Navigating the BBB Bubble Through Active Management

GRIPMAN
INVESTMENT ADVISORS, LLC
VALUE, STABILITY, GROWTH

"Work ethic eliminates fear." - Michael Jordan

In 1978, Michael Jordan tried out for the varsity basketball team at Laney High School and was cut. The reason that coaches did not choose Jordan was not that he wasn't already an outstanding basketball player or that he lacked talent. The biggest reasons were seniority and size. The coaches only had one spot left for a sophomore. Instead of Jordan, they decided to go with size and picked 6'6" Leroy Smith over 5'10" Michael Jordan.

In the investment management industry, the selection of investment managers is perfectly analogous to this example. Potential clients will often allocate investment management contracts only to seniors (Blackrock, PIMCO, etc.) and sometimes to juniors (Doubleline, Oaktree, etc.). The sophomores (Emerging Manager Firms) are typically overlooked for various reasons. However, the sophomore asset management firms are where most potential talent and alpha generation is located. The investment management industry can be challenged by the same short-sightedness that Michael Jordan faced. If your timeframe is the next 3-5 years, then picking Michael Jordan will be a better choice. However, some coaches are only focused on the next year.

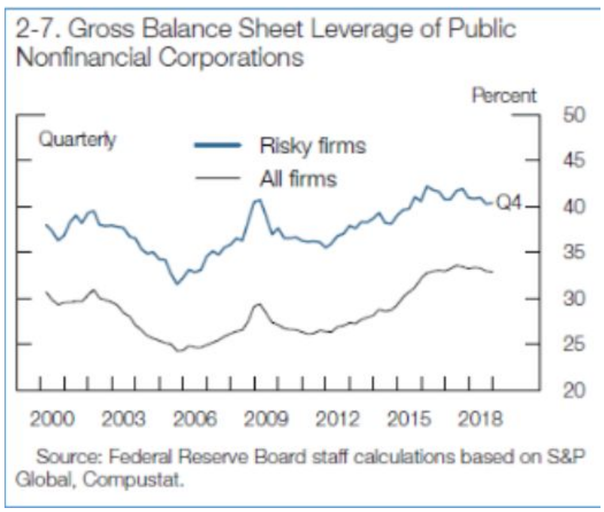
When Brian and I left JPMorgan Asset Management to start Gripman back in 2015, we wanted to create a firm that was different in that we could focus primarily on multi-asset investment strategies. Our goals were concentrated on helping our potential customers get good returns while striving to ensure that the downside was limited if the markets got spooked.

As sophomores, we are proving that coaches should be investing in our Absolute Value Balanced strategy. The fact that our strategy earned 1.7% for 2018 has the investment management industry looking to us as a long-term team player. We beat our custom index by 3.3% and we were able to provide a positive return for our clients in a market that had negative returns for 90% of the investable universe. That is MJ Championship quality, right there, fans. Not only were we prepared for the 2018 volatile market, but so far in 2019, we have been able to capture the recovery with an 8.6% YTD return to April month end and have maintained our outperformance to our custom index.

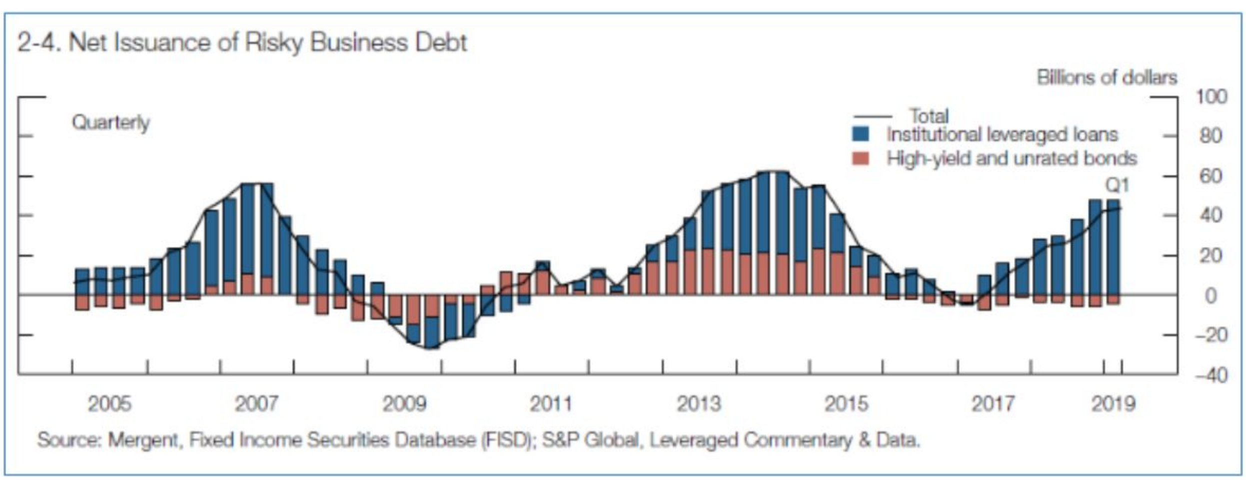
As investment thought leaders, we stated in our market outlook for August of last year that we had concerns about BBB corporate debt. We noted the growth of this portion of the market as follows:

