

On Bankruptcy

Published on: 19 February, 2021 | Author: Investment Team

“How did you go bankrupt?” Bill asked.

“Two ways,” Mike said. “Gradually and then suddenly.”

“What brought it on?”

“Friends,” said Mike. “I had a lot of friends. False friends. Then I had creditors, too. Probably had more creditors than anybody in England.”

Perhaps Mike in Hemingway’s story should have paid more attention to his Shakespeare at school, “Neither a lender nor a borrower be.”

In reality, as the Bard makes only too clear in *The Merchant of Venice*, even a pre-capitalist economy needs a balance of willing lenders and willing borrowers. The problem is, of course, that not all borrowers are “good” and not all lenders are “sympathetic” when things go awry.

Joseph Schumpeter saw the bankruptcy process as part of the “creative destruction” of capitalism replacing old inefficient firms with new and forward-looking dynamic firms.

The combination of the two crises of our age; the Global Financial Crisis of 2008 and the Covid pandemic have put the finances of both individuals and corporations under enormous pressure, bringing the insolvency process into the spotlight.

As in many areas of life, attitudes to insolvency across the shores of the Atlantic reveal deep cultural differences between the US and Europe.

In the US, Chapter 11 bankruptcy filings in 2020 rose by 26%. By contrast, according to the UK insolvency service, the number of company liquidations dropped to a 10-year low even as Covid was raging. In Germany, France and Spain insolvency applications dropped by between 6% and 40% in the same period.

The reason speaks to the different approach to handling financial failure even in times of great stress. The European approach has been to conserve and protect businesses by supporting company cashflows with transfer payments, furlough schemes and cheap loans. That is also true of the US, but to a much lesser extent. In the US, insolvency is very much part of the mix with firms being allowed to fail more readily. Capitalism, “red in tooth and claw,” as it were.

Some commentators fear that too much financial assistance from central authorities, accelerated by the onset of the Covid pandemic, has impaired the creative destruction and renewal that Schumpeter spoke of, impairing innovation, leading to large numbers of so-called “Zombie” firms. That is, firms that are not truly economically viable but dependant on cheap credit, assistance, and easy loans for their survival.

This conundrum for investors is made more difficult because, as we know, stock markets often have a loose connection with the underlying economy.

Paradoxically, markets often do well in periods of recession because interest rates tend to be lower and government funding is made available. One of the key criticisms of the Quantitative Easing programmes has been that much of the

money created has simply stayed in financial markets and, because final demand has been weak, has never found its way to the real economy.

Very often, as economies recover after a recession, it is then that insolvencies begin to accelerate as assistance stops, interest rate expectations begin to deteriorate, and weak companies find it harder to raise new funds or roll over maturing debt.

That is why, we are deeply sceptical of high yield credit at the moment, because we believe that as the economy recovers, somewhat counter-intuitively, default rates will rise. We know from earlier cycles that short-dated, high yield debt, is not a safe place to be in an economic recovery as money flows from the financial economy to the real economy.

The first part of the advice given by poor old Polonius to his son was mistaken. It is not a question of never being a borrower or a lender; it is a question of choosing when to be a borrower or a lender.

The second half of his paternal counsel was, perhaps, more prescient. A loan to someone close does indeed, "oft lose itself and friend."

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