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Bentham's Richard Quin plays credit moneyball

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In his 20 years managing fixed income and credit funds Richard Quin has had to navigate his fair share of financial crises, including ones triggered by complex credit products.

He's had a harder time trying to convince the broader investing public that the asset class he has championed has not been a source of financial catastrophe but one that delivered solid returns to investors with significantly less risk than other asset classes.

"Credit investments went through a crisis in 2008. It was a great recession in the US, and the closest thing to the great depression, and credit did well," he tells *The Australian Financial Review.*

"<i>The Big Short</i> is not great PR for asset-backed securities," Bentham Asset Management managing director Richard Quin says of the hit film. **Janie Barrett**

The headlines generated by the implosion in sub-prime mortgage-backed bonds fuelled a perception that all structured credit products suffered equally as badly in the maelstrom that wreaked havoc on financial markets a decade ago. But the reality was much different, as structured credit products – which include asset-backed securities and complex products best known by an alphabet soup of acronyms like CDOs (collateralised debt obligations) – performed well despite the carnage meted out to other asset classes, notably stocks.

CDOs backed by corporate loans sailed through the crisis, and investors who held their nerve and could handle the drop in price got their money back.

Quin is the managing director of $7 billion Sydney-based credit fund Bentham Asset Management, which was spun out of Credit Suisse Asset Management eight years ago.

Bentham manages many types of fixed interest, usually with a focus on credit, varying from government bonds, investment grade bonds and high yield bonds, loans and asset backed securities, which make up about 22 per cent of Bentham's Global Income Fund.

Tightly knit

Bentham is a small, tightly knit team and Quin is generally reluctant to appear in the media the media.

But on the 10-year anniversary of the global financial crisis, and the 20-year anniversary of the fund's high yield bond strategy that he has overseen, it is an opportunity to dispel some myths.

And one myth is that credit, and in particular asset-backed securities, is a toxic asset class.

In a recent presentation to investors in which the *Financial Review* was in the audience, Quin tried to convince them to focus more on the movie *Moneyball* than audience, Quin tried to convince them to focus more on the movie *Moneyball* than *The Big Short* when thinking about this part of the credit market.

The Big Short did a fine job – via guest appearances from Margot Robbie and Anthony Bourdain – of explaining the role collaterised debt obligations played in almost blowing up the financial system.

"*The Big Short* is not great PR for asset-backed securities," Quin admitted in the presentation at the Portfolio Construction Strategies conference last month.

Margot Robbie in The Big Short.

But he says structured credit is now more a *Moneyball* story. That is the other Michael Lewis book-turned-film that told the story about how a major league baseball team used data to unearth undervalued talent.

Credit, like baseball, is rich with data. The data, he says, shows that structured credit such as asset-backed securities and collateralised debt obligations have done the job.

It is a little known fact, but from 1994 to 2013 there has not been a single default of AAA-rated or AA-rated CLOs.

The cumulative defaults of AAA and AA-rated corporate bonds is higher at 0.87 per cent and 1.13 per cent.

Brad Pitt plays Billy Beane, the general manager of the Oakland A's baseball team, in the 2011 movie Moneyball.

For the riskier component of CLOs, the BB-rated notes defaults over that period have tallied 2.3 per cent, according to a Wells Fargo study, compared to 16 per cent for corporate loans.

Double the spread

Yet investors can earn more than double the credit spread (the additional margin above a benchmark rate, such as the Australian bank bill swap rate) for investing in structured debt compared to 2006.

In Australia, investors can earn 3.4 times the spread from mortgage-backed securities compared to 2006.

But can we trust those AAA and AA credit ratings? The lesson of the crisis was that these assessments were deeply flawed.

"People have less trust in rating houses so they are trying to gain your trust by putting more protection into these structures," Quin says.

That typically means the issuers of these securities have to increase the amount of equity to absorb potential losses to achieve those AAA or AA credit ratings.

"The rating agencies are trying to rebuild their reputation. It's a cost to the borrower but for the investor it's a good place to be," he says.

Quin's overriding message is a decade after the financial crisis the disdain for apparently complex corporate debt remains. But so does the opportunity for sophisticated investors prepared to do the work, and for investors prepared to back them.

In the context of an average Australian investor's portfolio, an exposure to structured credit would provide a return of about 4 per cent versus a 2.5 per cent yield for the Australian fixed-interest index.

Such an exposure would also avoid equity market risk or interest rate risk (because interest paid is a floating rate so moves up as rates increase).

"Investors always want to be in equities because there's the opportunity for the upside kick, but there is always an opportunity for the downside kick," he says.

But Quin is adamant that investors reaching for yield in credit, even if you have the principles of *Moneyball* in mind, should not make the mistake of believing these investments are a proxy for cash.

In fact, if there's one topic Quin feels strongly about it is liquidity risk. It remains dangerously underestimated by credit investors with short memories.

In January 2008, while he was still at Credit Suisse, Quin penned a white paper titled *Valuations and Liquidity in 2008*.

It was a response to what he was seeing among his competitors – they had large exposures to private loans but were a little slow to revalue them after a dramatic change in conditions.

He outlined that a well-constructed, open-ended credit fund should obey several basic principles: have market-to-market pricing to facilitate investments and redemptions, be diversified by issuer and industry (more so than an equity portfolio), invest in senior and secure exposures and invest in large markets with a broad mix of investors.

"When credit portfolios are constructed contrary to the principles of credit portfolio management theory we believe that investors are exposed to risks for which they are not generally compensated," he wrote in January 2008.

At the time that included some credit funds and mortgage trusts which were famously frozen in 2008 and ASX-listed hybrids which tanked in value.

"An ASX listing does not guarantee liquidity," he wrote.

Remaining vigilant

Those principles apply now more than ever, but he says there's evidence bad habits are creeping back into the industry and he's remaining vigilant despite the apparent value on offer in the asset class.

Though he says structured credit is providing investors with good value, there are some potential land mines that corporate debt investors need to avoid.

He's a little bearish on high-yield corporate bonds and the fund has been shorting emerging market debt, which he says offers little value to investors currently.

In the aftermath of the crisis, his fund was aggressively buying up Australian bank hybrids issued overseas that were trading as low as 30¢ in the dollar. It was a tough job convincing investors that the Australian banks were safe.

Today he's a little more cautious on the local banks which he says are still highly geared.

"The banks are like an asset-backed security but you are investing right at the bottom of the capital structure."

However, what worries Quin the most is the "high correlation" of the investments among the average Australians – they are highly exposed to the banks and the banking system through their holdings of stocks, hybrids, deposits and property investments.

"Gearing up the wrong collateral was a bad idea in 2008 and is still a bad idea."

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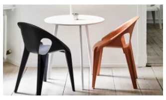

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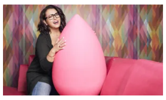

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