DIGGING UP MINEFIELDS

DISTRESSED-FOCUSED MANAGERS ARE OUTSHINING THEIR HEDGE FUND PEERS BY FINDING VALUE IN PLACES WHERE OTHERS FEAR TO TREAD.

BY ERIC UHLFELDER

WITH THE S&P 500 DELIVERING SOLID DOUBLE-DIGIT returns this year, hedge funds, along with most other investments, are failing to keep pace. But advisors need to remember that asset class outperformance is a rotating deal, demanding diversification. It wasn't long ago that investors were bemoaning the Lost Decade for stocks, when 10-year annualized returns were zilch.

Certain hedge funds can meaningfully diversify portfolios. But investors need to be mindful that, as a group, hedge funds have not delivered outperformance since 2008, when their losses were nearly half the broad market's massive selloff. A large part of this underperformance is due to chunky fees and expenses and lots of mediocre managers who bring down averages.

That said, a discernable benefit of some hedge fund strategies is their ability to target unique investment exposure that advisors would have a hard time finding anywhere else. Case in point: distressed investing.

Not to be confused with mutual funds that look at deep-value stocks going through hard times, distressed-focused hedge fund managers drill much deeper into the space. They work with a more diversified arsenal of investment tools than mutual fund managers to theoretically profit when companies suffer from a poor merger, a loss of industry leadership, shifting demand or restructuring. Funds' investment horizons are generally between one and two years. And unlike many other hedge fund strategies, distressed funds generally don't use leverage.

The potential upside of distressed investing is identifying intrinsic value in companies that "is often significantly higher than their prevailing market prices," according to a distressed strategy report by the Man Group. The price gap is caused by sellers of such securities tending to "react emotionally in anticipation of a potential bankruptcy and overlook or ignore the company's true worth." And many may be forced sellers, required by their portfolio rules to get rid of troubled holdings once valuation declines pass certain thresholds.

For Jason Mudrick, CIO of the $470 million Mudrick Distressed Opportunity Fund, which has racked up annualized gains of 12.4% since it started in July 2009, the appeal of distressed investing is in finding "equity-like returns with credit-like risk and volatility."

Mudrick said he adopted the strategy because he realized so few analysts take the time to unearth the value in distressed yet fundamentally strong companies.

"Distressed assets are difficult to analyze, surrounded by negative sentiment and press, with bankruptcy lurking overhead," he said. "Many analysts simply won't bother digging in such mine fields. It requires a lot of specialized work, from understanding debt and bankruptcy law, capital markets, to industry and securities analyses and valuing illiquid assets."

Unlike some managers who may look to profit from post-bankruptcy reorganization, Mudrick looks for good businesses with bad balance sheets, where restructuring can ease financial stress and unlock value.

Jeff Peskind, CIO of the JLP Credit Opportunity Fund, looks for similar situations, "involving troubled companies that the market is very much down on but which we believe have a low risk of bankruptcy." His track record since he started the fund 10 years ago—with annualized gains in excess of 15%—bears out the merit of his approach.

INDUSTRY AVERAGES

The distressed securities market exceeds roughly $1 trillion in the U.S. alone. It comprises of various below-investment-grade instruments, including high-yield bonds, bank loans, debtor-in-possession loans (loans of a company operating while under Chapter 11 bankruptcy), second-lien notes, trade claims/receivables, "busted" convertibles (convertibles trading well below their conversion values) and municipals, credit default swaps, credit default indices, preferred stock and collateralized debt.

BarclayHedge, the hedge fund industry data tracker, reports distressed hedge funds have been delivering the best returns of all broad strategies over the past year through August, and are up nearly 17%. Over the past three years, annualized gains were 8%, and over the last five years they were 5.8%.

Distressed-focused managers on average aren't beating the market over these periods. But they are topping virtually every other broad hedge fund strategy with moderate volatility: 4.14% over the past year and 9.7% annualized over the last five years. That's half the standard deviation of the market.

There are several reasons for these steady returns. One, when an experienced fund team is researching an investment that's made in a cheap secured bond, the bad news is likely already priced into the security and the manager can feel confident estimated residual value is recoverable. Uncertainty tends to be more focused on the upside rather than downside.

Second, distressed situations are created not just by broad downturns in the economy but by companies and industries that stumble—a phenomenon that happens all the time as a result of competition and especially disruptive technology, irrespective of the economic cycle.

Michael Gelblat, CIO of the 12-year-old Onex Credit Partners Debt Opportunity Strategy, which has been generating annualized returns of more than 8.5%, describes an investment that combines both of the above scenarios.

