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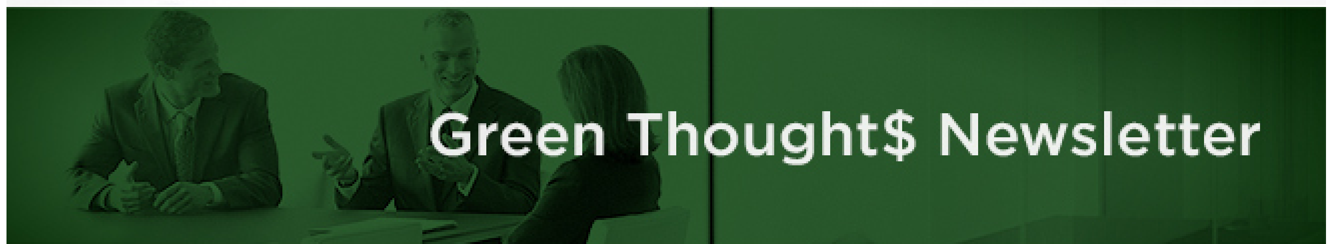

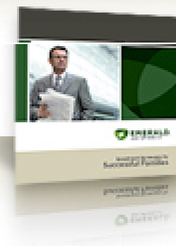

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Thank you for reading Green Thought$. It is our privilege to provide you with our insight on current financial market events and our outlook on topics relevant to you.

Searching For Values (and Yield) Among Distressed Debt Issuers

Synonyms for the word "distressed" include worried, troubled, anxious, and distraught. Given this fact, it's no wonder that many investors run for the hills when they hear the term "distressed debt."

While companies with extremely weak credit ratings may seem like a sure recipe for disaster, experienced investors have often achieved solid results by investing in distressed debt. These investors actively seek out companies that are experiencing financial difficulties, including companies that may be on the verge of bankruptcy or already in bankruptcy. In fact, some of the best returns in this unique asset class have been achieved during periods of extreme economic duress. With renewed worries about sovereign debt problems in Europe causing collateral damage for U.S. companies and the U.S. economy, it's possible that we're on the verge on another attractive opportunity for distressed debt investors.

Contrary to the notion of "grave dancers" who buy up a company's debt in the hopes of selling it for a quick

profit, distressed debt investors often become long-term stakeholders in their target companies. Because bondholders rank higher in the pecking order than equity shareholders during bankruptcy proceedings, distressed debt investors, via their "priority claims" often participate actively in the reorganization process via their "priority claims." This requires a unique blend of intellect, judgment, and patience.

A Counter Cyclical Market

The supply of distressed debt often runs counter-cyclical to the health of the general economy. During strong economic times, credit tends to flow freely and corporate default rates remain relatively low. This behavior is often followed by a period of lax lending standards, as occurred prior to the bursting of the housing bubble in 2007 and 2008.

When the music stops, as it did when the economy tanked in 2008, financially weak companies with high debt levels suffer. That's precisely when distressed debt investors sift through the rubble for new opportunities. In some cases, they are simply looking for high-yielding bonds; while in other cases the goal may be to eventually own a piece of a newly-reorganized company.

Just as there are variations in the degree of risk between investment grade and high yield debt, there are also different degrees of risk within the distressed debt spectrum. These include:

- **Performing Bonds and Loans.** These securities have a low probability of default, and therefore returns on these securities may be driven as much by interest income as by price appreciation. Yields on these issues are even higher than those of "regular" high yield securities.
- **Stressed Performing Credits.** These securities are issued by financially weaker companies and maturities tend to be shorter in duration. They may include bank debt or bonds that are secured by hard assets. Investors are typically seeking a high yield-to-maturity without too much downside risk.
- **Capital Infusions.** These investments usually offer attractive yields and first lien positions, with a low probability of default.
- **Distressed Credits.** Includes unsecured bonds and bank debt that is trading at a price that implies a higher probability of default.
- **Debt-for-Equity Restructurings.** In this scenario, the company is expected to restructure in court or out of court. When that happens, debt is often exchanged for a predetermined amount of new debt and/or equity. Investing in the fulcrum security-the senior-most security that will participate in the reorganization-can help ensure that debt holders participate in the reorganization process.

A Solid Record of Low Correlation

Looking at the performance of the distressed debt asset class, we found that between January 1997 and March 2012, the Barclays Distressed Securities Index generated average annual returns of 8.87%, outperforming the S&P 500 Index's 6.18%. More recently, year-to-date through April 30, 2012 the S&P 500 is up 11.88%, while the Barclays Distressed Securities Index has returned 6.15%.

