# Tetragon Financial Group

## Achieving superior returns from alternative assets

Investment companies

Alternative assets

**In 2018, Tetragon Financial Group (TFG) proved its ability to generate positive returns from a portfolio of alternative assets against a backdrop of negative returns across more traditional asset classes (including equities, bonds and commodities). Tetragon's 12.1% return on equity (ROE) in 2018 is well within its long-term target range of 10–15%, and its 10.3% NAV total return compares with the negative 8.9% and 14.8% returns of the MSCI AC World and FTSE All-Share indices, in comparable US dollar terms. While its NAV progressed steadily higher, Tetragon's share price declined broadly in line with global equity markets in 2018 and its discount reached 48.8% in early January 2019. However, this was turned to an advantage via the recently completed US$50m tender offer, which was 2.3% accretive to NAV per share, and the discount has subsequently narrowed. Maintaining a progressive dividend policy, Tetragon has a sector-leading 5.6% yield.**

| 12 months ending | Total share price return (%) | Total NAV return (%) | MSCI AC World (%) | FTSE All-Share (%) | US 10-year govt bonds (%) |
|---|---|---|---|---|---|
| 28/02/15 | (6.9) | 9.6 | 8.1 | (2.7) | 8.9 |
| 29/02/16 | (6.7) | 13.7 | (11.8) | (16.4) | 4.2 |
| 28/02/17 | 50.3 | 8.5 | 22.8 | 9.7 | (3.2) |
| 28/02/18 | 11.3 | 8.7 | 19.4 | 15.6 | (2.4) |
| 28/02/19 | 1.4 | 14.2 | (0.3) | (1.8) | 4.0 |

Source: Refinitiv, Bloomberg, Edison Investment Research. Note: 12-month rolling discrete total return performance in US dollar terms up to last reported NAV date.

## The alternative asset market opportunity

Global economic growth has weakened over the past 12 months and further downside risks exist. This provides an uncertain backdrop for corporate earnings growth and the investment outlook is also clouded by changing expectations for interest rate rises, which could lead to further volatility in equity and bond markets. In this environment, alternative assets could appeal to investors as a potential source of uncorrelated returns.

## Why consider investing in Tetragon?

- Diversified alternative asset portfolio has demonstrated ability to deliver positive returns in challenging market conditions.
- Continuing growth in TFG Asset Management's third-party assets under management provides capital growth and increasing fee income.
- Strong and stable 10-year NAV performance track record.
- Above-average ongoing charges are mitigated by strong net returns.
- Progressive quarterly dividend, with sector-leading 5.6% yield.

## Potential for discount to narrow; attractive yield

Tetragon's share price discount to NAV widened in 2018, due to its share price declining while its NAV progressed steadily higher. The discount has narrowed from 48.8% in January 2019, but is still some distance from its December 2017 narrow point of 32.8%, suggesting significant scope for it to continue narrowing. Tetragon's 5.6% dividend yield is well above the 2.5% average yield in its peer group.

**9 April 2019**

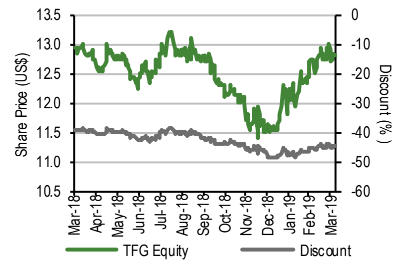
| | |
|---|---|
| **Price** | **US$12.80** |
| **Price (TFGS)** | **1,055p** |
| **Market cap** | **US$1,193m** |
| **NAV*** | **US$2,158m** |

| | |
|---|---|
| NAV* | US$23.15 |
| Discount to NAV | 44.7% |

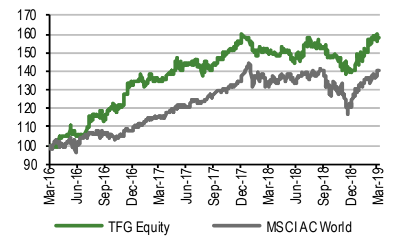
*NAV as at 28 February 2019.

| | |
|---|---|
| Yield | 5.6% |
| Ordinary shares in issue | 93.2m |
| Code | TFG/TFGS |
| Primary exchange | Euronext Amsterdam |
| Secondary exchange | LSE Specialist Fund Segment |
| AIC sector | Flexible Investment |
| Benchmark | N/A |

### Share price/discount performance




### Three-year performance vs index




| | | |
|---|---|---|
| 52-week high/low | US$13.20 | US$11.40 |
| NAV** high/low | US$23.15 | US$21.19 |

**Including income.

### Gearing

| | |
|---|---|
| Gross borrowings* | 1.8% |
| Net cash* | 11.0% |

*As at 28 February 2019.

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Edison profile page


***Tetragon Financial Group is a research client of Edison Investment Research Limited***

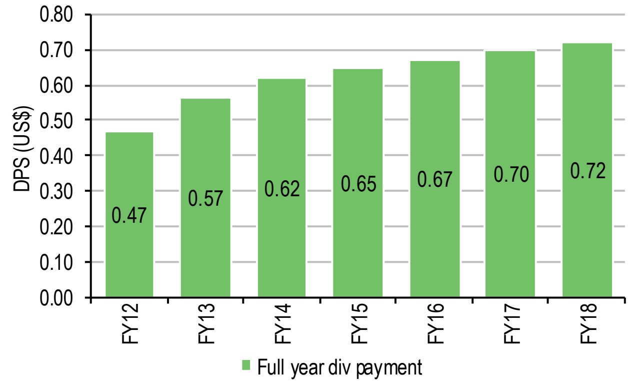
## Exhibit 1: Company at a glance

| Investment objective and fund background | Recent developments |
|---|---|
| Tetragon's investment objective is to generate distributable income and capital appreciation, aiming to provide stable returns to investors across various credit, equity, interest rate, inflation and real estate cycles. Tetragon's investment portfolio comprises a broad range of assets, including a diversified alternative asset management business, TFG Asset Management, and covers bank loans, real estate, equities, credit, convertible bonds, private equity and infrastructure. | ■ 28 February 2019: FY18 results – NAV total return +10.3% vs MSCI AC World index -8.9% and FTSE All-Share index -14.8%, all in US dollar terms.<br>■ 26 February 2019: US$0.1825 Q418 dividend declared vs US$0.1775 in Q417.<br>■ 28 January 2019: US$50m tender offer final result – acceptances confirmed for 4.3m non-voting shares at US$11.50 per share.<br>■ 31 December 2018: Deron Haley, Steven Hart and David O'Leary appointed as board directors, replacing Rupert Dorey, David Jeffreys and William Rogers.<br>■ 19 December 2018: GreenOak Real Estate merger with Bentall Kennedy announced. |

| Forthcoming | | Capital structure | | Fund details | |
|---|---|---|---|---|---|
| Investor day | April 2020 | Ongoing charges | 1.73% | Group | Tetragon Financial Group |
| Interim results | July 2019 | Net cash | 11.0% | Manager | Tetragon Financial Management |
| Year end | 31 December | Annual mgmt fee | 1.5% of net assets | Address | 1st Floor Dorey Court, Admiral Park |
| Dividend paid | May, Aug, Nov, Mar | Performance fee | 25% over Libor+2.65% hurdle | | St. Peter Port, Guernsey GY1 6HJ |
| Launch date | 19 April 2007 | Company life | Indefinite | Phone | +44 20 7901 8328 |
| Continuation vote | N/A | Loan facilities | US$150m rolling credit facility | Website | www.tetragoninv.com |

