Lead Left Interview – Martin Fridson (Part 2)

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This week we continue our conversation with Martin Fridson, chief investment officer, Lehmann Livian Fridson Advisors. Fridson is "perhaps the most well-known figure in the high yield world," according to Investment Dealers' Digest. His firm is a registered investment adviser based in New York City and Miami, managing investment portfolios for investors across the US.

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TheLeadLeft: What's the issue with "144a for life" registration rights?

Martin Fridson: For a number of years the dominant form of high-yield new issuance has been to offer a 144a, which is a private placement, but attach registration rights. The investor ends up with a fully registered deal, but the issuer can get into a market window that might close if the registration has to be done up-front. Eventually, issuers started doing 144a deals without registration rights and that practice has escalated recently. It's another gain for the issuer, who saves the expense of registering the deal. Investors don't view it as a disaster if the company is public or has other public issues outstanding such that it has to provide regular financial reports.

TLL: What's the impact of these looser covenants?

MF: For loans, some investors see covenant-lite structures as a good thing. Their thinking is that a basically sound company can avoid being pushed into bankruptcy by a covenant violation. The other side of it is that by kicking the can down the road, the covenant-lite structure enables an unsound company to dissipate more asset value before it finally defaults.

TLL: How did it work out in the last recession?

MF: There were definitely companies that escaped default with the help of covenant-lite packages and recovery rates were not drastically lower than in previous cycles, as some had feared, based on the scenario of dissipating more asset value before finally defaulting. But the Fed brought the default surge to an early end by massively reliquifying the system. It remains to be seen whether delayed defaults as a result of covenant-lite loans will lead to lower recoveries when a default surge is allowed to run its course.

TLL: What about rating agency reform? What's your perspective on that topic?

MF: Let me focus on the corporate ratings sector. There's a lot of misunderstanding and deliberate misdirection on this topic. Many money managers say, "We do our own research and pay no attention to ratings." But when the down cycle arrives, they change their tune and say they relied on ratings that turned out to be wrong. So the calls for reform are not necessarily responses to genuine problems.

TLL: There have been new entrants like Egan Jones and DBRS.

MF: Reformers who are looking to create new agencies should be careful what they wish for. In the past, competing agencies quickly figured out that the way to capture market share was to hand out higher ratings than the dominant firms. The reformers don't understand the dynamics of the ratings industry and imagine that investors and issuers are clamoring for better ratings. Actually, investors are happy if ratings are wrong, provided valuations are consequently wrong as well. That gives them opportunities to profit from market imperfections. Issuers don't care whether ratings are accurate in general. It's just that every issuer believes it's underrated relative to all the others. Clearly, they can't all be right.

TLL: Are there any other benefits of ratings?

MF: If you're running a small pension fund without a lot of resources, ratings protect you against a manager buying inappropriately risky securities to try to achieve high returns. By incorporating ratings into investment guidelines, the pension fund's trustees can ensure that an overly aggressive manager won't blow up the fund. The system works for that purpose. It's a low bar, but the present rating agencies meet it, so there's no clamoring from these end investors for new providers. We can nevertheless be confident that in next crisis, the ill-informed calls for reform will arise again.

TLL: Do you see any concerns about the upcoming bond maturity wall?

MF: The big debt maturities aren't until 2018, so there's little risk of a maturity-related default surge before then. And recent research by GMO shows, counter-intuitively, that it's actually better to buy high-yield bonds when the maturity wall is closer. That's because in a bear market, there's typically little refinancing, so the distance to the maturity wall shortens. But that's also when the market is poised to rebound.

TLL: Could you elaborate a bit more on that?

MF: Many observers mistakenly believe that inability to roll over maturing debt is the only reason companies default. Companies can also strategically default simply because their liabilities exceed the present value of their future cash flows. At that point, they're like the homeowner who's underwater on his mortgage and decides to mail in the keys. The bottom line is that investors who believe default rates cannot rise until we hit the maturity wall have a false sense of security.

TLL: Tell us what your firm is doing in this market?

MF: We manage money for high net worth individuals. The goal is to generate income and preserve capital, while avoiding major swings in principal value. The firm mostly focuses on preferreds, MLPs, REITs, some high yield and investment grade bonds, some closed-end funds, and a component of dividend-growth stocks to offset inflation.

TLL: What kind of yield are you targeting?

MF: Portfolio yields are typically around 5-6%, depending on clients' risk profiles. The goal is to add return by buying right and avoiding excessive turnover. Hands-on credit analysis is critical to our success.

TLL: Final question, Marty. Do you foresee any massive cash moves in anticipation of a rate hike?

MF: I don't think institutional money will move quickly out of funds. But retail cash may.

Contact:

Martin Fridson
Email: marty@fridson.com