Notably, distressed debt has achieved its superior performance with only 45% of the equity market's volatility, as measured by standard deviation. The Beta of the strategy is a low 0.26, with a compellingly low R-Squared of only 0.34...thus indicating that the strategy's performance patterns have not acted much like the S&P 500. In addition, the maximum drawdown was -35% versus the S&P 500's -51%. However, it's important to note that distressed debt declined almost as much as equities did, quite uncharacteristically, in 2008's disastrous year (down 31.7% versus a loss of 37% on the S&P 500).

A closer look at the historical numbers reveals that, in several cases, distressed debt managed to deliver gains during periods when stocks declined. For example, in 2000, 2001, and 2002, the Barclays Distressed Securities Index gained 5.34%, 17.07%, and 6.38%, respectively. During those same years, the S&P 500 Index fell -9.11%, -11.98%, and -22.27%, respectively. This ability to deliver non-correlated returns during certain periods is an attractive feature of distressed debt and its potential role in an overall portfolio.

In evaluating the distressed debt class vs. the traditional bond market for the same period measured above (January 1997 - March 2012), we found some interesting statistics which further support the case for considering an allocation to the distressed asset class.

First, using the Barclays Distressed Securities Index versus the Barclays U.S. Aggregate Index as the respective gauges, the Distressed Index actually exhibited a negative Beta of -0.16 to the Barclays Aggregate Index. It is rare to see a negative Beta of one niche strategy such as distressed debt versus its broader asset class family (fixed income). This suggests that despite the index being composed of fixed income securities, none of the return of the Barclays Distressed Index can be explained by the Barclays Aggregate Index (which serves as a proxy for the broad investment grade fixed income markets). In other words, it is totally independent of the behavior of investment grade fixed income markets in general. That is the essence of the benefit of portfolio diversification.

Second, the Distressed Index also exhibited a negative "Down Capture" to the Barclays Aggregate Index. The down-market capture ratio is used to evaluate how well or poorly an investment manager or strategy performed relative to an index during periods when that index has dropped. If a strategy exhibits a negative down capture, this indicates that the strategy did not simply lose less than the index, but rather made money during the down period in question. It reflects an inverse correlation to the benchmark index.

Finally, the Distressed Index had a fairly low correlation or R-Squared (0.58) versus the Barclays Aggregate. Overall, it appears that including exposure to the distressed bonds may enhance returns and diversify the risks of a traditional portfolio of stocks and bonds.

An Income Opportunity

Given that many distressed securities are currently paying their coupons and investors buy them at big discounts to face value, the opportunity exists to realize attractive yields on these portfolios. Of course, some defaulted securities don't pay any coupons so the portfolio manager must instead focus on the probability of those bonds reinstating coupons (and arrearages), appreciating, or being exchanged for post-bankruptcy equity.

No Stress: Summing It All Up

Historically, the only way individual investors could gain access to distressed debt was through hedge funds, which have high minimums, high expenses and lock-up periods, among other structural issues that make them an unfavorable choice for many investors. In recent years, however, several mutual funds that specialize in distressed debt have made it possible for investors to gain access to this specialized asset class.

We recently made our first allocation to this asset class within our Hybrid (conservative allocation) model by investing with an experienced distressed debt fund manager. Unlike many others, this particular fund offers pure exposure to the distressed debt asset class. As an added bonus, the fund currently generates a yield (30-day SEC yield) of 8.05% even with cash balances hovering around 19%.

We believe that distressed debt can provide attractive risk-adjusted returns that are not highly correlated to stocks and traditional bonds. In our opinion, the best way to gain exposure to this strategy is through an allocation to an experienced fund management team of distressed debt experts. Like all strategies, distressed debt has its own unique risks...and opportunities, but by conducting in-depth due diligence and ongoing monitoring, we believe it can serve as a valuable addition to a well-diversified liquid alternatives portfolio.

Disclosure

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The Barclays Capital Aggregate Bond Index is a broad based index and is often used to represent investment grade bonds being traded in United States. The Barclays Capital Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most U.S. traded investment grade bonds are represented. Municipal bonds, and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The index includes Treasury securities, Government agency bonds, Mortgage-backed bonds, Corporate bonds, and a small amount of foreign bonds traded in U.S.

The Barclays Distressed Securities Index is an index that tracks the monthly net results reported by Fund managers that invest in the debt, equity or trade claims of companies in financial distress or already in default. The securities of companies in distressed or defaulted situations typically trade at substantial discounts to par value due to difficulties in analyzing a proper value for such securities, lack of street coverage, or simply an inability on behalf of traditional investors to accurately.

Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Investing in distressed companies (both debt and equity) is speculative and may be subject to greater levels of credit, issuer and liquidity risks, and the repayment of default obligations contains significant uncertainties; such companies may be engaged in restructurings or bankruptcy proceedings. Investments in companies engaged in mergers, reorganizations or liquidations may involve special risks as pending deals may not be completed on time or on favorable terms. High-yield, lower-rated, securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets.

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