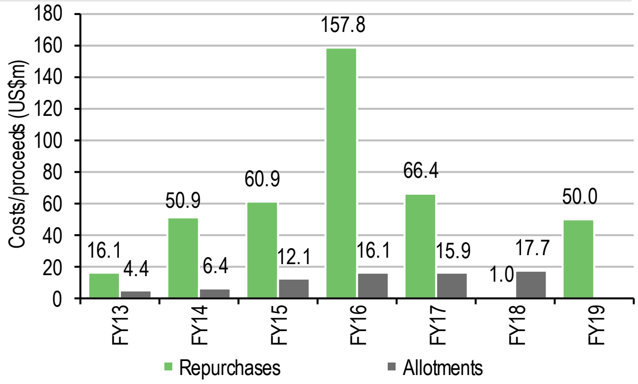
### Dividend policy and history (financial years)

Tetragon pays dividends quarterly and has a progressive dividend policy, targeting to pay out 30–50% of normalised earnings.

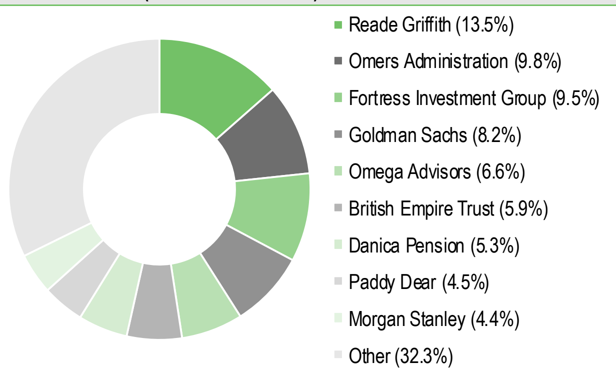



### Share buyback policy and history (financial years)

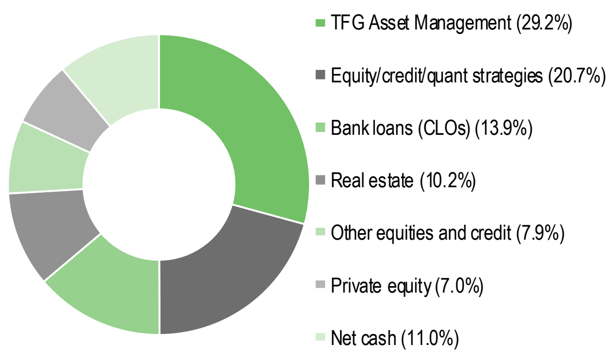
Market share repurchases made up to 2013. Seven tender offers totalling US$525m completed since 2012. Allotments mainly relate to scrip dividends.




### Shareholder base (as at 31 March 2019)




### Portfolio exposure by asset class (as at 28 February 2019)




### Top 10 holdings (as at 28 February 2019)

| | | | | % of NAV | |
|---|---|---|---|---|---|
| **Holding** | **Asset Category** | **Investment Structure** | **Description** | **28 Feb 2019** | **28 Feb 2018**** |
| GreenOak Real Estate* | TFG Asset Management | Private equity | US$10.6bn global real estate asset manager | 9.7 | 3.5 |
| Equitix* | TFG Asset Management | Private equity | £3.9bn UK infrastructure fund asset manager | 9.3 | 7.9 |
| Polygon Euro Equity Opp Absolute Return | Event-driven equities | Hedge fund | European event-driven equity hedge fund | 9.1 | 13.0 |
| LCM* | TFG Asset Management | Private equity | US$8.3bn CLO manager | 7.2 | 7.3 |
| Polygon Euro Equity Opp Long Bias | Event-driven equities | Hedge fund | European event-driven equity hedge fund | 4.6 | 0.0 |
| Polygon Convertible Opportunity Fund | Convertible bonds | Hedge fund | Event-driven credit hedge fund | 3.6 | 3.8 |
| TCI II | Bank loans | CLO fund | US broadly syndicated corporate loans | 3.0 | 3.3 |
| Private equity investment | Private equity | Direct investment | Undisclosed direct balance sheet investment | 2.6 | 2.1 |
| Polygon* | TFG Asset Management | Private equity | US$1.4bn hedge fund manager | 2.6 | 2.8 |
| QT Fund | Quantitative strategies | Hedge fund | Quantitative strategies hedge fund | 2.4 | N/A |
| **Top 10 at each date** | | | | **54.1** | **49.1** |

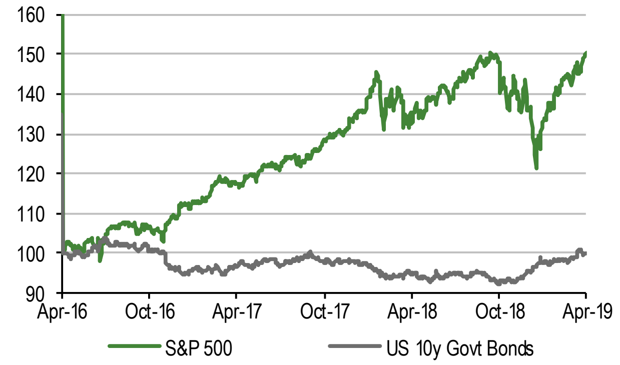
Source: Tetragon, Edison Investment Research. Note: *Part of TFG Asset Management. **N/A where not in February 2018 top 10.

