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Whistling past the graveyard

BY JAMES G. GEREGHTY, JR.

What a difference a year makes. On 16 May 2011, the VIX, a widely regarded measure of market confidence (or lack thereof), was quoted at 18.64. A year later, the VIX is around 22. The S&P Index closed at 1329.47 on 16 May 2011. The same index closed at 1324.80 one year later. Economic indicators in the US seem to have improved, recent housing data implies we are closer to the bottom, and inflation appears to be at bay as US interest rates are lower across the board. So why does it feel like market participants are whistling past the graveyard?

I know it when I see it

Despite the persistent levels of market volatility, as quoted by VIX, hovering around the 20-year average, market sentiment is varied and conviction appears to be low in 2012. Hedge funds are reporting low net positions and carrying high cash balances. Weekly retail fund flows have experienced record level in- and outflows over the last year. Volumes on the NYSE continue a three year trend lower. The market is experiencing a greater number of large daily price movements in the S&P 500 as measured in percentage terms than in any period since 1990 and the size of those movements is wider than it has been over the same time frame. Correlations have converged on 1.0 and dispersed over the last few years on multiple occasions. When headlines are matched with market spikes, the hypothesis of inconsistent sentiment and low market conviction is supported.

Investors use many quantitative measures to calculate market sentiment. As mentioned above, VIX is one quantitative tool used to calculate sentiment, as are the absolute level and trend of volume on the exchanges. In addition, technical analysts use other indicators such as the difference between stocks trading at 52-week highs and lows as an indicator of extremism in the market. Economic surprise indicators are produced to assess the level of expectations a market has relative to actual results with positive numbers generally meaning that actual results have been exceeding expectations. Market technicians also use point and figure graphs to measure the level of support a market has. Put-Call ratios and total option value are also used by market participants to gauge market sentiment. There are many ways to measure market sentiment with no single measure having a better or more conclusive insight into the actual level than any other.

While it is difficult to quantify market sentiment, it is more difficult to quantify market conviction. There are no easy formulas or definitions in dictionaries or glossaries of financial textbooks. A search using your favourite internet search engine results in no simple definitions of market conviction. So, if we cannot strictly quantify market conviction and we find it difficult to precisely define, (i) how do we measure the presence of market conviction and (ii) how can we use market conviction or the lack thereof in our investing discipline, distressed investing?

In answer to the first question, to paraphrase a famous US Supreme Court Justice, Potter Stewart, "I know [market conviction] when I see it." Intuitively, market conviction is the fervour with which the market expects directional movements to occur. In other words, if sentiment is positive, the market is expected to increase in value and conviction would illustrate how strongly this expectation is believed. Unfortunately, the presence and power of conviction is not currently quantified in a single, easily measured calculation. The answer to the second question will be discussed throughout the remainder of this piece.

A rising tide lifts all boats

Distressed investing is a process-oriented, event-driven, value-based investment discipline. The distressed investor is searching the market for opportunities to commit capital to securities or assets that are either out of favour, in need of a good shepherd to assist in rehabilitation, or are simply misunderstood. The asset may require financial or operational turnaround expertise or the seller may simply need liquidity, in which case good assets may be bundled with toxic assets and made available for sale despite the fact that the seller may be throwing out the good with the bad. In almost every distressed transaction, a level of experience is needed to work through a process within a set timeframe. Ideally, this timeframe contains a catalyst for an event or a series of events that may trigger distress. Yet the depth and complexity of processes within such a timeframe may obscure intrinsic value, requiring a high level of expertise and experience to guide and rehabilitate assets from start to finish.

Distressed investing is largely comprised of assets burdened by idiosyncratic issues that require a high level of specific knowledge and capabilities. As such, the correlation of returns in distressed investing should be market neutral. However, as we all know, a rising tide lifts all boats. Unfortunately, the opposite is also true. Therefore, market anomalies will impact distressed investing as it will impact other disciplines and strategies, particularly in periods of high volatility as correlations across asset classes approach one. Distressed investing is not immune to the vagaries of market conviction.

A supply/demand imbalance

Despite the idiosyncratic nature of distressed investing, distressed investing market participants are increasingly affected by market conviction and global macroeconomic forces. In addition to the direct influence on valuation, distressed investing is impacted through extension risk embedded in the asset. Distressed investors typically take a longer-term outlook but are affected by shorter-term events as they impact the supply of new opportunities and the demand for rehabilitated assets. It is the near-term events that trigger the initial distress which creates the opportunity to invest, and it is these same events that can trigger the ability to exit through a sale, IPO or debt-funded dividend payment. We focus on these events as they can extend the event and the exit, which could have a material impact on the ultimate return and the multiple of invested capital.

Of late, idiosyncratic events have been trumped by socioeconomic and geopolitical events, which have affected the level of conviction in the market and extended the life of assets on balance sheets. For example, the Long Term Refinancing Operation of the European Central Bank has provided a lifeline to European banks through three-year funding at 1 percent which affords the banks more time to work through troubled assets. This has negatively impacted the supply of distressed product. With the estimated €15bn of capital raised for or reapportioned toward distressed investing in Europe, the current supply demand equation is unsettled and uninteresting. As the banks generate earnings through the net interest margin from cheap financing provided by the ECB, reserve levels on distressed assets will approach market clearing prices and European distressed investing will become more interesting.

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Conclusion

Over the course of the last year and a half, the market has shrugged off what some might consider significant market disrupting events. Populist uprisings across the globe in developed and developing economies unseated entrenched regimes and provided the impetus for significant socio-political change in others. A tsunami off the coast of Japan contributed to a meltdown of nuclear reactors approximately 150 miles from Tokyo, a major global centre of financial activity with a metropolitan (and surrounding areas) population of approximately 35 million people. The polarisation of the US political landscape brought the country to the brink of insolvency during the debt ceiling debate and, ultimately, contributed to the decision by Standard & Poor's to lower the credit rating of the US government. The roller coaster that has become known as the Eurozone Crisis spread beyond containment in Greece and Ireland to Italy, Spain and France, as reflected in credit default swap spreads. Any one of these events might have created a sustainable dislocation in the markets, and yet, as stated before, the US equity market remains largely unchanged year over year.

Although distress occurs throughout the globe and is ever-present, distressed investing is not an evergreen discipline. It is highly opportunistic and a discipline that requires tactical allocation across assets and strategies. In a market of waning and waxing conviction, we continue to believe in a strategy of high selectivity and patience for investors with longer-term outlooks. However, as we experienced during the market swoons of August and September 2011, we also must be prepared to deploy capital as conviction turns severely negative or, as we experienced during the first quarter of 2012, to retract capital as conviction turns severely positive. For those who have the appropriate structure and access to capital, short-term trading opportunities provided by low levels of market conviction can augment long-term investing disciplines, such as distressed investing, and should be a portion of the strategic allocation today. ■

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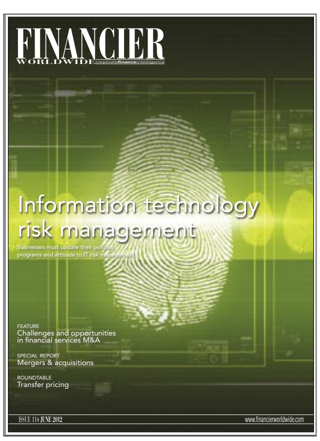

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