FRONTIER ADVISORS

Observations on US Debt Markets

US Research October 2013

Frontier Advisors Pty Ltd

International Research Issue 03

Frontier regularly conducts international research trips to observe and understand more about international trends, and to meet and evaluate first-hand a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high level assessment on the key areas and observations unearthed during this research venture.

Our research team

Kim Bowater, Justine O'Connell and Martin Thompson from our Debt and Alternatives Research team travelled to the US in October 2013, meeting with a range of debt oriented managers covering traditional, specialist, hedge fund and opportunistic strategies. This provided a diverse mix of perspectives on the state of debt markets today. More than 25 fund managers and other organisations operating in the US investment market were visited onsite as part of this research.

Kim Bowater

Justine O'Connell

Martin Thompson

Risks

As part of the ongoing research program we undertake at Frontier, a number of meetings and discussions with fund managers from across the US have solidified our view around six key risks in debt markets today.

Macro

The common base case view is the US economy is on a trajectory of slow recovery, however, several managers (e.g. Brigade, Babson) are seeing early signs the US economy is performing below consensus. Most managers consider an unexpected macro event to be the key risk for debt markets, but were not overly concerned with the US government budget/debt ceiling issues. Some managers that have the capacity to do so increased portfolio hedges, at least on the margin (York, MKP, Brigade), while others took advantage of US government debt pricing moving to more palatable levels, to shift to a more traditionally conservative stance (Bridgewater).

Technicals

Market technicals, such as investor flows, are of varied importance to managers, depending on their perspective and timeframe, but are increasingly being analysed. Managers are paying attention to where flows are coming from, how this has changed relative to pre-2008, and what this means for market risk. Key markets where flows are considered of some importance, at least to understand if not react to, are bank loans and the related CLO (collateralised loan obligation) market, high yield, and emerging market debt.

A recurring topic during our trip was CLO flows, which has gained some media coverage as having increased significantly. Credit Suisse commented that net CLO investment was stable, however lumpy CLO flows have influenced loan pricing at certain times. A newer source of flows into the loan market is retail investors (mainly via loan mutual funds and ETFs). Some managers consider this to be of concern, as a reversal in these flows would negatively affect the market. In contrast to 2007 however, investors are less leveraged and less trading oriented (hedge funds etc).

Investor flows in emerging market debt (and currency) are of concern post tapering led outflows, caused both by a view these markets have overly benefited from US monetary policy, as well as deterioration in some fundamentals. The degree of these moves surprised some participants, and some (Bridgewater, Brandywine) are looking in more depth at what feedback loop such outflows could have on the underlying economies, particularly those with high external funding (Indonesia, South Africa, India, Brazil and Turkey are of specific concern).

Valuation

Traditional, liquid debt markets are considered by most managers to be at fair value, if not expensive. Long only managers are typically making relative value calls or buying/selling with the market. Managers with more flexible strategies are either moving to safer positioning on the basis that investors are not being paid to take risk, or where allowed, seeking opportunities in less liquid areas. Some credit sub-sectors are considered to be less attractively priced (e.g. non-agency RMBS), while others appear to be providing interesting opportunities (municipal bonds).

Both high yield and bank loan markets have been trading above par, an unusual occurrence for bank loans. Credit Suisse commented that bank loan participants are less leveraged and more price sensitive, so pricing should not shift too far away from fair value. Yields are, however, still reasonable for loans. Mezzanine debt coupons have also decreased. Some managers (Brandywine, Goldman Sachs) view pricing in emerging markets to have moved to attractive levels and have reinvested. Also on the positive, government bonds and TIPS (inflation-linked bonds) have shifted off their absolute lows, which mean they now at least provide some small return.

Risks continued

Liquidity

Reduced liquidity is a key risk in credit markets that is yet to be fully recognised. There has been a significant change in liquidity due to broker dealers no longer holding inventory on balance sheet. While this is not an issue in the current positive, inflow driven market, the reduction in market participants will likely lead to a sharp shift in liquidity should a more negative outflow driven market emerge. MKP and Brigade noted when this occurs, pricing is likely to gap downwards in order to match sellers with buyers. This will cause more price volatility.

