

ALVARIUM

Credit: Distress Brings Opportunity for Patient Capital

May 2020



Overview

The impact of the pandemic has been extraordinary, and the ongoing human cost has been tragic. Our thoughts go out to those who are suffering, and we are grateful to the medical staff who are on the front lines fighting the virus and its spread. We have never faced a complete shutdown of economies globally, and the impact has been profound.

Financial markets have reflected investors' fear of the unknown, with equity markets recording their fastest and steepest decline on record. During mid-March, following the collapse in oil prices, certain parts of the financial markets were unravelling, causing the Federal Reserve (Fed) to act quickly in response and at an unprecedented scale. This monetary stimulus, combined with the fiscal impulse, helped stabilize markets, and the return of investors' confidence has been most apparent in equity markets, which have retraced (as we write) over 50% of the peak to trough losses.

However, parts of the credit market, in contrast, remain distressed, particularly where the Fed is not supporting the market through asset purchases. Opportunities arise as these **securities move from weak hands: investors with too much leverage or asset-liability mismatches and become forced sellers to investors with experience and a longer-term horizon, steady hands.**

This is the opportunity we see to generate quite attractive returns.

In this note, we aim to provide insights into the following topics:

- What factors are creating stress in credit markets
- How the investment landscape is evolving
- Why we think the opportunity is attractive
- How we are recommending clients access these investments

Our message in short

For the first time in many years, **we see opportunities to generate low teen returns without leverage in credit markets.** In a world of zero interest rates in most Government securities, and little prospect of this changing any time soon, we believe that well researched credit opportunities represent an attractive opportunity for clients seeking income who are able to take on a well-priced credit risk.

Initially, we are **focusing on credit securities associated the residential lending market** and, in particular, Non-Agency Residential Mortgage-Backed Securities (RMBS). To give a sense of the opportunity, senior tranches which are well protected by being higher in the capital structure and with low Loan-to-Value (LTV) ratios are trading at a significant discount to February 2020 market prices and also at a discount to fundamental or intrinsic value.

Over time, as the duration of the crisis on businesses becomes better understood, we expect securities in other parts of the credit market to also become attractive. **We are closely monitoring the Non-Agency Commercial Mortgage-Backed Securities (CMBS) market for deeply discounted values** that are adjusting to the new normal of lower capacity utilization rates for

hotels, offices and retail properties. As shorter term and leveraged investors exit this segment of the market as forced sellers, we expect attractive CMBS opportunities to also develop.

We are also closely monitoring the corporate credit markets. Default rates could reach high single-digit or low double-digit rates in 2021, from 4% today. If they do, we would expect to see quite significant opportunities for traditional distressed investing, where investors can purchase the fulcrum security at a discount to par and take control of the company in a restructuring. We expect the distressed corporate opportunity market to increase in attractiveness as default rates rise in the next few months.

The timing of opportunities is not a precise science. Consequently, we have identified **several first-class credit managers, who have the expertise to move across the full range of credit and distressed credit markets, as opportunities emerge**, using deep fundamental research. The managers we have selected have proven track records of investing in distressed market periods and seeing opportunities through to restructuring, value realization and the generation of strong investor returns.

Factors Creating Stress in Credit Markets

The groundwork of the current credit market dislocations started during the Global Financial Crisis (GFC) when central bankers did everything they could to support employment and economic growth. They primarily did this by suppressing interest rates down, which compelled investors to move further and further out the credit risk curve, which included packaging less liquid securities in daily liquidity structures. Additionally, to achieve return targets, cheap funding was used to leverage portfolios. The riskiness of the liquidity mismatches and leverage was obfuscated by one of the longest bull markets in history.

Leveraged positioning combined with cracks in the funding market made for a toxic combination as the pandemic forced the shutdown of all non-essential services. Credit markets went into disarray as businesses and individuals were left without means to generate revenue and income. The ensuing volatility created three self-reinforcing drivers of price declines in daily liquidity credit structures: (1) investors started selling, (2) banks pulled repo funding, and (3) managers reduced risk. **As a result, securities were being sold for uneconomic reasons, with portfolio managers selling what they could to raise cash quickly.** The market stress was so severe that for the first time, there were bid lists sent out on a Sunday night as funds struggled to meet margin calls.

The Fed saw the contagion spreading through credit markets, and had the 2008 playbook to follow, which is why they reacted so quickly and at such an unprecedented scale. It stepped in promptly with bond-buying programs designed to shore up market liquidity, and to a certain degree, its efforts have been successful. The Fed targeted Agency RMBS, Agency CMBS, Municipal Bonds (Muni), Investment Grade (IG) Corporates, and various Asset-Backed Securities (ABS) collateral types.

Importantly, Non-Agency RMBS, Non-Agency CMBS and certain parts of the corporate credit markets are currently outside of the Fed's mandate. However, we think the current market dislocation combined with the Fed's support further up the credit spectrum is creating pricing

dislocations and thus significant return opportunities in the non-agency and distressed corporate credit markets.

Investment Landscape Evolution

Strategies that worked in an economic expansion with low rates get exposed as flawed when borrowing cost rise and cash flows get disrupted. It is the unwind of these strategies that has and will continue to create attractive investment opportunities.

Financial crises are typically unique in how asset classes are impacted, but the dislocations they cause generally follow a similar pattern.

