

Investing in troubled companies takes nerve, says Mutual Recovery fund manager Michael Embler: “When we get a gun to our heads, we aren’t the first ones to blink.”

READY TO REBOUNCE

BY DYAN MACHAN PHOTOGRAPHS BY BILL CRAMER

LIKE TRUFFLE hunting, duck migration and hurricanes, investing in distressed securities requires perfect conditions. But instead of tall weeds or low-pressure zones, distress investors wait for the scent of layoffs in the air, consumers near paralysis—and escalating numbers of companies with crushing debt. Once those companies are driven

to such desperation that they’ll pay a premium for cash to bail themselves out, it’s happy hunting for the scavengers.

These vultures are the highly specialized investors who buy distressed securities—the bonds and stocks of companies teetering on the brink of Chapter 11 bankruptcy. While such companies may

not seem ideal candidates for investment dollars, they lure opportunists with an eye for a deal. This asset class has grown rapidly in recent years: There’s \$350 billion in “dedicated investments,” a combination of invested capital and money pooled for future investing—up from \$100 billion five years ago, according to Edward Altman, professor of finance at New York



Most mutual funds shy away from the volatile returns of distressed securities, but Embler and Mutual Series CEO Peter Langerman (right) have profited from plunging in.

University. The potential returns are high when the timing is right. In 2003, the year after the last surge of corporate bankruptcies, defaulted bonds and loans—the benchmark that economists say best reflects the performance of distressed securities—returned 49 percent.

Distress investors typically buy the debt of a troubled company from its original investors and then try to influence the process as the company restructures or implements a turnaround. They have to assess whether management can reach its goals, while also taking an educated guess at the future value of hellishly complicated classes of debt. When it comes to mutual funds, there aren't many willing to navigate this tangled world. Returns are volatile and highly cyclical, which makes them a hard sell for fund investors. Most players work for hedge funds, where they can take bigger risks and earn vastly more money.

Peter Langerman and Michael Embler, CEO and CIO, respectively, of the \$75 billion Mutual Series family of

funds, are proud exceptions to this rule. They're accustomed to wading through the muck of insolvency: Langerman is a former bankruptcy lawyer, while Embler is the cofounder of the *Daily Bankruptcy Review*, a publication of Dow Jones (which, along with Hearst Magazines, owns SMARTMONEY). Embler went on to a career in distressed investing; he's been the portfolio manager of the Franklin Mutual Recovery fund, the Mutual Series unit that specializes in distressed securities, since its inception in 2003. Since then its returns have barely beaten the market (returning 58 percent, versus the S&P's 54 percent), but this style of investing is extremely cyclical—and the new cycle is just beginning.

Since Langerman and Embler have teamed up, the Recovery fund has developed a reputation for behind-the-scenes acumen and sharp elbows. Prominent high-yield investors call Embler one of the best in the field. When financier Carl Icahn was fighting for greater influence over struggling Time Warner in 2005

and 2006, "Mike Embler was his secret weapon," says Brad Scheler, partner at New York law firm Fried Frank. Embler and Langerman also benefit from the counsel of Wilbur Ross, the private-equity investor known to some as "the bankruptcy king" for his work overhauling companies in the steel and auto industries. Ross has made several joint investments with Mutual Series.

Given the gloomy economic headlines, you might think investors with this pedigree would be making money hand over fist. But even with today's recession-like conditions and jittery markets, it's still early in the game. Corporate bankruptcies and debt defaults, though rising, remain low. What's more, because of the intricacies of the Chapter 11 process, there's a lag time between any wave of defaults and big distressed-investing gains. Still, the winds are changing rapidly. Over the past two years, the number of corporate bonds that yield at least 10 percentage points more than a 10-year Treasury bond has grown

fivefold—a sign of a looming default surge, says Altman. “It’s not a matter of if but when,” agrees Embler, adding ominously, “it’s coming.”