## Market outlook: Uncertainty over near-term prospects

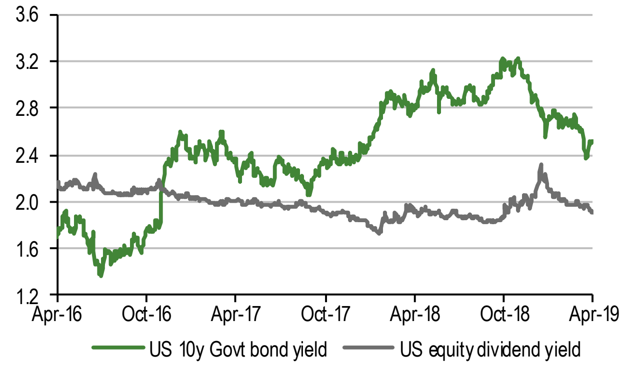
As illustrated in Exhibit 2 (left-hand chart), US equities have performed well over the last three years as a whole. Although equity market volatility increased dramatically in 2018, with a correction in the fourth quarter, the US stock market has rebounded strongly in 2019 to date. In contrast, US government bond returns have been lacklustre over the last three years, pressured by the outlook for interest rate hikes. However, the recent softening stance on rate hikes by the US Federal Reserve is reflected in a bond market uptick, with an associated relatively pronounced decline in yields (see Exhibit 2, right-hand chart). This has led to a narrowing in the yield premium of bonds relative to equities, moderating the relative appeal of bonds as an asset class.

**Exhibit 2: US equity returns and yields vs government bonds over three years**

**S&P 500 index returns versus US government bonds**




**US 10-year govt bond yield versus US equities dividend yield**




Source: Refinitiv, Edison Investment Research. Note: Data to 8 April 2019.

Global equity market valuations fell sharply in the fourth quarter of 2018, with Refinitiv data showing the world market forward P/E multiple declining to 13.0x in December 2018, c 20% below its early 2018 peak of 16.3x. However, equity markets have rebounded strongly over the last two months and forward P/E multiples for US, European and Asian stock market indices are now 3–13% higher than 10-year average levels. The data also show that dividend yields for these regional stock market indices are within 1pp of 10-year average levels, suggesting some scope exists for re-rating to lead equity markets higher, but that corporate earnings growth is likely to be the main driver.

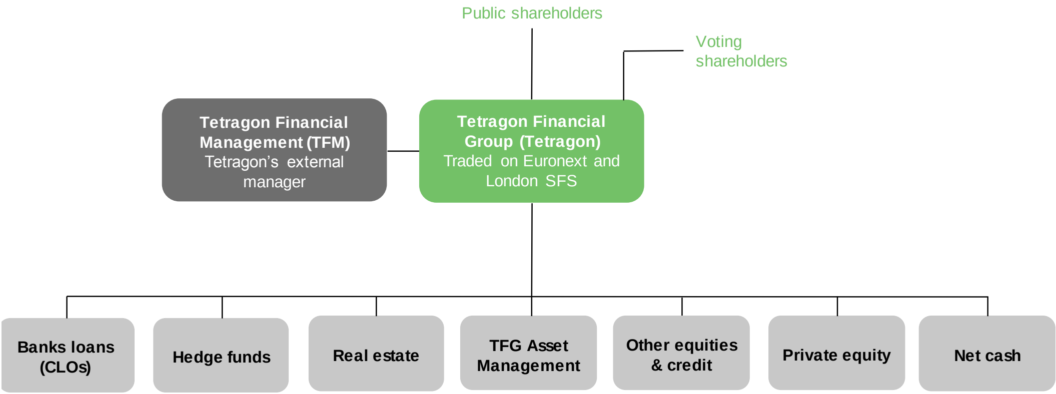
Global economic growth has weakened over the past 12 months, partly due to negative effects from trade tariffs imposed by the US and China, while in Europe, Germany was affected by new fuel emission standards, and natural disasters weighed on activity in Japan. Further downside risks exist, such as the UK making a disorderly exit from the EU and a greater-than-envisaged slowdown in China. This provides an uncertain backdrop for corporate earnings growth and the investment outlook is also clouded by changing expectations for interest rate rises, which could lead to further volatility in equity and bond markets. In this environment, investors may wish to consider a fund that invests in alternative asset classes with a strong performance track record.

## Fund profile: Diversified alternative assets portfolio

Tetragon Financial Group is a Guernsey-domiciled, closed-ended specialist investment company that was founded in August 2005. Tetragon's objective is to generate distributable income and capital appreciation, aiming to provide stable returns to investors across various credit, equity, interest rate, inflation and real estate cycles. Tetragon's investments include a portfolio of unlisted alternative asset management businesses (TFG Asset Management), and comprise a diversified range of assets, with exposure to bank loans, real estate, equities, credit, convertible bonds, private equity and infrastructure. Tetragon historically invested via the Tetragon Master Fund, but amalgamated with the Master Fund at the end of 2018 to simplify its investment structure (see Exhibit 3), which also simplifies its financial reporting, commencing with the 2018 annual report.

Tetragon's shares were admitted to trading on Euronext Amsterdam in April 2007 and listed on the Specialist Fund Segment (SFS) of the London Stock Exchange (LSE) in November 2015. Tetragon's functional currency is US dollars and its shares are quoted (under the ticker TFG), NAV reported, and dividends declared in US dollars. However, in April 2018 an additional sterling LSE market quote was introduced under the ticker TFGS and cash dividends may be received in sterling by shareholders through making a dividend currency election.

**Exhibit 3: Tetragon group structure**




Source: Tetragon Financial Group, Edison Investment Research

Tetragon's investment manager is Tetragon Financial Management (TFM), which is controlled by Reade Griffith and Paddy Dear, who are the co-founders of Tetragon and Polygon (now part of TFG Asset Management), and also control Tetragon's voting shares. TFM's investment committee, which determines Tetragon's investment strategy and approves each significant investment, comprises Griffith and Dear as voting members, Michael Rosenberg, David Wishnow and Stephen Prince (head of TFG Asset Management), who all have extensive experience in alternative investments. Former investment committee member Jeffrey Herlyn retired from Tetragon in September 2018.

There are four key elements to Tetragon's investment strategy:

- Identification of attractive asset classes and investment strategies.
- Identification of asset managers that demonstrate superior skill and experience.
- Negotiation of favourable terms for investments, using TFM's market experience.
- Where appropriate, acquisition of a significant stake in each asset management business with which it invests, to enhance returns.

Additionally, Tetragon continues to develop the alternative asset management businesses on its TFG Asset Management platform, through growing third-party assets under management and looking to add new asset managers, with a medium-term view to a possible initial public offering.

