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Zombie Apocalypse
By Alan Snyder

We are living the movie. A pandemic sweeps the country. An intrepid band of survivors seeks a safe place, which is, interestingly enough, on Catalina Island *(Ed. Note*: we live in California). All the way they are dodging zombies, analogous to us seeking safe havens versus additional losses on our hard-earned capital. No, we are not a heavenly messenger revealing the end of time and unveiling things not previously known (the apocalypse), but we do have thoughts to share about the seismic shift caused by Covid-19.

Imagine five birds sitting cheek by jowl on a wire. You shoot one, which falls to the ground. How many birds are left on the wire? None - the remaining four flew away. We are surrounded by swirling opinions flying about. Yet, we must hunker down and measure tactical responses against longer term strategy.

Situational Analysis
The Known Known

We have witnessed the fastest and sharpest drop ever experienced in the S&P 500. Recent equity market ebullience, not really shared in the debt markets, belies any awful economic news ahead. Volatility in all asset classes has been record setting.

1. Economic forecasts widely differ; however, the March report on Leading Economic Indicators (LEI) showed the largest drop in 60 years.
2. The impact from the virus on infections or deaths may be peaking but is such good result sustainable? No one knows or has the reliable data. Uncertainty abounds.
3. Supply chains have been broken.
4. The Covid-19 impact is global leaving no country unscathed.

As steely-eyed investors and shepherds of capital, we cannot assume the fetal position, calling out for Mom. Whether we project a V-, U-, or L-shaped recovery, we must be as rationally creative as possible, think deeply about knock on effects and ponder timing of decisions.

It is an election year. Fiscal restraint, wisely or not, has been furloughed; there have been three programs to date with common agreement of more to come. Trillions are in the offing. But, one must consider the percolation time for these funds getting from financial assets, to Main Street, and to the unemployed as well as the intermediate-term ramifications (inflation?).

Powell and the Fed got the message, the money presses are working overtime. Ruminate about this next example being put in place over the next month or so: As part of TALF (Term Asset-Backed Securities Loan Facility, administered by the Federal Reserve), loans will be made on a non-recourse basis at low rates with about a 10% investment against investment grade ABS (Asset Backed Securities), e.g., mortgages, collateralized loan obligations (CLO), CMBS, etc. Good or bad, we are talking about serious leverage and cheaply garnered with substantial gain potential at current prices. Want some?

Creativity Counts

Catching a falling sword by investing in beaten down stocks or bonds is worth noting. To do so, demands belief that further declines will not be significant and that the underlying businesses are strong enough to survive. Alternatively, some will seek to participate in further dislocations.

1. The obviously hammered – auto, entertainment, travel, gig companies, energy, nursing homes, assisted care, REITs with leverage, business development companies (BDCs).
2. Less obvious – hospitals, and surgical centers with no elective procedures, prosthetic providers, auto property and casualty insurers. Unsecured consumer loans are at risk. Lending Club, Prosper, etc. are seeing negative impact from consumers making hard choices on what to pay first, i.e., make a payment to them or keep cell phone and auto loans current? It is early, but "Katie, bar the door" in our view. In addition, there are many areas in structured finance ABS that have been hammered. In some cases, the pummeling exceeds any historical measures of default rates such as with BBB and BB CLOs.
3. Hard assets – they may not have the speculative upside of some of the earlier examples. However, there is enduring value that is not potentially ephemeral. Gold, Bitcoin with its fixed supply, cell towers, data centers solar arrays, collectibles (coins, stamps, high-end watches, and our favorite, museum-quality art, other specialty real estate such as warehouses). Does one invest in the asset or lend against it? Being long, clearly, has more upside with the concomitant risk of time for re-appreciation. Lending, possibly at an attractive yield, limits downside albeit truncates upside. Yet, what port in the storm fits which piece of one's portfolio diversification? It just may be hybrid vehicles that can capture both: yield plus an equity participation in the upside.

OK, real estate placed last, even though it can be a great investment. The watchword in all of the above, including real estate, is the degree of leverage. Leverage adds risk because historically anticipated cash flows may be substantially reduced from the current kerfuffle. The leverage provider may demand that interest and/or principal payments be made to avoid foreclosure and loss of the asset. Forbearance may not be offered to the debtor. Most tenants, whether commercial or residential, have stopped paying rent and make the cheese more binding for many real estate investments.

In sum, all of us must define our risk appetite in our search for return. Our myopia leads us to art lending with equity participation for a goal of double-digit returns. Ah, the power of durable compounding, the eighth wonder of the world!

As usual, we have no perfect crystal ball, but do seek to remove any clouds from yours. Please share your insights because we are shameless in the pursuit of good ideas. Silence, in this case, is not golden.