Distressed comes into play

The deep discounts on debt securities and expectations of a sharp increase in defaults have created a groundswell of interest in distressed debt strategies. Stephen Quigley talks to fund managers about this strategy. Additional reporting by US Editor Kris Devasabai.

The lure of distressed debt strategies is easy to understand given current market conditions. These funds buy debt trading at a discount because the borrower is at risk of defaulting and they aim to profit from a successful restructuring or turnaround of the company.

There is currently an abundance of opportunity to buy discounted debt securities. The corporate debt market has been badly hurt by the financial crisis. Bank debt is trading at historic lows due to balance sheet pressure and market illiquidity.

There are also enticing opportunities to acquire consumer and business debt at large discounts. The market price of these debt portfolios is believed to have fallen by anywhere between 60% and 80% in the past two years. This compares to a 10%–30% rise in default rates in the same period.

Investors specialising in this market say banks are making high-quality debt paper available much earlier than in the past. The price of this paper has been further depressed because many of the traditional debt buyers who relied on easy credit have been sidelined.

While hedge fund managers and some investors are enthusiastic about the strategy, experts warn investing in distressed debt comes with a strong health warning, particularly for those with a short-term investment horizon.

Distressed debt can be a risky strategy because it typically involves taking long debt positions in times of economic crisis. Some hedge funds began to buy distressed assets in 2008 as the subprime crisis started to unravel. They were badly burnt as the market deteriorated further in the second half of the year.

Oren Cohen, co-founder and co-portfolio manager at New York-based Brownstone Asset Management, says navigating the debt markets over the past two years has been a difficult challenge. Until recently there was more leverage in the system than ever before. Coupled with that is the fact that capital structures have become more complex.

This has made it much more difficult to identify what Cohen calls the ‘fulcrum security’ – the debt tranche below which everything becomes worthless. The fulcrum security has become a moving target as the economy has deteriorated and the debt leverage taken on by companies has increased.

Cohen argues that many traditional distressed debt managers suffered losses in 2008 because they have a one-sided view of the market and seek exclusively to invest long in distressed debt.

“These managers are looking for value trades. They ask themselves, ‘How cheap can I get into the trade to see the biggest upside?’ There are very few managers in this sector that look at both the long and short side of the market,” he says.

This one-track approach led many distressed managers to invest in bank debt and other types of senior debt they viewed as undervalued after the subprime crisis unravelled. These positions got trashed following the collapse of Lehman Brothers.

Concerns about the strength of the banking sector and the continuing deterioration of the economy have led to further losses across almost every tranche of the capital structure.

“Managers that get into long trades too early in the cycle tend to stay long and try to diversify their way out of the problem or move further up the capital structure to protect themselves. That is usually a mistake," Cohen comments.

Cohen and co-portfolio manager Doug Lowey, view high-yield bonds and distressed debt as a single continuum. They take "an unbiased view" of the market and seek to exploit opportunities on both the long and short side.

Round and round again

Cohen says this enables the fund to generate positive returns irrespective of the economic cycle. "Distressed debt is cyclical. There are some points in the cycle when the opportunities for long investors are limited. This is when we look at the short side. We can identify healthy companies that are likely to become distressed, rather than distressed companies that are going to restructure and become healthy, and express that view with short positions in high-yield bonds," Cohen explains.

Experts in distressed debt strategies agree many hedge funds got burnt in 2008 because they took long positions too early in the cycle. Marcus Vaughan, head of the event-driven team at RMF and co-portfolio manager of RMF Distressed Strategies, a fund of hedge funds (FoHF) that invests in managers who buy assets across the capital structure at distressed prices, says the collapse of the credit market hurt managers that took an aggressive position last year.

He has moderate return expectations for distressed debt strategies this year. He does not expect to see the highest returns until the recession nears an end and default rates have peaked. But he is bullish on the outlook for the strategy in 2010 and 2011, and claims there are unprecedented buying opportunities in the current market.

"Patient funds with a stable capital base, strong credit analyst skills and many years of workout experience should do well over the next two to three years," Vaughan says.

Jonathan Laredo, co-founder of Solent and the manager of the Solent Distressed Credit Fund, says the distressed cycle can throw up many false bottoms and turning points. "The best approach is to launch a strategy to take advantage of underperforming assets instead of attempting to predict the bottom, which can really only be done with hindsight," he says.

Solent entered the distressed debt market in the middle of 2007 because it believed the world's financial markets were about to hit a major bump in the road. The company also thought a lack of liquidity would cause many debt assets to underperform.

Laredo is not overly concerned about month-to-month performance because distressed is a long-term strategy. He does not expect to see the biggest returns until the worst of the recession is over, 12–18 months away.

"There can be fluctuations over short periods and the fund may show no profit for some months. But I believe this is not the strategy for investors and managers that are driven by month-to-month returns," he explains.