Even before Eastman Kodak declared bankruptcy, Gelblat had been watching the company because he saw successive turnaround strategies burn through cash rather than set the company straight. Kodak failed to recognize that technological innovation was placing

FIGURE 1
Performance Of Major Hedge Fund Strategies

HEDGE FUND STRATEGY	1 YR. RETURN ENDING AUG. 2013	CAR* LAST 3 YRS. ENDING AUG. 2013	CAR* LAST 5 YRS. ENDING AUG. 2013	CAR* SINCE INCEPTION ENDING AUG. 2013	WORST DRAW-DOWN SINCE INCEPTION ENDING AUG. 2013	1 YR. ANN. STD. MO. ROR ENDING AUG. 2013	3 YR. SHARPE RATIO ENDING AUG. 2013	5 YR. SHARPE RATIO ENDING AUG. 2013
Barclays Distressed Securities Index	16.97	7.99	5.80	9.08	35.26	4.14	9.69	0.59
Barclays Equity Long Bias Index	15.70	8.84	4.62	10.22	34.38	5.52	12.60	0.36
Barclays Equity Long/Short Index	10.70	5.57	4.02	10.07	14.25	3.14	6.14	0.64
Barclays Event Driven Index	8.71	5.50	6.19	9.81	19.62	3.58	7.20	0.84
Barclays Fixed Income Arbitrage Index	8.38	7.44	4.52	6.01	29.12	1.95	7.81	0.56
Barclays Convertible Arbitrage Index	7.75	6.57	8.80	8.13	31.53	1.94	10.27	0.85
Barclays Multi Strategy Index	7.18	4.84	4.93	9.21	19.29	1.65	6.49	0.74
Barclays Equity Market Neutral Index	5.81	3.38	1.62	5.57	6.26	1.73	2.38	0.63
Barclays Merger Arbitrage Index	3.24	4.04	4.43	7.92	7.18	3.26	3.26	1.32
Barclays Global Macro Index	0.71	1.60	2.32	8.20	6.42	3.70	4.65	0.47
Barclays CTA Index	–5.39	–0.42	1.10	10.43	15.66	3.41	5.19	0.19
Barclays Equity Short Bias Index	–26.80	–16.81	–10.45	1.02	56.69	10.00	15.67	–0.67
Barclays Hedge Fund Index	9.34	5.50	4.17	9.40	24.09	3.70	8.37	0.48
S&P 500 Total Return Index	18.70	18.40	7.32	11.4	50.95	8.56	18.42	0.39
MSCI EAFE Index (USD)	15.27	5.99	–1.40	7.91	58.24	10.33	22.79	0.07

Source: BarclayHedge. Data is through August 2013. *Compounded annualized returns.

it on the wrong side of the market and that it could no longer sustain its once-dominant brand leadership among consumers.

But bankruptcy was not enough to create an opportunity for Gelblat because he felt the company was plagued by insufficient transparency—particularly when it came to the value of its highly touted patent portfolio.

Analysts put the patent portfolio value at as much as $2 billion, but Gelblat had his doubts and waited for more reliable numbers. "When there was clearer indication in the early part of 2013 that the portfolio would eventually be auctioned off for nearly 75% less, certain bonds sold off," he says. "We felt this created a better risk-reward opportunity for specifically the junior secured debt, which was backed by property, plant and equipment, foreign subsidiary equity, as well as by intellectual property."

He established a position when these bonds were selling at a 25% discount. Six months later, they matured at par and paid back interest that had accrued since January 2012 when bankruptcy had been declared. Gelblat's total gain was 40%.

A third source of opportunity is shocks like a financial crisis, which cause refinancing costs to soar and access to capital to become more restricted, increasing the number of stressed and distressed situations.

When such a crisis hits, it's hard for even the most talented distressed managers to get out of the way of tumbling prices. This was seen in 2008, when the average distressed manager lost nearly 32%. But when the worst was over and recovery began in 2009 and 2010, managers again rallied, gaining nearly 31% and 14% in each year respectively.

While it may not have been evident in 2008, this doesn't mean distressed investors don't try to hedge their exposure. They will do this by buying credit default swaps that should increase in value when their long positions move against them. They also can short the high-yield CDX index—100 of the largest high-yield bonds—to the same effect. And managers can buy naked shorts of overvalued bonds that display excessive duration and which may be vulnerable to a ratings downgrade.

SPECIAL OPPORTUNITIES

Leveraged buyouts can be fodder for distressed investors. For Jason Mudrick, three-quarters of his book involves LBOs. Such financing schemes typically weigh heavily even on sound businesses with onerous debt service, often pressing on key valuation ratios. Mudrick says he often buys debt of such companies at up to half their par value, when "valuations over operating cash flow" are running at half the ratio of a financially healthy firm.

His firm, which only holds several dozen high-conviction plays at any one time, bought the senior-secured, first-lien debt of American Achievement—a leading producer of high school and college yearbooks and rings—at the end of 2011 and early 2012 at an average cost of 70 cents on the dollar. With the bonds maturing in April 2016 and a coupon of 10 7/8, Mudrick's position enjoyed an annualized yield-to-maturity that exceeded 23%.

"The reason for the deep discount was the company being six times levered after Fenway Partners had bought it and piled on $365 million in high-yield debt," Mudrick says. Debt was running seven to eight times Ebitda. With cash flow of $60 million, debt service of $40 million and Capex of $10 million, this left little room for operating error, which became evident when earnings slowed in 2011 and bond prices fell. But Mudrick saw an inelastic, sustainable high-margin business.

