FINANCIAL TIMES

Hedge funds seek long term money for distressed debt wagers

Investors prepare for falling prices in US credit and real estate after a long rise in value since 2009

June 20, 2016

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Hedge funds anticipating a rising tide of credit and real estate distress in the coming years are asking investors to climb aboard and lock up their money for an extended period.

Investors are increasingly willing to commit money for five years or more as they eye the end of the credit cycle, when strategies touted by distressed hedge funds flourish as opportunities arise to purchase securities at depressed prices.

“You are going to see a lot more new funds with more restrictive liquidity provisions with long investor gates,” said Chris Acito of credit hedge fund of funds Gapstow Capital Partners.

The distressed sector represents a bright spot in the outlook for hedge funds, after years of poor performance.

Funds focused on distressed situations or restructuring have generated almost 3 per cent this year, compared with 0.8 per cent for the industry overall, according to Hedge Fund Research.

In recent months a number of funds have convinced investors to stick around, including Gapstow, Mudrick Capital Management, Paulson & Co, Pine River Capital Management.

Investors are preparing for falling prices in US credit and real estate, after a long rise in value since 2009. A measure of US high yield bond defaults by Fitch Ratings climbed to 4.7 per cent in mid-June, up from 3.8 per cent at the end of April.

Two of the biggest hedge funds in the distressed investing landscape, Marathon Asset Management and Avenue Capital, began the shift earlier: Marathon used a similar vehicle for a fund focused on Europe in 2014, and last year Avenue shut its open-ended credit fund, leaving about 90 per cent of its assets in structures with lives of up to seven years.

“Quite frankly, for true distressed, it probably is the best way to go,” said Judith Posnikoff, managing director and founding partner at Pacific Alternative Asset Management Company, citing the involvement of having controlling positions in bankruptcy proceedings, or equity distributed after a reorganisation in which trading is restricted — limiting a fund’s ability to meet redemption requests. “It just matches much better.”

Jason Mudrick’s $1.3bn fund has three years to invest the new private-equity style money into distressed situations and two years to reap the rewards.

The recent rebound in oil prices has spurred a reversal in fortune for companies in the energy sector and the Mudrick fund, which has returned about 16.5 per cent this year through June 10, according to a person with knowledge.

However, the Mudrick Distressed Opportunity Fund has experienced volatile performance: it dropped 25.9 per cent in 2015 and another 8.4 per cent through February 12, hurt by soured bets including on oil and gas companies.

Paulson has been targeting $1.5bn for the Paulson Strategic Partners Fund, which has three years to find opportunities in less liquid or distressed investments, and three years to “harvest” the investments it made.

It charges fees only on money that has been deployed, not just what was committed, as in open-ended hedge funds.

Last year Pine River started gathering client money for a new fund focused on asset-backed lending, and this year it is developing another for commercial real estate and lending.