Chapter 27

Investing Issues: The Investment Decision Process

What's in this chapter:

- varied approaches to investment decisions
- a sample investment decision process
- investment traps

ANALYSIS FOR ITS own sake is not terribly useful; analysis should be undertaken with a goal in mind. That goal usually involves a decision. In leveraged finance, the goal of analysis is usually to make a decision about a debt instrument. Often the decision is to buy, sell, or hold—but it can also be whether to go ahead with a debt or equity financing or how to structure and price a new issue. Since numerous decisions likely have to be made to improve efficiency, it is best to have a process in place for decision making. It can be an informal one that involves a personal mental checklist or a more formalized one involving a team. Participants in the leveraged debt markets have a variety of resources and different strategies, so the investment process will vary from company to company.

Varied Approaches to Investment Decisions

The level of risk tolerance that an investor is willing to take makes a major difference in the prioritization of topics within a decision process. Risk typically takes a few forms: interim price volatility risk over a given investment horizon; principal and interest income loss due to a default; or an earlier debt retirement, which can cause a mismatch of assets and liabilities.

These risks have to be weighed relative to potential returns. This risk-reward relationship is what analysts are constantly trying to divine when making buy, sell, and hold recommendations. Each risk-reward decision also has to be weighed against other investment options. When a decision is made to invest in one debt instrument versus another, there is always the risk that great potential returns are being passed up. This is often called opportunity cost. Investment decisions need to be made in the context of other opportunities. Ranking/rating systems can help make these decisions easier to manage and will typically include a combination of objective and subjective inputs, which should have unique designs to fit different investment styles.

A variety of investment styles can be successful and styles that have consistently succeeded over time have similarities. Successful strategies have a defined investment style and a process for decision making. Usually, over long periods of time, they are consistent and tend not to react to each market whim or sudden change in market mentality. This does not mean that these strategies are not adaptive. They are forward-looking enough to be periodically reconsidered and to evolve with major changes in the global or market environments, but they do this through a process and with analysis to back up the decisions.

Portfolios will often include investments with diverse performance characteristics. The goal is often to blend these varied factors to create an overall investment solution at the portfolio level. For example, many portfolios will want a balance of low volatility, lower risk investments and those that are likely to have higher market risk and, ideally, higher return. Depending on the investment team's market outlook, they may shift the portfolio's weighting between these types of investment. A decision process may need to not just measure the risk-reward of an investment versus an opportunity set but also, often, include a view as to which portfolio basket an investment might fit in.

A Sample Investment Decision Process

There are many effective styles of organizing an investment process. The following sections describe some core ideas.

Big-Picture Items

- *Macroeconomics*: A sense of the macroeconomic environment is necessary in reaching a decision. This does not mean trying to be a global economist as well as a credit analyst,[21] but putting the investment in the context of key themes of an expanding or contracting economy, or an environment of rising or declining interest rates.
- *Trends*: The macro environment should also include thematic and strategic trends in corporate finance. For example, is one industry suddenly in vogue for PE firms to buy in leveraged buyouts? Is the IPO market particularly strong as a source of deleveraging? Is a new securitized financing vehicle being widely used? These types of theme often come in waves and are important to consider.
- *Supply, demand, and momentum*: Big-picture technical questions can be helpful too. These generally involve supply and demand: how much cash is uninvested and in the hands of portfolio managers versus how many new financings will be coming to market. Demand for leveraged loans and bonds can also be influenced by the relative attractiveness of these assets versus other investments such as asset-backed securities or equities. This addresses the bigger question of market momentum too.
- *Risk*: In the investment markets, does it feel like a risk-on market where investors are taking on more risky investments; or perhaps it is risk-off, or risk neutral?

The Company and Industry

- What business lines is the company involved in?
- What are the stated goals or aspirations of the company, if any?
- Is the business in a notable part of its life cycle?

21 Good macro strategists and economists tend to seek out details on business and investment trends from industry analysts and not just look at macro factors.

- What industry dynamics are most influencing the company, such as price cutting or acquisition activity at the company or in the industry?
- Is the company overdependent on one customer or a government program?
- What is the competitive landscape for the company?
- What operating trends are occurring at the company, based on financial statements and any specific industry KPIs?
- Review any trends in stock market activity in the company or industry and M&A.
- Are there any specific comments on ownership/management style or perhaps operational successes or failures?