Naturally, opportunistic investors don’t operate out of plush offices. Perched in a white concrete building off a busy highway in Short Hills, N.J., the Mutual Series conference room is artless and spare. With similar dispassion Langerman and Embler told SMARTMONEY about why they are keeping their powder dry for now. But with some prodding they also spoke about where they expect to find the best hunting and how they can be nice guys in a cutthroat business.

SMARTMONEY: What’s the best way to think of distressed investing?

EMBLER: The assets of a bankrupt company are a pie. There isn’t enough pie to go around to all the creditors, so the creditors wind up fighting to get their share.

SM: Where are we in the cycle?

LANGERMAN: We are in a slowdown, and there is clear evidence we are in a recession—whether we are technically or not. Spreads have widened dramatically, which is a clear sign of the increasing risk. Investors want to be compensated for taking the additional credit risk. Most of the market news has been negative—AIG’s announcement that it had overestimated derivative valuations and even the French rogue trader scandal. The market is panicky, and investors are freaking out.

SM: When was the last time we had, uh, great conditions?

LANGERMAN: In the past 15 years, there were two upticks. Following the Drexel financing boom in the late

1980s, many companies were saddled with high-yield debt. After the dot-com bust in 2001, there were opportunities in highly leveraged telecoms and companies like Tyco.

SM: How much do you have invested now?

LANGERMAN: A couple of percentage points—almost nothing across all six funds.

SM: Wait, this is an article about distressed securities, and you hardly hold any!

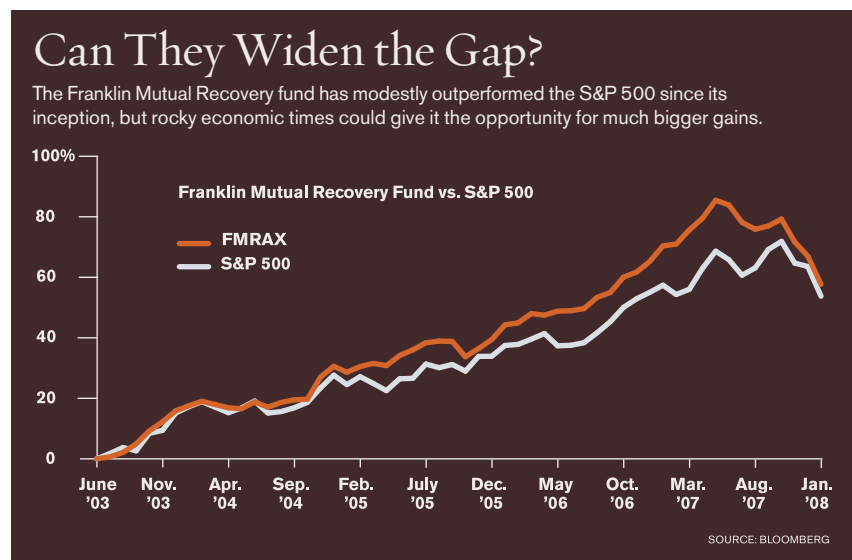
LANGERMAN: It’s still early. There is one company—which we can’t yet name—where we are building a position. It’s not distressed credit per se but a company that’s emerging from bankruptcy. It’s very difficult for it to get financing, with the credit markets in such disarray. So it’s trading at distressed prices. There may be other opportunities like that. The mortgage crisis has now spread outside the financial institutions and is manifesting in different places.

SM: Where else can we expect to see some action?

LANGERMAN: There is a record supply of leveraged buyouts that are running into trouble. The investment banks are trying to get some of that LBO debt off their balance sheets. Prices have come down on LBO paper another 5 percent from where they were a few weeks ago.

SM: Normally, rapidly increasing defaults follow the increase in interest-rate spreads and the record lending we have seen in recent years. Why are defaults still so low?

EMBLER: In the last round of financings in 2006 and 2007, there was huge demand for borrowers, so the lenders made terms more lenient. It used to be if the debt-to-cash flow became too high, a company went into default. Now lax covenants prolong their lives. Plus, private-equity funds still have a lot of cash they haven’t spent. They go in and put companies on life support that might otherwise default.