Tetragon currently deploys its capital across the following alternative asset categories:

- **TFG Asset Management** – investments in a diversified portfolio of unlisted asset managers, each specialising in a niche alternative investment strategy (see Exhibit 4).
- **Hedge funds** – event-driven equity and convertible bond fund investments managed by Polygon and a quantitative strategies fund managed by Credit Suisse.
- **Bank loans** – CLO equity investments primarily in US CLOs managed by LCM and TCICM, as well as third-party CLO managers. At end-2018, the portfolio effectively comprised 21 direct CLO transactions and two investments in CLO investment vehicles through TCIP.
- **Real estate** – primarily holdings in most of GreenOak's managed private equity-style funds and co-investment vehicles that focus on opportunistic investments in the US, Europe and Asia.
- **Private equity** – directly held stakes in unlisted companies and small allocations to various third-party managed private equity funds.
- **Other equities and credit** – directly held investments in single strategy ideas, either co-investments with underlying managers or idiosyncratic investments that may not meet the criteria for inclusion in a fund managed within TFG Asset Management.

## TFG Asset Management

TFG Asset Management is Tetragon's alternative asset manager platform, which owns majority and minority stakes in unlisted asset management businesses. TFG Asset Management seeks to generate fee income and achieve capital growth through increasing third-party assets under management. At end-2018, TFG Asset Management had aggregate assets under management of US$28bn (of which only c 3% was accounted for by Tetragon's own investments), with c 370 employees and main offices in New York and London.

Since 2010, TFG Asset Management has grown to comprise seven asset management brands: LCM, GreenOak, Polygon, Equitix, Hawke's Point, TCIP and TCICM (see Exhibit 4). Majority stakes are held in all of the managers except GreenOak and TCICM (a subsidiary of the TCI II fund managed by TCIP). Under the terms of GreenOak Real Estate's merger with Bentall Kennedy, announced in December 2018, Tetragon will retain a c 13% key strategic investment in the merged entity Bentall GreenOak, as well as receiving US$42.5m on closing of the merger transaction.

**Exhibit 4: TFG Asset Management businesses as at 31 December 2018**

| Manager | Tetragon stake | Description | Asset class | Managed funds/ investments | AUM (US$m) | Tetragon investment in funds (US$m) |
|---|---|---|---|---|---|---|
| LCM Asset Management | 100% | CLO asset manager | Bank loans | 16 CLOs | 8,300 | 202.9 |
| GreenOak joint venture | 23% | Real estate-focused principal investing, lending and advisory firm | Real estate | 12 funds and investment vehicles | 10,600 | 170.3 |
| Polygon Global Partners | 100% | Manager of open-ended hedge fund and private equity vehicles across a number of strategies | Hedge funds, Private equity | 4 hedge funds | 1,400 | 379.9 |
| Equitix | 75% | Integrated core infrastructure asset management and primary project platform | Infrastructure | 8 funds and managed accounts | 5,000 | No direct fund exposure |
| Hawke's Point | 100% | Asset manager that seeks to provide capital to companies in the mining and resource sectors | Mining finance | 2 investments in early-stage gold miners | 17.9 | 17.9 |
| Tetragon Credit Income Partners (TCIP) | 100% | General partner of two private equity vehicles that invest in TCICM and LCM-managed CLOs. | CLO equity | Tetragon Credit Income II & III (TCI II & TCI III) | 700 | 69.5 |
| TCI Capital Management (TCICM)* | 100% | CLO asset manager | Bank loans | 6 CLOs | 2,100 | No direct fund exposure |
| | | | | | **28,118** | **840.5** |

Source: Tetragon, Edison Investment Research. Note: *TCICM includes TCICM II, which is a subsidiary of TCI II.

Investment decisions over acquisitions and disposals of asset management businesses are made by Tetragon's investment manager, TFM. Once acquired, the businesses are incorporated into TFG Asset Management, which has its own management team that provides oversight of the managers as they form and grow funds under management, and manages the cost base. Operationally, each asset management business may run autonomously or utilise TFG Asset Management's wider resources. In either case, while maintaining its entrepreneurial independence, the business should benefit from an established infrastructure that can assist in risk management, investor relations, financial control, technology and compliance/legal matters.

**Exhibit 5: Polygon fund assets and performance as at 31 December 2018**

| Fund | Description | AUM (US$m) | Tetragon investment (US$m) | Fund 2018 net return | Fund inception | Fund annualised net performance since inception |
|---|---|---|---|---|---|---|
| Convertible Opportunity | Primarily investing in North American and European convertible securities | 642.8 | 76.8 | 1.8% | 20 May 2009 | 13.9% |
| European Equity Opportunity – Absolute Return | European equity markets event-driven focus (c 20% net exposure) | 298.8 | 190.7 | (0.9%) | 8 July 2009 | 8.8% |
| European Equity Opportunity – Long Bias | European equity markets event-driven focus (c 75% net exposure) | 312.2 | 91.0 | (7.7%) | 8 July 2009 | 11.4% |
| Global Equities | Event-driven fund focused on global equity markets | 25.0 | 21.4 | 14.3% | 12 Sept 2011 | 12.7% |
| | | **1,278.7** | **379.9** | | | |

Source: Tetragon, Edison Investment Research

Tetragon's approach to growing TFG Asset Management involves an assessment of both the risk and reward of the opportunity. Maintaining the discipline to close funds that do not deliver adequate risk-adjusted returns is considered as important as identifying new managers to add to the platform. This is reflected in the decision in late 2017 to close the Polygon Distressed Opportunities Fund.

The fund's returns since inception were positive and attractive relative to its peers but it was determined that expected returns did not support Tetragon maintaining its investment in the fund and the portfolio manager, within the TFG Asset Management platform. A similar decision was taken over the Polygon Mining Opportunity Fund, which was closed in the fourth quarter of 2017.

**Exhibit 6: Valuation of TFG Asset Management businesses at December 2018**

| Asset manager | Tetragon holding | Fair value (US$m) | Value % of Tetragon NAV | Valuation approach | Discount rate | Earnings multiple | Valuation % of AUM |
|---|---|---|---|---|---|---|---|
| Equitix | 75% | 230.9 | 10.7 | Discounted cash flow with debt at par plus accrued interest | 9.75%<br>15% DLOL | N/A | N/A |
| GreenOak | 23% | 208.5 | 9.7 | Discounted cash flow sum of the parts | 5% to 25%<br>Base discount rate 11% | N/A | N/A |
| LCM | 100% | 154.9 | 7.2 | Discounted cash flow and market multiples | 11.5%<br>15% DLOL | N/A | 2.3% |
| Polygon | 100% | 55.1 | 2.6 | Discounted cash flow | 12.5%<br>20% DLOL | N/A | N/A |
| TCIP | 100% | 11.0 | 0.5 | Discounted cash flow | 11.5%<br>15% DLOL | N/A | N/A |
| Hawke's Point | 100% | 1.7 | 0.1 | Replacement cost | N/A | N/A | N/A |
| | | **662.1** | **33.2** | | | | |

Source: Tetragon, Edison Investment Research. Note: DLOL = discount for lack of liquidity. N/A where valuation method not used.

