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Student loans, mortgages, regulation offering opportunity for credit hedge funds

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First it was mortgages, now student loans are gaining the attention of hedge funds focused on finding returns in credit. Student loan debt which is hitting all time highs as tuition increases and more people get advanced degrees hoping for a better job market when they emerge from school. However, the rate of student loan default is also on the rise as the job market hasn't been all that welcoming to recent graduates. Taken together, some funds are eyeing a new opportunity set - shorting student debt.

"The growth in the student loan sector has been growing since the crisis. Without any new subprime mortgage origination, there is now more student loan debt outstanding than subprime mortgage," says Chris Hentemann, Managing Partner at New York-based 400 Capital, a credit focused hedge fund. He spoke with Opalesque after speaking on a panel during the Skybridge Alternatives (SALT) Conference in Las Vegas.

"We learned from the subprime crisis that homeownership is a privilege not a right. The same may be true with education as the price of that asset keeps going up. Who can manage that debt?" Hentemann says. "The current employment environment is not absorbing the new graduates and we are seeing that borrowers are not finding the jobs needed to repay the debt. You can see a correction occurring as delinquencies and defaults rise."

Sallie Mae, one of the largest providers of student loans in the US also provides securitization of those loans in the asset backed securities (ABS) market similar to how mortgage backed securities (MBS) are offered. Hentemann notes that some of these loans, just like mortgages, are better than others. "We are focused primarily on the loans that are between 97-100% guaranteed by the US government." Meaning that they will be paid up to at least the point of guarantee.

While it is not possible to get outright short student loan debt, there are ways to be opportunistically positioned. "This is a market that is experiencing some distress and one where there are likely to be some changes in the landscape going forward. As a result we are trying to position ourselves to take advantage of this distress by being long the parts of the market where prices are overly pessimistic while being short through CDS, equities or other instruments, or simply avoiding securities which will be negatively impacted by changes in the landscape," Hentemann explains.

He is also taking a more positive view of mortgages as growth in that space comes more quickly than many expected, given the depth of the 2008 crisis. "Our biggest current surprise has been the momentum in the mortgage recovery. We positioned our portfolio for performance in mortgage credit without being dependent on a directional recovery but retained a structurally leveraged position to the upside recovery," he says.

Going forward, Hentemann sees significant opportunity in the mortgage space as originators return to giving mortgages only to those with the best credit histories. "Although mortgage origination never completely stopped, recent origination has to have perfect credit qualifications such that we expect default rates to be very low in the like it was in the mid '90's after the last correction. Given this environment for origination, we see the mortgage opportunity like buying high grade risk for high yield prices."

During his presentation at SALT, Hentemann also outlined opportunities arising from new regulation. Changes for banks including the capitalization requirements in Basel III and the Volcker Rule will return credit risk to the domain of lightly regulated, hedge fund "specialists." He also noted opportunities in commercial real estate in the US due to these changes.

Hentemann pushed back against those who say a correction is coming in the credit space, noting specific risks instead of an overall bubble. "In mortgage credit, you will see the usual volatility-driven disruptions, but not an outright correction. We aren't quite there yet. The main place we see a risk of a correction in MBS is in agency MBS which have been crowded by the REITs, and the leverage there is a red flag for us."

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