

March 2009

# *View From the Trenches*

---

The stock market has declined more than 50% from its peak in October 2007. Spreads in all sectors of the bond market have widened to historic levels. Hedge funds and real estate managers have been forced to deleverage. Private equity is seeing valuations decline significantly. And, there appears to be very little positive news coming out on the economy. As a result, Stratford interviewed some of the most talented managers across asset classes to learn what they view as the risks and opportunities in the markets going forward.

---

## **Equities**

Value managers believe a “for sale” sign has been hung on stock markets across the globe, with discounts to value among the best they have seen in their careers. Technology and commodity oriented sectors are generating the most interest from value managers, after an early misstep into financials by some. Interestingly, some value managers indicate that corporate bonds may be more attractive than stocks. Growth managers are much more cautious seeing little visibility on earnings and revenue growth, nor a catalyst to push stocks higher. Growth managers are hoping that fiscal policy will be the catalyst investors are seeking. The consensus among international equity managers is that the markets are attractively priced. But, there is a great deal of uncertainty regarding the timing of a recovery. Managers, consequently, have reduced risk, becoming more benchmark like, raising small amounts of cash, and hedging currency for the first time in years. While the managers are decidedly cautious on emerging markets, they believe that emerging Asia and Brazil will be the drivers of future growth as the long term case for these economies remains intact.

---

## **REITS**

Real estate woes and tight credit markets put significant pricing pressure on REITs, with values down about 75% since their peak in 2007. There has been little differentiation across companies with strong and weak balance sheets. REITs remain a favorite short position of hedge fund managers despite an increase in capitalization rates, a measure of value, to an implied 11%, with managers believing 7-9% is more reasonable. However, a number of REITs need to improve their balance sheets. Cash yields on REITs have declined as companies seek to preserve cash. Recovery is expected to begin in 2010. Select high quality REITs should be winners as they are able to acquire properties well below replacement cost.

---

## **Fixed Income**

A widely-held belief is that the stock market cannot recover until liquidity returns to the bond market. Unfortunately, liquidity remains very poor and price declines have been severe. The good news is that valuations are compelling across most spread sectors. Managers indicate that credit spreads present an historic opportunity. As a result, nearly every fixed income manager has increased their allocation to investment grade credit or is thinking of doing so. Sector emphasis within credit is on firms that fall under the umbrella of government assistance. Sentiment on structured securities is mixed. Many managers view select senior, front-pay non-agency MBS securities as offering compelling value while others are cautious given the securities’ illiquidity as well as uncertainty surrounding the value of mortgage collateral. Views on high yield are cautious given expectations of an increase in defaults. Additionally, the demise of a number of the largest high yield brokers has affected trading liquidity. High yield trading talent has moved to smaller brokerage firms that are seeking to grow market share. Unfortunately, these smaller firms don’t have the balance sheets to hold securities in inventory and as a result are mainly matching up buyers and sellers. This has kept bid-ask spreads wide and made it difficult to trade large lots. For those with a longer term view, high yield bonds present an opportunity to earn above average returns.

## Hedge Funds

To quote one hedge fund manager, “liquidity analysis is much easier than valuing a business right now”. Managers investing across asset classes favor stressed bonds and loans having more confidence in companies’ abilities to meet interest and principal payments near term than in longer term projections of earnings and cash flows. Distressed debt managers are finding a number of very attractive opportunities, yet remain cautious on the overall market believing recovery rates are likely to be much lower than in previous cycles because of the volume of covenant-light loans outstanding. Most long/short managers have reduced net exposures to neutral or slightly short. However, they note that in the current environment, even short positions can be risky if a weak company could be targeted for federal aid. Commodity plays remain popular, especially gold, which is selling well below its 1980 peak of \$2200 (adjusted to reflect 2009 prices).

## Private Equity

Within the private equity space, managers are fairly pessimistic believing that corporate defaults are likely to increase to about 20% in 2009, with one manager indicating that under a worst-case scenario defaults could reach 50%. Under this environment distressed debt is expected to generate “once in a lifetime” investment opportunities. At the same time, valuations have contracted significantly from a peak of 9.5x EBITDA in 2007 to 6.3x by the end of 2008. Valuations are expected to decline further in 2009. The good news is that returns from funds formed during recession years tend to be well above average, although it may be difficult to raise sufficient capital for a new fund with so many investors over allocated. Under this environment, secondary investments are expected to be very attractive, although managers caution that initial discounts may be overstated given still inflated valuations.

## Real Estate

The commercial real estate markets appear to be at a standstill, with sellers’ prices still unrealistic and lack of available financing for buyers. Prices are expected to decline through the first half of 2009, as property incomes continue to fall due to weakness in the retail and office sector. Expectations are that the property market will stabilize late in 2009, in part because supply growth has been relatively modest in recent years. The views of the real estate managers appear at odds with those of private equity managers and the much more difficult financing environment.

---

**Bottomline:** Despite the view that valuations may be very attractive, investors remain fearful of the equity market due to a lack of earnings visibility. Other risky asset classes are viewed negatively as well, particularly those such as real estate that rely on leverage to generate returns. Select opportunities in stressed and distressed credit, as well as secondary market investments taking advantage of liquidity-squeezed sellers appear most attractive in the current environment.