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Investing Perplexity - Diminishing returns in a changing world

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- History repeats itself but with a twist
- Wall of cash feedback loop- But what unintended consequences?
- Can 1 + 1 = 3, as in stable returns, safety and scalability?
- What about now?

<u>History repeats itself but with a twist</u>

As 2021 unfolds we are experiencing new and radically different conditions, both in the historic context, and relative to what we would have expected from the global pandemic.

Context- In economic and market terms, the cycle produced a deep but short recession. It is concentrated in social proximity dependent sectors, and small businesses. These and their employees have been devastated. But the recession is now over for the vast majority of businesses. It appears the long cycle beginning in 2010 continues, with activity working back to levels before Covid hit. This long cycle likely continues and has been characterized as slow growth overall but punctuated by rolling recessions in specific sectors such as carbon energy and big box retail. This pattern continues, with Covid causing steep continuing recessions in travel and leisure but limited in context of the broader economy. The lower for longer growth and rate outlook appears to be even lower for longer, in what appears to be an extension and reshaping of an already decade long cycle.

Expectations- It could have been a sharp and long-lasting contraction across the board for all industries. However, as 2020 unfolded post Covid, it became clear that the Quantum QE unleashed by the Fed, plus a huge fiscal injection, created a firebreak that prevented a 2009 recession free-fall, and enabled recovery for most sectors.

However, both the shape and the pace of the recovery continue to disappoint. First there was the expectation of a V recovery, which resumed when terrific vaccine developments suggested a snapback. But surges of Covid 2nd and 3rd waves across the globe continue. We have the good fortune of multiple vaccines arriving albeit fitful deployment so far. Progress here, together with the tidal wave of government injected cash, monetary and fiscal, provides an unprecedented trifecta of support for the economy, which will stimulate demand. The accumulating cash will be spent, including on financial assets. The companion to this is uncertainty, as the economy likely reshapes itself as underlying human behaviors change in ways that may or may not be obvious. The key of course is confidence of consumers, investors, and citizens.

Wall of cash feedback loop- But what unintended consequences?

The questions are likely not if there will be any consequences, but what these may be. The obvious ones are more asset inflation plus an ever-widening wealth gap and the related political ramifications. A big issue that will frame the near-term future, and likely longer, is how societies and the economy adapt to Covid.

This may range from things such as changing spending patterns, to something as fundamental as the disruption of education at all levels. The latter is one example of how profound undercurrents of change may be. If Covid recurs like the flu, to quote a Sicilian author, "If we want things to stay as they are, things will have to change".[1]

In the financial world the massive flows of government supplied cash have stimulated transaction activity and elevated asset prices even more than before.
In this ecosystem, expanding debt issuance, both the necessary variety and opportunistic re-financings, plus M&A activity, is burgeoning. In Leveraged Finance, the combination of PE's $ 1.5 Trillion of "dry powder" and unprecedented systemic cash, plus intensified investor "search for yield", is generating much activity. In the capital markets ecosystem, the effects of a negative real risk-free rate, plus the imbalance of greater investor demand than supply is further elevating

[1] Giuseppe Tomasi di Lampedusa, The Leopard

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valuations. For fixed income investors, the increasing demand compresses low yields even further.

Can 1 + 1 = 3, as in stable returns, safety and scalability?

One conclusion has been to allocate more to “income” producing assets, of which rent-based real estate is the most long lived, but also most troubled example. Another is to embrace “hybrid” investment strategies, such as using leverage or derivatives, to enhance underlying asset class returns. While “hybrids” introduce complexity, they can be value added. Combining “income” producing assets with leverage can be compelling.

The first consideration should be the asset class. In this environment selecting ones where returns are primarily cash driven makes sense given valuation trajectories. Also, cash generation reflects the underlying entities’ economic activity in real terms, whether asset prices reflect this or not. In this sense price appreciation can be viewed as an option instead of being the main driver of returns. Price appreciation is important, and indeed over time, it is the measure that the underlying entity is creating value and/or growth. But for returns to primarily depend on the future market prices, this means more dependency on variability and volatility. Cash flow is the bedrock of valuation, and the more this is the driver of return, the more dependable that will be.

Investing in a “hybrid” solution, such as using debt to increase returns, has become mainstream with the Broadly Syndicated Loan (“BSL”) asset class. Leverage and BSLs pair very successfully together, as vividly demonstrated in the 2009 recession, and more recently last year. This pairing works for two reasons. The first is non mark-to-market debt where fund portfolio cash flows effect repayment, not forced asset sales. The second is that the leverage magnifies “net” cash flows, which are after deductions for any losses, and these have been a fraction of interest income in even the most draconian scenarios. As such, leverage does not amplify any potential losses, which are funded by the income stream, but instead increases the level of returns. The two factors function independently. The long-term debt is repaid by BSL principal cash flows, whereas costs and realized losses are funded by robust interest income cash flows.

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The key fact enabling what may appear to be counterintuitive, is that while an individual BSL can have high credit risk, a broadly diversified portfolio of them does not. Its aggregate cash flows absorb all costs. The net result is attractive excess returns earned on safely invested capital.