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FIGURE 2

Performance Sampling Of 10 Hedge Funds Focused On Distressed Securities

NAME OF FUND	START DATE	MONEY UNDER MGMT. $M	1-YR. RETURN	3-YR. ANN. RETURN	5-YR. ANN. RETURN	ANN. RETURN SINCE INCEPT.	WORST DRAW-DOWN SINCE INCEPT.	SHARPE RATIO PAST 5 YRS.	ANN. STD PAST 5 YRS.	SHARPE RATIO PAST 5 YRS.
Hildene Opp Master Fund, LTD	May-08	842.1	46.40	27.62	28.92	29.24	11.59	9.66	9.77	2.95
JLP Credit Opportunity Fund LP	Sep-03	487.6	19.87	10.51	22.36	15.48	51.71	9.63	24.14	0.92
Marathon Special Opp Fund Ltd	Apr-99	790	19.18	9.21	6.79	15.30	34.16	4.81	11.39	0.59
Mudrick Distressed Opp. Fund Ltd	Aug-09	217.2	11.01	8.69	N/A	11.75	8.55	3.16	N/A	N/A
Waterstone Quarry Master Fund Ltd	Oct-05	310.6	14.02	8.25	12.99	10.15	27.06	3.65	8.93	1.44
Candlewood Special Situations Fund LP	May-03	776.5	11.09	8.14	7.81	21.30	25.86	2.74	8.85	0.87
Venor Capital Offshore Ltd	Oct-05	511.7	13.07	7.78	12.69	9.96	26.65	3.67	8.85	1.42
OCP Debt Opp Intl Ltd	Jan-06	312.5	9.48	6.71	10.10	7.76	24.14	1.45	9.05	1.10
Scoggin Worldwide Distressed Fund LLC	Jan-07	208	13.78	5.25	8.54	7.82	26.32	3.83	10.07	0.84
Alcentra Gl Special Situations Fund	Nov-07	182.2	13.24	4.45	11.65	5.41	47.18	3.49	16.96	0.68

All Data is through August 2013. Table is organized by three-year annualized returns.
* Total fund assets will typically be more, combining on- and off-shore funds plus separately managed accounts.

He was proved right as earnings improved. Combined with investor appetite for yield, his bonds recovered back to par in early 2013, when he sold out, producing a total return of nearly 60%.

Mudrick felt his investment would've performed well even if earnings had failed to recover and bankruptcy ensued. "Burdensome debt service would then have been wiped off the books and our substantially discounted debt would've converted into equity at an attractive price that would've likely returned even more than what we had earned, albeit requiring more time to be realized," he says.

This past March, Jeff Peskind's fund ventured into another debt-laden operation, Caesars Entertainment. The casino and hotel operator had been acquired through an LBO, with debt now running at 10.5 times cash flow. Peskind purchased collateralized 9% senior-secured debt, due in 2020, that was trading just below par.

In June, when Fed Chairman Ben Bernanke rattled the markets by suggesting he might consider tapering off quantitative easing, Peskind's debt held up well versus the company's much more volatile unprotected junior debt. The fund manager believes that within two years, management will likely start refinancing its much more expensive junior debt paying more than 20%, which would improve cash flow and propel his higher quality bonds toward 105, at which point he would likely sell out.

Because performance of distressed bonds of the same company will vary across the capital structure, as seen in Caesars, this creates potential arbitrage opportunities, according to Thomas Della Casa, who co-wrote the Man study. One way hedge fund managers may set up this trade, he explains, is through buying senior secured debt and shorting junior subordinated debt and/or equity. In bankruptcy or the threat thereof, the former should sustain more of its value while the price of the latter two securities may decline at a greater rate. The potential widening of this spread is where profit may be found.

RISKS

But such spread widening doesn't always happen for a variety of reasons, illustrating one of the many risks associated with distressed investing. Even managers with a world of insight and experience know that forecasting the future of any company is hard. The myriad moving parts in a distressed enterprise make it even harder.

Distressed securities are often illiquid, generating wide pricing spreads. This makes valuation challenging, and the valuation ultimately defines performance.

Mathew Ridley, a former hedge fund manager and an author, says analysis errors concerning tax issues, listing documents or corporate actions can be costly.

"Negotiations about rankings in a capital structure and the payout afforded to each can turn against the most experienced investor," he says.

Legal issues are often tangled webs. When a company ends up in bankruptcy court, judicial fiat can challenge the most established precedent. A CEO who is trying to turn around a company may suddenly leave. Even when done for benign reasons, the market may think otherwise and turn against the value of many of the improvements the manager had put in place. Misinformed reporting can wreak havoc to the best laid plans.

The list of impediments to success is very lengthy. That's one reason Peskind diversifies his portfolio across more than 70 holdings.

On the other hand, Mudrick thinks the experts he has assembled can decipher the vagaries of distressed investing and deliver better performance by betting on half as many situations.

Ultimately, when choosing a distressed fund manager, advisors should look for a seasoned diversified team of professionals with a proven, long-term investment record across various market cycles. This may increase the chance of consistent, positive performance regardless of the specific types of distressed opportunities being pursued and the state of the economic cycle.