The Capital Advisor presents III:
A Corporate Treasurer's Guide to Investment Challenges

CORPORATE RESEARCH

Treading Merck-y Waters: How to Cope with Event Risk?

On the day Merck announced the withdrawal of its arthritis drug Vioxx, its stock price closed down 27% from the previous day. By the time Moody's downgraded Merck's debt to Aa2 40 days later, the formerly AAA-rated company had lost 42%, or $58 billion of its equity value.

Is it time for investors of short-duration corporate securities to head for the exit on Merck? How does one prevent against Merck-like incidents in the future? These are but a few examples of the lingering questions from our corporate treasurer clients regarding their cash portfolios.

Merck's fall from grace highlights the need to address event risk -- a risk that inundates even the most experienced risk managers throughout credit cycles. Here, we offer some perspectives on dealing with this type of risk for corporate cash investors.

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What is Event Risk?
Event risk refers to the risk of a severe and sudden loss in a security's value due to an unexpected event. Such events may include corporate takeovers, operational errors and accounting fraud, stock market crashes, major regulatory changes, terrorism, and natural disasters.

Event risks can be either company-specific or industry-wide. Merck's drug liability case represents a company-specific risk, while asbestos and tobacco litigations are industry-wide. Credit events can occur any where at any time. Fannie Mae, American International Group, and Shell Oil Company are some of the other AAA-rated companies that have subjected their investors to event risk in 2004.

Characteristics of Event Risk
It is important to be cognizant of the characteristics of event risk to appreciate its potential impact on a portfolio. It can be difficult to predict, frequently causes a liquidity crunch or even crisis, and often results in market contagion.

Difficult to predict: By definition, event risk refers to the occurrence of an adverse corporate or market event that catches the investor by surprise. Either by natural occurrence, such as a major hurricane, or by human design, such as the WorldCom fraud case, credit events often do not provide a clue ahead of their outbreak. When the market is focused on a certain type of event risk, it tends to correct itself until a different type of event risk shows up elsewhere.

Liquidity crunch: Liquidity problems from event risk are two-fold: inability to sell current holdings and reduced credit quality from the credit's lack of funding. Unlike stocks, which are traded on exchanges, broker-dealers sell bonds "over-the-counter." In volatile market conditions, liquidity often dries up, thanks to a lack the of interest by broker-dealers to “make a market.” In extreme cases, an investor may not be able to sell a security at all.

A credit event can also trigger a cash flow crisis that shut down an issuer’s funding channels, further reducing its credit quality. Finance companies are particularly vulnerable to liquidity crunches, as they finance major portions of their balance sheets with commercial paper and notes so as to support loan balances and to rollover old debt.

Contagion effect: The phenomenon of events in one security or one market triggering large movements in other securities or markets in a domino fashion is called a contagion effect. As an example, bonds of other painkiller makers, Pfizer included, sold off briefly after the recall of Merck’s Vioxx. Often times, the initial shock is not the worst, as one event can precipitate other events and lead to contagion across markets that result in systemic risk affecting many securities.

Being Prepared for Event Risk

Event risk is unpredictable by definition. However, there are ways a corporate investor can prepare for expected events. In fact, one of the positive outcomes of the latest credit cycle has been an increased emphasis on event risk preparedness.

Diversify, diversify, and diversify: Regardless of investment objectives or asset classes, risk diversification remains a key event risk management tool. When a portfolio is sufficiently diversified among asset types, industry sectors, and geographical locations, the impact of a credit event to the portfolio is likely to be greatly diminished. For example, a corporate bond investor can reduce risk by investing in high-grade sovereign and supranational securities that are not subject to events affecting the corporate world. Similarly, a portfolio of unsecured bonds may weather risk better by including asset-backed securities, which offer the double benefit of instant diversification and being secured by collateral. Please refer to our recent article, “Asset-backed securities: Do they belong in corporate accounts?” for detailed information on the subject.

