The Interview – Michael Craig-Scheckman, Deer Park Road: “We have sold positions with too much downside risk and raised cash levels in anticipation of buying cheaply”

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Michael Craig-Scheckman, chief executive, president and portfolio manager at Deer Park Road, says the firm distinguishes itself from other managers through its focus on deeply discounted, high cash-flow, shorter-term asset-backed securities, coupled with a philosophy of not using leverage and viewing all purchases as potential hold-to-term securities.

GFM: What is the background to your company and funds?

MCS: Deer Park Road is an alternative investment manager that I founded in 2003 as a registered investment advisor after spending the previous 10 years as an internal investment manager for Millennium Partners in New York.

Deer Park Road has managed up to USD500m and has always focused exclusively on distressed asset-backed securities. The firm's investment goal is to produce high returns in both absolute and risk-adjusted terms investing in distressed mortgage-backed and other asset-backed fixed-income securities.

GFM: What is the structure of your funds?

MCS: The master fund, STS Partners Fund, is a limited partnership domiciled in Delaware with one feeder fund, Ski Time Square, an offshore corporation based in the Cayman Islands. The general partner and investment advisor to both master and feeder funds is Deer Park Road Corporation, an investment advisor registered with the state of Colorado.

GFM: Who are your key service providers?

MCS: Custody is provided by Wells Fargo, external audit by Rothstein Kass, third-party administration by Stone Coast Fund Services, and external securities pricing by Clayton IPS. Our external legal counsel is Baker Hostetler.

GFM: Have there been any recent changes to the management team?

MCS: On August 3, Scott Burg was named as associate portfolio manager, reporting to myself. In addition to assisting with the management of the firm's portfolio of distressed mortgage-backed and asset-backed securities opportunities, Scott assists with risk management.

He was a principal at General Capital Partners, focused on advising middle market companies in distressed situations, having previously analysed asset-backed securities at USD500m fixed-income hedge fund manager Pursuit Partners. Earlier Scott founded Clayton IPS's asset-backed securities pricing division.

GFM: What is the profile of your current and targeted client base?

MCS: Our internal marketing resources are focused primarily on funds of funds, family offices, foundations, endowments and high net worth individuals.

GFM: How would you assess the impact of the recent global financial crisis and economic downturn on your business?

MCS: They have created a significant opportunity to obtain returns that have never been seen before. The high cash flow nature of our portfolio enables us to take advantage of these opportunities.

GFM: What is your investment process?

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MCS: We focus on high-yielding, shorter-term distressed asset-backed debt, predominantly backed by real estate, which provide steady and substantial cash flows. Although the portfolio is actively traded, our philosophy is to buy securities that we are comfortable holding to term.

Maintaining abundant deal flow is critical. Our extensive expertise and experience in the distressed asset-backed arena provides the opportunity to screen hundreds of securities in a typical day. A subset, typically 20 or 30 out of 300 to 500, is analysed in further detail, using our proprietary valuation model, which narrows the universe of issues to a smaller subset that meets our investment criteria.

Our goal is to manage toward a target monthly cash flow of 3 to 5 per cent of the fund's value, translating into 36 to 60 per cent cash flow per year. All securities are purchased under the assumption that they will be held to term, typically three to four years, but adjustments to the portfolio are made as required by the market. Positions may be sold to take advantage of positive movements, protect against negative price movements, rebalance the portfolio in terms of sector weighting or meet any redemptions in excess of our quarterly portfolio cash flow.

Deer Park Road's proprietary valuation model is used to value all buy or sell candidates. A bid range is assigned, establishing an acceptable purchase or sale price, and all securities transactions are executed at prices within predetermined minimum or maximum limits. Because securities meeting our investment criteria are typically thinly traded and have bid/ask spreads greater than 10 per cent, this offers significant opportunities to buy at the 'right' price.

We believe our process and methodology gives us a competitive edge in the trading of distressed fixed-income **s**ecurities.

GFM: How do you generate ideas for your funds?

MCS: We are typically opportunistic and continually monitor the market to look for areas that present themselves. In effect, we let the market tell us what to buy and what to sell within the context of our deep discount, high cash flow philosophy.

GFM: What is your approach to managing risk?

MCS: We focus on high-yielding securities, providing steady and substantial cash flows to mitigate many of the market risks. Typically, we avoid securities that have deferred cash flow in favour of current cash flow. We focus on relatively short-term securities of three to four that we expect tobuy and hold, and typically avoiding long-term securities of 10-plus years.

To control risk, we use minimal leverage and diversify within ABS market sector and security type. We focus on short-term securities, those with high current cash flow and the purchase of deeply discounted securities. We hedge market risks though security selection and model credit risk in-house rather than relying on outside rating firms. Ongoing sensitivity testing of portfolio securities is done on a regular basis using underlying parameters such as prepayment rates and interest rates.

GFM: How has your recent performance compared with your expectations and track record?

MCS: Long-term target returns for our portfolios are in the range of the mid- to upper teens, which is consistent with our long-term track record. Performance in the past two years has been significantly above targeted returns.

GFM: What opportunities are you looking at right now?

MCS: On a daily basis we continue seek out high-yield/high cash flow, shorter-term ABS securities. Currently, we believe we are seeing many buyers in our market who are buying based on overly optimistic assumptions. This has allowed us to sell out of positions at excellent valuations and move into sectors and specific securities that we believe will yield the target yields and cash flows we desire while decreasing our risk profile.

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In addition to various random, older deals that we have been able to pick up at attractive prices, we currently see a good opportunity in second liens.

GFM: What events do you expect to see in your sector in the coming year, and how will they affect your portfolio?

MCS: We expect moderate weakness in the housing sector in the coming year. A moderate decline would have a limited impact on the portfolio and could potentially limit gains in the short term. However, given our market expectations, we have made efforts to sell out of positions that we believe have too much downside risk and raised our cash levels in anticipation of buying cheaply.

GFM: What differentiates you from other managers in your sector?

MCS: Our focus on deeply discounted, high cash-flow, shorter-term asset-backed securities coupled with a philosophy of not using leverage and viewing all purchases as potential hold to term securities differentiates us from many other managers. In addition, our extensive experience of analysing and trading the full array of asset-backed securities, not just mortgages, differentiates us from the numerous mangers focused exclusively on this sector.

GFM: How do you view the environment for fundraising over the coming 12 months?

MCS: Although the general fundraising market has been challenging for the past few years, and we expect this to continue for several more, we do believe that high alpha investment strategies such as ours, which can truly produce low volatility and low correlation with other strategies and asset classes, will have an easier time raising capital in this environment.

GFM: Do you have any firm plans for further product launches?

MCS: Although we have no firm plans, we do have several other products under review.

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