Distressed Debt: Room to Roam?

Alternative investment funds which specialize in distressed debt have done exceedingly well over the past few years.

Philip Niles
Butterfield Fulcrum

Alternative investment funds which specialize in distressed debt have done exceedingly well over the past few years. The credit crisis, which hit its apex in late 2008 and early 2009, created an incredible amount of opportunities for investment managers in this sphere. With the market rebounding substantially over the last 24 months, these assets have shown tremendous returns. Distressed companies have emerged from bankruptcy protection and have returned to viability, while otherwise healthy companies whose valuations were unjustly punished by indiscriminate selling have recovered to more rational levels.

With such outsized gains generated by distressed debt and credit funds recently, it is reasonable to ask: is there room left for healthy gains? Or has the money been made and it's time to move on to other investment strategies? This author would argue that there is still room to run in the distressed debt and credit realm, but investors would be wise to focus their investments in this area with a few established, capable investment managers.

The Recent History

As mentioned in the opening, the last few years have been very good for investors in distressed debt. Just how good were those returns? To some extent it depends on the source, but by almost any metric, the results were phenomenal. For the year 2009, the LSTA Leveraged Loan index gained approximately 52% and the CCC index was up more than 100%. Going beyond just a couple of the broad-based indices, some individual issues did even better. Household names like General Motors, Six Flags, Abitibi, Capmark, and Nortel all saw their bonds increase five to ten fold throughout the year. Perhaps most telling, the net inflows into distressed debt funds amounted to tens of billions of dollars.

In addition to the success of 2009, 2010 proved to be quite lucrative as well. Returns on broad-based indices were generally in the high teens or low 20's as far as a percentage annual return is concerned. For instance, distressed securities as defined in the CSFB High Yield Index were up about 17.6% for 2010. And again, as in 2009, individual issues performed very well for those investment managers, ranging from basically anything in the stressed financials sector to airline debt. These were two landmark years for distressed debt hedge funds, but as the old saying goes, past results are no guarantee of future success. Fortunately, as mentioned previously, there is sufficient reason for continued optimism in distressed debt investing.

The Foreseeable Future

The frequent and long-term reader of *Canadian Hedge Watch* may remember an article from late 2008 by this author on the subject of distressed debt. Specifically, it was articulated that favourable investment prospects were evident, even in the midst of the carnage that engrossed capital markets around the world (in light of the aforementioned results in 2009 and 2010 for distressed debt, the "see, I told you so" comments will be kept to a minimum). One of the core arguments in this treatise was the performance of distressed debt following periods of economic contraction; the years 1991 and 2003 each saw annual returns in excess of 60% on distressed debt and both these performance periods followed phases of financial turmoil.

Many would argue that the United States, and indeed many developed economies, is still teetering on the edge of economic recovery with full revival still very much in doubt. Depending on the figures one has at hand, there are any number of reasons to remain pessimistic about the near-term future of America; high unemployment, a weakening dollar, an ever-increasing national debt, and increased competition from foreign jurisdictions are just a few of the issues one could cite. The point is that the United States has a ways to go in its resurgence and, as such, there is likely still room for companies to improve. There is even the potential for a double-dip recession, one which would likely push more companies back to valuations where distressed debt managers begin to lick their chops. This leaves the door wide open for distressed debt investing; should America right the ship in the medium to long term, its businesses should improve as well.

The Mortgage Market

Despite the performance of distressed debt in 2009 and 2010, there would appear to still be encouraging investment prospects for distressed debt money managers. Drawing from the corporate side, a number of major organizations went into default in 2010, and though the pickings are slimmer in 2011 as compared to 2010, there are still ripe opportunities. However, beyond the typical corporate opportunities, many distressed debt managers are turning their heads towards the ugly step-sister of distressed debt, mortgage backed securities (MBS).

In recent months, pools of mortgages have become increasing attractive to distressed debt fund managers. The logic for the opportunities is the same as it has been in the past for any distressed asset: there is an incredibly large market, there are many distressed sellers, and there are few buyers of the assets. As it currently stands, many holders of MBS simply want out and do not have the energy, patience, or risk appetite to continue to hold and manage mortgages. Many financial institutions are still trying to shed risk from their portfolios and, generally speaking, American mortgages are a good place to start that process.

Another plus for alternative investments as a whole in this area is that sophisticated hedge funds with specialized knowledge of distressed debt and financial modelling have a distinct advantage in the market for MBS these days. The math that underlies these assets can be complex, often downright mind-boggling, and the quantitative reasoning required to properly evaluate these securities is possessed by very few individuals and groups. Hedge funds generally swim in that pool of talent and, as such, are well situated to take advantage of the renaissance in the MBS market.

Sovereign (Distressed) Debt

Rarely is there a sizeable opportunity for distressed debt investors in sovereign debt, but the world right now seems to be filled with both financial danger and bureaucratic red tape, two items which tend to create substantial opportunities for diligent distressed debt investment managers. One cannot pick up the newspaper without reading about renewed fears of default in Europe, South America, or a host of other jurisdictions. There are even Republican murmurings from south of the border of a temporary United States default on its debt obligations (please tell us you are kidding, America). Quite obviously, to say there are opportunities in the world of sovereign debt would be a gross understatement.

That being said, despite the opportunities in this sphere, it is a field of landmines best navigated by an investment manager with both experience and expertise in the area. Greek sovereign debt yields might look attractive at 16.25%, but countries that default on their debts do not kick off cash flow for their bond holders, negating the yield no matter how large the number might be. Does the yield in Greece, or in so many other struggling nations around the world, justify the risks? This rhetorical question best typifies the trouble with investing in distressed sovereign debt. The lesson here is that, if one does not understand the investment products, one has no business investing in the products. Leaving it to the professionals is one of the most logical, and likely profitable, choices an investor could make.

Conclusion

Despite the outsized gains that have been experienced by distressed debt and credit investment managers over the last few years, there still appears to be plenty of opportunities in the marketplace. Most notably, pools of US mortgages as well as sovereign debt offer some unique prospects to investors around the globe. That being said, there are extremely profound risks associated with distressed debt, as much now as ever before. The economic recovery of the United States, as well as the developed nations of the world, is still very much in doubt and even a moderate setback could easily derail the finances of both consumers and governments.

As with any investment, requisite due diligence is not only prudent but effectively required. Experienced, capable distressed debt managers have both the experience and the infrastructure to successfully implement what can often be a risky, but lucrative strategy such as this. Even attempting to keep track of the day-to-day undulations in the markets, as well as the ever-evolving macroeconomy and governmental negotiations, is a full-time job. Distressed debt investing can often be credited as being closer to an art than a science; those who cannot paint are thus advised to stay away from the canvas. *