Since this works so well, how much leverage could be employed? Quite a lot actually. The "efficient" level is a function of cost and impact on returns, as more debt increases costs and reduces investment flexibility. In maximizing leverage, the "efficient frontier" for BSL CLOs is 9X or so, and it can produce above or below 15% IRRs, depending on the manager. Lower leverage can also be very attractive, as the thicker junior capital layer means cash returns have little variation irrespective of market and economic environments. A 35% junior capital layer, which means 2 parts debt and 1 part equity, can generate 8%+ returns, and ratcheting the debt to 3X the equity or more, takes this into double digits. As most institutional investors globally seek a stable 7-8% annual return from all asset classes combined, a 2X levered CLO can be a good fit, especially as capital can be invested at scale, repeatedly, and frequently. It should be noted that BSL portfolio cash flows, leveraged or not, have low correlations to other investments, as these are the pooled cash flows of idiosyncratic borrowers across diversified industries. They also offer an exposure to the US economy very different from multinational public companies, or Direct Lending at the other end of the size and risk spectrum.

<u>What about now?</u>

Aren't BSLs, CLOs and credit generally, impacted by the forces affecting other asset classes, namely lower returns, more indebted borrowers, and in the case of BSLs, fewer investor protections?

BSLs number approximately 1200 borrowers, whose debt held by institutional investors totals $1.2 trillion. This is in addition to what originating banks retain which is mostly in the form of committed revolving credits. This BSL asset class subset held by investors is now almost as large as the High Yield universe and estimated to be 40% larger than Direct Lending. In the BSL world, as in the two adjacent asset classes, there is wide dispersion of borrower types and degrees of credit risk.

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For the latter, the most important consideration is the borrower's ability to handle leverage in all plausible scenarios.

BSLs, unlike High Yield or Direct Lending, have been an orphan asset class for some investors. There are several reasons for this. Unlike High Yield, which has been an asset class since Milken created it in the '80s, BSLs are neither fixed rate nor securities, although they have CUSIPSs. BSLs are originated, agented and syndicated by the leading banks, which for some reason, is the inverse appeal of Direct Lending, which are not. It will be interesting to see how Direct Lending, this new and popular asset class, fares in a severe recession, which these loans have yet to experience having come into existence post GFC. By comparison, BSLs are produced by the most experienced and informed credit originators, and have an important positive risk characteristic, among many, which is larger company size. BSLs have market transparency including credit agency ratings, and are liquid, so can be actively managed for both risk management and portfolio optimization. BSL managers have the option to be "private side" which provides non-public information including access to borrower managements. Most importantly, BSLs can be assembled into diversified portfolios in short order, which is what creates the loss absorbing net income streams that safeguard invested capital. Also, with talk of reflation, it is worth recalling that BSLs and CLOs, are floating rate. All attractive features.

What about BSL credit quality today?
Over the past decade and before, the credit quality of the average borrower has been improving. Top-down credit statistics indicate otherwise, but this does not capture the fact that the enterprise value of many BSL borrowers has been rising, with many consisting of enterprise software providers and other companies with recurring revenues. While many of these are value added services companies, there are many industrials which have a high proportion of contractual revenue.

Today BSL credit quality is strong, especially given the 2020 recession. Separate from the safety afforded by diversification, and in the CLO format from the structure, the troubled sectors of the economy are largely absent. By definition, there are no small businesses in the BSL asset class, and the large ones that are social proximity dependent are small industry subsets (travel, leisure, hospitality).

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Healthcare, which is a large industry in BSLs, was affected but has been recovering. Where BSL portfolios had notable deterioration, that is “credit migration” to CCC/Caa or lower, it was due to borrowers of all types already “on the edge”. The shock of 2Q2020 had a significant impact. In addition, there were downgrades from an arguable overreaction by Rating Agencies. Nonetheless, default rates are low, and likely to remain so considering we had a recession, and one that continues severely in specific sectors.

It is an unfortunate fact that traditional contractual investor protections, namely covenants, continue to erode, but this is very transparent, and factors into the assessment of how much any debt a borrower can take on. The question is what level of debt allows a borrower to maintain credit worthiness in a stress situation, and is the risk adjusted return appropriate? Credit investing can produce bad results as has been proven many times over. The causes are concentrated risk, mispriced risk, or worse, both. The spectrum of credit opportunities is wide, as are potential pitfalls, and this is part of a long continuum where experience is exponentially beneficial.

BSL portfolios maybe a safe asset class relative to individual BSLs, but what about returns?
Unique for a capital markets’ product, BSL new issue pricing (the contractual spread plus original issue discount) has to meet a fairly concrete “higher of” threshold. It has to meet the requirements of the underwriting banks, whose capital charges have risen steadily, and those of investors. The latter include CLOs which are over 70% of the “buyside”. CLOs fund these investments with debt and equity issuance, the combination of which must be sufficiently below the asset returns for these investments to work. BSL returns have in effect a double yield floor, the level both the banks require, and that of the investors, principally, CLOs. While interest rates and other returns set new lows, BSL returns oscillate and can compress over the cycle and in volatility down-spikes but continue within an attractive risk adjusted band. When BSL spreads at times downshift also due to supply/demand imbalance pressure, the same happens on the liability side, so CLOs continue to be issued. The CLO AAA spread compression underway reflects QE flows which of course continue. In this unprecedented environment, where different decisions may be necessary,

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BSLs, especially in a “hybrid” form with leverage, continue to offer attractive returns where the investor can select the target level and employ the related strategy. For CLOs, another set of factors benefitting returns, is the optionality to improve asset spreads and liability costs. In downcycles and market volatility, these long-term funds can reinvest in “cheaper” loans. When the opposite occurs and spreads tighten, CLO debt has short non-call periods that enable refinancing or re-setting the fund to lower liability costs. The BSL asset class and CLOs are both battle tested, and the latter is flexible to take advantage of changing environments.

As mentioned in prior AGL quarterly commentaries, we recommend that BSL strategies should be in all institutional portfolios.

Thank you, best Peter

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