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Preparing for 2023 – Defensive but Constructive Credit Investing

A pending US recession and continuing market volatility has induced caution and a "risk off" mindset for most investors. Exacerbating this is the first steep rate hike cycle in decades. While new issue bond yields are higher and incremental equity purchases cheaper, the price-based total returns of existing investments are down and under continuing pressure. The direction and rate of change in asset class valuations has disrupted conventional allocation models including the 60-40 equity / fixed income model.

What has not changed is the need for cash income investments suitable for the current and prospective environment in terms of risk profile and target returns. Necessary caution notwithstanding, prudent investments can still be made. Relatedly, most asset prices have declined significantly and are "discounting" the future outlook which the IMF characterized as a "confluence of calamities" earlier this year. While a defensive posture is appropriate for both repositioning and new allocations, timing considerations are also relevant, as the "bottom" can well occur within a year or sooner. This will require action now, as some periods of time are better entry points than others, and "bottoms" are difficult if not impossible to recognize at the time. So long-term investors are best served by "averaging-in" but prudently so.

Private Credit is expanding and includes portfolios of senior secured floating rate loans to corporate borrowers. These consist of two adjacent, both defensive, asset classes: bank originated broadly syndicated loans (BSLs) and asset manager offerings in Direct Lending (DL). These currently total $1.5 Trillion and approximately $750 Billion respectively and since 2005 the former has grown 11% per annum and the latter by 16%.

BSLs, which are liquid and trade in a deep and active daily secondary market, are now steeply discounted. "Regular way" loans that traded at 99+ in January have been close to 90 in recent weeks (note that risk premia for expected and unexpected losses are priced into the credit spread at the time of issuance). Are these discounted enough? My view is that not one but possibly three moderate recessions are priced in, or a single one more severe than the Great Recession of 2009. And this does not count the contribution of the credit spread for potential credit losses, which has averaged 4% per annum over the floating SOFR or LIBOR base rate. On a price basis, a relevant concept is the "breakeven" level. This means the exit price where invested capital is returned but no return is generated. For example, the market convention of credit losses is 30% or 40% for a defaulted BSL (based on 70% or 60% recovery rates), the so-called Loss Given Default ("LGD") for computing realized credit costs. This can also be incurred by selling a loan at a realized loss before or after any default. To illustrate the point and being conservative, with all things relatively equal in a portfolio, consider a 60% average recovery rate, so a 40 bp LGD for all 1% portfolio defaults.

This is a 4% LGD each time at 10% defaults, and 8% LGD at 20%. At a 92 price level, the implied default rate in "breakeven" terms, can be viewed to be 20% in addition to the average 2-2.5% level priced in the credit spread. In cumulative terms, this 20% default rate could be in one or any number of years. If we are entering a severe recession with a cumulative 3-year 20% default rate, this could be either 6.6% as a constant default rate (the market term is "CDR") or a mix of different default rates in different years such as 5%, 10%, 5%. If such levels occur, equity and many other assets would be worthless in valuation terms. For reference, the 2008-2010 default sequence, measured in dollars, for all BSLs was 3.8%, 9.6% and 1.9% which cumulatively was 15.3%. As BSL prices have averaged close to a 90-dollar price (versus par of 100) many times so far this year, the "breakeven" price has approximated a 20% cumulative rate at such times. Prices are likely to move in and out of this zone in the coming months, and I expect the future price bias to be downward as disappointing news may continue to exceed positive developments.

Table 1: Annual Credit Losses at Various Default Rates

Annual Default Rate	Recovery Rate	Loss Given Default	Annual Credit Losses
1%	60%	40%	0.40%
2%	60%	40%	0.80%
3%	60%	40%	1.20%
4%	60%	40%	1.60%
5%	60%	40%	2.00%
10%	**60%**	**40%**	**4.00%**
20%	**60%**	**40%**	**8.00%**

Table 2: Implied Credit Losses at Various Price Levels

Loan Index Price Level	Total Implied Credit Loss	Implied Total Default Rate (Given 60% Recovery)
$88.0	12.0%	30.0%
$90.0	10.0%	25.0%
$92.0	**8.0%**	**20.0%**
$93.0	**7.0%**	**17.5%**

Current levels = $92.4
as of 10/11/2022

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To summarize, current BSL prices can be used to estimate the extent to which future losses can be absorbed. As noted, this does not incorporate the contribution of the credit spread component of cash yields, which also contain compensation for potential losses. This framework can serve as a guide to consider how deeply discounted BSL prices are.

