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I wrote the book on vulture investing.

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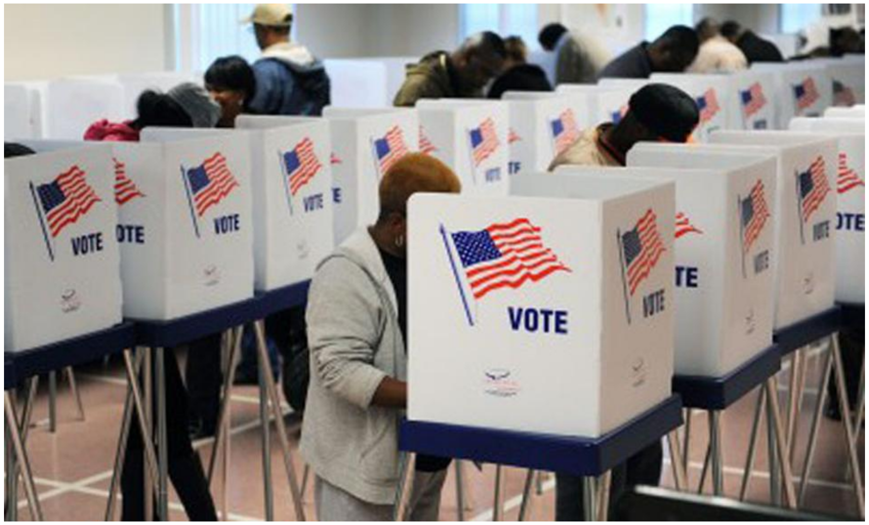
Post-Election Outlook Is Good For Distressed Investors

We're now several weeks past one of the most contentious political campaigns of the last century, and before the next campaign gets off in earnest, it might be a good time to take a look at the change in administration's potential impact on distressed securities investing. Although there was an initial sell-off by some investors in the days immediately following the election, since then there have been two major trends that bear following.



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There's been a big bid for investments related to commodities and if all the talk about rebuilding infrastructure turns into action that bodes well on a number of fronts. The second trend that bears watching is the drop off in the fixed income market. Like many other investors, we've found the pace of this to be frustratingly slow, but we're finally starting to see some repricing in the fixed income market as interest rates creep up. As a result, some of the many companies which issued junk-rated debt when interest rates were at record lows are more likely to have considerable difficulty getting refinancing as their debt matures.

None of this has caused us to alter our view of the macroeconomic picture. At the end of this year's third quarter, the GDP was up 2.8% and inflation, as measured by the CPI, was +1.5% while the Fed maintained an extremely low interest rate policy. In their December meeting, the Fed raised short term interest rates by 25 basis points. Against that backdrop, continuing broad market volatility is inevitable.

As far as our area of specialty—distressed securities, we are well into the middle of a new default cycle in certain overleveraged industries (metals/mining, oil & gas) and that has provided us with ample new investment ideas (both long and short). In the current environment, a good strategy is to seek exposure to value-oriented equities while avoiding, or short selling, overpriced long-dated fixed income securities. Although volatility will continue in the equity markets, long-term patient equity investors should be well-rewarded if they prudently select businesses with strong earnings power, modest leverage, and shareholder-friendly corporate governance. The upside from investing in businesses like these will prove itself over time.

Distressed security trading has been active due to the increased incidence of defaults this year. Through the end of the third quarter, some 53 companies defaulted on $54.6 billion in debt ($43.0 billion in bonds and $11.6 billion in loans) according to figures published by J.P. Morgan. This amount is already 45% higher than 2015's full year total of $37.7 billion ($23.6 billion in bonds and $14.1 billion in loans). In fact, 2016 already ranks as the fifth highest total debt default year on record! When adding in so-called "distressed exchanges," 80 companies have defaulted on $63.3 billion in debt ($51.6 billion in bonds and $11.7 billion in loans) so far this year – an amount which is 23% higher than all of 2015. Clearly, distressed securities activity is busy. As of October 31, the U.S. high-yield corporate bond default rate (including distressed exchanges) was 4.8% while the U.S. high yield corporate loan default rate was 2.1%.

With distressed activity picking up substantially over the last few months, active investing in long distressed debt has become more attractive. A key component of this kind of opportunity is finding situations where the issuing company's distress is temporarily misunderstood by the market, but which actually presents a sizable margin of safety. Focusing on firms that exhibit excessively positive cash flows, as compared with their current market valuation metrics, is part of that strategy, as is finding the so-called "fulcrum security"— the one most likely to achieve equity-like upside through the course of a full restructuring.

The challenging environment for active investment management which started in 2015 continued throughout 2016. Moreover, the shift, from active to passive money management, is a secular trend that seems to be accelerating. However, heading into 2017 the macroeconomic environment outlook is much more favorable than it has been in recent months. As a result, individual security selection will regain much of its luster. We expect higher growth, a steeper interest rate yield curve, and a more business-friendly environment in the coming months. There are still a number of questions about exactly what a Trump administration will entail, but it's bound to include a new opportunity set for distressed investors.

George Schultze is a hedge fund manager and the founder of Schultze Asset Management. He is the author of The Art of Vulture Investing: Adventures in Distressed Securities Management.