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INVESTORS AND INVESTING

BNA Insights: Retail Investors Face an Uphill Battle as Debts Surge

BY CRAIG WEINER AND CARLY KESSLER

Higher Risk, Higher Reward?

High-yield bonds, also known as ''junk bonds'' have a higher default risk compared to other bonds, e.g., investment grade bonds. However, high risks can come with high rewards, as junk bonds offer higher yields to those that have the risk appetite and are willing to invest. Since 2008, high-yield junk bond investors have infused roughly $240 billion into junk-bond funds. Now, with the junk bond market having posted its first annual loss since 2008, investors want their money back and they are slowly finding out that it won't be as simple as they had hoped.

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Mutual Funds Prepare to Defend Against Angry Investors

Just this past December, Third Avenue Focused Credit, a junk bond mutual fund, suspended investor redemptions in order to conduct a sale of its assets. The prohibition followed a period of many investor withdrawals and a declining junk bond market. The suspension was also fueled by anxious investors demanding withdrawal which the fund could not meet by selling assets at what it considered to be ''rational'' prices. Ultimately, the fund explained that they would ''gate'' their funds, meaning that investors could not receive their money until the assets were sold at a later date. Unsurprisingly, the filing of a securities class action lawsuit followed soon after. The suit was announced on February 2, 2016, on behalf of frustrated investors of the mutual fund who purchased securities between March 1, 2013 and December 10, 2015. The complaint accused Third Avenue with violations of the Securities Act of 1933. Specifically, the complaint alleges that defendants failed to disclose that the fund had taken on excessive amounts of illiquid securities as it grew in size, more than tripling from approximately $1 billion to about $3.5 billion from 2012 to 2014. The lawyer for William Engel, lead plaintiff on behalf of fund investors, commented ''Third Avenue is a mutual fund. They treated it like it was a hedge fund. Third Avenue had more than two years of warning that a high number of redemptions was coming, but kept buying illiquid, untraded securities. This conduct is reckless.'' Around the

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same time, Stone Lion Capital Partners and Lucidus Capital Partners announced they would liquidate their entire portfolios. Like Third Avenue, Stone Lion told investors they could not receive their money until the assets were sold at a later date.

Retail Investors at Risk

Retail investors in junk bonds should fear the possibility that their investments will not be seeing much, if any, return. For example, increasing bankruptcies and the potential of more bankruptcies of retail companies and oil and gas companies, which issue junk bonds, has led to additional risks associated with these mutual funds. Ultimately, the more investors that demand their money back, the more certain it becomes that the underlying value of the assets held in mutual funds become worth pennies on the dollar. Jack Delaney of *Money Morning* explained the risks of investing in high yield bonds, stating, ''First, investing in junk bonds means that you have to be comfortable with never receiving your money back. If the company goes bankrupt, you will not only lose your yield, but you will also lose your entire principal.'' Further, even when bond issuers survive bankruptcy, bondholders do not always get cash, but may receive stocks, bonds, warrants, or some combination of them in exchange for their defaulted bonds. Eventually, if a number of these bonds are held in a mutual fund, it will crater the price of the fund, forcing it to freeze its assets and suspend investor redemptions, which is what is currently happening to funds like Third Avenue.

Opposing Predictions From the Experts

Bob Phillips, managing principal at Spectrum Management Group, warns that now is not the time to be taking risks in the high-yield market and that it is imperative for investors to balance risk and reward carefully before making any decisions. Jeffrey Gundlach of DoubleLine Capital took a similar approach, stating to *Forbes*, ''Now is a time to not be a hero. It is a time to protect your capital.'' Gundlach stated in December that the Federal Reserve may regret increasing rates because of the worsening financial situation. He also remarked, ''Credit fund bankruptcies are coming. It's not a market to be flopping around in. The trends are relentless and powerful.'' Furthermore, Jack Delaney warns retail investors to stay away from the junk bond market. However, others seem more optimistic as Adam Richmond, head of U.S. corporate-credit strategy at Morgan Stanley told *Bloomberg Business*, ''Even if the cycle has turned and defaults will trend higher over multiple years, high yield can still see a positive return in 2016.'' Yet, retail investors should be aware of the potential that they may not be able to get their funds back.

We believe that additional litigation and bankruptcies are on the horizon and a prudent investor will consider market conditions and react accordingly.

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