STS Partners Fund, named best fixed income/credit hedge fund at the Americas Awards 2012, is run by deep-value, buy-and-hold investors such as Deer Park Road Corporation president Michael Craig-Scheckman, reports Kris Devasabai

Finding jewels among the ‘junk’

Michael Craig-Scheckman, founder and president of Deer Park Road Corporation and portfolio manager of the STS Partners Fund, likens his investment strategy to running a “bond junkyard”.

As a deep value investor specialising in distressed mortgage and asset-backed fixed income securities (MBS and ABS), he says his job is to “sort through the wrecks and find the salvageable parts”.

Craig-Scheckman looks to buy high-yielding distressed MBS and ABS securities at deep discounts to what he thinks they are worth, and then waits patiently for a buyer that will pay a high price for the bonds.

“A junkyard owner buys a pile of discarded spare parts at low prices and waits for someone who needs an axle or a shaft to come in... that’s essentially what we’re doing with MBS and ABS,” says Craig-Scheckman. “That’s essentially what we’re doing with MBS and ABS, with the difference being that all our junkyard parts are cashflow generating.”

Purchasing unwanted bonds has proven to be a lucrative strategy. The STS Partners Fund has posted annualised returns of 29.87% since inception in 2008 with 4.96% volatility and no losing years.

The fund returned nearly 24% in 2011 despite a sharp decline in the price of many MBS and ABS securities in the second half of the year. The portfolio contains around 250 to 300 securities. Of this, 65%–80% is in primarily non-agency residential MBS and the rest in other ABS, including bonds backed by commercial mortgages, car loans and aircraft leases.

The bonds in the portfolio generate cashflow of 3%–5% a month and have an average duration of two to four years.

In selecting investments for the fund, Craig-Scheckman...
We don’t have hedges in the portfolio because we consider ourselves to be investors, not traders... I also have concerns about the liquidity of the ABX indexes. You pay a huge liquidity premium to get in and out of those trades. You end up giving away chunks of return.

Craig-Scheckman currently sees the most value in subprime mortgage bonds.

The fund owns a number of subprime mezzanine bonds with trigger mechanisms that could release principal payments to mezzanine tranches if certain collateral tests are met in the future.

Deer Park also has significant exposure to subprime credit interest only (IOs), many of which were purchased from distressed sellers at steep discounts.

The biggest position in the portfolio is an aircraft lease ABS. Deer Park Road first purchased the bond in 2010 and took advantage of distressed sellers to increase its position significantly in the first half of 2012. The bond, which is backed by a legacy pool of aircraft leases that have performed poorly, provides for the liquidation of the underlying assets in certain circumstances.

Deer Park Road’s initial analysis revealed the position would generate a 15% yield if there was no liquidation and 25% in the event of liquidation. The bond went into liquidation in late 2011 and two airplanes have already been sold, netting the fund a tidy return.