

The view from Secured Loans



Julian Green, 18 December 2008

Tiptoeing through the secured loans minefield still has the potential to reap long-term rewards



“The secured loans market has been a fertile hunting ground for the hedge fund industry in recent years. However, 2008 changed all that. The credit crunch has had a significant knock-on effect on the asset class as a whole. Hedge funds have sought liquidity above all else and the indiscriminate secured loans sell-off has been brutal.”

Hedge fund managers had been buying aggressively into the secured loan market, aided by favourable finance terms from banks. Once the collective attitude towards bank lending turned from accommodative to prohibitive, a chain of events was set into motion.

The forced selling spiral

Investors sought to reduce their hedge fund exposure at an alarming rate, and hedge funds were therefore forced to become indiscriminate sellers of their assets, in order to meet liquidity calls. With few investors looking to buy loans in these uncertain times, secured loan prices have subsequently fallen to historic lows.

Rebuilding confidence

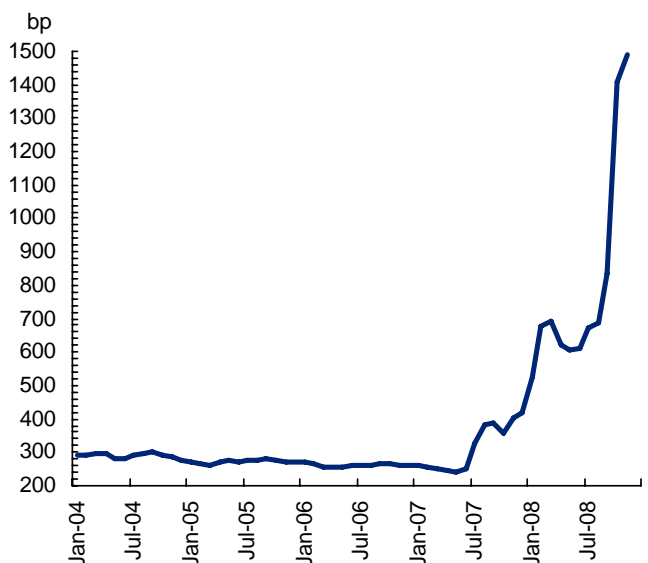
At present, sentiment remains delicately balanced. While the forced selling has abated, the opacity of the hedge fund world makes it impossible to guarantee that it is all behind us.

However, what we can see is the corporate world moving into a less certain phase; sales are more difficult to achieve and profit margins are being squeezed. The world certainly seems an uglier place and corporate defaults will certainly pick up.

The corporate default rate

In an efficient market the return on an asset would compensate an investor for defaults. With average loan prices currently hovering in the high-60s it certainly seems that even the most extreme level of defaults are now priced in.

Secured loans spread above Libor



Source: Credit Suisse, Henderson Global Investors, as at 30 November 2008
Note: Discount margins (spread over Libor) shown for the Credit Suisse Western European Leveraged Loan Index. Four year life assumption

Opportunities for the long-term investor

As the corporate outlook has become more uncertain, the secured loans market has become more discriminating. Loans issued by non-cyclical and utility companies (such as telecoms and cable) are performing markedly better than the loans from companies within other sectors.

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We are currently seeing some utility stocks with prices in the mid-80s, and manufacturing stocks priced in the 60s. Investment strategy is therefore about balancing the short-term gains with the long-term opportunities.

Just as with most parts of the credit market, there is a growing school of thought that the current downturn is already more than adequately priced into returns on loans, with the assumed default levels far higher than likely.

In fact, we are starting to see more interest from a number of institutional investors who believe it a good opportunity for pension funds and insurance companies with a medium to long-term investment horizon to start to buy back into the market.

However, human psychology being what it is, most investors may continue to ignore the fundamentals until they find the clarity they need in order to feel comfortable about getting back in. They may find themselves missing out on some excellent prospects within the secured loans market in the meantime.

In this sort of environment, secured loan fund managers will need to display real credit skill – firstly in tiptoeing through the minefield of potential blow-ups, and also in recognising where the genuine opportunities are to be found.

Julian Green
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