# The fund manager: Tetragon Financial Management

## The manager's view: Positive on prospects for niche strategies

Tetragon director Paddy Dear observes that the 12.1% ROE achieved in 2018 was Tetragon's strongest return since 2015 on a reported basis and since 2013 on a like-for-like basis. He reflects positively on Tetragon's ability to deliver this robust performance in challenging market conditions, noting that the S&P 500 index was down 4.2% for the year and the US equity market had its worst December since 1931, while European equity markets fell between 7% and 26% over the year, and many emerging market equity indices fell by double digits.

Acknowledging that the US$98.4m valuation uplift to Tetragon's investment in GreenOak from its announced merger with Bentall Kennedy made the largest contribution to Tetragon's US$331.1m total investment gain, Dear points out that strong underlying performance led to a further US$51.0m gain on GreenOak. Additionally, Dear notes that all but one asset manager contributed positively to TFG Asset Management's US$230.9m gain in 2018, with Polygon's US$0.9m or 1.6% decline in value partly reflecting the closure of the Distressed Opportunities Fund during the year.

While positive returns from Tetragon's investments in the TFG Asset Management businesses generated the bulk of its 2018 returns, Dear emphasises that, except for hedge fund strategies, positive returns were achieved across all other asset classes, which contributed an aggregate US$100.2m or 30% of investment gains. He observes that gains were well spread, with notably strong contributions from direct listed and private equity investments, non-LCM and LCM-managed US CLOs, Asia-focused GreenOak Asia real estate investments and Tetragon's Paraguayan commercial farmland investment, managed by third-party specialist manager Scimitar.

Within hedge fund strategies, Dear notes that most of the negative return in 2018 came from the Polygon Distressed Opportunities Fund, which was closed with a US$12.0m loss for the year. He explains that Tetragon's holding in Polygon's European Equity Opportunity Fund was separated into 'absolute return' and 'long bias' share classes during 2018, with 'long bias' recording a US$9.0m loss, while 'absolute return' achieved a US$0.9m gain. While seeing the hedge fund sector in general as being somewhat saturated, with many strategies competing for diminishing intrinsic alpha-generating opportunities, Dear views capacity-constrained, niche and targeted approaches – such as Polygon's event-driven equities and convertible bond strategies – as more likely to make good investments. While not generating significant gains, he believes these investments protected capital in 2018, with only modest losses recorded. Furthermore, he notes that Tetragon's hedge fund investments are generally more liquid than its private equity and CLO investments.

Despite increasingly negative sentiment in the leveraged loan market, Dear continues to be optimistic about Tetragon's allocations to bank loans through CLO equity. He points out that covenant deterioration in the leveraged loan market and increasing levels of debt generally should be of concern to long-only holders of corporate debt, but CLO equity remains an attractive investment due to a number of factors. He notes that, with fixed liabilities and floating-rate assets, CLO equity can benefit from spread widening, provided that exposure to loan defaults is minimised.

Looking forward, Dear comments that, with many risks existing in markets generally – exemplified by the volatility and negative returns experienced in 2018 – Tetragon's investment manager remains cautious. However, he believes that Tetragon's ability to invest in a broad range of asset classes and strategies; partner and invest with superior asset managers; make investments directly on its balance sheet; adjust its cash holdings as appropriate to market cycles; and maintain a long-term view, provides positive prospects for performance in 2019 and over the long term.

Dear notes that, as Tetragon has grown and evolved, so too has the breadth of its capabilities for sourcing compelling and differentiated investment ideas, with the managers on the TFG Asset Management platform being key contributors, as well as the third-party managers with which it invests. Additionally, Dear highlights that TFG Asset Management has a number of businesses that it will have the opportunity to expand either geographically or with product offerings (and in some cases, both), as well as building out new businesses over the short to medium term.

# Asset allocation

## Investment process: Targeting excess risk-adjusted returns

To achieve Tetragon's objective of generating distributable income and capital appreciation, the investment manager focuses on alternative asset classes that offer 'intrinsic alpha' (excess returns relative to their assessed investment risk), seeking uncorrelated, alpha-generating strategies. Analysis of prospective investments includes evaluations of risk/reward, correlation, duration and liquidity characteristics, to gauge attractiveness and expected incremental effect on the portfolio. This approach has driven the steadily increasing diversification of Tetragon's portfolio to comprise a range of income-generating alternative investment strategies.

On identification of a new attractive asset class, Tetragon searches out high-quality specialist managers with a successful track record of investment within the asset class. The range of potential investment vehicles is also reviewed, before selecting the most appropriate investment structure for Tetragon to optimise its risk-adjusted returns. Highlighting the potential value of combining the two aspects of this approach, the manager points to the superior returns achieved by Tetragon's US CLO equity strategy compared with the wider US CLO market in each year from 2008 to 2015.

Where appropriate, Tetragon also seeks to own a share of each asset management business with which it invests. The aim is to enhance already attractive returns on the fund investments with fee income generation and capital appreciation from growing the third-party assets managed by the underlying asset manager. Tetragon uses its financial resources and experience to support the growth of these unlisted asset management businesses, similar to a private equity investor.

Prior to acquiring a stake in a new asset manager, a thorough evaluation process is undertaken, typically including consideration of performance track record, reputation, regulatory requirements, infrastructure needs and asset-gathering capacity. Potential profitability and business scalability are also important factors, while the core capabilities, investment focus and strategy of a new business should be complementary to TFG Asset Management's existing businesses. The investment manager notes that the small number of new businesses added to the TFG Asset Management platform reflects the challenge in finding a superior risk/reward balance versus investing more in an existing business. To mitigate potential correlated risks across asset managers, Tetragon seeks to diversify exposure across asset classes, investment vehicles, durations, and investor types.