- Initially, market strain forces sellers to raise cash by selling their most liquid securities first because buyers can underwrite them without fully knowing the depth of the economic impact.
- Eventually, as the crisis unfolds, and investors have a better sense of the full implications of the financial slowdown, securities trade based on fundamental expectations.
- Finally, as economic conditions bottom out and winners and losers become identifiable, balance sheets get restructured, and long-term capital providers take control of the businesses.

Using this roadmap, we expect the current distressed opportunity to play out in a similar series of stages where forced selling, margin calls, and risk reduction result in a spiral of lower prices and thus increasingly highly attractive security valuations.

Most Attractive Investment

This economic slowdown has been severe, and there are a significant number of unknowns around the virus and what it means for a recovery in economic growth. We are **focusing on investment strategies that benefit from price dislocations in securities that can withstand a variety of economic outcomes.** We do not believe investors are currently getting paid sufficiently to move out the risk curve, yet, especially since the initial round of deleveraging had the most significant impact on high-quality leveraged securities.

In the current market environment, where high quality traditional fixed income yields are paltry, and equity markets are highly volatile, we believe a **Non-Agency RMBS strategy can generate highly attractive risk-adjusted returns.** The strategy should produce high single-digit yields even in a challenging economic environment where home prices are significantly stressed, and mid- to high-teen returns if economic conditions recover quickly.

From our perspective, RMBS securities have the following unique structural advantages in today's environment:

- **Mortgage payments are now at the top of the capital stack for homeowners** due to the shelter in place orders. There should be a prioritization of cash flow to service mortgage

debt from household balance sheets that are improving from a reduction in spending elsewhere.

- **Non-Agency RMBS securities are currently excluded from the Fed's existing liquidity facilities.** Therefore, the supply-demand dynamics remain unbalanced, resulting in favourable pricing during Bid Wanted in Competition (BWIC) auctions.
- **Repurchase (repo) facilities are altering their collateral terms,** which will likely continue to create selling pressure in RMBS markets. If liquidity conditions don't improve, and investors are unable to come up with cash to pay down the margin, there will likely be more selling pressure.

We believe the following Non-Agency RMBS opportunities are attractive:

- **Legacy RMBS** that were issued before 2008 in structures where LTVs have fallen materially as housing repaired following the last crisis and borrowers made principal and interest payments. There are two investment profiles that we find attractive, that together create a barbell risk profile. The lower risk investments are higher in the capital structure and are trading in the 70s. Given the credit protection and subordination, the bonds should be money good in most economic scenarios. The higher risk investments are loss taking bonds that are trading in the mid-50s, which should have significant upside in an economic recovery.
- Entering February 2020, **RMBS 2.0** bonds were mostly trading at par or a premium to par and were yielding around 4%. Therefore, market participants were using leverage to achieve their return targets. In March, as prices started to decline, leverage lines were pulled, forcing additional selling. As we understand it, lenders are providing temporary forbearance and working with their borrowers by giving them more time to come up with cash for margin calls. Still, we expect more reductions in leverage coming as economic numbers worsen, and investors redeem assets from these over-leveraged pre-crisis investment vehicles.
- **GSE Credit Risk Transfer (CRT)** bonds have pristine underwriting standards, and loss expectations under most reasonable scenarios are benign, given the high quality of the mortgage pools. Prices fell to lifetime lows in the middle of March. Even though prices have recovered since the lows, there is an opportunity to generate double-digit total returns in securities that have excellent downside protection.

Investment Access

To access these types of Non-Agency RMBS securities and, potentially over time, CMBS and other distressed credit opportunities as they emerge, we are leveraging our network and global research. We have worked hard in the last few weeks to identify fund managers with proven track records in structured credit and excellent research teams. Our preference is to work with a select group of best-in-class firms that have the following characteristics:

- The firm is launching a new investment vehicle with no legacy positions, so we know the portfolio marks are transactionally driven and not based on street estimates.

- The investment team has demonstrated an ability to invest opportunistically in the full range of distressed credit, a proven track record, focusing initially on Non-Agency RMBS, where we see the best near-term opportunity.
- The investment team has proprietary systems for valuing securities at the collateral level and expertise in evaluating the terms of loan documentation.
- The firm prioritizes risk management and takes a conservative approach to leverage.

As mentioned, we think distressed credit today represents an attractive return opportunity, potentially mirroring the type of double-digit gains that were seen post the global financial crisis.

That is what we do: investing side by side with our families.

Disclaimer

The information contained herein is given as of the date specified and does not purport to give information as of any other date and are subject to change based on market and other conditions. Neither the delivery of this memorandum nor any subsequent contact made hereunder shall, under any circumstances, create an implication that there has been no change in the matters discussed herein since the date hereof. The views and strategies described herein may not be suitable for all investors. The opinions expressed may differ from those of other market strategists or entities affiliated with Alvarium that use different investment philosophies.

No representation or warranty is made to the sufficiency, relevance, importance, appropriateness, completeness, or comprehensiveness of the market data, information or summaries contained herein for any specific purpose. These comparisons are for information purposes only and should not be used to make investment decisions or reach any conclusions about performance or suitability.

All brands, company names, and product names are trademarks or registered trademarks of their respective holder.