Fishing for Distressed Debt? Use the Right Bait

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Quite obviously, the recent undulations in the capital markets have led to substantial losses for investors of all varieties with many bourses in the world's industrialized nations pulling back sharply from their previous highs. Indeed, the last few months have seen unparalleled market swings and conditions not witnessed in generations, if ever. With these pullbacks, the value of the equity and debt positions for many firms has dropped severely. As such, the world of distressed debt investing has again come to the forefront as savvy investment managers have begun to hunt for value in the wreckage of the credit crisis.

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Before we begin, it is prudent at this point to offer a working definition of distressed debt. This asset category consists of securities (bonds, bank debt, etc.) of entities that are either in default, under protection from bankruptcy, or in trouble and might eventually find themselves in such a predicament. Though there is no consensus as to when a security truly becomes 'distressed', it is widely believed that when the yield to maturity of a debt security is in excess of 1000 basis points over a risk-free rate of return (generally, treasury bills are considered the risk-free product), a security is distressed. Another tell-tale sign of a distressed product, and generally a lagging indicator, is one which carries a below investment-grade credit rating from one of the major rating agencies such as Standard & Poor's and Moody's, with distressed companies carrying a credit rating of CCC or lower.

Armed with this knowledge, we can examine one of the more important measures in this investment category, the distressed debt ratio. Quite simply, the distressed debt ratio is the percentage of corporate bonds that are trading in excess of 1000 basis points over the risk-free rate. Not surprisingly, this ratio has skyrocketed throughout 2008, most especially within the last few months. December 2007 saw the ratio stand at just 6.1%, but market turmoil at the beginning of 2008 sent the ratio to over 11% by the end of January. Furthermore, according to S&P Credit Research, July witnessed a 10% rise in the metric and at the end of August the ratio stood at 24.8% with the ratio rising further in the fall. The enormity of this situation cannot be overstated: nearly one in four corporate bonds would be considered 'distressed', and that was before the major fall in the financial sector and the full onset of the global credit crisis. It is quite clear why distressed debt investment managers are salivating at the opportunities currently presenting themselves in this area.

The current market conditions have also presented some interesting opportunities for investment managers who specialize outside of distressed debt. Not only are many pieces of distressed debt available for mere pennies on the dollar, but the debt of otherwise healthy companies is available at distressed prices. While many companies have deservedly had their debt punished due to real concerns regarding operational viability, liquidity, or the ability of the firm to service the debt, countless other firms have been unfairly labeled in a similar fashion. Despite strong balance sheets and positive cash flows, a multitude of companies have seen the value of their debt fall due to prevailing market sentiments rather than idiosyncratic conditions.

This has opened the door to the more traditional investment managers seeking to generate outsized, risk-adjusted returns. Though many hedge funds would be tempted to isolate their investment horizon to the battered equity markets, similarly profound opportunities are available in corporate debt and portfolio managers ignore this sector to their own detriment. Distressed debt, when properly undertaken, can offer remarkable risk-adjusted returns. For example, from 1991 through 2005, returns on distressed debt were approximately 14%. While this figure may not seem particularly impressive or convincing, it should be noted that the best returns to investors came in periods of economic turmoil. For instance, 1991 and 2003 each saw returns in excess of 60% and both periods coincided roughly with recessions in the United States. During these hard economic times, there were many more companies in distressed situations, leading to greater investment choices for talented money managers. Today's market environment would appear to be presenting similarly robust opportunities.

Despite these opportunities, investors must be careful with their investment capital, especially in liquidity-constrained environments such as the one underlying the global economy at the moment. Just as all companies are not equal, the same applies for hedge fund managers, especially in the world of distressed debt investing. As with any capital allocation, an investor must carefully consider the implications of an investment in a distressed debt hedge fund or with a manager seeking to capitalize on current conditions in the market for corporate and government debt. There are a few key items which an investor must consider in the present environment.

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Style Drift

With limited regulatory oversight and often less-than-transparent portfolios, it is quite easy for an investment manager to invest in securities which do not meet the initial profile of the fund. While sometimes it is natural, almost logical, for a fund's investment methodology to change over time due to prevailing market conditions, investors must use caution under such circumstances. As mentioned previously, the distressed debt market currently features some attractive possibilities and, as such, money managers may be tempted to enter this arena in search of outsized returns. However, if the fund was launched under a different mandate (ie. long/short equity, arbitrage, etc.), then investors may become involved in a situation which does not match their risk tolerance or portfolio-level objectives. As with any investment, increased and more effective due diligence on the part of the investor can help to mitigate this risk factor.

Skill-Based Investing

Unlike some areas of hedge funds, distressed debt investing is almost entirely a skill-based strategy. A great number of hedge funds, especially many of those launched in recent years, use program trading (or "black box" strategies) to identify specific investment opportunities. At the end of the day, portfolio allocation decisions are executed independently by a computer rather than a trader or money manager. On the other hand, distressed debt investing works very differently. There are no convenient algorithms available (at least to this author's knowledge) which accurately and successfully predict which pieces of distressed debt are veritable investment opportunities and which are deservedly labeled junk. Rather, a distressed debt hedge fund requires a talented, experienced money manager and a well-selected and coordinated team of professionals in order to make appropriate investment choices.

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Often, a great deal of legal knowledge is required (many distressed debt hedge funds employ internal legal counsel on a full-time basis) as well as a familiarity with bankruptcy proceedings. All of this means that, for an investor looking to allocate capital to a distressed debt fund, a great deal of homework must be undertaken to ensure that money is being invested effectively. If a hedge fund claims to invest in distressed debt, but lacks some or all of the above mentioned resources or skills, then an investor must use extreme caution before investing.

Liquidity

A third area of interest with regards to distressed debt is the issue of liquidity. Indeed, this has always been a concern with this strategy, but today's market conditions have heightened this facet. Distressed debt, especially in the form of bank debt, is illiquid from the outset. The market itself is extremely segmented and inefficient, which is partly why the area is so attractive from an investment standpoint in the first place. However, since this type of debt is not publicly traded or exchange-based, finding a ready buyer or seller to move in and out of positions can be difficult. In today's economic reality, liquidity has dried up even further in all capital markets, making the realm of distressed debt even less populated with parties seeking to exchange assets. This means that, almost by definition, an allocation of capital to a distressed debt hedge fund is an illiquid and scarcely marketable investment and must be viewed as such. The situation can be compounded even further if the hedge fund receives a large amount of redemption requests at a single time. The fund may be forced to sell illiquid portions of the portfolio at less than attractive prices in order to meet the redemptions, much to the detriment of the investors still in the fund. While there are general structures available to counteract this issue (such as sidepockets and gate provisions), an investor would be wise to thoroughly review the offering documents of the hedge fund in order to determine how the fund accounts for illiquidity.

While investors have been severely bruised by losses in capital markets over the past few months, there are still attractive areas for investment, perhaps most notably distressed debt. The carnage that has decimated a number of asset classes has also created some outstanding investment opportunities which brave, forward-looking investors can harness for their benefit. However, distressed debt investing is not for the faint of heart or the underprepared, so before diving headfirst into this illiquid market, an interested investor must exercise caution and perform the necessary homework. Risk factors such as style drift, liquidity, and investment manager abilities are impossible to sidestep entirely, but can be effectively managed through heightened due diligence and prudent diversification. Though certainly this area of investing is not without profound risks, past returns in this market have shown that, in the aftermath of substantial economic downturns, enormous gains can be captured by a well-positioned and competent investment manager. As such, as part of a managed portfolio, distressed debt funds could offer outstanding opportunities for investors in the not-so-distant future. ■

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