Credit Fundamentals

- Review key financial statements metrics and historical changes.
- Review cash flow and liquidity.
- Go over balance sheet details and compare to asset value.
- Review the company's structural issues and be clear which entities support the company's debt.
- Review sources of liquidity other than cash flow from operations.
- Review and analyze asset values and the implied equity value cushion for the debt.
- Summarize the overall credit quality, with a focus on liquidity and asset protection, and find out what the risk of default is.

Event Analysis

- Are any liquidity events likely to occur in the near future (over at least three years)?
- Is a refinancing likely?
- Are there maintenance covenants that might be violated?
- What is the probability that the company will be sold or acquire something?
- Is there a possibility of an IPO, dividend, or stock buyback?
- Is there a new plant or product launch, or a patent expiry, on the horizon?

For all these possibilities, a probability should be assigned. If the probability is high, it is worth conducting a scenario analysis as to what pro forma credit metrics would look like with and without the event over a given time horizon.

Structure and Security Analysis

- What are the key structural issues with the investment's ranking? This should not just involve the investment that is being discussed, but all the pieces of the debt capitalization and how they might impact or restrict the investment.
- Review key covenants and highlight any that stand out.
- Also review technical issues: How large is the security? Is it actively traded? Will it be a private placement or a publicly registered issue?
- Is it likely that the maturity, covenants, or structure of other debt in the capital structure will impact the bond or loan that is being examined?
- Review any unusual structural issues, such as off-market call prices or unique aspects in the coupon.

Relative Value and Return

- Review financial metrics and operating metrics relative to comparable credits. This should include the business trajectory and stability.
- Review specific debt characteristics of the peer group such as ranking, pricing, yields, spreads, and duration. This sheet should include similar data for any relevant indices or benchmarks.
- Review the likely return on investment. This should include an upside-downside return horizon analysis that can estimate where the investment might be valued at the end of the time horizon. A one-year time horizon is a good starting place.

It is not uncommon to establish a list that includes many of these items listed above and develop a credit scoring system where each item is given a score based on a scale (e.g., 0–10). The score could weigh some items more than others, or it could be even-weighted. The key is to try to make the scoring system consistent throughout the industry and across all industries. The score can be compared to the relative value metrics on the potential investment. Any scoring should be done before entering into the decision process. A simple ranking and summary list might include the following:

1. Credit: financial liquidity score
2. Credit: asset value protection score
3. Credit: operational trend score

4. Credit: event score (5 is neutral; below 5 is a negative event)
5. Debt instrument: trading liquidity
6. Debt instrument: structure
7. Debt instrument: relative value
8. Investment category relative to sector: ___more defensive _____neutral _____higher risk

The Decision

- Do the potential returns look attractive relative to the risks?
- Does the security fit with the general strategy of the investment portfolio? Where do its characteristics differ from the portfolio's averages?
- If this investment is bought, should something else be sold to balance exposures?
- Are there other ways to invest in this company that are more attractive—that is, are there other debt issues, equities, options, or converts that should be considered instead?
- Has this process triggered other investment ideas worth reviewing?
- Is the recommendation a buy, sell, or hold, and how heavily weighted should the investment be within a portfolio?

Every credit that is being invested in should be reviewed quarterly, or whenever earnings or news items are released. It is also important to design certain triggers that cause an immediate credit review. Some examples of triggers are a meaningful movement in the underlying equity or comparable equities (maybe 15% or more); a meaningful move in the debt prices of this credit or a peer; or some key target KPI or financial metric is missed. Additionally, if an event was listed as part of the investment thesis and it passes, such as an asset sale by year end, this should trigger a review of the investment as well.

Often analysts and portfolio managers may want to categorize the investments. In the ranking list, above the final item, categorize the type of investment by a risk tier. This could be a category tag. Category tags can include basic data such as debt ranking, or more specifically, something that has a high level of event risk, or exposure to currency volatility. All of these can be used in a database and can be queried if needed.

