Pursuing niches to beat the headwinds

Guest comment by Raphael Schorr

The coming cycle could be particularly challenging, but still lucrative for those prepared to adopt an opportunistic approach to investing

Investors over the past decade have benefited from stable markets, a relatively benign economic climate and low-interest rates. Within credit, these conditions have created a sense of complacency at a time when market stability is rapidly eroding, setting the stage for lower returns or even losses on a look-forward basis.

The major credit selloffs of the past 20 years (global financial crisis, 2015 oil bust and covid-19) were all either localised or met by significant monetary loosening. These factors mitigated the pain that investors in traditional credit areas such as direct lending and traded credit strategies experienced. Naturally, the positive investor experience encouraged additional capital inflows, and growing credit markets created a powerful and self-reinforcing tailwind where borrowers refinanced easily and cheaply, credit losses were low and investor returns were high.

Today's environment is different. Factors including supply chain disintegration, labour unrest and war have contributed to a three-headed monster of inflation, higher interest rates and, ultimately, a slowing economy. From a creditor's view, the virtuous cycle of easy and cheap credit has been thrown into reverse, auguring a challenging period of higher losses, asset mark-downs and forced deleveraging.

We do not expect history to repeat itself perfectly, but comparisons are useful. The oil embargo and stagflation of the 1970s are often viewed as a relevant foil for today. During the 12 months beginning October 1973 (the beginning of the embargo), the S&P 500 fell by over 40 percent – two times the year-to-date losses. Yet while scary – this was a more innocuous time pre-dating globalisation – credit markets were a fraction of the size and domestic growth was structurally robust.

Now the situation is clearly different and the risk facing investors may be more severe. Credit investors would be wise to avoid excessive duration and leverage while making sure that they do not find themselves over-exposed to crowded trades where they could be crushed by a stampede to the exits in a painful unwind of momentum. One way investors can do this is by focusing on opportunistic credit strategies.

Investing opportunistically

An opportunistic investment approach seeks to generate higher returns and lower risk than traditional areas of credit by focusing on "off-the-run" parts of the market while tactically investing in pockets of dislocation in traditional markets when they occur.

Off-the-run markets are often less competitive with fewer participants and, as a result, offer the potential for higher returns relative to underlying credit risk. On the other hand, these areas are tougher to underwrite and access, requiring more work on the part of the investor.

While traditional credit markets are priced competitively, at times of turmoil these markets can sell off drastically and create mispricing that may be captured. Of course, these opportunities are episodic, and investors must know when to pull their capital from these markets as risks subside and spreads tighten.

In either case, investors should take care to maintain a disciplined approach to thematic and asset underwriting, limiting duration risk (ie, via short-maturity assets or catalyst-driven opportunities), while adhering to a strict focus on underlying collateral value and downside protection, as investors must assume that refinancing take-outs may be off-the-table. If implemented appropriately, it is possible that opportunistic credit investors could earn 500 basis points or more of return premium or "alpha" relative to traditional credits of comparable seniority and risk.

Which credit themes may be attractive today?

Nimble investors constantly seek to identify the most attractive opportunities across an ever-changing universe of credit investments.

Naturally, opportunities vary across industry, financing structure, and geography, to name a few. Like proverbial fishermen, investors must find the best ponds just as they must master their individual fish-catching technique.

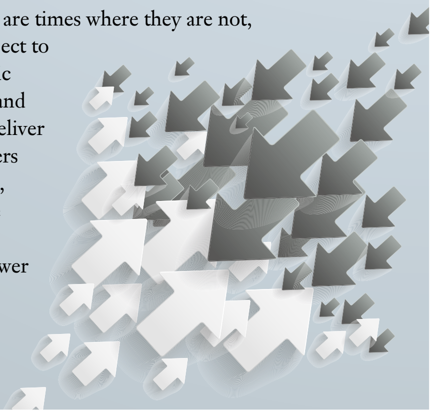
To highlight the richness of the opportunity set, consider the following examples:

Growth companies: Traditional cashflow lenders underwrite against EBITDA and tend to struggle with anything outside of that framework. Yet many high-growth companies without consistent EBITDA possess real enterprise and collateral value. Premium returns can be earned by those able to underwrite and enforce on more nuanced appraisals of value, including contract value, IP value, or recurring revenue, for instance.

Retail: On the other hand, retailers find themselves challenged structurally and cyclically. How could these be creditworthy? It depends on who you ask. A liquidator could find substantial collateral where a corporate ratings agency may find little. Specialist lenders have filled this gap by carefully underwriting the liquidation value of retail goods in order to earn high interest rates with minimal downside risk.

Litigation: Once considered truly esoteric, the financing markets in litigation-related assets have developed significantly in recent years as both borrowers and lender interest has evolved while structures custom-suited to the asset class have emerged. While competitive intensity has steadily increased, returns in the space may remain very high for some time.

Real estate special situations: While real estate credit markets tend to be well-served, there are times where they are not, and capital availability is subject to macro crosscurrents. Episodic retrenchments in bank loan and private credit markets may deliver rewarding outcomes to lenders who can step into the breach, especially if they can manage construction/refurbishment requirements, process/borrower complexity, or absorption overhang.



Unfortunately, not all investors are able to or willing to do this. Large-scale investors may not be nimble enough to access these markets and will be deterred by the relative lack of scalability in many of these areas. Other investors may not be willing to expend the effort to allocate nimbly among thematic and idiosyncratic opportunities as they appear, instead opting to pursue a "set it and forget it approach" to investing in the most liquid and ever-present asset classes within private credit.

Still, for those willing to expend the energy, adopting an opportunistic credit approach could confer compelling returns and diversification benefits relative to traditional credit markets – both features that are particularly welcome in the face of rising rates and deteriorating credit conditions.

Hidden in plain sight

Any investment approach will struggle to succeed if unaccompanied by the appropriate investing toolkit.

For opportunistic credit investors, a great toolkit starts with having a strong and far-reaching network of reliable knowledge partners with expertise in different asset classes, industries and types of credit. An investor's network should support one's sourcing while delivering important insights into specific credits and themes that will bolster the underwriting process. No single individual or organisation is an expert in all areas of the investment universe, so an investor should use their network to cultivate specialist partners to drive superior execution at the individual credit and thematic portfolio level.

Markets are apt to throw up new challenges. While an opportunistic approach to credit investing requires resources, talent and sweat, it may be among the best options to navigate today's choppy credit markets. ■

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