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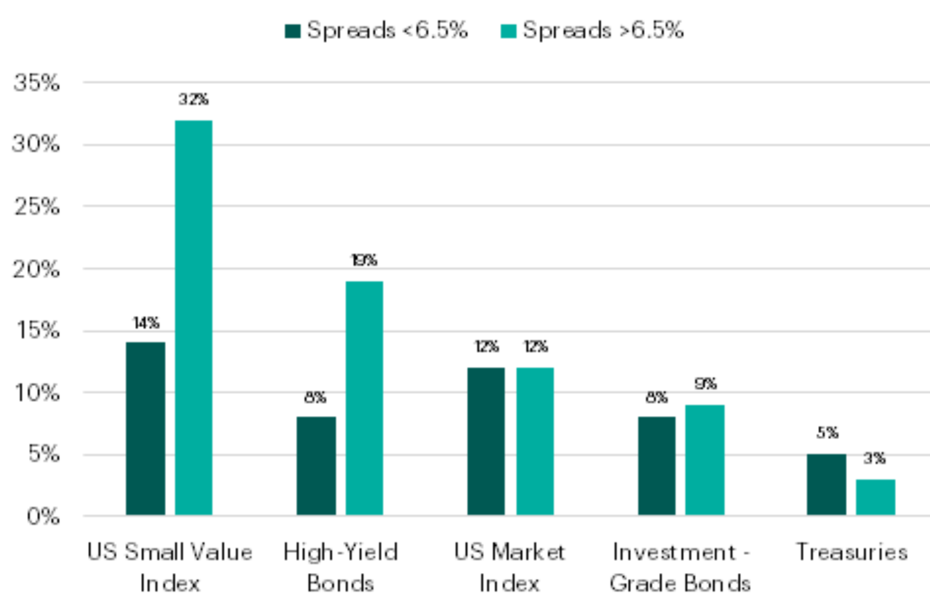
Crisis Investing Part III

What Works by Asset Class

This is the third in our series on crisis investing. To read the full 77-page report, click on the link at the end of this email.

We first looked at how different asset classes perform when high-yield spreads are above and below 6.5% to get a sense for how they perform during tranquil times and periods of panic. Small value stocks outperform other asset classes when spreads are below 6.5%, but vastly outperform when spreads are at or above 6.5%. The results by asset class are shown below.

Figure 1: Avg. Returns by Asset Class While Spreads Are Above and Below 6.5%



Source: CapitalIQ

Not surprisingly, high-yield bonds perform in line with investment-grade bonds when spreads are low (or rising to 6.5%) but perform well when spreads are high (or falling to below 6.5%). The US market and investment-grade bonds perform roughly in line before and after, and treasuries are the lowest yielding asset class both when high-yield spreads are low and high. Regardless, the best performing asset class during these periods has historically been small value stocks by a country mile.

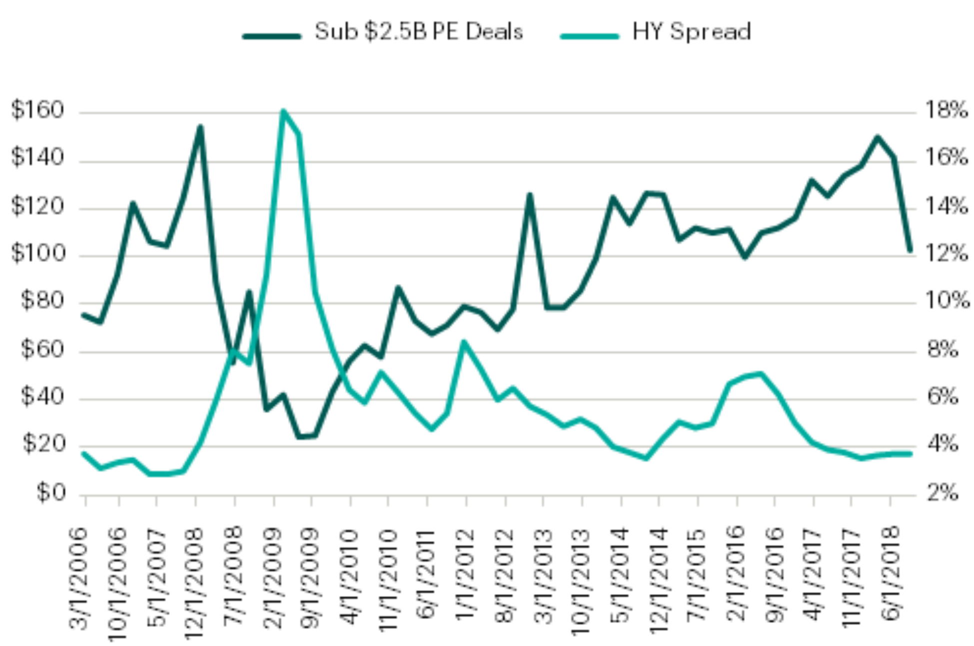
Alternative Assets

Investors might plan to take advantage of the next crisis through private alternatives like private equity and distressed debt. In fact, many investors have private equity and distressed debt allocations to take advantage of precisely these moments of panic in the markets. We consider both alternatives.

