AltCredit

This time is different, says Arena Investors' CEO Daniel Zwirn

Arena Investors CEO and CIO Dan Zwirn presents an analysis of five secular changes brought up by the over-regulation of the marketplace after the 2008 financial crisis, by David Graubard

In a recently published white paper entitled *This Time Is Different, but It Will End the Same Way*, Arena Investors CEO and CIO Dan Zwirn presents an analysis of five secular changes brought up by the over-regulation of the marketplace after the 2008 financial crisis – changes that the author argues are not getting much attention relative to the extreme demand from investors for yield assets, but that are likely to exacerbate the next downturn (and that investors would be well-served to be aware of, and in some cases specifically avoid).

Alt Credit (AC): If you had to prioritise the five secular changes from your recent paper, which is the most significant?
Daniel Zwirn (DZ): Actually, all of the changes we identified touch on why investors not receiving adequate compensation for the risk they are taking, and how those investments might also prove to be less liquid than they expect, which will probably lead to even further declines in prices.

So as an example on the first point, there has been record issuance in CLOs, with investors gaining comfort in owning the equity tranches based upon the fact that they "came all the way back" in the 2008 crisis, but not recognising the fact that the underlying collateral quality has deteriorated significantly, and probably also not appreciating the razor thinness of the slice they own (and/or, assuming they survive a hit, whether they have the fortitude to sit through a 90% mark-to-market hit).

AC: Is a mid-teens return for CLO equity an appropriate compensation?
DZ: Perhaps it should be four or five times that amount given the risk investors are taking. Similar dynamics exist in subprime auto, leveraged loans, middle-market corporate, and more generally across almost all of the tradable fixed income markets – for example, today's BBB corporate bond is the equivalent of yesterday's BB.

AC: Are illiquid assets more fairly priced?
DZ: Illiquid investments trade as a spread to the liquid markets, and not only are the liquid markets at all-time highs, but those levels further do not make sense when you consider that investors holding "liquid" positions will have little ability to exit when they actually need to.

The Volcker Rule has removed the banks from market making (which will be only further exacerbated when the market is moving in one direction – i.e., down). And the claim that large asset managers will step in and "be the market" stretches credibility given they will already be invested in enormous amounts of these assets on behalf of investors who will likely be deeply displeased.

Then add in that there has been an explosion in asset-liability mismatched fund structures, namely all of the daily liquidity mutual funds and ETFs that are holding huge positions in corporate and high-yield bonds, which will have great difficulty providing daily liquidity when investors are in sudden and desperate need of it. And that dynamic extends to monthly and quarterly liquidity hedge funds and other alternative vehicles, where you not only have the same mismatches, but also a massively different compliance regime (relative to pre-crisis) that only increases the likelihood of gates and NAV suspensions should investors start fleeing for the exits (given the difficulties in determining fund NAVs in the absence of efficient price discovery).

AC: Many of these dynamics are known to market participants, yet the blistering pace of issuance and fundraising continues. Why do you think that is?
DZ: I think it's in large part due to the fact that the money management industry has evolved in a way where investment managers are offering (and allocators are demanding) extremely specialised mandates – like a real estate strategy that only invests in Midwestern US Opportunity Zones.

In addition to the economic incentives for these managers to always justify putting money to work in those areas (versus returning the money to investors – a dynamic I refer to as "backing hammers that see only nails"), we would also refer to the old parable of the blind men and the elephant, where it is somewhat natural that an investor (who is only focused on one piece of the overall system) is going to draw different conclusions than if they were looking at the entire picture.

AC: So what is your advice for investors?
DZ: The markets are the tightest I have experienced in my 25-year career, so holding more cash is probably a good discipline, though we also think there are compelling opportunities if you're looking at the whole elephant, so to speak. We tend to focus on opportunities that don't easily fit into the "boxes" in which most narrow mandate strategies are packaged.

But in addition to examining collateral and covenants, we think it is more important than ever for investors to carefully scrutinise their seniority and width in the credit stack (i.e., their attachment points) vis-à-vis their compensation and duration, and also being realistic about their liquidity, with an eye towards categorically avoiding structures that are not asset-liability matched.