# Where Are The Opportunities In Fixed Income Oriented Hedge Funds?

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With rising interest rates and fairly tight credits spreads, are there still opportunities with fixed income oriented hedge fund strategies? Agecroft Partners recently spoke with five leading hedge fund industry experts who will be presenting on the "Opportunities in Fixed Income Oriented Hedge Fund Strategies" panel in early November at Gaining the Edge - 2018 Hedge Fund Leadership Conference in NY. Panelists include, James J. Challen, CFA, CAIA, SVP Principal, LCG Associates, Tom Williams, CFA, CIO Pine Grove Funds, Man FRM, Cedric Fan, CFA, Senior Portfolio Manager, Russell Investments, Brian Walsh, Principal & Chief Strategist Titan Advisors and Thierry Adant, Consultant for Credit Willis Towers Watson.

Brian Walsh of Titan Advisors mentioned that he has been focused for a while on how the structure of markets and liquidity has changed over the past decade. He provided a very interesting statistic: "In 2008, corporate bonds outstanding were $2.8 trillion, and dealer bond inventories were $269 billion (close to 10%). Today the respective numbers are $5.3 trillion and $40 billion (less than 1%). So bonds outstanding have essentially doubled while dealer inventories are down 85%. This is a classic example of unintended consequences of government regulation. The next crisis or accident will most likely be a liquidity driven one."

This change in market dynamics has both negative and positive consequences. On the negative side there is significantly more tail risk in many fixed income strategies than most investors realize, which will be a result of market liquidity drying up. It is important to stress test a fixed income strategy to see how it performs in a less liquid scenario. It is also important that strategies investing in less liquid securities have liquidity terms appropriate for the strategy. These include length of notice period for redemption and gates or a private equity structure. Properly structured, these funds can successfully weather a short term liquidity crisis.

One positive consequence is that markets trade less efficiently today. Talented managers with sophisticated analytics can provide liquidity previously offered by bank proprietary trading desks as a means to buy and sell under and overvalued securities. These strategies are less reliant on the direction of interest rates or credit spreads. Their performance is primarily driven by analytics, trading skill and how frequently they turn over the portfolio.

James Challen of LCG Associates mentioned that his firm's "…focus has been on exposure to bank debt and CLOs. Today, greater than 80% of bank loan issuance is cov-light or no-covenants compared to approximately 45% going into the Great Financial Crisis of 2008. CLOs are quite profitable to run and are being issued at a high rate to satiate the thirst for yield. Now 60% of bank loans are owned by CLOs. This is in conjunction with a rising rate environment, where some borrowers are doing share buybacks with the proceeds. Altogether, this raises a red flag. We might be fine for a few more years, but assuming rates continue to increase, expect recovery rates to be much worse given the lack of covenants." He indicated that this could create a great buying opportunity for those with available capital.

"We see the opportunity with drawdown funds that are willing to be patient with commitments and are focused on CLO tranches facing downgrades and potential issues with private debt, especially those originated by Business Development Companies (BDCs)" added Challen.

During the financial crisis of 2008 realized losses from loan defaults to rated debt tranches of CLOs were very low. As a result CLOs are seen as a survivor of the crisis and have become increasingly popular. At the same time many levered vehicles that bought senior CLO tranches prior to the crisis do not exist today, which has resulted in much wider spreads for AAA and AA tranches for the post crisis CLO issuance. Consequently, the junior tranches (CLO equity and BBs) are getting a much smaller share of the cash flow. In pursuit of higher yielding and floating rate products, many investors have gravitated towards these junior tranches. These products have performed as expected in the current, stable environment. However, when the credit cycle turns many of these investors may not have the tools necessary to manage their holdings, which have very high embedded leverage. At the same time, dealers will be very unlikely to provide sufficient, if any, liquidity given their own capital constraints. Agecroft Partners believes this will create a great opportunity for investors with sophisticated analytics who can step in and provide liquidity to distressed sellers.

Tom Williams of Man FRM noted his focus on distressed hedge fund managers and shared his thoughts on which strategies he believes are best positioned going forward. “Defaults and distressed ratios are at relatively modest levels in my view. I believe credit hedge funds are going to need more than just distressed debt positions to hit risk/return targets. Managers with expertise in single name shorts, post-reorg equities and even event/relative value strategies such as merger arb, special situations, or stub trades may be a better bet than long-only distressed managers at this point in the cycle.”

Willis Towers Watson likes private debt, stating “We feel the asset class is simply too big and too important to ignore.” However, they also caution: “mid-market direct lending is now demonstrating signs of material deterioration in credit underwriting and future return potential.” They “advocate for an approach that looks to exploit the full breadth of private debt markets and is sufficiently flexible to direct capital towards areas seeking to offer the most attractive risk-adjusted returns. We are looking to identify borrowers in private debt markets with a genuine and credit-positive need for our clients’ capital. And, in addition, we are seeking situations where there are greater barriers to entry for providers of debt capital like us.” One area of the market they like is the non-qualified mortgage segment. “For those unable to achieve qualified mortgage status, mortgage providers have tightened credit standards dramatically, and availability has been greatly reduced.” They also prefer strategies that focus on niche markets which are not that scalable, keeping out competition. “We believe this bias towards a smaller specialist is particularly well rewarded in periods of market complacency and higher valuations, characteristics we observe in most credit markets today.”

Another niche direct lending market that is overlooked by many is the under-competed, mid-market commercial real estate construction loan sector, where one manager we spoke with believes one can get much higher yields than in the over-competed mid-market corporate direct lending sector. This strategy involves lending 70 to 80% of the construction project cost where they expect the finished building to be worth substantially more than it cost to build. Because completion LTVs are 55 to 70% of completed value, it would require a very significant deterioration in real estate prices for the loan to become impaired.

Cedric Fan of Russell Investments stated, “We believe convertible bond arbitrage has become increasingly attractive over the past year. Issuance trends are favorable and, based on the strength of volumes in the first half of the year, we could see the largest amount of convertible issuance in the US since 2007. One factor that may be driving higher issuance is the US tax reform bill, which was passed in late 2017. Within several years, the bill will limit the tax deductibility of interest expenses, which provides an incentive for companies to lower their coupon payments, and instead compensate lenders via potential equity upside. We believe this will lead to more trading opportunities, cheaper valuations and opportunities to work directly with companies to optimize their capital structures. In addition, convertible arbitrage could benefit from increased equity volatility, either due to idiosyncratic factors or broader macroeconomic events such as global trade uncertainty.”

Even in the face of rising rates and widening credit spreads, opportunities remain available for talented fixed income managers. Various strategies can capitalize on the reality that the dealer community, in relinquishing its market making role post the financial crisis, provides relatively little liquidity to the credit markets. Some niche segments of the direct lending market still offer relatively attractive returns. Other market segments may experience dislocations as market participants find their economic incentives impacted by the US tax reform bill. Inefficiencies in the fixed income markets remain present and are likely to reward sophisticated and patient investors.

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