FINANCIAL TIMES

Investors ignore the 'bezzle' at their peril

Low returns drive search for yield via risky assets

MARCH 1, 2016 by: Satyajit Das

John Kenneth Galbraith in *The Great Crash, 1929* describes "bezzle" theft where there is an often lengthy time period between the crime and its discovery. The person robbed continues to feel richer as he does not know of his loss, at least yet. In favourable markets, bezzle increases, only being exposed by changed conditions.

Today, investors, either directly or through pooled funds, are being "bezzle-d".

Since 2009, low returns and loose monetary conditions have driven a search for yield. Investors looking for income initially moved out of traditional safe investments into corporate bonds and high dividend paying shares. As returns fell further, investors have increased credit risk and their exposure to long dated fixed rate bonds as well as assuming non-traditional risks.

The volume of high yield, non-investment grade bonds, leveraged loans and collateralised loan obligations issued over the past four years totals about $3.5tn, compared with about $1.3tn in subprime mortgage loans outstanding in 2007.

Many loans have minimal covenant protection for lenders. Some are payment in kind, or Pik, allowing interest to be paid in the form of further IOUs rather than cash.

Moving beyond well-known emerging markets, investors have embraced riskier African and Asian frontier economies.

Attracted by high yields, investors oversubscribed many new issues. Inclusion in popular bond indices means many investors have become "index tourists", forced to invest in these issues.

Many issuers are economically fragile, dependent on commodity revenues, foreign aid or International Monetary Fund support. Funds were sometimes not used for their intended purpose. Some $850m raised at an interest rate of 8.5 per cent by Mozambique, one of the poorest countries on earth, was allegedly not used for the planned tuna fishing venture.

Even where used as indicated, proceeds frequently financed pet vanity projects which may not prove economically viable.

Much of the debt is denominated in US dollars. A rising dollar and higher US rates will increase the debt servicing costs, creating solvency risks.

Most issuers also face refinancing risk as the borrowings were three to five years in maturity. With yields on some frontier bonds now in double digits, some issuers have lost market access.

To quote one prospectus, such investments now have "non-negligible risks to repayment". Investors have also increased duration, purchasing ultra-long dated bonds, whose prices are more sensitive to changes in interest rates.

In order to meet the costs of developing offshore oilfields, Petrobras, the state-owned Brazilian company, borrowed extensively. In part, debt compensated for its inadequate operational cash flow reduced by artificially low domestic administered energy prices.

In June 2015, Petrobras issued century (100-year bonds) yielding 8.45 per cent. Investors purchased the long maturity convinced that there is minimal economic difference between a 30-year and 100-year bond because present value mathematics means that the principal is a small component of return.

Within three months of issuance, a combination of low commodity prices, concern about high debt levels, and a corruption scandal saw the bonds lose about 30 per cent of their value.

Investors have assumed difficult to quantify risk in bank hybrid capital issues and bail-in bonds. The design allows the principal to be converted into equity or written down at the behest of regulators if the bank is threatened with insolvency. The recent sharp fall in the value of contingent capital notes issued by European banks and the negative feedback loops affecting share prices highlight the issue.

Investors have embraced hurricane and earthquake risk in Cat or catastrophe bonds, where interest or principal is lost if a specified natural disaster occurs.

A common feature of these structures is high current returns, which may not compensate for the real risk that only emerges much later.

Fearing depreciation of the purchasing power of their savings, investors have been forced into bezzle-based investments that will impoverish them over time.

Satyajit Das is the author of "Age of Stagnation", which will be released as "A Banquet of Consequences" in the UK in April