RBC Global Asset Management

# How distressed debt can help spread risk and diversify returns

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**"We believe there has been a 'perfect storm' brewing in markets in recent years."**

**In 2024, there are multiple macroeconomic and geopolitical challenges that are set to continue to impact global markets. At the same time these challenges are likely to lead to a rich opportunity set for a special situations investment strategy.**

We would start off by noting that distressed debt and special situations investing represents an evergreen opportunity, as companies can experience stress or distress at any point of the economic cycle. Companies can get into difficulty for idiosyncratic reasons such as bad luck, bad business plans, or excess leverage. Furthermore, even without a broad economic downturn, specific sectors can face significant challenges. For instance, retail and related sectors have faced considerable disruption due to digitalisation.

We believe there has been a 'perfect storm' brewing in markets in recent years. Many companies went into the Covid-19 pandemic highly levered and emerged with even more leverage and reduced profitability. After the pandemic, supply chain disruptions, higher interest rates and inflation – felt initially through higher commodity and energy prices – further hampered companies' ability to bounce back. Most significantly, interest rates have broken out of a thirty-year downward cycle, and consumers and corporates are now facing much more challenging financing conditions.

Against a backdrop of potentially volatile traditional asset markets, a special situations/ distressed debt strategy can provide access to a diversified pool of idiosyncratic investments uncorrelated to each other and risk assets in general.

Notwithstanding a 'black swan' event such as the Global Financial Crisis, there is unlikely to be a massive rise in defaults. However, because the size of the market has grown considerably over the past fifteen years, even a modest rise in the default rate would mean that the volume of defaults could be similar to that seen in 2008/09. As more than a decade's worth of quantitative easing and cheap borrowing is unravelled. We anticipate a protracted period of unwinding, with multiple opportunities for a distressed/special situations strategy, across a broad range of sectors and jurisdictions.

Identifying the best opportunities, A skilled and experienced investment team should be able to identify and build a diversified portfolio with considerable downside protection combined with asymmetry to the upside.

One approach we take is to group opportunities into three principal categories: stressed, distressed and event-driven.

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Stressed credit opportunities include bonds or bank debt trading at a discount as part of a market sell-off or idiosyncratic issues with the companies issuing the debt. These companies will usually be able to resolve their issues without restructuring their debt and bonds can be sold at a higher valuation later or potentially held to maturity. This is essentially a ‘passive’ strategy, buying low and selling high without rolling your sleeves up and engaging in a process.

Distressed debt is entirely different. These opportunities involve a much more active approach and a financial and/or operational restructuring, having bought bonds or bank debt at very low prices. To do this effectively, we strive to be a part of ad hoc groups of bondholders in order to achieve the best outcome for our investors. These situations often involve a debt-for-equity swap where you end up owning a different set of investments at the conclusion of the process.

Meanwhile, event-driven opportunities are similar to stressed opportunities but where a catalyst exists for a recovery in market pricing. This could be anything from an M&A event to a rating upgrade or something as simple as having a better outlook for a company than the market. This approach may even involve holding equities when a company is trading at an attractive valuation.

Defaults are increasing, and we expect this trend to continue. The opportunity for distressed debt and special situations is wide-ranging across sectors and geographies. For those investors seeking a potentially higher yielding and diversifying investment return, they would do well to consider this asset class.

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