October 2015

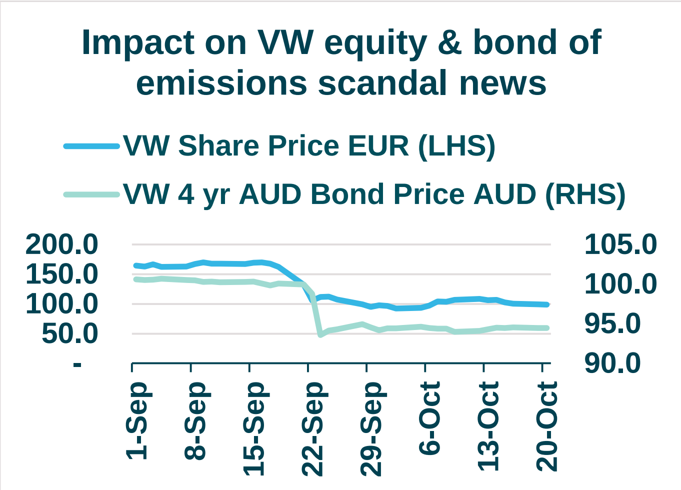
Alas, Das Auto

It's been a rough few months for the global economy as financial markets vacillate over the timing of eventual United States Federal Reserve rate hikes – will they begin in September, October, December or ever…

September nonfarm payrolls[1] disappointed at 142,000 jobs gained (well below the 201,000 expectation), August payrolls were revised downward to 136,000 and consensus grew for zero rates enduring over the remainder of 2015. Somewhat counterintuitively, markets rallied, content in the knowledge easy money would last a bit longer, stimulating risk assets.

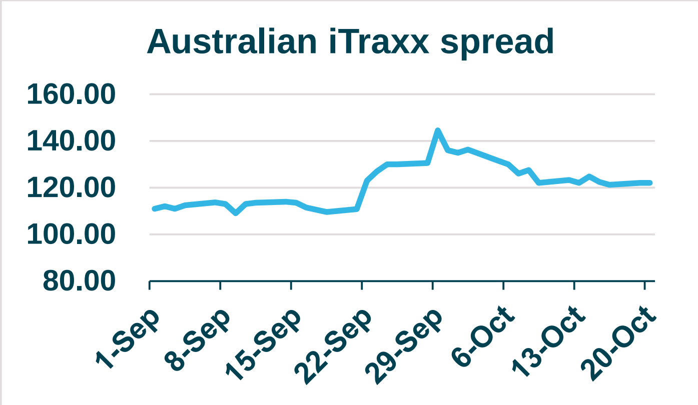
Despite continuing low rates and easy money remaining in most of the developed world, not all credits rallied. Two names stood out as major headaches for investors over the third quarter, Volkswagen (VW) and Glencore.

Glencore's equity fell 64% over the quarter amidst a commodity downturn and ballooning debt, while VW's equity fell 53% following an emissions testing scandal. Unsurprisingly, Glencore and VW were amongst the worst performing bonds in the Australian market over the quarter with VW's 4yr AUD bond falling 5.6%, in the week following the scandal, as the chart below shows.



Source: Bloomberg

The misfortune of VW spread throughout other auto names causing a sell-off across the board, highlighting the surprising impact a single name can have on an already jittery market. Spreads on the Australian iTraxx credit default index (a broad proxy for Australian investment grade credit) rose more than 0.30% following the news.



Source: Bloomberg

While there will always be default risk for every issuer, in the investment grade world, deterioration in credit quality tends to be slow moving and well telegraphed. Rapid, unexpected defaults in the investment grade universe are rare, with two important exceptions:
1) Issuers with too much leverage and a reliance on short-term funding, or
2) Issuers committing fraud.

