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The old bets on defaulted bonds won't work this cycle

Distressed debt investing is likely to prove tougher this cycle given years of easy policy

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by: Ara Lovitt

Credit cycles are nothing new.

In 1837, Lord Overstone wrote of the "apparently established cycle" of "quiescence, —next improvement, —growing confidence, —prosperity, —excitement, —overtrading, — convulsion, —pressure, —stagnation, —distress, —ending again in quiescence."

In more recent times, the high-yield market has undergone three cycles since becoming an institutional asset class in the 1980s. History teaches that, as each cycle turns, there is a "Minsky moment" followed by glamorous opportunities for distressed debt funds.

Most investors know that distressed investing takes specialised skills. "Mega funds" pursuing this strategy tout their large teams of analysts and lawyers as a competitive advantage.

But ironically, in the coming cycle, the sheer size of some of those funds may place them at a disadvantage because of changes to the credit markets since the global financial crisis.

Immense volumes of new debt, unresolved excesses from the prior cycle, and thin levels of trading liquidity create a tough environment for mega-funds to manoeuvre. Simply put, the old playbook of buying defaulted bonds at 35 cents because, on average, they tend to recover 50 cents, may be obsolete. In the coming cycle, nimbleness will be critical to success.

What is different this time is, at least in part, the unintended consequence of actions taken in response to the last crisis. Years of extraordinary monetary policy have encouraged corporations to borrow colossal amounts of debt, often for dubious purposes.

There are problems in the credit markets, the most obvious being energy and mining. What is more, zombie companies from the previous cycle that were bailed out by easy credit are due for their comeuppance. While it is impossible to predict the exact timing, based on the indicators we track, it seems default rates have begun their inexorable climb.

For the past several years, in an environment of low default rates, recovery rates (that is, the price at which bonds trade upon default) have been running considerably lower than in prior low default periods (about 40 cents instead of 50 cents previously).

Performance has been even worse during bankruptcy, as measured by the Altman-Kuehne Defaulted Bond Index, which returned -39.5 per cent in 2015 after a disappointing -13.0 per cent in 2014.

Investors in distressed debt funds the past few years are doubtless familiar with the major disappointments in shipping, power, retail, and, worst of all, the oil and gas sector (in which we saw virtually zero recoveries for many 2015 vintage defaults). For whatever reason — excess monetary stimulus, zombie companies, unsustainable profit margins, or other factors — there is something different happening this time.

The problem is compounded by regulations that have severely curtailed credit trading. While the amount of debt has skyrocketed since the crisis, we have lower trading volumes, less market depth, and more challenged financial intermediation. Many broker-dealers are stepping away from the markets altogether. Today, news (whether good or bad) tends to cause exaggerated, and sometimes fleeting, price moves on light volumes.

Like all investing, in distressed debt one must buy at the right price. But distressed debt investing also requires buying the right instrument — backed by the right subsidiaries or assets, with the right covenants or other structural features.

Often successful investments require the pairing of multiple instruments, whether bonds, loans, credit-default swaps, equity, options — long and short — to isolate the best risk/reward relationship.

This type of painstaking work is much harder in the post-Dodd-Frank markets. Instruments that might have traded in $25m increments before the crisis may now trade in $5m, if at all. For a mega-fund, this means fewer good ideas that can affect performance, and more difficulty entering and exiting investments — effectively an extra "tax" on investors.

It may be anathema to some managers to argue against raising a huge fund in advance of an exciting opportunity. Much as the man who only has a hammer is tempted to treat everything as a nail, so too a dedicated distressed manager may naturally think it always a great time to be gathering more assets.

When investors look back at what they achieved, or didn't, after the coming cycle, many will wish they had invested with managers who stayed nimble enough to maintain the luxury of picking their spots.

Ara Lovitt is a portfolio manager at GMO