

Tricky course facing distressed debt investors

With evidence of economic strain growing the time could be right to snap up bargains



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Interest rates are expected to remain [lower for longer — again](#).

Economists are downgrading their forecasts for GDP, the number of defaults and companies in financial distress is rising and troubled sectors show little sign of healing. An opportune moment, then, for investors to return to distressed debt?

The US economy will clock growth of just 1.2 per cent for the first quarter of 2016, economists at JPMorgan Chase estimate, down from their earlier estimate of 2 per cent. Meanwhile, the global corporate default tally has risen to 36 this year, compared with 25 for the same period in 2015.

Of these defaults, 30 are based in the US, (and only five in [emerging markets](#)) according to Standard & Poor's. As the economic cycle turns, many distressed specialists anticipate that it is their time in the sun once more.

[Distressed debt](#) investors are all about shopping at bargain prices and betting a strong recovery will buoy the value of the assets they snap up.

However, the immediate past has not proved a great time to embrace this strategy. The HFR distressed and restructuring index fell 8 per cent last year, making it among the worst performers.

Investing in distressed assets is challenging even at the best — or, more accurately, worst — of times. That is because it demands large, concentrated bets on outcomes that can sometimes depend on arcane judicial rulings.

Oaktree Capital Management, which has a solid record when it comes to distressed investing, noted to its clients last month that conditions are similar to those in previous distressed debt cycles as lower quality debt “is tested by economic difficulty and gives rise to increased defaults.”

Today there is almost \$3.5tn in junk debt outstanding, up from \$2.5tn at the time of the financial crisis of 2008-2009.

The materials Oaktree shared with investors in its funds during its annual meetings two weeks ago, which described some of its best and worst positions, shows how deep the macro malaise is in many sectors including shipping, power, semiconductors and retail, and how hard it can be to get things right.

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If there is one lesson to be drawn from Oaktree's experience, it is that bets on an eventual — and only moderate — recovery in global manufacturing and trade will prove testing as the [commodity bust](#) continues.

Oaktree's best investments were regional and perhaps surprisingly many were in Europe, particularly in real estate where it made money on stakes in companies such as Countryside Properties, and in European listed Reits, and non-performing loans in commercial sector.

Shipping, for example, has been one of the most treacherous sectors. Virtually all distressed investors underestimated how low most shipping rates would go, and how long those rates would persist due to "indiscriminate ordering of new vessels in the boom times" and the mistaken expectation that China would keep importing ever more commodities.

Among the worst positions Oaktree taken were in Star Bulk Carriers and Eagle Bulk. But, at the same time, there were pockets of strength: among the best positions was an investment in product tankers Taiwan Maritime Transport on which Oaktree made a \$115m gain on an investment of \$263m.

Certainly, such snapshots of investments are merely a static view of a portfolio that fluctuates and what appears deeply underwater can prove more buoyant in time.

The [macro environment](#) remains challenging as deflationary forces, poor demand and slow growth continue to plague most parts of the globe. At the same time, though, [central banks](#) continue to encourage a search for yield that entails more risk than the fundamentals justify.

And so this year appears to continue the trend of recent years, as the markets play their game of chicken with [central banks](#) and risk assets rise and fall in response to the contradictory pulls of zero-to-negative interest rates and some sobering corporate and macro data.

It is a course distressed debt investors will have to navigate. It may be that any new normal is less a tale of a stellar or even moderate recovery, than a mediocre one — at best.

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