Q&A

CIFC Asset Management

Are credit investors being too anxious?

Credit investors are perhaps bearish by nature – always looking for threats. But even CIFC veteran Stan Sokolowski wonders whether investors are being overly pessimistic about the market. Here he offers a balanced assessment of the threats and opportunities, evaluates why investors may need to recalibrate their return expectations and explains why fears about debt covenants are perhaps overplayed.

What's your view on the economy today?

It is our view that we are in a world of moderating growth – but growth nonetheless. There are a number of flashing yellow lights – geopolitical flashpoints around the globe, trade tensions, below-trend growth, and bouts of elevated volatility. At the same time, we also have ultra-supportive global central bank policy and low inflation. These are all conditions that have been with us for the past decade and will continue to be around going forward. In the U.S., we are seeing a deep inversion at the front end of the yield curve. Is the yield curve indicating recession and signaling the official end of the credit cycle? There are many opinions on both sides of this argument. For us it is certainly a signal to be cautious. However, we do not foresee an imminent recession. One way to monitor the health of the economy is to monitor credit spreads. Credit investors have historically been credited with foreseeing economic deterioration. If a recession were close, we would expect to see credit spreads materially wider than they are today.

What threats do you see ahead?

We mentioned those flashing yellow lights. As credit managers, our job is always to be on our toes trying to spot risk. There are plenty of threats to consider – a contentious U.S. election cycle, the ongoing headlines of political discord out of Europe, Brexit, and now an increasingly belligerent Iran. The potential risks can be endless. However, avoiding investment risk altogether is not an answer. We have to be alert to the upside potential as well. What happens when Brexit concludes or if a deal is agreed with China and all that money pours in from the side lines? What happens if the pockets of mixed signals from the U.S. economy come in stronger than expected, as we saw with GDP numbers for the first quarter of the year? If you look back through history, periods of slowdown are far more common than periods of recession. As the investment guru Peter Lynch once said: "More money has been lost by investors preparing for corrections, or trying to anticipate corrections, than in corrections themselves."

But we're now in the longest bull market since World War II. How much longer can it go on for?

Show me an economist who says that market cycles have to be determined by calendar turns. How long a bull market has endured has absolutely nothing to do with why it might end. Look at Australia as an example – they have not seen a recession in 28 years. Now, it may be that the longer a bull market goes on, the more likely it is that there will be some kind of dramatic jolt to investor confidence – as they say, bull markets always climb a wall of worry.

When people are out with their friends, they aren't talking about how great their portfolios are performing. They're all generally nervous. This is actually perfect for credit investors, because it means that everyone is behaving a lot more sensibly and taking on risk they can service. If "complacency" is the word that best describes the pre-crisis days then "paranoia" best describes this post-crisis period.

So why all the gloom, do you think?

The truth is that investing is always worrisome. There is an eagerness to identify the top of the cycle, in all likelihood due to how few people actually accurately predicted the last financial crisis. It is certainly keeping euphoria in check, which is healthy, but on the negative side, there is always the potential for prophecy to be self-fulfilling. People can fall into the trap of convincing themselves that things are very bad and that it's only going to get worse. The media is not always helpful here either. We so often observe pundits substituting emotion and opinion for facts and analysis, thereby perpetuating a negative feedback loop. The fourth quarter of 2018 was the perfect case study.

In terms of the credit market, what are the key things you would say are different now from pre-crisis?

A number of structural conditions are very different across the credit markets broadly. Pre-crisis, new issue pipelines were enormous, deals were highly levered, had low equity contributions and many were bridged by the banks. Overall leverage in the system was also significantly higher as investors were highly margined in their investment accounts and banks were extending enormous amounts of capital to CLO warehouse facilities.

Today we are in a transformed regulatory landscape and all the evidence indicates, in a much stronger position. Investors are still nervous but with over $13trn of zero or negative yielding debt globally, the hunt for yield will remain a powerful inducement.

How should investors approach this new normal?

For one, they should reassess their unshakeable faith in traditional equity and fixed income products, which have not performed to expectation in recent times. Equities require earnings growth or multiple expansion to generate performance, conditions that are difficult to achieve in a low-growth world. While on the other side, traditional fixed income has failed to be the "safe" and effective hedge to equities that it once was.

