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DISTRESSED M&A AND INVESTING

# Blowing in the wind

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The global financial crisis of 2008 (the 'GFC') impacted financial market theory and continues to challenge longstanding beliefs. The halcyon assumptions of allocation models and the benefits of diversification across asset classes came under direct scrutiny as correlations broke down and asset management policies were challenged. Sophisticated institutional investors with complex risk models and diverse scenario planning suffered equally with buy-and-hold retail investors. But then, as the destruction of these theories quickly proved detrimental to portfolio construction, central bank actions gained footing and asset prices increased, inflating previously impaired balance sheets. Five years later, the investment world is a happier place, but, undermining this euphoria, the market continues to suffer from inconsistent outcomes despite adjusted risk modelling.

**When a butterfly flaps its wings**

The greatest change in capital markets over the past 20 years has been the inter-relatedness of assets and the speed with which changes in one can affect another. But, what is meant by interrelatedness? Is it correlation? Is it some form of interdependency? Or, is it all just a myth of coincidence?

In 1963, Edward Lorenz, a meteorologist and mathematician, published 'Deterministic Nonperiodic Flow' in the *Journal of the Atmospheric Sciences* launching chaos theory. In the publication and in subsequent interviews and publications, Lorenz described what has become known as the Butterfly Effect. The Butterfly Effect is the dependence of the occurrence of an event on the initial conditions of a nonlinear system (think: the global capital markets), in which a small change in one position results in a large difference in another position. These can be near simultaneous events or sequential events that may take time to reveal.

As globalisation has increased and diverse capital markets have become more interrelated, small changes in one market can have meaningful changes in another. In addition, access to information has become cheaper and more readily available. As the ability to store and recover this information for processing and reprocessing has improved, analysis has become more robust and decision making has become more confident. This confidence, however, was shaken in the wake of the GFC and the ensuing European crisis.

**The 60:40 headstand**

The seeds of the overconfident market were planted in the 1950s with the findings of Harry Markowitz that have become known as Modern Portfolio Theory (MPT). MPT introduced the concept of the optimal portfolio based on a basket of potential investments that minimises risk and maximises return. The underlying assumptions included a rational investor who was risk averse and the constant correlation of investment pairs.

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This was revolutionary in thought because it illustrated that careful portfolio construction can outperform individual asset selection. In addition, MPT is logical, intuitive and straightforward in its application. In fact, for many years, investors simplified it even further with the '60:40 Rule' creating a basket of equity and debt investments based on that simple ratio.

Unfortunately, the assumptions underlying MPT were soon challenged as correlations were observed to be inconsistent and distributions of outcomes were not symmetrically or normally distributed. The growing field of behavioural finance has even challenged the notion of a rational investor, particularly in times of excess and crisis.

Today, MPT has been turned on its head by interrelatedness and human tendencies. The internal correlation of the S&P 500, as quantified by the internal correlation indices ICJ, JCJ and KCJ, has been upward sloping since 2008 and currently stands at about 60 percent, off from its recent highs of 80 percent in 2012. This means that 60 percent of the movement of an individual stock within the index is tied to the movement of the index itself, or, in other words, tied to the movement of the other stocks within the index. Therefore, individual stocks are not independent. Between 1999 and 2008, the S&P 500 and the 5-year US Treasury Note moved in opposite directions. As bond yields declined (and prices rose), the equity index decreased in value. Following the GFC, however, the S&P 500 and the 5-year US Treasury Note have moved together. Interrelationships exist and are not consistent.

**The Texas tornado**

As mentioned above, central bank actions in the period following the GFC have inflated asset prices and provided stability to the capital markets. The directed actions have reverberated to other asset classes and, intended or not, have impacted balance sheets. For example, the quantitative easing actions by the Federal Reserve have driven interest rates in the US to historically low levels. In response, these actions have driven yields and spreads in risky assets to extremes.

In fact, at the beginning of 2012, the spread between leveraged loans and high yield in the US was approximately 143 basis points according to JP Morgan High Yield Research. After a year that included the risk of Greece leaving the European Union, contagion spreading to Spain and Italy, and highly contentious elections in Greece and the US, the spread between these asset classes was 27 basis points on 31 December 2012. The perception of risk was mitigated by central bank actions including the Long Term Refinancing Operation, the European Financial Stability Facility, the European Stability Mechanism, and the expansion of Operation Twist in the US.

The quest for yield has attracted significant capital to higher returning strategies. The leveraged capital markets in the US have experienced substantial growth. According to AMG Data Services, high yield funds attracted $30bn on net capital in 2012, the third largest annual inflow in a decade. Not to be outdone, the CLO market resurgence of 2012 brought $55bn of demand for loan product.

As a result, US issuers have had access to inexpensive capital and have been able to dictate more favourable terms. Maturities have extended with high yield deals reaching up to 10 years. Covenants have been weaker than historically normal levels. And, the purpose of issuance or usage has migrated away from refinancing to include more dividend recapitalisations, acquisitions and general corporate purposes.

**Conclusion**

Today, the lessons of the GFC appear to be forgotten by the leveraged capital markets in the US. Demand for yield has stripped the rational investor of rational thought. Portfolio risk planning exercises are being ignored in lieu of short-term gains. The impact of government intervention, the butterfly, is being felt in the inflation of asset prices to levels previously experienced only in the period preceding the tech and telecomm bubbles of the late 1990s and the liquidity bubble

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of 2007 and 2008.

Not all asset classes and geographies have enjoyed this rising tide equally, but all are benefiting from it. The interrelatedness of diverse markets continues to drive performance, but, as a caution, investors must be sensitive to the fact that this interrelatedness is inconsistent at best. Currently, the greatest single risk factor impacting markets is central bank support of asset prices. Until the US and European economies experience inflation in prices of goods and services (rather than assets), central banks appear to be substantial market participants. But, once this artificial demand subsides, is history condemned to repeat itself? ■

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