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Pensions Seek Magic 8% With Neglected Junk Debt

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U.S. pension-plan managers are pouring cash into debt from the smallest speculative-grade borrowers, seeking to meet targeted 8 percent returns at a time when average yields are at about record lows.

California's San Bernardino County Employees' Retirement Association, which oversees $6.1 billion, is poised to recommend investing in a fund from Tennenbaum Capital Partners LLC that exclusively focuses on lending to smaller companies. The New York State Common Retirement Fund, with about $150.3 billion of assets, committed money to funds from Brightwood Capital Advisors LLC and Monroe Capital Partners LP this year.

Figure 1 Loans to smaller companies had a 12-month trailing default rate of 1.25 percent in May, compared with 1.05 percent for bigger companies, according to S&P LCD. Photographer: Daniel Acker/Bloomberg

Fund managers that oversee retirees' health and pension benefits are seeking the debt of smaller junk-rated borrowers, pushed toward riskier investments as the Federal Reserve pledges to hold interest rates near zero through 2014. Borrowers with $500 million or less in annual revenue are paying disproportionately higher yields as U.S. banks reduce commercial and industrial lending by 12 percent from the 2008 peak.

"We like this space," Donald Pierce, chief investment officer of the San Bernardino County pension plan, said yesterday in a telephone interview. "This segment of the marketplace is having a tough time accessing capital," he said.

Middle-market loans have average yields of 7.8 percent compared with 6.6 percent on large corporate obligations, according to Standard & Poor's Capital IQ Leveraged Commentary & Data. S&P LCD defines middle market as issuers with earnings before interest, taxes, depreciation and amortization of $50 million or less.

'Getting Traction'

Loans to smaller companies had a 12-month trailing default rate of 1.25 percent in May, compared with 1.05 percent for bigger companies, according to S&P LCD.

Pension plans are poised to play a bigger role in financing the smallest companies after banks reduced commercial and industrial loans and leases to $1.4 trillion as of May 30, from $1.6 trillion on Oct. 22, 2008, according to Fed data.

"The strategy is definitely getting traction," said Frank Barbarino, a consultant with NEPC LLC, an investment adviser. "It's that magic 7 to 8 percent number that institutions are shooting for at the plan level. Many are willing to lock up their capital for a few years in order to add strategies that help them get there."

Elsewhere in credit markets, the cost of protecting corporate bonds from default in the U.S. rose, with the Markit CDX North America Investment Grade Index, which investors use to hedge against losses or to speculate on creditworthiness, climbing by 0.9 basis point to a mid-price of 124.3 basis points as of 11:24 a.m. in New York, according to prices compiled by Bloomberg.

Bondholder Protection

The index typically rises as investor confidence deteriorates and falls as it deteriorates. Credit-default swaps pay the buyer face value if a borrower fails to meet its obligations, less the value of the defaulted debt. A basis point equals $1,000 annually on a contract protecting $10 million of debt.

The U.S. two-year interest-rate swap spread, a measure of bond market stress, declined 0.03 basis point to 30.18 basis points as of 11:24 a.m. in New York. The gauge narrows when investors favor assets such as corporate bonds and widens when they seek the perceived safety of government securities.

Embraer Bonds

Bonds of Brazil's Embraer SA (EMBR3) are the most actively traded dollar-denominated corporate securities by dealers today, with 60 trades of $1 million or more as of 11:26 a.m. in New York, according to Trace, the bond-price reporting system of the Financial Industry Regulatory Authority. The world's fourth- biggest planemaker sold $500 million of 5.15 percent, 10-year bonds yesterday.

San Bernardino's pension plan, attracted by bigger yields and more favorable covenants, is setting its sights on the smallest borrowers as it faces an actuarial rate of 7.75 percent, Pierce said. Pensions for public employees typically trail the 8 percent average yearly gains that officials set as their benchmark to cover rising costs.

The New York State Common Retirement Fund allotted money for the first time this year to funds from Chicago-based Monroe and New York-based Brightwood Capital, which is led by Damien Dwin and Sengal Selassie. Both firms focus on investing in smaller companies.

'Actuarial Needs'

Pennsylvania's Public School Employees' Retirement Board, which oversaw $50.8 billion as of March 31, 2011, agreed in March to invest as much as $200 million in Cerberus Institutional Partners V LP.

The fund will buy "distressed assets on a global basis" and invest in "private-equity turnarounds focused on the middle market," according to a Feb. 16 letter to the pension plan's trustees from Portfolio Advisors LLC, recommending the investment.

"All these pension funds have a huge issue right now: they need to hit a 7 to 8 percent annual return in order to hit their actuarial needs," said Theodore Koenig, Monroe Capital's chief executive officer. "The market isn't giving them that."

Demand for the debt comes as smaller companies seek a place to borrow. Issuance of loans to the smallest companies has declined to $3.77 billion for the first five months of the year, compared with $7.59 billion during the comparable period in 2011, the S&P LCD data show. In the first five months of 2007, the borrowers sold $15.3 billion of loans.

"In the large-cap market, the maturity wall has been pushed out with the ability to issue high-yield debt in 2011 and 2012," Monroe Capital's Koenig said. "In the middle market, that has not been the case."

'Pulled Away'

About $130 billion of loans that are less than $100 million each are coming due in the next five years, according to Newstar Financial Inc.

"The banks have pulled away in fairly significant ways over the past several years although they're returning to the market in some capacity," Barbarino said. "Middle-market loan volumes are down, and banks are focused on larger companies."

Corporate bonds and loans set to mature through 2014 tumbled 66 percent to $413 billion as of last September from $1.2 trillion at the end of 2008, according to JPMorgan Chase & Co. research.

U.S. leveraged loan issuance has totaled $257.7 billion this year and $603.6 billion in 2011, Bloomberg data show. U.S. junk bond sales have totaled $138.5 billion this year.

Issuance of collateralized loan obligations may reach $30 billion this year, JPMorgan said in April. That's down from $91.1 billion at the peak of the market in 2007, according to Bloomberg and Morgan Stanley data. CLOs buy high-yield, high- risk loans, including those from smaller companies and slices them into securities of varying risk and return.

'Thinned Dramatically'

"We have seen a couple of new entrants in the market, but as you know, the middle-market lender universe has been thinned dramatically over the past few years," said Timothy Conway, Newstar's chief executive officer, in a May 2 earnings call.

Pension plans are facing "lackluster" returns in 2011 that weren't sufficient to offset rising liabilities, causing funding gaps that are poised to widen, according to a Feb. 14 Fitch Ratings report.

The California Public Employees' Retirement System, the largest U.S. pension, has seen its market value decline 4.8 percent this year after stocks fell amid the brewing fiscal crisis in Europe and slowing of the U.S. economic recovery.

Investment-grade bonds yield 3.49 percent, according to Bank of America Merrill Lynch index data, while U.S. Treasury 10-year notes are at 1.66 percent. Including reinvested dividends, the S&P 500 (SPX) has returned 6.3 percent this year after gaining 2.1 percent in 2011.

"Pension plans are really looking to expand the list of approved investments," said Mark Oline, Fitch Ratings' global head of corporate ratings in Chicago. "Secured loans were not very common in the asset list but are gaining favor in portfolios."