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Savvy Moves for the Deleveraged Age

Amid the rush to shore up balance sheets, asset prices have tumbled. But the new focus on risk could be a good thing for investors

By [Ben Levisohn](#)

Deleveraging is the bogeyman of the current financial crisis. In order to shore up balance sheets, investors of all stripes have been forced to sell assets of all stripes, causing stocks to crumble, bond prices to plummet, and the value of everything from commodities to real estate to crater.

But for investors with cash, patience, and know-how, deleveraging may be good news. After years of pricing in little risk, all sorts of markets are pricing in boatloads. Says Ben Thompson, a principal at Samson Capital Advisors, a fixed-income manager: "The risk pendulum has swung the other way."

In theory, the more risk investors take, the greater their potential returns. But the risk premium goes out the window when almost anyone can get his hands on cheap cash. One good example: Investors had ample access to low-cost capital during the dot-com boom. Stocks became expensive—the ratio of the Standard & Poor's 500 index's price to book value (book value is a company's shareholders equity divided by the total number of common shares outstanding) climbed to nearly five times book value in 1999, after historically trading around two. Even after the 2000 stock market crash, the ratio fell to only three times book. Starting in 2002, the markets became less volatile, reflecting reduced fear that prices could drop. And the spread on returns between risky and safe assets become almost negligible—in fixed-income markets, junk bonds yielded one percentage point more than investment-grade bonds, which returned one percentage point more than ultrasafe Treasuries.

Mispriced Risk

"Risk just wasn't priced appropriately," says Todd Youngberg, senior vice-president for high yield at the investment management arm of insurance company [Aviva](#) .

Investment returns languished. Since no one makes money on small gains, investors took on massive amounts of debt to boost returns. Investment banks jacked up their leverage to 30 times their capital from a historical level of around 10 times. Hedge funds produced huge returns, but it was almost impossible to know whether they were earned by a manager who made savvy stock or bond selections or one who used boatloads of debt to magnify small gains.

The urge to leverage extended beyond Wall Street. According to Sageworks, a financial analysis firm, American companies doubled their debt-to-sales ratio from 2003 to 2005, essentially using borrowed money to spur growth and keep their shares moving upward. And all that debt was packaged and repackaged, leveraging returns even further for investors who bought the securitized loans.

But all that debt had a downside, says Olivier Le Marois, chairman and senior business consultant at risk manager Risk Data. "Leveraging makes the true source of risk and returns less apparent," he says.

Forced Selling

The housing market collapse, which began in 2006, started a vicious circle of deleveraging. As housing prices fell, investors in real estate or securitized mortgage loans—banks, hedge funds, and mutual funds, to name a few—were forced to write down the value of the assets. Unfortunately, the securitized bundles were easy to create but difficult to sell, so firms writing down the value of these assets were forced to sell stocks and bonds instead to raise cash. As the asset values fell, the levered players, whose losses were multiplied 10, 20, even 30 times, had to sell even more to keep up.

The forced selling brought risk back, sending the VIX index, an equity-market gauge that tracks the volatility of options on the S&P 500, skyrocketing as high as 80—the highest reading on the "fear gauge" since 1987. Unlike the rosy view of the past five years, the VIX reflects investors' greatest fear: a return to Depression-like conditions. "The losses have been driven by distressed sellers," says Dory Wiley, an investment banker at Commerce Street Capital. "The more distressed the seller, the more the opportunities for the buyers."

For investors who want to keep their cash safe, Treasury bonds are the way to go, but with the Federal Reserve having cut rates to historical lows, that means accepting yields of 0%—or less—after inflation. But everyone else can pick and choose among asset classes and risk levels. Investors can get into top-rated municipal bonds—once considered nearly as safe as Treasuries—that yield around 4.42% tax free, compared with a 10-year Treasury note's taxable 2.19% yield—a stark reversal from 2006, when the same Treasury note returned 4.46% to the municipals' 3.56%.

Junk Bonds for Strong Stomachs

Investment-grade corporate bonds, a step up the risk ladder, yield about 8.5%, more than six percentage points higher than a Treasury. And even high-yield bonds may prove a solid bet for an investor with a strong stomach. Junk is now yielding more than 20%, which could still give investors double-digit returns in a Depression-like scenario if held to maturity, says Moody's Analytics economist Ben Garber. (One caveat: don't expect to make a quick buck. Bond prices may continue to fall, but bonds, if held to maturity, could produce the desired returns).

Stocks are cheaper than at any time since 1985, as measured by the price-to-book ratio of the S&P 500, according to UBS ([UBS](#)) strategist David Bianco. (It's currently around 1.8 but could fall to one, a level last reached in the late 1970s). For more safety, says Don Wordell, manager of the RidgeWorth Mid-Cap Value Equity Fund, look for companies with strong balance sheets.

For more risk-tolerant investors, bargains can be had in private equity—shares in the secondary market can now be purchased for less than 50¢ on the dollar—if an investor believes the fund can make profits without borrowed money. Others, including hedge fund [SJC Capital Partners](#), prefer to bypass the secondary loan market altogether, using their cash to make direct asset-backed loans with contractual returns nearing 15% to companies in need of cash.

Making money in the delevered world won't be easy, nor without pain, but nimble investors may still be able to find some attractive opportunities.

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