It is new-generation products, such as senior secured loans, that are able to solve for many the challenges most concerning investors today, namely the need for downside protection (thanks to secured collateral), seniority, lower volatility, liquidity and, perhaps most importantly, income. Again, 2018 was a case study that is still fresh in our minds – over 90% of global financial assets delivered negative returns. Loans, however, posted a +1% gain with a fraction of the volatility seen just about anywhere else. The asset class did what it was designed to, proving itself to be a "port in the storm" for investors. In fact, loans have a two decade track record of consistently demonstrating their investment qualities of yield generation, lower volatility and lower correlation to other asset classes in unpredictable market environments while delivering positive returns, with the only exception being the Great Financial Crisis.

As we look to the future, nobody knows where global growth will be in the long term though it is likely to be more challenged. We don't know what the Sino-U.S. relationship will look like but the macro and political backdrop is also likely to remain complex. Headline risk will therefore stay elevated and heightened volatility will play out across various asset classes. What we do know is that with risks abounding and markets worried, positioning will matter more than ever. In investing, you can do anything at any time but always have to ask the question – do I want to be aggressive or do I want to be defensive? We continue to argue for a defensive step up in quality bias. We would therefore argue that on a risk-adjusted basis, leveraged loans in some format make sense as a core holding in any portfolio, either in plain vanilla long-only form, or levered through a structured vehicle that has inherent structural protections like a CLO. Whether it be for a pension fund, endowment, family office, sovereign wealth fund or even a retail investor – there are many different approaches to incorporating leveraged loans into a portfolio that will likely fit with the liquidity and return profile the investor is seeking.

Should we be concerned by the growth of the loan market?

There has been much ink spilled on panicked headlines ringing the alarm bells on the "unchecked" growth of the loan market. Over the last couple of decades the market has grown to approximately $1.19trn and is now comparable in size to its sister asset class, the high yield bond market. Leveraged credit markets (high yield bonds and loans) have not "exploded" in growth, as some pundits have claimed. When we assess growth and look at the numbers we find these markets have grown at approximately 4.6% and 6.6% respectively over the last decade. Hardly an overheating! Bear in mind that the U.S. economy itself has grown by 42% in the same period. Most of the credit market growth has actually been in "safe" investment grade bonds, which have increased by over 30% over the same time span.

Is the increase in 'covenant-lite' loan agreements a concern for you?

The prevalence of covenant-lite issuance is another condition that has been with us for some time and will continue to exist going forward. A covenant is not going to protect an investor from a default and a covenant will not pay you back, cashflows do that. At the end of the day, we invest in good companies, with strong balance sheets, healthy cash flows and able management teams who service their debts.

For context, it can be helpful to know a bit about the history of the credit markets and how they have evolved over the past few decades. Historically, the loan market was dominated by banks, who were the predominant buyer base of "bank loans". However, banks have high expenses with infrastructure costs, large numbers of staff, and high balance-sheet capital costs. There was no secondary market to help manage risk either. As a result, banks made loans that were expensive and decidedly structured with covenants.

In the 1990s, the loan and traditional fixed income markets began to converge due to a number of factors, including deregulation. As they converged, traditional fixed income investors, whose markets were already covenant lite from inception, began to see these well-priced bank loans as a good investment opportunity. As a result, the need for covenants waned as these more flexible, sophisticated investors used their experience in analysing and pricing traditional fixed income assets to take a more relative, value-driven view of loans.

Today, loans and traditional fixed income markets are more like two sides of the same coin. But there are still some key structural differences between the assets. Senior loans are paid before traditional fixed income assets, and are collateralised by the assets of the issue. Traditional fixed income assets generally are not.

Ultimately, there is no substitute for the manager doing a thorough assessment of the merits of the asset. The increase

in the amount of covenant-lite loan agreements does not change that the need for good underwriting and that means not having to fall back on covenants but finding high quality companies that will perform well through various economic cycles. We will invest in a *good* company with a bad or no covenant. However, we will not invest in a *bad* company with a good covenant.

Should liquidity be a concern for loan investors?

Not greater a concern than for any other financial market. In fact, the Federal Reserve Bank published a research report recently in which they noted how well the plumbing actually operated in the loan market in December 2018, when loans experienced one of the largest drawdowns (~2%) in the last decade. From my seat, I saw some of the highest volume trading days in the loan market that I've experienced ever in that period. It comes back to where we started – while we must always be on our guard against risks, it can be costly to overplay them.

Stan Sokolowski

Stan Sokolowski is a Senior Portfolio Manager and Deputy Chief Investment Officer at CIFC. He has more than 25 years of credit, portfolio management and trading experience, having invested across the credit spectrum of high-yield, loans, stressed and distressed situations. He previously held roles with Lucidus Capital Partners, Caxton Associates and J.P. Morgan. Stan holds a B.A. in Finance from Michigan State University.

About CIFC

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*As of 1 July 2019

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