Private Equity

Unfortunately for investors in private equity, private equity firms essentially stop deploying capital when high-yield spreads rise above 6.5% – which is also the time when returns in private equity are the best. High-yield spreads had a – 69% correlation with quarterly private equity deal volume from 2006-2018, shown in Figure 6. When spreads are high, debt financing is hard to acquire, and deal volume plummets. When markets are in free-fall, most private equity investors will wait for things to settle before resuming deal flow, instead of buying the most distressed assets at the optimal time.

Figure 2: Private Equity Deals <$2.5B in EV vs. High-Yield Spreads



Source: FRED, Pitchbook

Investors with large PE allocations therefore find their capital flows are pro-cyclical, investing the most money when debt is cheap and multiples are high and the least money during times when the high-yield spread is wide and deal valuations are low.

Even for the most prepared and disciplined private equity investor, reacting in time to rising high-yield spreads would be extremely challenging. As we mentioned previously, equity returns are maximized in the 2-3 months after high-yield spreads hit 6.5%. It would be near impossible for a private equity investor to deploy meaningful amounts of capital into multiple opportunities in 2-3 months while borrowing rates for debt are rising.

In terms of returns, private equity vintage year returns are significantly higher in years where the high-yield spread is over 6.5%. The average IRR for a vintage year where spreads averaged over 6% is 17% versus 12% for a vintage year where spreads averaged below 6.5%.

But if we compare private equity vintage year returns and 12-month forward returns on the Cambridge Associates Private Equity Index to Fama-French Value or our multi-factor model (which we will describe below), we see that performance is significantly worse.

Figure 3: Performance by Strategy during High-Yield Events

	Multi-Factor Model	Fama-French Value	PE Vintage Funds	PE Index
12/31/2000	86%	37%	22%	(12%)
3/31/2008	(43%)	(53%)	20%	(24%)
4/30/2010	17%	(1%)	16%	23%
8/31/2012	65%	43%	15%	18%
2/29/2016	55%	53%	14%	18%
Average	36%	16%	17%	5%
Average ex 2008	56%	33%	17%	12%

Source: Verdad Analysis, Ken French data library, Cambridge Associates

In summary, while private equity seems like it should be an ideal asset class to take advantage of these opportunities, higher borrowing costs, short windows of opportunity, and high degrees of uncertainty prevent private equity from acting.

Distressed Debt

Distressed debt would seemingly be the optimal asset class to take advantage of times of financial distress. Distressed funds will opportunistically invest in the debt, equity, or trade claims of companies in financial distress or already in default. Distressed funds can take advantage of these opportunities by buying stakes at considerable discounts to their proper value.

Given this mandate, they could outperform during periods of uncertainty. However, the performance of distressed funds as shown below lag even the CCC index. The multifactor equity model we will discuss below outperforms distressed debt by 4.5x (8% vs. 36%).

Figure 4: Performance of Distressed Funds and Debt during High-Yield Events

	Barclays Distressed Index	CCC Index	BB Index
12/31/2000	17.1%	(0.9%)	11.1%
3/31/2008	(26.6%)	(34.2%)	(11.1%)
4/30/2010	11.7%	15.1%	12.8%
8/31/2012	17.0%	13.5%	4.9%
2/29/2016	22.1%	53.2%	15.2%
Average	8.2%	9.3%	6.5%

Source: FRED, BarclayHedge

In the most optimistic case, distressed funds may be outperforming the CCC index before fees, but the fact remains that the returns lag far behind the multifactor model. Distressed investing underperforms the multifactor model because the multifactor model is buying companies that are cheap and healthy whereas the distressed debt funds are buying businesses that are in an unhealthy, precarious, high bankruptcy risk situation. With a lower default or bankruptcy rate than distressed fund portfolios, it should be no surprise that the multifactor model outperforms.

In summary, neither private equity nor distressed debt funds are the right vehicles to take advantage of these opportunities. Given the significant outperformance of small value during these time periods, a dedicated public small value exposure is the optimal way to capitalize on these moments.

However, deciding to allocate to public small value during these time periods is likely not enough. To ensure that capital is put to work during these events, funds should commit to having a dedicated allocation that is drawn down when high-yield spreads hit a certain threshold, similar to private-equity-style commitments. This would suggest that even during the most trying times, investors have the discipline and structure in place to take advantage of these truly unique opportunities.

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