Personal Process

Even if a firm does not have a clearly defined structure for the decision process, analysts should have their own checklist for walking through key items and reaching a conclusion about a credit investment. Analysts may want to have their own decision-process format—one when time is short and a longer process when they have more time. Even if the credit work is being done for a purpose other than making an investment decision, using a checklist to reach the appropriate conclusions can allow for repeatable success.

Some Investment Traps

While trying to reach an investment decision based on analysis, it can be easy to fall into certain traps during the decision process. Any process that is put in place to help the decision process should be designed to avoid some of the common mistakes.

The decision process can become too controlled by market prices. If the prices are high, it is a good credit and if low, it is a bad credit. While the market should not be ignored, it does not mean it is always right. Some common traps caused by market pricing include the following:

- *Yield*: A common trap is to think that yield can make up for poor credit quality. Notice in the investment decision process that the discussions about credit quality and price, yield, and relative value are separate. A common trap is being lured into an investment in a credit that cannot fundamentally survive, but the low price and high yield make it attractive. Maybe someone suggested that the investment could be exited before it became too bad, but that is likely when others are selling too.
- *Low price*: On the opposite side of the equation, a low price on a company in disfavor should not color the fundamental credit decision (although it should be a warning sign to do more cautious analysis). Just because the market has decided a credit is in disfavor does not always mean it is right.
- *Complacency*: A high-priced investment that has had a history of stable market prices can also create complacency. Just because an issuer has been

a market leader for a long time does not mean that things cannot change. If an investment has a tendency to have a relatively high price and stable market performance, it can lure investors into complacency over a credit and keep them from properly assessing the risks.

- *Assets bias*: Some traps make investors miss opportunities, such as being overly biased toward one type of company, perhaps technology, or manufacturing. As an example, some investors may have a bias to have hard (physical) assets in a company to make it a compelling investment. Ultimately, the value of that hard asset is based on the cash flow it can produce for the company that owns it. The value of hard assets can be overweighted in making the investment decision and lead to misleading conclusions. For example, suppose the market has an overabundance of digital printing machines. Would it be better for a bank loan to be secured by these hard assets or by a valuable patent that can produce significant cash flow for a consumer products company? When looking at asset value, a prudent investor should consider which is more sellable and valuable relative to the amount of debt on a company.
- *Overdependence on ratios and metrics*: Depending too much on financial ratios and metrics in choosing an investment is another common trap. This is especially true in the age of data extraction and computerized spreadsheets. It is too easy to spit out a model that highlights bonds and loans with attractive relative value based on financial metrics and yields. This type of data query does not analyze structural issues of the individual security, potential positive and negative event risk, or the strategies that management wants to undertake with the company assets. Using relative value data queries can be a valuable way to search for opportunities, but this data shouldn't be the sole basis of a decision. Data extraction can also make analysts complacent in their model building and not add forward-looking thought into modeling, but simply rely on extrapolation.

There are many investment and decision biases that practitioners in the investment world should be aware of. There is a fascinating field of behavioral economics that, among other things, explores biases in investing. It is valuable to step back from the analysis and consider what personal or institutional biases are driving investment decisions. Below is just a sampling of some types of biases that can impact investment decision-making:

- *Anchoring bias*: An initial piece of information biases other decisions so that all other information received after the initial information is underweighted or ignored relative to the anchor.
- *Confirmation bias*: The decision-making process is diverted and exploited to reaffirm some previous decision that has been made or to prove some predetermined opinion.
- *Selection bias*: The decision-making process is biased because of the data that is used to derive that decision. In many cases this is caused by subjectivity in the selection of a peer group or a process that skews the data that is actually shown to the decision makers.
- *Availability bias*: What people have experienced before or what they can most easily comprehend drives their decisions.
- *Recency bias*: A decision-making process overweights the most recent piece of information received and underweights or ignores historical data.

Closing Comment

Be cautious about the lemming effect. This happens when it appears that all market participants have the same investment thesis or want to invest in the same type of company. In the flurry to invest in the next available hot item, analytical mistakes are often made, and investment decision rules are pushed aside. This is where a disciplined strategy for decision making can often pay off in the long run. The words of General George S. Patton Jr. highlight the risk of just following the current trend rather than following a disciplined process: "If everyone is thinking alike, someone isn't thinking."