Derek Stewart, founder and director of Mellon Global Alternative Investments and portfolio manager of the Mellon Recovery Fund, says managers must be patient and disciplined to take advantage of the opportunities in the distressed debt market.

He believes the best approach in the current market is to build exposure carefully because asset prices are still falling. He says hedge funds with large cash balances are best positioned to benefit from the full cycle. "Now is not the time to be fully invested in distressed situations. Funds should have capital ready to deploy as opportunities develop," he says.

Stewart says the opportunities to profit from distressed debt are growing every day. He describes the current cycle as the biggest ever because of the sheer amount of lower-quality debt issues in recent years and the excess leverage in the financial system. "The debt of many performing companies is also trading at distressed prices due to forced selling in the market," he adds.

Distressed debt specialists have differing opinions on the specific strategies and assets that are likely to produce the highest returns in the current cycle.

Stewart believes long/short is the best way to invest because timing the bottom is less important with this strategy. "You can benefit from long and short positions without taking a view on the overall direction of credit markets," he explains.

He says now is the time to invest long in senior secured bank debt in companies with asset value. On the short side there are opportunities in consumer-related sectors like retail and advertising as these businesses have a higher probability of default in an economic slowdown.

RMF's Vaughan believes the most attractive investment opportunities are in leveraged loans, which have been particularly hard hit by the unwinding of leverage. He says these securities are currently trading at below previously assumed recovery rates.

Ken Kinsey-Quick, the portfolio manager of the Thames River Capital Distressed Focus Fund, believes the performing loans being offloaded by distressed sellers are a good buying opportunity. He says the current cycle will throw up opportunities over an extended period of time because the path to recovery for companies will be longer than in the past due to the lack of liquidity in the market.

Hedge funds that invest halfway through the cycle may be a lower risk alternative for investors. "These managers may lose some of the upside by not investing in the asset at the beginning of the cycle, but there is less risk with this type of approach because a deal with creditors should be in place, making the outcome more certain," explains Kinsey-Quick.

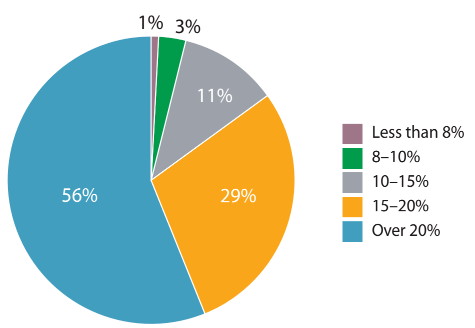
Long opportunities

At Brownstone Asset Management, Cohen says opportunities to invest long in distressed debt started to emerge following the collapse of Lehman Brothers. Brownstone has had a bearish view on the economy since 2007. The fund began to short high-yield bonds in companies related to the US domestic consumer sector in 2007 and moved to a net short position in the second half of the year. By the middle of 2008 the portfolio was over 50% net short.

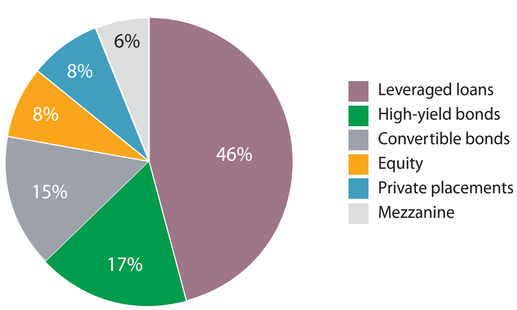
Cohen says at this point "most of the damage has been done" but cautions that "it is still way too early and too dangerous to just go in and buy a long basket of debt securities."

He is taking long distressed debt positions on a case-by-case basis. "You have to undertake deep credit research and identify companies that are going to survive a deep recession," notes Cohen. The fund is hedging its exposure by shorting the debt of companies that have not yet filed for restructuring.

What percentage return will you target in 2009?



Which primary market will recover fastest in 2009?



Source: European Distressed Market Outlook 2009, January 2009, DebtWire.

Brownstone is also selectively buying bank debt that has not historically featured in the portfolio.

Los Angeles-based hedge fund Paradigm Select Assets invests exclusively in consumer and business debt. In 2008 the fund produced returns of around 15%. Toni Das Gupta, managing director of Paradigm Select Assets, says the company has been able to take advantage of the deep discounts on business and consumer debt portfolios.

Paradigm's strategy is to commence litigation to enforce payment of the debt at an early stage. The company uses high-volume law firms that work on a contingency fee basis to turn the debt into enforceable judgments within a 12-month window.

Power of judgment

"The judgment turns the debt into a hard asset. Once you have the judgment you have access to a number of options for securing payment. It is an asset that will be alive for an indefinite period of time," says Das Gupta.