These fluctuating price and all-in return levels (contractual spread plus purchase price discount) present an opportunity to invest in BSLs with a comparatively high degree of safety coupled with outsized excess returns, especially on a relative value basis. Existing DLs are not readily accessible as these do not trade, but like new issue BSLs, new originations today have wide contractual spreads and original issue discounts.

What about investing with leverage in this environment? CLOs are the proven and recommended form of leverage to use. Their debt cost is more expensive in the current environment, but the benefits of BSL price discounts outweigh the higher interest expense, and "tier 1" managers can execute attractive new BSL investments with CLOs.

The BSL new issue market is open but supply has been interrupted by a financial market version of supply chain issues, as leveraged finance bank underwritings predating the onset of the war in Ukraine and rate hikes this year are still clearing the market, or need to, at big discounts (such as Citrix, Tenneco, Nielsen, Brightspeed and now, evidently, Twitter). Meanwhile, this lack of additional new issue supply together with ongoing BSL repayments and continuing issuance of new CLOs has been supporting prices. This hiatus will end as the overhang is worked off, as most borrowers and sponsors are prepared to pay the higher cost of capital, and banks plan to resume the economy's integrated capital markets and M&A functions. The key point is that scalable BSL investing can be and is underway in this interim period due to plentiful opportunities offered in the secondary market, and constructive investing conditions should continue with increased new issue supply. De novo portfolios can of course be created and managed in the context of a prospective severe recession, as these should. However, it is not likely that many investors consider that this recession will be one with a 20% 1- or 3-year cumulative default rates and 60% recovery rates as the base case as implied by current prices (not including the contribution of the credit spread part of the cash yield). As such, BSL prices assume a recession far worse than the most pessimistic forecasts.

"How cheap… is cheap enough"? For the long-term investor this is not likely a relevant question, provided significant excess returns, that create additional cushions of safety, are generated in aggregate. After past periods of disruption, most investors lament having paused for too long and re-entering only when good times, even fantasies, are priced in. Averaging-in has historically been the better approach to capture the investment benefits of price downturns.

What about valuations and performance measurement? Many investors use mark-to-market for reporting and comparative assessment. Being price-based, this represents asset liquidation values, which is are a questionable indicator of the theoretical present value of future returns.

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Judging performance on this basis is often misleading and may induce an investor to eliminate consideration of investments either now or later. One benefit of credit investments such as BSLs, assuming a long-term horizon versus option to redeem, is that value is driven by the income generated by borrower performance that funds the cash yield and principal repayment. This value driver is “internal” and can be analyzed and predictable to some degree (such as credit ratings), and to a greater degree at the portfolio level. Conversely, price-based investments, such as public and private equities, depend more on the appetite of other investors to realize value. By comparison, this driver is “external” (more bids than offers), and not analyzable or predictable, being a function of investor sentiment and supply vs. demand (“market technicals”), as well as fundamentals, which can be overridden by the first two as is the case now. Market prices are extremely useful but only as one component of valuation, where the other is the earnings power of the asset(s). Accountants, consultants, regulators, and many investors follow a “one way or the highway” approach instead of a combined “and” approach. This underpins ongoing debates between total and absolute (cash-on-cash) performance valuation and measurement. In banking terms, it is the difference and schism between “accrual” and the “held for sale” asset categories. A better way is “and” not “or." To summarize, cash-on-cash yield investments have low variability whereas those where the return is mostly price driven are volatile.

Markets are and will continue to be unstable with prices fluctuating. The direction for now is downward as multiple uncertainties persist and overall trends are negative despite impressive resilience of the US economy. Notably, most BSL borrowers continue to perform well and for those behind plan, this mostly reflects inflation cost-pass-thru challenges (and of course one-off problems which are always present). The point is that BSL price levels imply a future outcome worse than the most pessimistic forecasts. BSLs can be invested in now, and at scale, and continuously so, by accessing the secondary market, and the resumption of new issue supply will present more choices. Moreover, these have mostly "internally"-driven versus "externally"-driven outcomes, and so are more inherently predictable. BSL portfolios are an “across the full cycle” asset class and portfolios created now can be specifically recession-resistant with exceptional risk buffers. This is a good environment to deploy capital with the right partner.

Best, Peter Gleysteen

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