Lead Left Interview – Martin Fridson

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This week we chat with Martin Fridson, chief investment officer, Lehmann Livian Fridson Advisors. Fridson is "perhaps the most well-known figure in the high yield world," according to Investment Dealers' Digest. His firm is a registered investment adviser based in New York City and Miami, managing investment portfolios for investors across the US.

The Lead Left: Marty, you've been at the forefront of high-yield bond research for several decades. You've been commenting the new-issue market lately.

Martin Fridson: I gave a talk recently at the Financial Management Association on pricing. The norm is to price a bond deal so there's a bit of a jump in the secondary market. What's wrong with a clearing price? Buyers feel it's a bad deal if it doesn't trade up. The theory is that the next time the issuer comes to market, investors will say, "That's a good company because it traded up!"

TLL: What's the alternative explanation?

MF: Academics provide the explanation that holds up the best, which is that issuers understand that it will be a lot more work for the underwriter, and therefore involve a large underwriting fee, if the deal has to be sold at the full clearing price. So they're willing to pay for the distribution effort partly by accepting a price that makes the deal a relatively easy sale. But as the manager of the deal you can't leave too much on the table.

TLL: Everyone has certain rate expectations. What are yours?

MF: Investors are clearly concerned about rates going up. Last year a lot of investors were hurt by that assumption! Some people have concluded that stocks are the only option. But while you're out of the fixed income market, you're giving up yield. I just have to take the Fed at its word that the increase will be gradual.

TLL: Certainly doesn't seem to be any imminent threat of inflation.

MF: Not on the horizon. So while the Fed will raise short-term rates, the likelihood is that the curve will flatten rather than move up in parallel in the long end. The US is a safe haven for many sovereign wealth funds because euro rates are not competitive. But investors get nervous because they lose sight of the fact that even the good years contain some mini-bear markets. For example, in every year since 2001 that the BofA Merrill Lynch US Treasury & Agency index returned 7% or more, returns, there was at least one negative quarter. Investors have to avoid overreacting to every blip and bleep.

TLL: Where can readers look for data on that?

MF: Dalbar has put out a research study showing that over the last 20 years, the S&P 500 averaged 9.85% total return but stock mutual fund investors earned only 5.19% over that period. The main reason for that gap is the emotional response of buying at the top and selling at the bottom. If the mutual fund shareholders had just stayed in and not traded, they would have been better off.

TLL: Our readers are familiar with the deterioration of loan covenants. How about bonds?

MF: Moody's has developed a rigorous scoring system for covenant quality and is generating good research on the subject. The agency rates the top five covenants for each high yield bond deal, and gives an aggregate score for the market to digest. Moody's also reports the combined scores for all deals, month by month, to track the overall trend of covenant quality.

TLL: How far back does the data go?

MF: Since January 2011, so going forward they'll be able to provide pretty good historical perspective. I publish a slightly improved version that adjusts for ratings mix. In recent months, we've seen the lowest covenant quality for the series since it started. For example, we've seen a steady deterioration of limits on debt.

TLL: Is that a cyclical trend?

MF: Some say that, but it's becoming a pattern of lower lows from one cycle to the next. The problem is that issuers can time their deals so that they only issue when the bargaining power versus investors is in their favor. And they select the lead underwriter. Bankers like to present the image of being a football referee – "Hey, we just mark the spot where the ball was downed!" In reality, they're more beholden to the issuers. And covenants are one important way that underwriters compete for business. They see what carve-outs and loopholes they can sneak into a deal that their competitors haven't thought of yet.

TLL: We're familiar with bond-like [debt incurrence] covenants in leveraged loans. Is there an equivalent of covenant-lite in high-yield bonds?

MF: Yes, in fact it's termed high-yield-lite, defined as lacking either or both a restricted payments test and a debt limitation.

TLL: I would call that "equity."

MF: Back in 1977 when the first junk bond deals came to market, they had no meaningful covenants. Drexel's early deals contained covenants, but didn't offer real protection. Layering of debt was permitted and there was no real call protection. In the mid-1980s investors got burned so badly by the weak covenants that the investment banks were afraid they would abandon the market. To keep the revenues coming in, the underwriters improved the terms, eliminating some of the loopholes.

TLL: Could you give an example?

MF: If a company has fewer than 300 registered holders, it's not required to continue publishing quarterly 10-Q reports, even if it issues debt in the public market. To prevent investors from buying a bond and then getting cut off from financial reporting, the underwriters made it a standard provision that the company would issue financial reports comparable to 10-Qs whether required to by the securities laws or not. The newer covenant packages also contained anti-layering provisions and call protection was improved. Unfortunately, for the next 30 years the terms of the bond contract went the other way. For example, call protection was undermined by "claw-back" provisions, which allowed the issuer to retire 35% of the otherwise non-callable issue with proceeds of an equity sale. The definitions of change-of-control, triggering a premium put to the company, were narrowed. Meanwhile, underwriting practices also changed, with "drive-by" deals becoming commonplace and, over time, eventually not restricted to the best-known, highest-quality names.

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