The debt portfolios acquired by Paradigm typically generate cash flow from day one, and this is invested in new debt. "We invest with a two- to three-year horizon. If the collections start falling off we will sell the debt and the judgment on to a new buyer," says Das Gupta, adding that there is a "semi-liquid" market for consumer and business debt.

Das Gupta says the fund is targeting performance in excess of 30% for the next two years and describes the outlook for the strategy as "very positive".

Some managers are casting their nets far and wide in the search for potentially high-yielding distressed debt. The Finisterre Special Situations Fund invests in emerging markets corporate debt and other distressed assets trading at discounted prices.

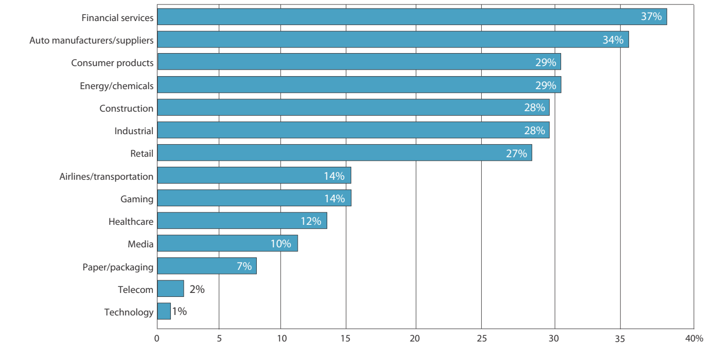
"The emerging markets offer a substantial amount of alpha for those willing to look for non-traditional situations," says Alex Williamson, senior analyst of the fund.

Williamson says there are fundamentally healthy assets in emerging markets trading at distressed prices as well as distressed companies which will not survive the current cycle. "We analyse how jurisdictions and issuers are likely to behave under stress and predict the likely scenarios. The investment horizon is up to 18 months and we target investors who think with a long-term view," he adds.

The sheer range and depth of investment opportunities in the distressed debt sector continues to generate interest from investors. The Swiss FoHF Unigestion plans to launch a dedicated credit FoHF in the second quarter of 2009 in response to client demand. Nicolas Rousselet, a strategy analyst specialising in the arbitrage and credit/distressed sectors, is currently seeking to identify managers that will buy high-quality assets trading at distressed prices and those that can take advantage of increasing defaults.

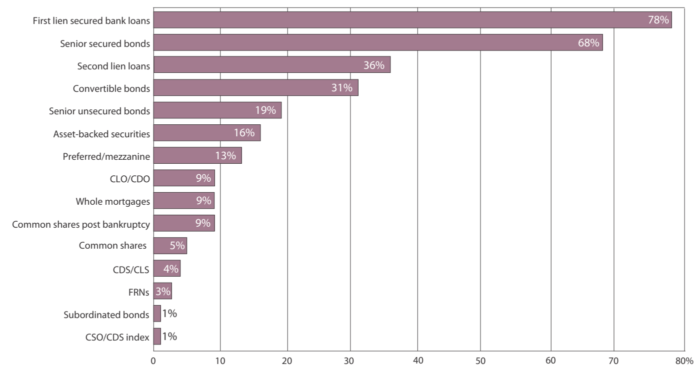
He remains cautious and points out that the quality of distressed assets can be mixed. He believes the opportunities in residential mortgages are more advanced than corporate debt. He says Unigestion will avoid managers that invest purely for the sake of buying cheap assets. "Managers need to be sure about the assets they buy and have a clear exit strategy to monetise the assets they acquire," he says. ■

Which sectors do you expect will offer the greatest opportunities for distressed investors in 2009?



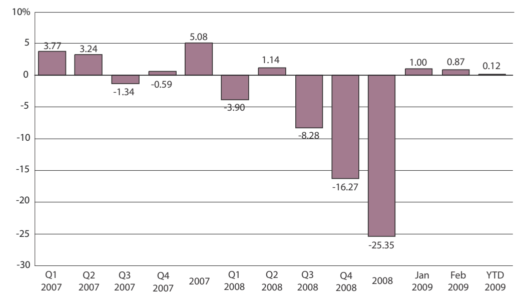
Source: Survey findings

Which instruments do you think will offer the most attractive investment opportunities for distressed investors in 2009?



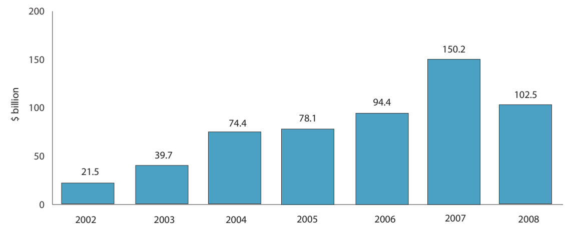
Source: Survey findings

Quarterly performance 2007 – Q1 2009: HFRI ED: Distressed/Restructuring Index



Source: *HFR*

Distressed securities – assets under management: historical growth of assets



Source: BarclayHedge Alternative Investment Databases