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A Dressing Down

Published on: 20 November, 2020 | Author: Investment Team

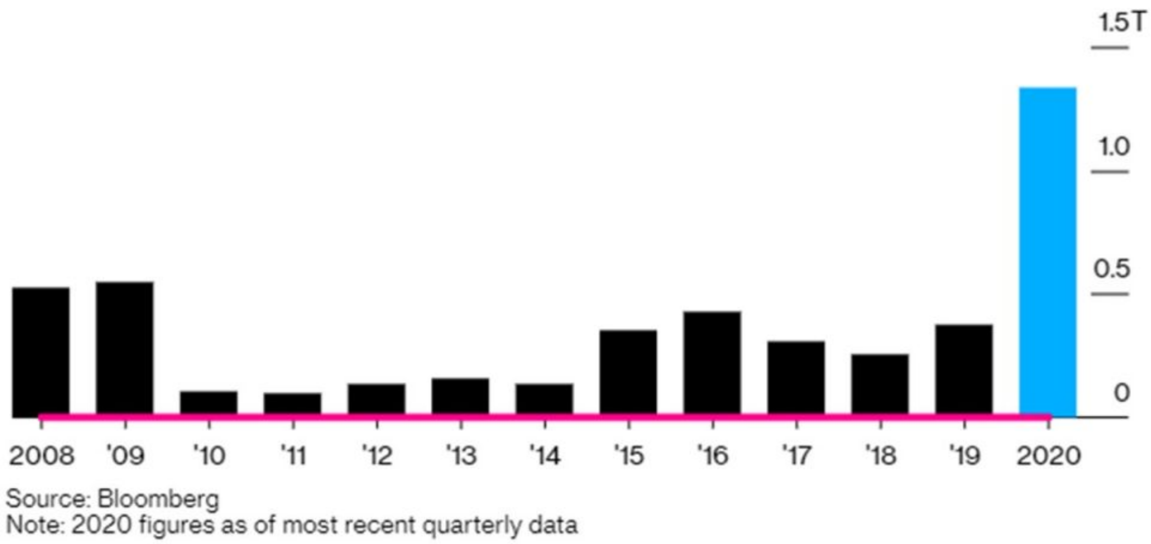
In Ancient Greece, people that defaulted on their debts were forced to sit in the marketplace with a basket placed over their heads. In 17th century Scotland, defaulters were required to wear a half yellow and half brown coat and cap in public. In France, they were ordered to wear a green bonnet.

While these may seem crude and barbaric when viewed through the lens of post Enlightenment modernity, they served a useful, albeit unpleasant evolutionary purpose. The basket over the head, brown and yellow coloured coats or a green bonnet were a signal of unreliability and poor financial strength. The stigma associated with defaulters also served a useful purpose as it discouraged other would-be defaulters from taking on excessive debt which they could not service.

Today, many large and well-known corporations are heavily indebted and often barely make enough profit to service the interest payments on their debts. Years of low interest rates and low defaults has encouraged financial recklessness.

Quantitative easing has distorted natural price signals, as falling bond yields has led to investors chasing yield at all cost. Currently, US junk bonds yield an extra 4.5% above US government bonds. This seems odd because:

1. We are currently in a global recession
2. This yield spread is in line with historical averages i.e. junk bond yields are currently indicating that this is a normal period
3. Corporate debt levels are at all time highs as shown below for corporate America



The announcement of vaccines from Pfizer, Moderna and Oxford University are welcome news. Countless lives will be saved, the misery of forced lockdowns will ease, and some form of normality will return.

However, the corporate carnage caused by the pandemic is not over. While we have increased our equity exposure over the last month, this has been very selective. We have avoided the “cheap” but heavily leveraged companies. Some of these companies may well recover unscathed but the risk of defaults and further financial stress is not a necessary risk to take, especially when highly cash-generative, predictable and unleveraged equities rendered cheaper as equity markets retrenched in response to the pandemic are now available for purchase at reasonable prices.

The ancient Greeks, Scots and French who forced defaulters to wear funny coats and hats were cruel but collectively understood the importance of discouraging bad behaviour for the greater benefit of the society. If the executives of highly leveraged companies that defaulted on their debts were forced forever to wear a green bonnet in public, perhaps others would think twice before using excessive debt to financially engineer higher returns.