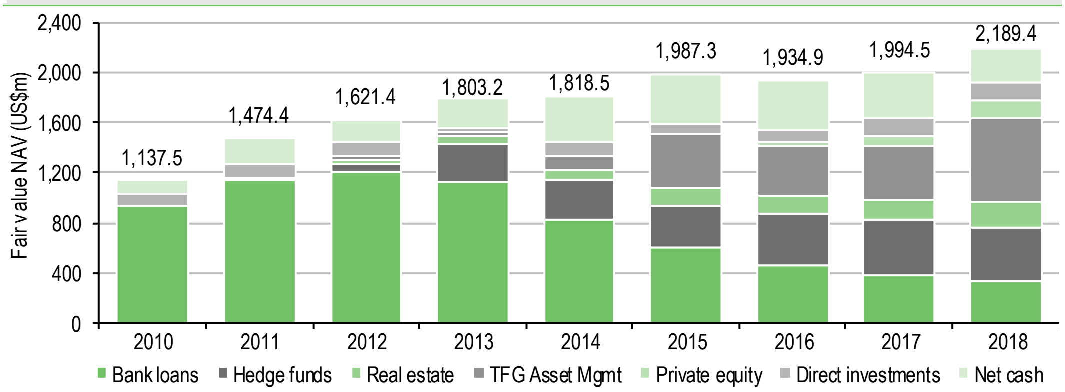
As part of its investment strategy, Tetragon may employ hedging strategies and leverage in seeking to provide attractive returns while managing risk. However, in practice, Tetragon typically holds net cash equating to c 10–20% of its net asset value to fund cash flow commitments for existing and new investments, as well as dividends, fees payable to TFM and other potential uses of cash.

## Current portfolio positioning

Tetragon's portfolio is broadly diversified across a range of alternative asset classes, with c 30% of net assets invested in unlisted asset management businesses and c 60% spread across hedge fund strategies, bank loans, real estate, private equity and other direct investments. Tetragon also has indirect exposure to a number of infrastructure investments through its ownership of asset manager Equitix (which holds stakes in the projects that it manages). At its inception, Tetragon invested primarily in bank loans (mainly via CLO equity), but has steadily diversified its portfolio across alternative asset classes since 2012, as illustrated in Exhibit 7, and bank loans now represent only c 15% of net assets. Net cash remained at c 20% of net assets from 2014 to 2017, but had reduced to c 12% at end-2018 (in line with outstanding investment commitments), which would reduce cash drag on performance if maintained at this level.

Tetragon made its first investments in asset managers (LCM and GreenOak) in 2010, while hedge fund strategies were introduced to the portfolio along with the acquisition of Polygon in 2012. Over the subsequent six years, Tetragon's investment diversification has steadily increased, with its portfolio of asset managers (TFG Asset Management) expanding through the acquisition of Equitix in 2015, as well as the establishment of Hawke's Point and TCIP, in 2014 and 2015 respectively.

**Exhibit 7: Progression of Tetragon's net assets by value – 2010 to 2018**




Source: Tetragon, Edison Investment Research. Note: Year-end net asset values shown.

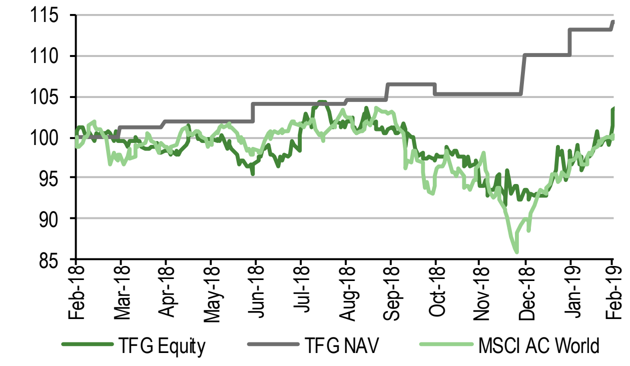
Tetragon's net asset value increased from c US$1.1bn at end-2010 to c US$2.0bn at end-2015. It then remained broadly stable over 2016 and 2017, largely due to the US$349.2m of distributions that Tetragon made over these two years through dividends and share repurchases, which offset underlying NAV growth. 2018 saw a return to growth in Tetragon's net asset value, with a c 10% increase, only partly offset by the US$50m tender offer that commenced in December 2018 but completed in January 2019. (This reduced net asset value but was accretive to NAV per share.)

# Performance: Double-digit compound annual returns

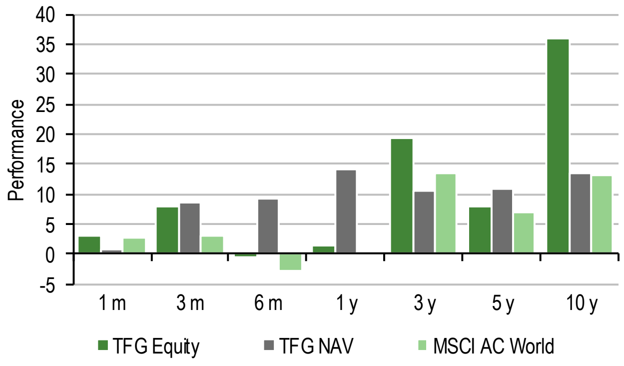
Tetragon targets an absolute return of 10–15% pa and does not measure performance relative to a benchmark index. However, comparison with the MSCI AC World index is provided as a reference for investors. As shown in Exhibit 8, in US dollar terms, Tetragon's NAV total return was ahead of the MSCI AC World index over five and 10 years to end-February 2019. Tetragon modestly lagged the index over three years, but substantially outperformed over one year. While its 10-year NAV total return of 13.6% pa was comfortably within the target return range, Tetragon's 10-year share price total return was particularly high at 36.0% pa, reflecting the narrowing of the discount to NAV from its exceptionally wide level in early 2009 in the wake of the global financial crisis.

Exhibit 8: Investment company performance to 28 February 2019 in US dollar terms

Price, NAV and index total return performance, one-year rebased




Price, NAV and index total return performance (%)




Source: Refinitiv, Edison Investment Research. Note: Three, five and 10-year performance figures annualised.

As shown in Exhibit 9, Tetragon's NAV total return has materially outperformed the FTSE All-Share index over one, three, five and 10 years. It has also been considerably higher than the returns from US 10-year government bonds (treasuries) over these periods.

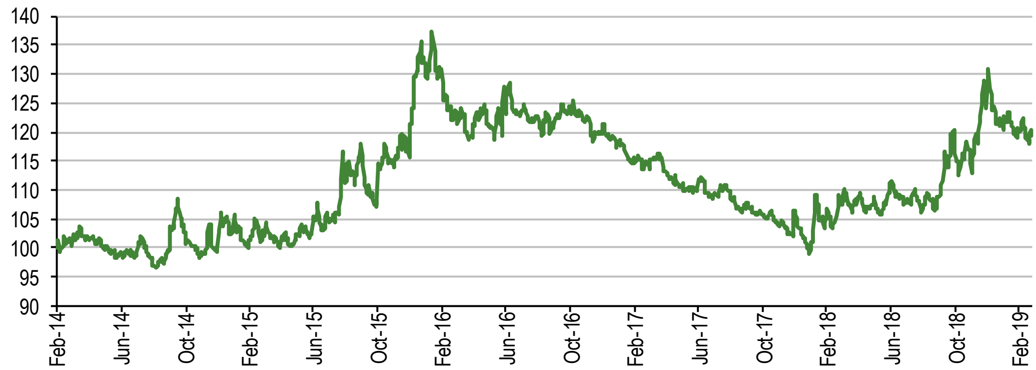
Exhibit 9: Share price and NAV total return performance, relative to indices (%)