Those placed to provide liquidity to markets in a stressed market environment will be able to turn this risk into an opportunity. Several managers (Brigade, Babson) also observe an increased illiquidity premium in smaller issue bank loans and high yield debt, as investors seek more liquid securities.

Rates

An increase in the underlying discount rate is a concern for most investments, and tilting to floating and short dated debt is a logical decision ahead of expected interest rate increases. A number of managers (Brandywine, Brigade) have reduced duration in recent months (particularly with the Fed tapering announcement) but some active managers have also rotated into long duration bonds (Bridgewater). The rate environment is a key driver for the increased popularity in bank loans. However, typically these instruments have a LIBOR floor (e.g. 1%), which means they will not adjust to an increase in LIBOR until that floor has been reached.

Covenants

As demand in debt markets has grown, managers have seen a shift towards lower credit standards. In the loan market, this includes covenant-lite documents, and some issuers have tested the market with other more aggressive terms. This type of practice reduces protection for investors, but there is mixed opinion regarding how significant the change has been so far. It also does not necessarily result in a lower recovery in a default situation.

Opportunities

A broad observation from our debt related meetings is that the outsized opportunity set in credit markets that investors have benefited from since 2009 has now closed. Many markets having rallied over the recent period and many sub-sectors fairly (or fully) priced. However, we did identify several themes and areas where managers are seeing opportunities.

Change in competitor landscape

The regulatory driven trend of investment banks no longer purchasing assets on balance sheet has been a trend for several years, as is less hedge fund capital (due to both lower leverage and lower appetite to take on illiquid investments). These factors continue today, making the competitive landscape more attractive for less liquid investments in particular. Other investors have tended to close the gap in liquid markets. Apollo observed a heightened illiquidity premium in the markets it operates. While outsized returns are less available compared to three years ago, there still appears to be less competition for some assets, particularly those that are large, illiquid and complex as these factors combined reduce the number of potential participants, leading to still attractive risk-adjusted returns. Some of these are niche opportunities (discussed below), and others are loan or debt structures.

Europe

Several managers (Apollo, Siguler Guff) commented that after several years of disappointed expectations, Europe is now providing attractive deal flow to debt investors, with significant selling now seen from European banks in particular. This includes stressed sellers, distressed assets, and non-performing loans. Attractive individual transactions and large portfolio deals are being observed (Apollo notes 4-5 reasonable transactions reviewed each week). However, it is unclear whether deal flow is matched by the degree of “dry powder” available for this opportunity set.

Niche opportunities

We identified a general trend of broad-based scouring for idiosyncratic (and generally less liquid) investment opportunities by managers like Siguler Guff, GMO, and Apollo, including in niche areas, such as shipping, student loans, healthcare royalties, and aircraft leasing. Energy also remains an industry where there are capital shortages, and where some managers (BAA, Apollo) are sourcing transactions backed by real assets. This speaks to a view that innovation and flexibility (while remaining within a firm’s core competency) is necessary to achieve good risk-adjusted returns in the current environment. In the liquid space, areas like municipal bonds are appearing more attractive (Brigade). Some managers with a multi-asset mandate (York and GMO) are also finding opportunities outside of debt, for example, merger arbitrage.

Comparison of sub-sector opportunities

In the table below, we summarise the aggregate view of various debt sub-sectors (discussed to varying degrees) during our research trip. Not all manager views accorded, but we have sought to provide an aggregate view of the managers, overlaid with our own assessment.

