

# GRANT'S

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## Corporate debt pre-mortem

Postmortems of the next financial crisis will be forthcoming at a respectable interval after the yet unscheduled train wreck. For the anticipatory analysis of what will go wrong, consult an essay just posted on the social-sciences website SSRN. It's free to all comers.

The lead author is Daniel Zwirn, CEO and CIO of Arena Investors, L.P., and the paper is top flight. "This Time Is Different, but It Will End the Same Way" is the short-form title. Zwirn and his co-authors, Jim Kyung-Soo Liew and Ahmad Ajakh, identify five big changes that will likely contribute to the next display of cyclical fireworks. They are:

- the lack of market-making and other regulatory changes that will impede price discovery in the next downturn;

- the masking of the deterioration of underlying collateral and "rearview mirror" analysis;

- new versions of the old games played by the rating agencies;

- an explosion in asset-liability mismatched structures;

- regulatory changes in the compliance of financial institutions.

A summary of the first point affords a fair preview of the tone and correctness of this formidable opus. "To fully understand trading dynamics," the authors write, "one must understand asymmetric market-making risks, whereby in up markets these underlying OTC securities trade relatively efficiently, but in down markets their liquidity and the market-makers that supply it complete-

ly disappear. In down markets, redemption suspensions will catch corporate-bond ETFs and mutual-fund investors by surprise and result in tremendous confusion and possible retail investor panic, as this asset-liability mismatch becomes evident. The investors in the assets—ETFs and mutual funds—will be shocked to find that they cannot quickly redeem because the underlying OTC securities will have no bids, and thus, no exits."

The paper runs to 50 pages, complete with footnotes and bibliography (Zwirn's co-authors are faculty members of the Johns Hopkins Carey Business School). It's a must-read.

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