| | One month | Three months | Six months | One year | Three years | Five years | 10 years |
|---|---|---|---|---|---|---|---|
| Price relative to MSCI AC World | 0.4 | 4.7 | 2.1 | 1.7 | 16.0 | 5.7 | 519.2 |
| NAV relative to MSCI AC World | (1.8) | 5.2 | 12.3 | 14.5 | (7.8) | 20.5 | 2.9 |
| Price relative to FTSE All-Share | (0.3) | 1.0 | 0.8 | 3.3 | 36.3 | 45.5 | 704.2 |
| NAV relative to FTSE All-Share | (2.5) | 1.4 | 10.8 | 16.3 | 8.3 | 65.9 | 33.6 |
| Price relative to US 10y Govt Bonds | 3.6 | 4.1 | (3.5) | (2.5) | 72.5 | 32.0 | 1,489.5 |
| NAV relative to US 10y Govt Bonds | 1.3 | 4.5 | 6.1 | 9.8 | 37.0 | 50.5 | 164.1 |

Source: Refinitiv, Edison Investment Research. Note: Data to end-February 2019. Geometric calculation.

As illustrated in Exhibit 10, Tetragon's absolute return approach has achieved a substantially higher return than the MSCI AC World index over five years, significantly outperforming the index during 2018, having lagged the market rally over the previous two years.

Exhibit 10: NAV total return performance relative to MSCI AC World index over five years




Source: Refinitiv, Edison Investment Research

## Discount: Modestly wider than historical averages

As shown in Exhibit 11, Tetragon's share price discount to NAV narrowed steadily from 56.3% in February 2016 to 32.8% in December 2017, but widened during 2018. As illustrated in Exhibit 8 (left-hand chart), the discount widening in 2018 reflected Tetragon's share price declining, broadly in line with global equity markets, while its NAV progressed steadily higher. This divergence left Tetragon's share price at 31 December 2018 c 14% lower than a year earlier, while its NAV per share was c 7% higher. Since reaching its one-year widest point of 48.8% on 3 January 2019, the discount has narrowed to its current level of 44.7%, which is modestly wider than its one-, three-, five- and 10-year averages of 42.8%, 41.2%, 41.8% and 42.1%, respectively.

**Exhibit 11: Share price discount to NAV over five years (%)**


Source: Refinitiv, Edison Investment Research

## Capital structure and fees

Tetragon's issued share capital comprises 10 voting shares and 139.7m non-voting shares. Voting shareholders may vote on the election of board directors and other matters, but do not receive dividends. Non-voting shareholders are entitled to receive dividends and other distributions. Tetragon co-founders Reade Griffith and Paddy Dear control the voting shares, while also holding large stakes in Tetragon's non-voting shares (see Exhibit 1). In total, principal and employee holdings (including equity-based awards) account for 27.6% of Tetragon's outstanding shares.

At end-December 2018, 38.7m non-voting shares were held in treasury and 8.6m in escrow, leaving 92.4m shares outstanding. On a fully diluted basis, there were 97.4m shares outstanding at end-December 2018, including 2.3m escrow shares relating to deferred incentive fees payable to TFM, and 2.7m in equity-based awards[1] to senior employees of TFG Asset Management (of the total 6.3m award-related shares in escrow). There are no remaining unexercised options relating to the acquisition of a 10% stake in GreenOak in 2010. After completion of the US$50m tender offer for 4.3m shares, at end-February 2019 there were 93.2m fully diluted shares outstanding.

Tetragon has a three-year US$150m revolving credit facility that provides additional flexibility to the manager to take advantage of investment opportunities. At end-February 2019, US$38m was drawn against this facility, representing 1.8% gross gearing, while Tetragon held net cash of US$238.4m, equating to 11.0% of NAV. Historically, Tetragon has typically maintained a c 20% net cash position to meet its new investment commitments and pay dividends and fees, partly due to the illiquid nature of its underlying investments. Tetragon's lower current cash position corresponds with its level of outstanding investment commitments and also reflects the recent tender offer. Tetragon currently has the following investment commitments: GreenOak US$97.0m, TCI III US$77.6m, Hawke's Point US$54.9m, and six private equity commitments totalling US$18.8m. Not all of these commitments may be drawn in 2019, leaving scope for the manager to allocate funds to the development of new businesses, opportunistic investments and acquisitions.

Tetragon pays a 1.5% pa management fee to TFM based on its net assets. TFM is also eligible to receive a quarterly incentive fee at a rate of 25% on the increase in NAV above a hurdle. The hurdle is calculated as the higher of the two prior quarter-end NAVs (adjusted for dividends and capital adjustments) plus a hurdle rate, which is equal to three-month US dollar Libor plus 2.65% pa (giving annualised hurdle rates of 5.05% for Q418 and 5.44% for Q119). If the hurdle is not met in any calculation period, the shortfall is not carried forward to future periods.

[1] TFG Asset Management's employee reward schemes typically have multiple vesting dates up to 2024. The shares are held in escrow until they vest and the dilutive effect is reflected over the life of the plans.

Management and incentive fee structures vary across Tetragon's investments. Since May 2017, Tetragon has paid full fees on its investments in the Polygon European Equity Opportunity Absolute Return Fund (1.5% management fee, 20% incentive fee), Polygon Convertible Opportunity Fund (1.5% management fee, 20% incentive fee) and Polygon Distressed Opportunities Fund (2.0% management fee, 20% incentive fee). Launched on 1 October 2018, the Polygon European Equity Opportunity Long Bias Fund, which targets 75% net exposure (compared with c 20% net exposure for the absolute return share class), charges a 1.5% management fee and a 20% incentive fee above a hurdle rate equal to 75% of the STOXX Europe 600 index total return.

Management fees for 2018 were US$30.7m, compared with US$29.5m for 2017. Incentive fees for 2018 were US$47.6m (of which US$17.5m related to Q418), compared with US$32.2m for 2017. Tetragon's ongoing charges (excluding incentive fees) for 2018 were 1.73% of average net assets, in line with 1.74% in 2017. We estimate that ongoing charges including incentive fees were 4.06% in 2018 and 3.38% in 2017, noting that Tetragon's NAV performance is stated net of all fees.