Table 1: Comparison of Debt Sub-Sectors Opportunities

Sub-Sector	Valuation	Technicals	Fundamentals	Aggregate View
Government Bonds	Expensive but improved	QE led, some flows back following price moves	Poor duration outlook, low actual risk of default	Negative
Investment Grade Credit	Fully priced	Retail flows out into bank loans	Poor duration outlook, strong company fundamentals	Neutral
High Yield	Fully priced	Strong flows in H1 2013, but now abated. Retail flows out into bank loans	Increasing levels of debt but companies generally healthy, low default rates	Neutral to Negative
Bank Loans	Fully priced	Significant flows 2013 to date due to CLO raisings and retail, significant refinancing in 2013	Company debt levels marginally increased, low default rates, faster refinancing speeds, floating rate secured nature	Neutral
Emerging Market Debt	Improved, fairly priced	Following significant inflows in H1 2013, flows moved out off the back of tapering comments. Some limited move back in	Rising risk of default for more indebted markets, broader risks from negative terms of trade	Neutral
Non-Agency RMBS	Fully priced	Significant flows in over 2013	Improving property market in the US	Neutral to Negative
Municipal Bonds	Some attractive opportunities	Recent significant outflows from retail investors	Varied	Neutral to Positive
CMBS	Fully priced	Significant flows in over 2013	Improving property market in the US	Neutral
Mezzanine Debt	Less attractive	Reduced coupon due to funding availability in other debt markets e.g. loans	Increase in company leverage but company earning quality improved	Neutral to Negative
CLOs	Decreasing attractiveness but some opportunities	Significant new capital raising, some “drive through” raisings	Improved structures, risk to returns in a rising rate and loan pricing environment	Neutral
Distressed	Idiosyncratic opportunities, particularly in Europe	Competitive landscape, unless manager has specific edge	Some signs of stress in US but still low default rate, Europe still struggling	Neutral to Positive
Illiquid Lending Opportunities	Idiosyncratic opportunities	Reduced competitive environment in some instances	Varied	Selectively Positive

Conclusions

A clear take away from our debt related meetings is that the broad based, outsized opportunity set in credit markets that investors have benefited from since 2009 has now closed. While reasonable returns are still available, markets are now fair to fully priced and we do not expect investors to achieve the same outsized returns in the future.

In addition, risks are beginning to emerge, such as increased company leverage and weakening terms.

In this environment, flexibility of mandate and good security selection is particularly important. For liquid debt and credit investments, an active strategy that can allocate across multiple sub-sectors is of particular value. This may include not participating in less attractively priced new loan issues, rotating out of a less attractive sub-sector, or hedging to reduce market risk. Managers that have more flexibility in their strategy and can take an absolute return approach have more opportunity to balance risk and opportunity in this environment.

We also observe a number of debt sub-sectors that are not traditionally accessed in debt allocations, but at various times can prove to be attractive investments from a risk-adjusted return standpoint. For example, the municipal bond market has been noted by a couple of managers as being of emerging interest due to current price dislocations. This isn't likely to be a market that would be attractive to Australian investors on a standalone basis, but indicates the benefit of having a broad multi-sector mandate, particularly with a manager that has the skill to allocate across a range of specialised sub-sectors.

We continue to see some attractive debt investment opportunities in the less liquid space, particularly of medium levels of risk and return (e.g. 10-15% gross returns in US dollars). An opportunistic fund or mandate investment that can consider a wide variety of sub-sectors, industries and instruments with a higher quality and selective manager is likely to be a relatively attractive investment over the medium term and offers useful diversification to traditional private equity strategies.

Managers visited

Goldman Sachs	Stone Harbor	York
Apollo	Brandywine	Lexington
Shenkman	Greenspring	Healthcare Royalty Partners
PEM	Babson	Newbury
Bridgewater	MKP Capital	GMO
Oaktree	BAA	SSgA
PIMCO	Angelo Gordon	Windham
Rho	Siguler Guff	Sankaty
Brigade	Credit Suisse	

Level 16, 222 Exhibition Street
Melbourne, Victoria 3000
Tel: +61 3 8648 4300

www.frontieradvisors.com.au

@frontier_adv

About Frontier Advisors: Frontier Advisors is one of Australia's leading asset consultants. We offer a wide range of services and solutions to some of the nation's largest institutional investors including superannuation funds, government/sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis, and general investment consulting advice. With around $160 billion in funds under advice we have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients. At Frontier, we're on your side.