Ringing in the new credit funds

The chase for unleveraged bets on the revival of loan and high yield prices is likely to herald a fund-raising frenzy as the new year begins. *Euan Hagger* reports

Two thousand and nine has been a long time coming. Having pretty much given up on 2008 by early September, many credit fund managers have been pinning their hopes on a return of investor appetite in the new year.

The fervent hope is that investor allocations will bring about a significant revival, at least in the loan and high yield segments of the credit market. The argument is that investors will have to be blind to overlook the deeply discounted valuations on offer in leveraged loans and speculative grade debt.

Fund managers confirm that they expect increased inflows from investors this month as the new year starts. Some have even been successful already with recent fundraisings for investment in leveraged loan assets. The scale of the inflow has been modest, but may point to greater inflows to come.

Given the extreme duress that continues to be felt by most structured credit investors – and the lack of available leverage – these new funds are being introduced in an unleveraged format.

Managers that have been on the road include London-based credit manager BlueBay Asset Management. The firm recently launched its High Income Loan Fund. It will buy high yield loans and has initial seed capital of €137 million.

"We have monitored the opportunity to launch a loan fund for some while but have resisted because we felt valuations were not compelling enough," says Anthony Robertson, senior portfolio manager at BlueBay. "We wanted to wait for a time that was more exceptionally dislocated. We are at that point now."

Robertson says that the fund will buy assets over a one to three year period, and is targeting 15% to 25% returns without leverage. "Generating equity type returns at the top end of the capital structure is more than attractive," he says. "For returns of 15% to 25% the assumption is that loan prices will go back to trading between 80 and 85 cents in the dollar between now and the next year three years. That is a fair assumption."

"It's possible to achieve returns of 15% unleveraged and you have security. It's unprecedented"
Zak Summerscale

He adds that good, stable, recession-resilient sectors such as telecoms, cable and consumer staples will form the core of the portfolio.

The fund may be unleveraged, but that does not mean it is long-only. Like other new offerings, the BlueBay fund is able to use credit derivatives. "The fund has no leverage but it has the ability to be short," says Robertson. "We might go short to help minimise volatility at the overall fund level using an index, or we might want to take advantage outright of a deteriorating credit."

In the European market, other leveraged loan managers that have been on the road include Babson Capital. "We are looking at raising money on an unlevered basis for performing and non-performing loans," says Zak Summerscale, managing director, Babson Capital Europe. "We have sized several funds on an unlevered basis for individual clients. We are also looking to launch a distressed fund next year when the default rates pick up on certain non-performing names."

Summerscale says that non-performing names will provide good opportunities for equitisations, where companies are essentially sound but saddled with excessive leverage. Meanwhile, the recent mass deleveraging has created opportunities to pick up performing names that are trading as low as 50 cents in the dollar.

Says Summerscale: "We are seeing huge yields. You don't need leverage when senior loans are at 1200bp over Libor. It's possible to achieve returns of 15% on an unleveraged basis and you have security. It's unprecedented."

Even so, getting investors to bite remains extremely challenging. It won't be lost on investors that loan funds set up within the past year to take advantage of dislocated valuations have been among recent forced sellers. "A lot of funds were set up on the basis that there was fantastic value when loans were at 85 cents in the dollar," says Summerscale. "Typically the funds would have been three times levered and deemed to be very prudent. In reality, there has been forced selling as assets have fallen another 25 points."

He believes some investors will come in next year when they have seen a rising market. But not every investor needs to see the market turn before they put money into credit. "Others are saying that assets are ridiculously cheap and that they want to average in, or give money every month over the next four months," says Summerscale.

Loan managers do not rule out continued sharp falls in asset prices in the new year. "It's possible that loan prices could fall further as we are not through the deleveraging," says Robertson. "It's hard to know how big the next wave of redemptions might be or how high margin calls might get hiked. However, the investor base for the High Income loan Fund are long-term committed institutions that are happy to ride out short-term volatility in exchange for very good medium term returns."

He believes it is unlikely we will see the same level of dislocation that occurred October. "Buyers are still outweighed by sellers but new pockets of money are being unearthed, which will accelerate in the early part of next year," he says.

"We could see a fresh start in the new year for loans and high yield," agrees Mahesh Bhimalingam, high yield strategist at Barclays Capital in London. "Things should improve as liquidity from dealers should pick up as well as some real money investors putting cash to work because of where valuations are."

However, assuming a rally materialises, the question is how long it will last. "Will there be opportunities in leveraged loans and high yield? Yes there will be. But are we ready to call the bottom? Absolutely not," says James Hunter, a partner of Fairhope, Alabama-based investment manager, Point Clear Capital Management.

"There could be a rally, but we would be sceptical about its longevity. You can have aggressive rallies during a bearish trend or during periods of heightened market volatility, like we are seeing now. It is conceivable that we have not seen the all time high for the VIX or the all time wides for investment grade or high yield credit."

Point Clear, which has been managing credit hedge funds since 2005, is a relative rarity. It is among the small universe of managers that have delivered a good performance in 2008. According to Creditflux data, its long-short credit hedge fund, Piedmont Alpha 1 Fund, has returned 10.3% year-to-date.

"While we have a prime broker, we haven't had any reason to use traditional leverage in constructing our risk profiles," says Hunter. "We've used some notional leverage through swaps, but we have been able to constrain our downside risk through our risk management process. There is no reason to use aggressive leverage when the market is giving you attractive risk profiles that will pay handsomely."

"We could see a fresh start in the New Year for loans and high yield – things should improve"
Mahesh Bhimalingam

Loans and high yield may feature on Point Clear's radar screens soon. Meanwhile, index trading is a core strategy for its Alpha 1 fund, particularly using the CDX investment grade index. The fund also invests in senior tranches of the investment grade index. "The 30-100% tranche paying north of 90bp is probably a position we won't want to part with," says Hunter. "We've viewed various pricing points as an incredible opportunity to integrate correlation positions with virtually bullet proof credit risk into our portfolio. The default scenarios where you are at risk in that part of the capital structure are wildly improbable."

Hunter says that there could also be opportunities to take advantage of market anomalies in both the loan and high yield markets, despite reservations over the sustainability of any rally.

"We can evaluate those markets as macro credit players and identify the types of asymmetric opportunities that fit our risk reward tolerances," he says.

Plenty of other managers have their eye on the two asset classes. For example, in the high yield market, London-based Threadneedle Investments says it has moved to overweight. The manager points out that yields of 20% are now available. Says Trudie Rothery, investment specialist at Threadneedle: "Spreads in the high yield market are now at historic wides. Whilst fundamentals are set to deteriorate, with defaults likely to peak by 2010, spreads reflect unlikely rates of default. The technicals in the market have been overwhelming, with continuing deleveraging and the market generally lacking confidence. However, we are now starting to see some support in the market with selling lists finding a clearing price and some buying."

Rothery adds that increasing interest in the asset class has translated into inflows. "We have been buying. It is, however, difficult to not be bearish and therefore we are conservative in our investing, preferring defensive and better quality stocks, senior rather than subordinated paper, and issuers with a prudent debt profile."