## Dividend policy and record

Tetragon has pursued a progressive dividend policy since 2009, and aims to pay out 30–50% of normalised earnings (which includes investment income and capital gains), based on its long-term target ROE of 10–15%. Tetragon has an optional dividend reinvestment programme through which scrip dividends are paid. The board declares dividend payments based upon the recommendation of the investment manager, subject to approval by Tetragon's voting shareholders. Recommended dividend distributions take into account the following considerations:

- the expected sustainability of Tetragon's cash generation over the short and medium term;
- Tetragon's recent performance and the anticipated level of future returns;
- the outlook for the operating and economic environment; and
- other potential uses of cash, such as new investment opportunities.

Tetragon pays dividends in May, August, November and March each year and has increased the quarterly dividend steadily since rebasing it at the start of 2009. Continuing the historical pattern of the quarterly dividend being increased in the second and fourth quarters and held steady in the first and third quarters, in February 2019 Tetragon declared a US$0.1825 per share fourth interim dividend for FY18. This was 1.4% higher than the US$0.1800 dividends paid for Q3 and Q218 and 2.9% higher than the US$0.1775 dividend paid for Q118. The US$0.72 total dividend paid for FY18 represents a 2.9% increase over FY17 and equates to a 5.6% yield on the current share price.

## Peer group comparison

Exhibit 12 shows a sterling-based comparison of Tetragon versus the other 10 members of the AIC Flexible Investment sector with a market cap over £100m. The peer group funds' investment mandates vary widely, with none considered as a direct comparator for Tetragon, but the peer group average provides a broad context for comparison. Tetragon's NAV total return is significantly above the peer group average over one, three, five and 10 years to end-February 2019, ranking first, second or third out of 11 in each period. US dollar strength versus sterling (+3.6%, +4.8%, +26.0%, +7.2%, respectively over one, three, five and 10 years) had a positive effect on Tetragon's performance in sterling terms.

Tetragon's share price discount to NAV is among the widest in the peer group, at a comparable level with two other funds, while three peers are trading at a premium to NAV. Tetragon's ongoing charge is at the higher end of the peer group range and it is one of four funds that charge a performance fee. Similar to the majority of peers, Tetragon is ungeared at the corporate level, while its 5.6% dividend yield is the highest in the peer group, well above the 2.5% average yield. If its discount fully unwound, Tetragon's shares would yield c 3.1%, still above the peer group average.

**Exhibit 12: Selected AIC Flexible Investment sector peer group in sterling terms as at 8 April 2019***

| % unless stated | Market cap £m | NAV TR 1 year | NAV TR 3 year | NAV TR 5 year | NAV TR 10 year | Premium/ (Discount) | Ongoing charge | Perf. fee | Net gearing | Dividend yield |
|---|---|---|---|---|---|---|---|---|---|---|
| Tetragon Financial Group | 897.1 | 18.3 | 41.2 | 111.6 | 285.5 | (44.7) | 1.73 | Yes | 100 | 5.6 |
| Aberdeen Diversified Income & Growth | 381.1 | (1.6) | 7.6 | 3.2 | 139.1 | (3.1) | 0.88 | No | 110 | 4.5 |
| Caledonia Investments | 1,636.6 | 6.7 | 34.5 | 61.3 | 194.2 | (18.4) | 1.24 | No | 100 | 1.9 |
| Capital Gearing | 327.7 | 5.1 | 20.6 | 31.6 | 102.6 | 1.7 | 0.76 | No | 100 | 0.5 |
| Hansa Trust A | 234.0 | 6.1 | 42.3 | 29.8 | 165.4 | (31.3) | 0.51 | No | 100 | 1.6 |
| Henderson Alternative Strategies Trust | 103.5 | (0.1) | 32.3 | 21.0 | 41.9 | (21.6) | 1.06 | No | 100 | 1.9 |
| JZ Capital Partners | 350.9 | 4.4 | 6.9 | 37.6 | (79.6) | (46.2) | 3.18 | Yes | 132 | 3.9 |
| Personal Assets | 966.6 | 1.1 | 13.1 | 28.2 | 114.0 | 1.2 | 0.89 | No | 100 | 1.4 |
| RIT Capital Partners | 3,254.6 | 3.7 | 28.4 | 49.0 | 139.0 | 8.5 | 0.68 | Yes | 101 | 1.6 |
| Ruffer Investment Company | 383.3 | (3.8) | 11.1 | 11.3 | 81.4 | (5.0) | 1.19 | No | 100 | 0.8 |
| UIL | 159.2 | 16.6 | 89.3 | 162.5 | 288.6 | (48.3) | 1.15 | Yes | 177 | 4.2 |
| **Average** | **790.4** | **5.1** | **29.8** | **49.7** | **133.8** | **(18.8)** | **1.21** | | **111** | **2.5** |
| **Rank in peer group** | **4** | **1** | **3** | **2** | **2** | **9** | **2** | | **5=** | **1** |

Source: Morningstar, Edison Investment Research. Note: *Performance data to end-February 2019. TR = total return in sterling terms. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

## The board

Following a number of changes to its composition in 2018, Tetragon's board currently comprises five directors, three of whom are independent. Each board member stands for re-election by Tetragon's voting shareholders each year at the AGM, with the voting shares controlled by Reade Griffith and Paddy Dear, who co-founded Tetragon and Polygon.

In July 2018, Frederic Hervouet retired from the board after four years' service as a non-executive director, reducing the board from six to five directors. At the December 2018 AGM, the remaining three independent directors, Rupert Dorey, David Jeffreys and William Rogers, stepped down from the board and three new independent directors were appointed. Dorey and Jeffreys retired after more than 13 years' service, having joined the board in August 2005 when Tetragon was first established, and continuing to serve as directors on its listing in April 2007. Rogers had served as a director since June 2016, having previously acted as adviser to Tetragon from its listing until his retirement from Cravath, Swaine & Moore in December 2015.

The newly appointed independent directors, Deron Haley, Steven Hart and David O'Leary, bring extensive private equity and asset management expertise to the board, as well as considerable operational and administrative experience. Deron Haley is a founding partner and chief operating officer at New York-based private equity firm Durational Capital Management. Steven Hart serves as president of Hart Capital, which he founded in 1998 as a family office to invest in a diversified portfolio of assets. David O'Leary retired from State Street Corporation in 2012, having served latterly as chief administrative officer and formerly as global head of human resources.

Reade Griffith (appointed April 2007) and Paddy Dear (appointed August 2005) are Tetragon's non-independent board directors. Griffith is head of TFM's investment and risk committees, CIO of TFG Asset Management and CIO of Polygon's European event-driven equities strategy. He was previously a partner and senior managing director at multi-strategy hedge fund Citadel Investment Group. Dear is a member of TFM's investment and risk committees. He was previously a managing director and global head of hedge fund coverage at UBS Warburg Equities.

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