does not reward optimistic marks. Style drift is the risk that the portfolio moves away from what investors agreed to, often after a strong run in a riskier sleeve; limits, reporting and investor consent control it.

WORKED EXAMPLE: FROM GROSS ATTRIBUTION TO NET RETURN

A flexible fund with a net asset value of 1,000m earns, over a year, 80m of carry (income), 20m of spread capture, 10m of trading gains and loses 15m to credit losses. It charges a management fee of 1.25% of net asset value, expenses of 0.30% and a performance fee of 15% of profit above a 6.0% hurdle, calculated after management fees and expenses with no catch-up. What is the attribution and the net return?

Answer: Gross return is 9.5% (carry about 84% of profit), fees take 1.84 points, and the net return is about 7.66%.

> **Interview tip:** Say which part of the return repeats, then walk gross to net in order: management fee, expenses, hurdle, performance fee.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.