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Lead Left Interview – Andrew Brady

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This week we chat with Andrew Brady, Managing Director and Leveraged Loan Portfolio Manager of Marathon Asset Management, L.P. Marathon is a global credit manager with approximately $13 billion of capital under management investing in the global credit markets.

The Lead Left: Andrew, it's been a while since our last conversation. What's your view of the current market environment?

Andrew Brady: We have seen significant market volatility and major changes in lending conditions in recent years, including continued convergence of terms in high-yield markets between loans and bonds. Terms and risk for many bonds look like loans and vice versa, particularly for larger companies but also in certain middle market issuers, including more unsecured loans and secured bonds. This has been driven partly by the growing base of global investors desperate for yield, which is unavailable in the largest bond markets. These investors see no maintenance covenants on investment-grade bonds or high-yield bonds (with generically lesser and greater risk than leveraged loans, respectively) and therefore do not push for covenants on loans. Still, covenant lite debt is not inherently bad; credit quality is far more complex than a single term.

Other aggressive changes in terms are more troublesome, including loose baskets for restricted payments, investments, debt incurrence, and M&A. Hazards for investors further increase by pairing such terms with inherently aggressive transactions, which have become prevalent. For example, quick dividends after an LBO, aggressive add-backs to earnings, and focus on projected earnings rather than proven performance. We simply assume much of the marketed earnings are false, and often refer to covenant limits as "debt divided by fiction." For example, we have long followed one leveraged company and were puzzled by purported earningsduring a major acquisition that were almost double our calculations. We kept hearing "Hey, it's only 6x leverage." It's beholden upon institutional managers to protect investors from such nonsense.

TLL: What is your view of current market moves?

AB: The global desperation for yield is highlighted by $12 trillion of global bonds recently trading with negative yields. Financial history indicates such conditions will end poorly for those investors. Surplus capital is chasing yield in less liquid opportunities, including middle markets and private lending. It can be challenging to maintain a rational investment view amid such an irrational climate.

TLL: How do you distinguish between all the diverse yield strategies out there?

AB: Investors often underestimate risk to achieve targeted returns. Returns for high-yield bonds are usually estimated near the average coupon rate. That has only been true of actual annual returns a couple of times ever. Reality is much more volatile, driven by other factors including sentiment, Treasury yields, defaults, and specific exposures. Just because two investments had the same return does not mean they had equal risk. If two people crossed between buildings but one walked across a solid bridge while the other bounced across a high tightrope over a crocodile-infested river, we would not say the end result made the path irrelevant.

Yield strategies across various types of debt and equities often usually ignore difference in risk. For example, equity investments in REITs, BDCs, and MLPs have been considered or marketed as nearly risk-free perpetuities. Linn Energy was an MLP with years of consistent dividend payments that blinded investors to inherent volatility from natural gas exploration and increasing debt loads, right until it imploded and that supposed dividend perpetuity was zero.

While the average equity asset manager has a tough time outperforming the index, that is less true in high-yield credit given the importance of avoiding downside rather than chasing upside. Active portfolio management can consistently improve risk-adjusted returns over the index; again, one should not ignore the risk taken to get returns, and risk is not simply price volatility.

By definition, the upside of fixed-income investing is capped while your downside is 100%. Perhaps it is the mentality of experienced credit investors to count your troubles more than joys. A maxim for debt investors is the Trumpism from many years ago: the best investments are often the ones you avoid. What you do not own can be more important to relative portfolio returns than what you own. That factoid is ignored when outsourcing fundamental and bottoms-up research to rating agencies, or using WARF as a measurement of risk in CLOs. Credit ratings change over time, and though rating agencies have proven generally right on average and over time, they have been seriously wrong in many critical phases. For example, optimistic credit ratings encouraged many capital providers desperately seeking yield to find willing borrowers in the capital intensive commodity sectors in recent years. Those were weak credit stories even before acknowledging that commodity prices are nearly impossible to predict. Since then, investors experienced massive losses in high-yield energy companies, including some borrowers that defaulted even before their first coupon payment.

Clearly, one needs to exercise discipline and objectivity and avoid getting caught up in market fervor, but that is easier said than done. Insanity is uncommon for individuals, but very common in groups, resulting in many overpriced and underpriced assets historically and presently. For example, areas we often find difficult to predict – those subject to technological change, health care pricing, and commodities – can be much more volatile and difficult to price credit than people think. There are few things as dangerous in investing as confident "self-knowledge". This has a dangerous habit or appearing when hope is prevalent or real information is lacking, as is often true in unpredictable situations.

TLL: Post-election, have you modified your investment views?

AB: I would repeat that last sentence. There's been no change in the practice of our core credit analysis and discipline across portfolios. There is great debate across markets regarding prospects for fiscal, tax, monetary, trade, immigration, and regulatory policy changes following the election, but little real information and real discord within Congress and the Republicans. The market's current optimism reflects wishful thinking that taxes will shrink and the economy will rise, while few are giving credence to the real challenges. Keep in mind, the President does not control the economy and Congress remains fractious and opposed to increased spending and deficits. Remember 2011? The U.S. government almost shut down and was yammering about a debt default. There was a government shutdown in late 2013. Congress still fights through repeated stopgap spending bills and increases in the government debt limit. It is unclear if or when the proposed policies will be enacted and what might be the impact on deficits, but many signs from the government, Fed, and markets point to higher interest rates, which would benefit investors in several ways. Still, we are mindful of unintended consequences of major changes in government policy.

To be continued the week of Dec 19

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