

# For Distressed Funds, It's Not Quite Bad Enough Yet

■ *Managers are looking to pick up cheap leveraged loans, but they're not sure they are cheap enough and are treading cautiously with due diligence on individual issuers.*

BY MARA LEMOS STEIN

Rising bankruptcies and debt defaults might well provide a rich set of trading opportunities for managers of distressed-securities hedge funds, but many are still waiting for markets to settle before plunging in.

One thing is certain, though: The leveraged-loan market is the most fertile patch for investment. This was a niche corner of the debt markets until leveraged and second-lien loans became a popular financing tool for companies, especially those in leveraged buyouts. But the onset of the credit crunch has triggered fire sales of loans, wherein the opportunities lie for well-capitalized hedge fund management firms.

"The selling pressure on a lot of debt is increasing, that's primarily what we're spending a lot of time on," said Kjerstin Hatch, principal and portfolio manager at **Madison Capital Management**, a distressed-securities hedge fund in Greenwood Village, Colo., that has about \$400 million under management.

"The first group [of loans sales] that we saw at the beginning of this year wasn't cheap enough, but as we see an acceleration of sales, we're seeing the discounts make sense."

Leveraged loans are attractive because they have been trading recently at the same yield spreads as high-yield bonds. Typically, leveraged loans trade at tighter spreads thanks to their seniority in

the capital ladder. That widening of relative spreads has been caused by the fact that banks, hedge funds and investment vehicles known as collateralized-loan obligations have been forced to unload leveraged loans in recent months to reduce leverage in their portfolios or make margin calls.

The rationale of the trade is simple: to pick up leveraged and second-lien loans at deep discount and hold them until the markets come back and they move higher. If the company that issued the loan defaults, the holder can expect recovery at higher levels than bonds because of their seniority.

In previous cycles, the average recovery has been 70% to 75%, said fund managers and investors, and in recessions or at times of higher stress, that could be around 60%. Niels Jensen, founding partner of **Absolute Return Partners**, a fund of hedge funds in London, said that the loans are trading at levels that imply a default rate of over 10%. During the last down cycle of 2001-02, the default rate was actually 8%. At these cheap levels, implied returns on these loans are at about 10%, on a nonleveraged basis, unless a serious recession hits.

The risk to the strategy is that each issue has its nuances, and under times of stress, the average numbers don't apply, said other hedge fund managers and investors.

"The fear is that issuance of leveraged loans grew to exceed high-yield as a source of financing for companies at the lower end of the speculative-grade spectrum, so recovery rates there could be not as expected," said an allocator of assets to distressed-securities strategies for a large institutional investor in the U.S.

This allocator said that the large volume of loans issued since the 2001-02 cycle and the relatively low quality of issuers - many related to leveraged buyouts - will likely mean a greater number of defaults this time around. The average recovery rate of leveraged loans may have been 70%, but averages "aren't relevant because in periods of high default, recovery rates are negatively correlated," said the investor, who spoke on condition of anonymity.

In previous cycles, banks were the main holders of loans, which meant a higher chance of their getting involved in pushing the borrower to negotiate in case of default. "But most of those loans have been syndicated now, institutional investors hold them, CLOs hold them. And the perspective of those lenders might be markedly different, and their capacity to influence the recovery is diminished," the investor said.

With the increased opportunity comes increased risk, so extra due dili-

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## Distressed Funds

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gence is in order. Fund managers have to sort through the particulars of each issue, such as the collateral, covenants, credit agreements and other documents, as well as the company's credit quality.

"There are deals to be had in different situations if you do the work, but you can't really put a blanket strategy over them," said Hatch, of Madison Capital. She said that she expects to see a lot of distress in companies in the retail sector because of the tighter credit lines. These companies tend to need short-term capital to replenish stocks, for instance, she said.

Other sectors eyed by hedge fund managers are home builders and autos. Consumers will continue to need their

homes and their cars, so after the slow-down, these are the sectors to recover first, said Jack Hersch, managing partner of the Context Phyton Fund of **Context Capital Management**, a hedge fund based in San Diego, Calif. He declined to talk about specific trades.

Defaults are more likely to come from media and entertainment companies, consumer producers, and retail and restaurants, according to Standard & Poor's, the rating agency. In its monthly report that tracks companies at greatest risk of default, S&P analysts said that 93 companies rated B- or lower are more likely to file for bankruptcy, and those involved in leveraged buyouts are at particular risk of default.

Staying out of the trade isn't an option for hedge fund managers who raised a lot of capital to play the next

round of bankruptcies, even if the environment so far in the cycle has been treacherous. Hedge funds investing in distressed securities are suffering on the back of the credit sell-off, posting negative returns for most months since last summer. The strategy was down 2.3% in the first quarter, according to preliminary data from Chicago-based Hedge Fund Research. This compares with 4% returns in 2007.

"March was not a pretty month," said Absolute Return's Jensen. "There were a couple of weeks where the economic fundamentals seemed to become the driving force, and the gap between leveraged loans and high-yield bonds started to widen." As long as leveraged loans perform better than high-yield bonds, the strategy should be a winner in the long run, he said. ■

## Convertible-Arbitrage Funds

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month.

Class A, B and C shares of the \$195.2 million Argent Classic Convertible Arbitrage Fund were down 12.9%, 27.6% and up 1.66%, respectively, through March. The fund is braced for \$15 million of withdrawals in May, according to a company document. "Weak economic data and continued credit market skittishness caused most convertible paper to cheapen in March, as de-leveraging continued throughout the financial system," Argent said in a March investor letter.

Unusually adverse market conditions put some funds in the red. Credit spreads on investment-grade convertible bonds widened by 49 basis points to 282 bps, and noninvestment grade spreads blew apart by 119 bps to 769 bps last month while volatility soared. The VIX index spiked to 29.84 on March 19 from 21.9 on Feb. 8.

Some convertible-arbitrage hedge fund managers were squeezed when

losses from deteriorating credit overwhelmed gains from increased volatility. "The credit markets were more volatile than the equity markets, and that's the worst-case scenario you could have," said an executive at a convertible arbitrage hedge fund in New York.

To make matters worse, some hedge funds helped push prices lower by selling off convertible bonds to meet redemption demands, reduce leverage or meet margin calls. Convertible bonds are often the first assets that hedge funds sell because the securities are highly liquid. **Plexus**

**Partners** in London reportedly sold off hundreds of millions of dollars of convertible bonds around the time its assets plunged by 35% this year, according to a recent report in the *Financial Times*. Plexus declined to comment.

Convertible bond prices fell 2.78% in March and 5.6% for the year, according to Lehman Brothers Holdings. "There was a lot of selling of positions in the convertible bond area, which has put a lot of pressure on the bonds," said Philippe Schenk, director of alternative capital at Credit Suisse. ■

### Hedge Fund Trades

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#### EDITORIAL

**Nicholas Elliott, Managing Editor**

nick.elliott@dowjones.com

**Andrew Yurkovsky, Editor**

andrew.yurkovsky@dowjones.com

**Gregory Zuckerman, Consulting Editor**

gregory.zuckerman@dowjones.com

**Mara Lemos Stein, Reporter**

mara.lemos-stein@dowjones.com

**Eric Baum, Reporter**

eric.baum@dowjones.com

SALES & ADVERTISING

**Carlos Mesa**

202.862.7147

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