"The part of the market that has me the most concerned going into this part of the economic cycle would be the BBB rated corporate sector. Companies that have levered up and that have not been through an economic cycle with their new more levered capital structure will likely struggle, in my opinion. These firms will see leverage spike and likely see downgrades from investment grade to high yield. The BBB category has grown to a size of $3 trillion and now makes up over 50% of investment grade debt outstanding. Potentially making this situation worse is the liquidity squeeze as index funds are forced to sell the debt upon the downgrades."

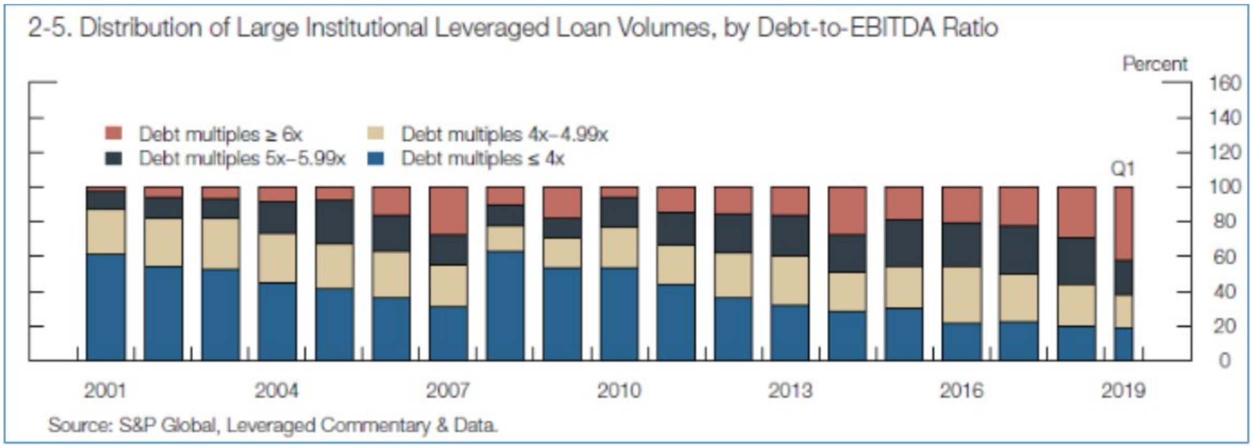
The Federal Reserve just released its Financial Stability Report and addressed multiple factors that they use to monitor the stability of the financial system. They have stated that borrowing by businesses is historically high relative to GDP, with the most rapid increases in debt concentrated among the riskiest firms amid signs of deteriorating credit standards. They provided the following graphs for corporate debt and bank loans that show the rise in leverage over the past ten years.



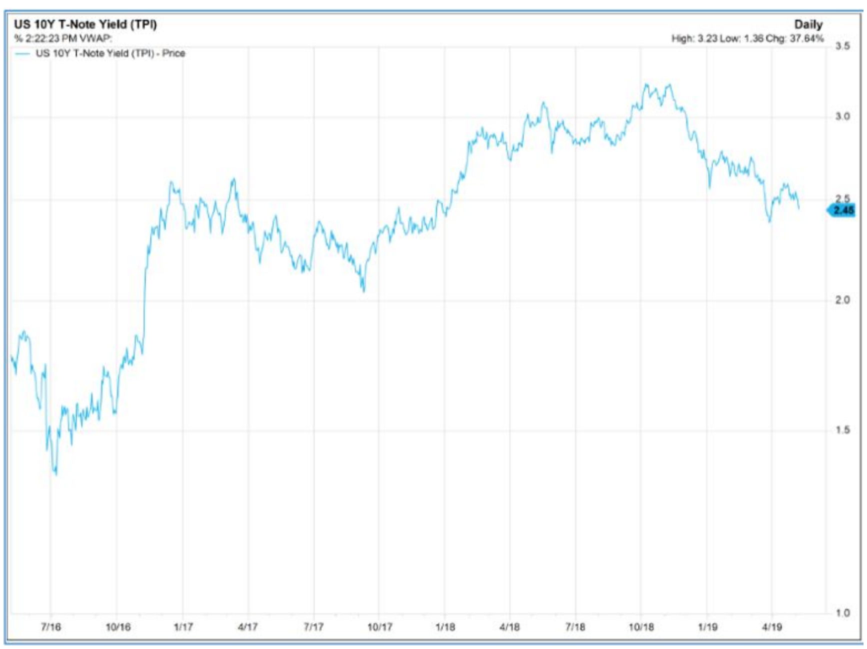
Most of the growth in debt has come from leveraged loan issuance:



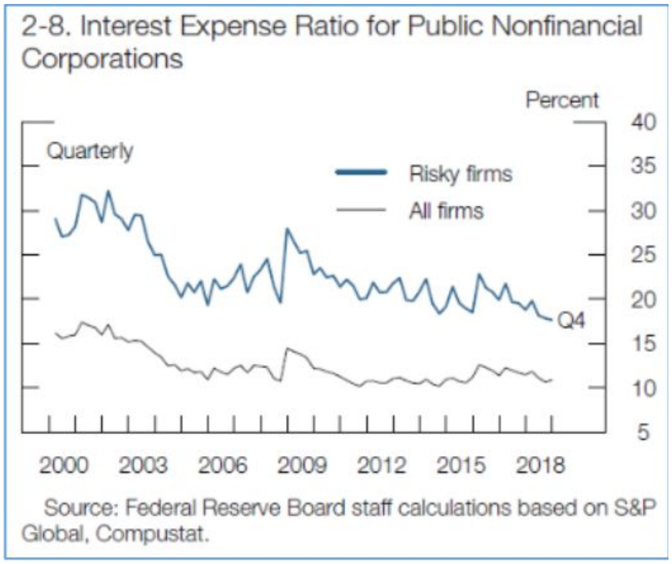
& underwriting appears to be the worst ever tracked in this sector:



The numbers look problematic. However, we must pause and consider the reason for the changes that we have seen over the past decade. We believe that the biggest driver for this rise of leverage and the leverage loans issuance comes directly from low-interest rates. The leverage loan market demand had risen due to consistently higher interest rates, sparking investors to shift somewhat to the leverage loan market adjustable rates. This calmed down considerably as interest rates peaked in August 2018.



From a supply perspective, companies liked being able to issue debt with yields that remained attractive, even though interest rates were a bit higher than the previous years. Public Nonfinancial company CFOs knew that they had a bit higher leverage. Yet, they felt that interest rates were low enough that their financial risk was still manageable since interest expense was still close to historic lows.



The move lower in late 2018 was all about leverage. As interest rates increased and investors started to worry about growth, investors became fearful of firms with too much leverage. Investors essentially performed a stress test of many leveraged companies in the market. The biggest headline grabbing name was General Electric Company.

The company came under pressure late in the year as they faced operational challenges combined with debt issues. Spreads widened due to the concern of a downgrade to below investment grade combined with GE being a large issuer. Here is a chart of GE's short-term and long-term bonds.

This chart shows that the market is still worried about GE's overall risk profile and a potential downgrade to BB due to the spread staying well wide of old levels. However, through asset sales, the company's liquidity profile has improved and the short-term risk has dropped.

This highlights where we are as investors in the current market and why, over the coming years, active and not passive investing will be so important. Active managers pick through different issuers and bonds in the BB/BBB ratings categories. Bonds issued by companies in these ratings categories, that are more cyclical, and that have not improved their liquidity profiles will suffer. Especially, if you own or buy bonds with a maturity of five years or greater. The greater the maturity of the bond the greater the risk as the duration adjusted effect of spread widening will lead to a bigger potential loss and more volatility.

A good example is CenturyLink, Inc., which is a BB/Ba3 rated Telecom company. The company has seen challenging user losses over the last five years. Even though they recently merged with Level 3, it is uncertain what kind of revenue/margin profile CenturyLink would have in a recession. However, the company made a bold move to significantly cut its equity dividend in half and improved the company's five-year liquidity profile.

As a result of this management shift and the improved liquidity profile, we were comfortable buying a shorter maturity bond in the CenturyLink capital structure. By waiting until we had the confirmation of a credit positive event (dividend cut) and staying in the shorter duration bond (to limit the bond price volatility), we were able to buy a good individual bond that can give us a solid 4%+ yield over the next several years.

The corporate bond market is still a good place to find value. However, you must be the insightful coach who is looking for the Michael Jordan's to round out your team. The active manager that will take your team to the finals knows how to do in-depth credit work and allocate properly in building your portfolio. As Michael implied in the beginning quote, putting in the work allows us to more clearly segregate the corporate bond market to find true value and not be fearful of the coming BBB reckoning. When Michael was talking about work ethic, he was referring to the way he looked at practice. He would practice hard and push players around him as it prepared them for not only games but the big games. In that same way, we run scenarios around what would happen if liquidity dries up in corporate bonds and how a recession could affect the ability of firms to pay back their debt obligations.

We don't know what the remainder of 2019 will bring. Yet, we are confident with our current portfolio. We will do well if markets stay sanguine and are positioned to look for opportunities created by the BBB bubble if, in fact, we do see an economic slowdown and massive downgrades from BBB to BB.

If you are looking to add alpha to your investment portfolio and be a leader in the league, then choose skilled, hard-working sophomores with an active management, multi-asset balanced strategy. If our strategies do not fit into your investment profile, then we suggest looking to avoid passive long fixed income strategies with credit exposure.

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