Maintain a high credit quality bias: Should an adverse event occur to a credit, a portfolio of highly rated securities provides a rating cushion. For example, even though Merck received a severe three-notch downgrade from Standard & Poor’s to AA-, it retains its double-A status, a very high credit measure. By contrast, Tyco International, a formerly Baa1 credit, reached the junk status of Ba2 after three downgrades in two months by Moody’s. Given the principal preservation and liquidity concerns of corporate cash investors, we disagree with the notion that a shorter duration portfolio can afford to take on more credit risk. The yield benefit of buying a lower rated bond may not justify the added credit and liquidity risks.

Invest in public securities only: The ability to get out of a troubled position immediately is paramount to a corporate cash investor, especially one with unstable cash flows. It is essential to purchase commercial paper offered by at least two dealers, and refrain from investing in proprietary brokerage products, such as auction rate securities. Liquidity of a proprietary product becomes extremely constrained in a volatile market, when the ability and willingness of the broker-dealers to hold illiquid or unsafe securities are greatly reduced.

Look for telltale signs from management: Even though many credit events hit without warning, a company's management behavior, such as its appetite for financial or business risk, can broadcast certain warning signals to an alert investor. For example, an issuer with a history of aggressive earnings per share growth targets and a large share buyback program may suggest a higher probability of mergers or acquisitions financed by debt. A flamboyant CEO with a lavish lifestyle may imply an ineffective board of directors or sub-standard internal control measures.

Dealing with a Credit Event after It Occurs

On more occasions than not, an investor can deal only with the after effects of a sudden credit event. Having a cool head and a methodical process is extremely important in working through a credit situation.

Get a reality check: Half the battle in dealing with a credit event is to maintain a calm and analytical state of mind. At the early stage of an outbreak, information is frequently incomplete, inconclusive, and conflicting. The investor needs to quickly assess whether the event represents a real credit risk, a substantially lower credit quality of investment at hand, or mere headline risk as the result of sensationalized reporting by the financial press.

For example, when Fannie Mae's regulator turned up disturbing evidence about the company's accounting practices, much of the widening in its agency debt was unwarranted since the credit quality of Fannie Mae's senior debt is supported by its implicit government guarantees, not by the company's operating or financial positions.

Assess the aftershock: It is prudent to anticipate the effect of an aftershock. Risk managers, always aware of contagion risk, frequently identify potentially hidden risks by understanding the connections between securities and markets. Sometimes, even when no near-term weakening of credit is expected, severe deterioration may occur due to loss of management creditability, higher funding cost, increased liquidity risk, and investor's general reluctance of returning to the issuer.

Maintain current position: From time to time, an investor may fall victim to the "fast finger" syndrome, and dump securities at the first sign of a credit problem. Such an investor may suffer the market equivalent of "whiplash", as the value of a security tends to go down sharply just as the news breaks, and then trades at a higher level when investors decide to get back into the security. When one is sufficiently confident of a limited credit impact on a highly rated security, it is generally advisable to ride out the storm by holding onto the security.

Reduce exposure when warranted: Other times, a risky move is holding on to a problem credit too long. Psychologically speaking, some people tend to be "loss adverse" rather than "risk adverse", i.e. they unwittingly take on more risk by holding onto bad credits in the hope of avoiding losses. For short-term portfolios with cash flow fluctuations, taking a realized loss and getting out of a tarnished credit before liquidity dries up can sometimes be a prudent move.

Conclusion
In summary, a short-duration corporate cash portfolio is not immune from event risk that has plagued longer-term fixed income portfolios. Since a credit event often occurs unexpectedly, investors need to place greater emphasis on diversification, maintain a high credit quality bias, invest in liquid public securities, and be wary of management risk appetite. While there is no easy answer whether to hold or sell a security, strong fundamental knowledge of the credit in question, the portfolio's cash flow needs and the investor's risk tolerance should guide decisions. While often tempting, increasing exposure to a distressed credit is generally discouraged in a corporate cash portfolio.

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