We’ve had numerous inquiries over the past 24 hours for our thoughts on the closure of the Third Avenue Focused Credit Fund (ticker: TFCIX). This story is likely to dominate headlines over the next several days given its shocking nature and possible effect on a sizable segment of the fund universe. Below I’ve rattled off a few of my thoughts on the subject, in no particular order. It should be emphasized that these are my opinions based on my experience and my assessment of the current market environment. Others could, and likely would, disagree with some of my thoughts.

Investor anxiety regarding the credit markets, and high yield in particular, was already high before the announcement of the Third Avenue Focused Credit Fund closure. Corporate credit has performed poorly for a second consecutive year, especially in high yield. Consequently, spreads have steadily widened, and in some segments like energy, have done so at a rapid clip. Further, investors have been battered with countless articles regarding deteriorating market liquidity conditions and an impending Federal Reserve rate hike. Now, following the TFCIX announcement, many are left to wonder if this is a “canary in the coal mine” moment, similar to the two large Bear Stearns hedge funds that collapsed quickly in 2007. I speculate that this is more of a one-time event, as opposed to an early warning sign of doom to come in the credit markets. While segments of the high yield market have gotten crushed recently, this closure was more of a fund-specific issue. There may be some longer lasting effects on the high yield and mutual fund universe, but I don’t believe any of these will permanently impair asset class returns going forward. Following are my answers to many of the questions that I’ve been asked recently.

How could this happen to a high yield fund?

The characterization of a “high yield fund” failure is not entirely correct. This fund, from my examination, is not your typical high yield fund. For years, investors with whom I’ve spoken to have all known that the fund primarily invested in high beta, CCC, and some restructuring credits. I’ve been asked for my opinion of the fund by numerous investors over the years. My response has been the same each time, “The fund owns the juiciest CCC credits, as you know, which comes with risks and potential rewards.”

Has being invested in CCC credits made that big of a difference?

In short, yes. CCC exposure of almost any kind has been a treacherous trade over the past two years. As you can see in Exhibit 1, while the spread of the high yield index has widened by roughly 275 basis points over the past two years, CCC credits have widened by roughly 750 bps. Over the past month alone, CCC spreads have widened by over 200 bps! Consequently, year-to-date returns on the high yield index are -2.2%, while year-to-date returns on CCCs are -10.6%.

Exhibit 1: High Yield Index and CCC Option-adjusted Spreads

Source: Bloomberg
Moreover, CCCs vary widely in price and liquidity. In other words, there are some CCC companies that are far worse in terms of credit quality (at least in the market’s eyes, if not the credit ratings firms’) from other CCC companies. I downloaded the top 50 holdings of TFCIX from Bloomberg, as of July 31. These holdings, according to Bloomberg, comprised over 75% of the fund’s AUM. After I excluded equity holdings, I was left with 43 bonds. As of yesterday, the average price as a percent of par of these holdings was 54, as compared to 68 for the Merrill Lynch CCC & Lower US High Yield Index. It should be noted that there were several securities for which Bloomberg could not find a price, so they were excluded from the calculation. The average yield of these holdings was 38%, compared to 17% for ML’s CCC & Lower Index. Even the median yield of these holdings (24%) was materially higher than ML’s Index. Finally, over 15 of the credits had undergone a capital restructuring between 2013 and 2015 in a relatively benign default environment.

I present this data not to disparage this fund (as for all I know, these securities may turn out to be terrific investments), but to demonstrate that this portfolio was not representative of a typical high yield fund (the index average par weighted price is 90 and yield-to-maturity is 8.6%), or even the CCC and lower segment of the high yield universe. This portfolio was filled with deeply distressed credit.

What questions would you ask if you were worried about liquidity in a credit portfolio?

What’s the yield of the fund? If it’s greater than 1.5x to 2x the index, then there are likely some juicy (aka, perhaps distressed and illiquid) holdings in the fund.

What’s the average dollar price of the positions in the fund? If it’s below 70, that should tell you something.

How many holdings do you own where you comprise more than 10% of the outstanding issue? There were a number of positions in this list where the fund held about 20% of the issue, and that can make liquidity quite difficult should you need to sell.

How many holdings do you have that aren’t current on their coupon or are in a form of restructuring? Generally, though not always, liquidity is materially poorer for these types of companies.

Can any mutual fund suspend redemptions, or was this a unique fund structure?

According to our analysis, which was not an all-inclusive review of the mutual fund world, there was nothing unique about TFCIX in terms of its ability to immediately suspend redemptions and place all illiquid assets in a liquidating trust for a lengthy period of time. Virtually all mutual funds can do this (not just credit funds). In addition, if the SEC becomes concerned about a situation like this, the SEC can force a fund into liquidation and appoint a receiver to liquidate the assets and distribute them to shareholders.

Do you expect this to weigh on the high yield universe for some time to come?

From a fundamental perspective, the answer is no. There’s nothing that has changed in terms of credit fundamentals over the past 24 hours (outside of oil being 3% lower).

From a technical perspective, it’s a bit more complicated. This fund suspended redemptions with roughly $800 million in AUM. Now, they can take all the time they want (presumably, within reason) to sell its holdings. That may take a quarter, or a few years. Regardless, that’s not going to move the market. Lipper reported this morning that investors pulled nearly $3.5 billion from high yield just last week—so $800 million over the span of months or years is not going to move the needle.
That being said, I expect that this announcement will cause modest outflows from the asset class for months to come. Additionally, I would expect the trend of dramatic CCC underperformance to continue for the time being. This event will likely increase the liquidity risk premium required to hold these securities. That fact, coupled with a more restrictive refinancing environment, will create a challenging backdrop for this segment of the credit universe. Eventually, distressed credits will reprice to a point where they are attractive relative to many other investment alternatives. At that point there will be buyers, but they will likely come from other investment vehicles, such as limited partnerships.

Last, and perhaps most importantly, will this prove to be a seminal event in the high yield market, similar to the Bear Stearns mortgage-backed hedge funds that collapsed in 2007?

I don’t believe so, though the financial media might try to convince you of that over the next several days. There are a number of differences between then and now.

First and likely most importantly, is leverage. Many hedge funds that collapsed during the credit crisis were running portfolios that were levered 10x. Mutual funds have no financial leverage. If one experiences a 10% decline in an asset class in which you’re invested, and you’re levered 10x, then your fund could go to zero very quickly.

Second, this fund invested in a narrow niche of the high yield market called distressed. As the data that I surveyed shows, this portfolio was assessed to be materially worse than ML’s CCC and Lower Index by the market. This fund is by no means representative of your typical high yield fund.

Third, defaults are still running below historical averages, and may remain that way into next year. To have a crisis, there needs to be a material worsening of credit fundamentals, which we currently don’t see and don’t expect to see in the near future. Yes defaults will rise in the energy sector, but that is priced in by the market. Ex-energy, credit fundamentals look just fine.

Last, the global financial system isn’t on the verge of collapse. During the credit crisis, we experienced levered sellers trying to sell on top of other levered sellers. Now, the leverage within the investment management business is not high. Prop desks have already been decimated over the past few years. Hedge funds have already been running with no-to-low leverage. There’s simply not the froth, nor the systemic risk, to spark a credit crisis.

The most likely “game-changer” of this event is that the SEC is likely to take an even more stringent look at liquidity requirements in fixed income funds. This movement was already underway, and I’d expect that TFCIX’s closure would strengthen the argument for a more conservative approach to assessing liquidity of fund holdings.

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