

Credit Investing in Tight Spread Environment

Credit Markets had a tough year in 2005, as the impact from GM and Ford and the general increase in interest rate left indices with subdued performance. The USD high yield indices were up about 3%, while the higher quality European indices were in the 6% range. In that environment, many long short credit hedge funds did well, while the more directionally exposed funds suffered from the GM induced high yield volatility in the US.

2005 revisited: “Bar-bell” vs. Short

We started 2005 with a cautious view that given the “great” rally that had lasted for over two years and tight spreads, long-biased credit exposures would not fare nearly as well as our preferred “bar-bell” portfolio.

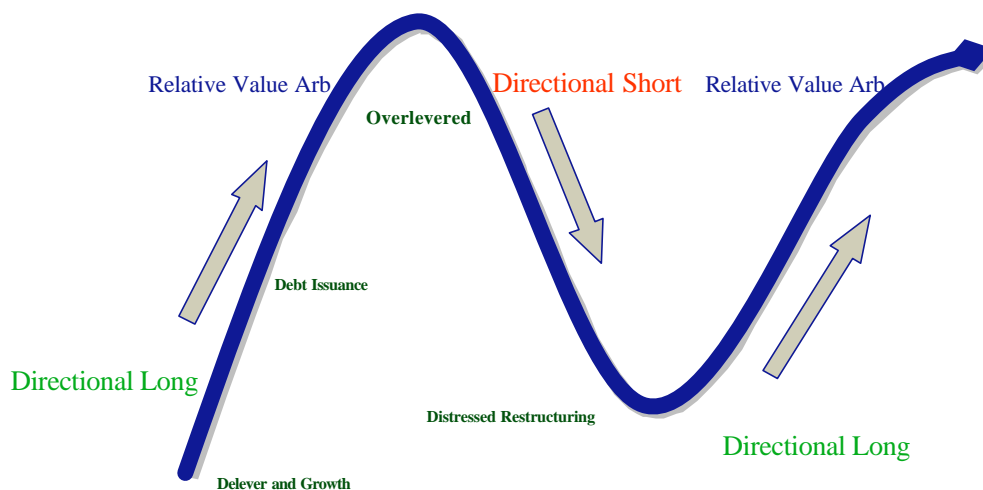
Synthetically long spread volatility, a “bar-bell” approach is characterized by seeking “defense” through moving up the capital structure, being variable long/short, credit market neutral and active trading but in the meantime, “juicing” up returns through distressed mainly outside of the US. The “defense” greatly helped performance by cushioning losses caused by the GM/Ford downgrades and the unwinding of correlation trades in April and May. Later in the year, distressed exposures kicked in sizable returns, closing off 2005 nicely. Overall, credit portfolios ended the year up around +8% net in USD terms.

Another widely held approach, which we avoided, was an outright short credit allocation. Inability to accurately time the market was only part of the reason that we eschewed that possibility. More importantly, it was because of the belief that credits ought to be long or short in the capital structure context, which spans from equity, unsecured bonds to secured bonds/loans. This belief entails a relative value approach in investing credits—shorts are always relative to other parts of the capital structure (long distressed, however, is another story).

Unlike dedicated equity short managers, dedicated credit shorts have a drastically different pay-off: the upside is relatively muted (and sure, the downside risk is not infinite either) over a prolonged period, as bonds’ prices do not typically go down to zero in a matter of days, thanks to recovery value. Cost associated with shorting credits such as borrowing and coupon payment could also be daunting in maintaining the shorts.

And now: Where are we in the credit cycle?

We asked the same question last year: “where are we?” Corporations have become more leveraged than a year ago. However, without any meaningful rise in default rates, currently under 2% globally vs. the 3.5% historical average, another traumatic year like 2001 or 2002 is not in sight.



With that said, is the credit cycle slowly turning? The first signs of “danger” have been spotted in selected sectors such as Autos, Auto Parts and Aviation and most recently, Home Equity Loans. What sectors would come next? Instead of being bearish on the overall market, we think that a discerning eye toward sector selections will be critical to succeeding in 2006.

The Continuous Challenge

How do we find a balance between 1) the risk of a meltdown and 2) the risk of missing out on rallies or continued strength? One might say we are getting closer to a turning point, but before that happens, uncertainly surrounds us. Some say that approaching the end of 2006, we may finally see the turn. But we are not in the camp of judging the market direction and its timing.

A well-implemented “bar-bell” portfolio, the right combination of offense and defense, is the best approach to us. In order to weather a credit storm when it comes, our first and foremost job is to find the right funds with complementing styles, which promises to keep us in the game when the going gets tough and affords us the “luxury” to patiently wait for the next wave of opportunities.

Many opportunities in 2006

Along with challenges also come with opportunities. Attractive “pockets” have started emerging, particularly in 1) Asset Backed Securities (ABS) credits in the form of ABS Credit Default Swaps (CDS); 2) Home Equity Loan CDS; 3) Aviation distressed credits; 4) Commercial Mortgage Back Securities (CMBS) credits in Europe 5) Secured and asset-based lending.

Well publicized in the summer of 2005, CDO correlation trade was undoubtedly the least “attractive” strategy of all. Will correlation trade stage a quiet but strong comeback just when no one is paying attention? The probability cannot be under-estimated if spreads widen out systematically without much interference from idiosyncratic risk and dry-up in liquidity.

Bank loans may be attractive. New issuance will not abate given the pick up in capital devoted to private equity and LBO deals. One concern is the influx of leveraged capital and the growing share controlled by loan hedge funds, many of which do not have financing appropriately set up yet. Convertible arbitrage from 2001 to 2003 may not be an exact analogy but we know it ended in tears. Will the music stop soon if the party has just started?

Our preferred allocation

With the challenges and opportunities, a model portfolio is expected to allocate around 50% in defensive sub-strategies and 25% each in stressed/distressed and non-US opportunities. Such allocations would depend less on market timing/directions and the geographic/strategy diversifications would help mitigate losses in a market down turn.

With that in mind, at this point of the cycle, no traditional credit allocation can do better than a well-structured long short credit portfolio.