

Debt Doldrums

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Every financial crisis is marked by the failure of supposedly infallible corporate behemoths. In 2001, it was Enron. In 2008, there were several – Freddie Mac, Fannie Mae, Lehman Brothers and Bear Stearns. On this side of the pond, it was the collapse of HBOS. Every bull market has its poster child of corporate excess, be it one company or a basket of them. The poster child of bull markets is often conceived out of a fundamentally good idea. However, bad ideas are often born out of good ideas taken to their logical extreme.

Prior to its collapse, Enron was voted as the most innovative company in America by Fortune Magazine. Not just once, but for six consecutive years. For Enron, their “good” idea was helping to create the market for energy related derivatives – financial instruments used to allow its customers hedge the fluctuations of energy prices. This was truly a useful innovation. However, it did not stop there, and Enron started trading through derivatives everything it could get its hands on, such as insurance risk, advertising time and high-speed data transmission. It exaggerated its revenues, which kept Wall Street happy, while hiding its losses through off-balance sheet entities before it was ultimately overwhelmed by the scale of its losses.

Similarly, mortgage backed securities, the fuel that started the fire of the global financial crisis of 2008 were, at their conception, a fundamentally good idea. It allowed lenders bundle up mortgages and sell them off to third parties thereby freeing up their balance sheet to lend more and help millions of Americans achieve the dream of home ownership.

The problem? A limited supply of prime borrowers. The only way to keep the mortgage machine humming was to reduce lending standards. There were also political incentives that encouraged home ownership, regardless of affordability. It got to the point that lenders were offering NINJA loans (no income, no job, and no assets) combined with low ‘teaser’ rates that were subsequently hiked after a few years. The lenders did not care about the credit-worthiness of the borrowers; they simply packaged and offloaded the mortgages to investors. The credit rating agencies blessed the mortgage backed securities as investment grade and institutional and retail investors flocked to get exposure to apparently low default risk, low volatility assets. The high priests of the rating agencies could not, alas, protect investors from the losses to come.

Today, the problem, we believe, lies with excess corporate debt. A company like AT&T for example has about \$190 billion in net debt on its balance sheet, which is equal to its market capitalisation. If it were a country, it would be the 36th most indebted nation in the world. More indebted than Venezuela, Iran, and Colombia.

Debt is a tool. And like any tool it can be useful or useless depending on how it is used. However, debt is unique in that if not wielded properly, it can be worse than useless. It can be harmful. And because of our tightly coupled financial system, excesses of debt can create systemic risks that can cascade like falling dominos.

Over the long-term, a company's stock price will match its ROE (Return on Equity). Financial engineering via the use of debt can increase a company's ROE. However, like any good idea taken to its logical extreme, this can be dangerous. Many company executives are incentivised to leverage up their balance sheets. A decade of low interest rates has provided useful encouragement in this regard.

However, increasing leverage just to improve the ROE is very flawed because eventually, debt levels can reach unsustainable levels. AT&T is the world's largest issuer of corporate debt. It is however a company in decline. Revenue per share has trended downwards for a few years now. So here you have a company in decline with a very leveraged

balance sheet, particularly exposed to an economic shock like the Covid-19 pandemic. Yet the high priests of the rating agencies rate the debt as investment grade. Where have we seen this before?

At Tacit, we have always had an aversion to highly leveraged companies. Holdings like the American Century Global Small Cap fund, Finsbury Growth and Income, Lindsell Train Japan, JOHCM UK Opportunities and the Crux European fund all avoid companies with excessive financial leverage.

This aversion to excess debt not only applies to our growth assets but also to the stabilisers. Some investment grade corporate debt is not as safe as is implied in the ratings. And while they yield more than the debt issued by governments of developed nations, the default risk is significantly higher. The poster child of corporate excess this time around will be heavily leveraged companies.

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