Three Little Letters...

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In the aftermath of the financial crisis, investors appeared to avoid anything that was identified by letters rather than proper words: CDO, ABS, RBS...

It was understandable. Headlines screamed about three-letter debt instruments packaged up by banks that often contained worthless securities – and their holders had no idea until they went "pop".

Against this backdrop, we saw many institutional investors turn to bonds issued by blue-chip companies that, although yielding less than their portfolios would like, were easily identified, explained and measured against competitors.

The blue chips, for their part, were only too happy to oblige – dramatic cuts to interest rates meant they could issue bonds at record low levels.

Over the next decade, issuance soared. By the end of 2017, there was more than USD9 trillion in outstanding corporate debt in the US alone, according to the nation's debt tracking agency. This was more than double the level of just twelve years earlier.

Roll forward to 2019, however, and it appears the sheen of these bond investments has tarnished a little.

The global economy, though jump-started with huge amounts of quantitative easing, has not improved sufficiently for regulators to begin raising interest rates again. This means the linked corporate borrowing rate is stuck, too.

Additionally, companies and their advisors soon realised the desire for yield from institutional – and other – investors and began loosening the terms under which they would lend in their own favour.

Combined with these relatively low returns and often relaxed covenants, global regulators have begun to sound the warning bell on the amount of debt that has been issued. They are also concerned that when rates do start to rise again, a wave of defaults will ensue as so-called zombie companies have been kept on life support for too long.

So where can investors concerned about over-indebted companies look for opportunities? It could be time to go back to some of those three letter acronyms.

Since the financial crisis, regulation has focused on people rather than companies and making sure banks do not lend them too much. Over the past decade, it is reported the average US citizen's level of personal debt has shrunk to around a third of what it was.

Additionally, lending requirements for banks have been tightened up, so mortgages are of a higher quality and loans made to companies have better checks and balances than before.

This means that the packages of debt, such as collateralised loan obligations and mortgage-backed securities, are of much higher quality than a decade ago. The range of securities within them can make them an attractive diversifier, too.

Also, managers working with partners to put these packages together have learned the lesson of transparency and are more willing to show investors how these sausages are made.

We know the adage of being bitten once and shy the second time, but if investors are better equipped this time around and demand more clarity and information, these three little letters could produce some interesting returns.

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