SM: Will particular sectors become vulnerable?

LANGERMAN: No sector themes have emerged except for home builders and financials—we're doing our homework now. The places to look are the LBOs, like [real estate broker] Realty, which was taken private in 2007, just as housing hit a wall. Last year \$1.2 billion of its existing debt was downgraded. Linens 'n Things, the home-furnishings retailer, went private in 2006 and is struggling because people redecorate when they move. Both have too much debt and are on our radar screen. But we don't own the bonds.

SM: What do you own?

LANGERMAN: We own senior secured bank debt of First Data, which was brought private by leveraged-buyout firm Kohlberg Kravis Roberts in 2007. First Data is highly leveraged but an excellent company that's the market leader in supplying credit card companies with back-office operations

for their transactions. Its senior notes have drifted into the 80-cent range. But its debt is well covered with cash flow, it has a seven-year maturity and returns 10 percent. It won't be a double or triple, but it seems like little downside and a decent yield.

SM: Tell us about an investment that made the homework worthwhile.

EMBLER: Telewest, the largest cable company in the U.K., was caught in the telecom meltdown, and we bought half of an unsecured note at 15 cents on the dollar in 2003 on the likely bet that it would be converted to equity. When it did, we quadrupled our money in 18 months. We still own Virgin Media, the successor company.

SM: Why can't we try this at home?

EMBLER: You have to roll up your sleeves. In the case of Telewest, I had to work with creditors and management and push for our rights. Every day there are discussions and decisions—it's time-consuming. The



Peter Langerman talks about profiting from troubled companies, in a video interview at smartmoney.com/mag.

securities are hard to buy, and even if you could, I shudder to think what you would have to pay in trading costs.

SM: Another reason?

LANGERMAN: Volatility. Take [home-loan provider] Countrywide. While Bank of America is investing in the equity, it hasn't yet decided how the debt will be treated. So if B of A announces it won't refinance Countrywide's debt, it could sink very rapidly. Another example we don't own is Delphi, the auto-parts dealer in bankruptcy. Delphi bonds over the past couple of years have traded at 30 cents to par [\$1] and back to 30 cents. Prices fluctuate with General Motors' news on labor agreements, issues with pensions, short squeezes and macroeconomic headwinds.

EMBLER: I bought the unsecured debt of Ampad, which made yellow legal pads. It was getting crushed by cheap competition in 1998. At the end of the day, the bonds were wiped out.

SM: This is a street-fighting business, yet you two seem like gentlemen.

EMBLER: You can be tough and not a jerk. We have been at this a long time and plan to stay in it. It helps to have sizable assets. When we get a gun to our head, we generally aren't the ones to blink first.

SM: And if the bears are right and we do head into a recession?

EMBLER: We'll be ready.

Funds That Swim With the Sharks

Most individual investors can't invest directly in distressed securities. But these mutual funds have taken calculated risks with troubled companies and seen them pay off.

Fund (Ticker)	Five-Year Return (%)	Expense Ratio (%)	Comments
FPA Crescent (FPACX)	12.96	1.25	This go-anywhere fund keeps a high cash balance until it finds out-of-favor stocks; it also buys distressed debt.
Fidelity Capital and Income (FAGIX)	12.27	0.75	A mostly bond fund with a twist: Up to 20 percent of holdings are in bonds rated B or lower.
Mutual Shares (TESIX)	12.60	1.10	Like its cousin Franklin Mutual Recovery, a deep-value fund that dabbles in distressed debt.
Third Avenue Value (TAVFX)	18.29	1.08	Veteran manager Marty Whitman has recently been buying beaten-up financial stocks.
Wintergreen* (WGRNX)	-	1.91	Invest-anywhere fund run by Mutual Series alum David Winters. Currently buying "sin" stocks in gambling, tobacco.

Data as of 2/11/08; returns are annualized. *Fund launched 10/17/05.

SOURCES: MORNINGSTAR; SMARTMONEY