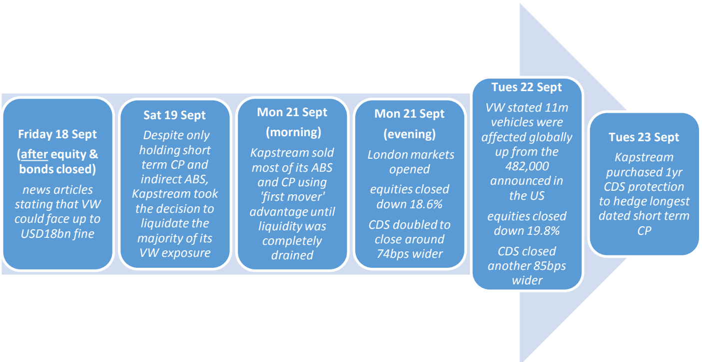
Reflecting Kapstream's role as a low volatility, 'sleep at night' manager, Glencore was excluded from our investment universe as we have perpetually avoided highly indebted companies, and have always been cautious of issuers in the volatile mining industry.

VW, however, remained on our radar, although we focused only on short-dated, high quality collateralized asset-backed securities, and commercial paper of 1 to 5 months' maturity. Fortunately, we retained a general reluctance in holding longer-dated automotive names, given the cyclical and relatively volatile nature of the industry.

[1] As of 2 October 2015

Nonetheless, even conservative VW positions were impacted following release of the US Environment Protection Authority's (EPA) notice on Friday 18th September (after equity and bond markets closed). In their disclosure, the EPA announced a 'Notice of Violation of the Clean Air Act' (CAA) after VW admitted certain vehicles contained emission 'defeat devices'. It was alleged that affected cars – numbering 482,000 diesel vehicles in the US – emitted nitrogen oxide up to 40x over the limit. Under the CAA, the Justice department could impose fines of up to US$37,500 per vehicle, totalling US$18bn. The US$18bn figure equated to 21% of the company's stock market cap and we expected the problem to be worldwide given the globalised nature of car sales and environmental regulations.

Over the weekend of September 19th & 20th the Kapstream team resolved – given the overarching 'sleep at night' philosophy applying to the flagship strategy – to move swiftly first thing on Monday to dramatically reduce exposure to VW. We were able to sell all of our asset-backed securities and about a quarter of our commercial paper through the day, predominantly the longer-dated issues, exhausting the Australian market of VW liquidity. We were somewhat surprised that securities were sold close to their Friday closing marks – we suspect because markets hadn't fully digested the impact of the EPA violation. However, by Monday evening as London opened, the market began trading based on more dire scenarios, with equities closing down 18.6% and credit default swaps widening 74 basis points, almost doubling. As VW's corporate bond liquidity evaporated over the following days, we also purchased 1yr credit default swap protection to insure our remaining commercial paper exposure.



Guten Nacht…

While we continue to expect VW to survive this scandal, many unknowns remain:

- US regulatory investigators include the EPA, Department of Justice, California Air Board, Congress, and potentially 50 state attorney-generals, could all impose fines
- 11 million cars potentially impacted globally mean international litigation and fines will go on for years
- Consumer and investor litigation over false statements
- Dealer litigation over unsalable inventory
- Fall-off in sales due to reputational damage
- Repair costs

In our view VW simply ceased to be a 'sleep at night' position, despite the relatively short maturity profile of less than 5 months. We're thankful we're not equity managers, as it's hard for us to see any silver lining in VW's long-term prospects.

In managing our fixed-income portfolios we continue to maintain a conservative stance, holding interest rate duration at 0.9 years and maintaining our 'liquidity bucket' of cash and government-related securities above 20%, and we continue to firmly favour higher-quality assets. Most of our portfolios are managed with capital preservation as an objective of equal billing with absolute return targets, and (although we believe investors may benefit from taking greater risks in fixed income portfolios over the medium term) the lesson of VW is one of unforeseen impact, and while the environment remains uncertain we prefer to avoid compromising on our promise to investors to protect their capital.