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CIFC Asset Management

Why credit can continue to defy the gloom

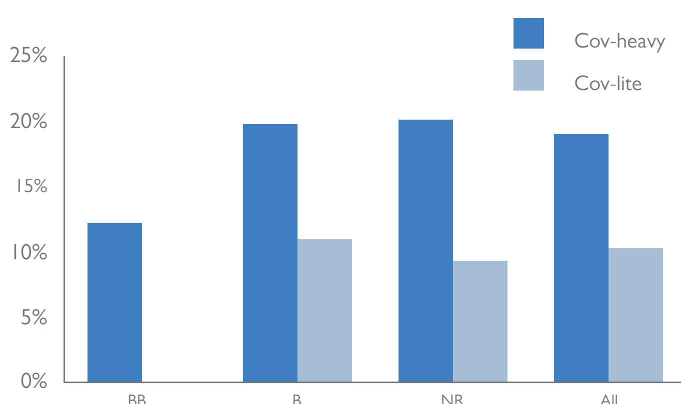
In the second of two interviews, CIFC Deputy Chief Investment Officer Stan Sokolowski finds reasons to be optimistic, despite the doubts and fears of credit bears, and explains why trying to time credit markets can be costly.

There's a lot of talk about structural deterioration in loan market covenants and documentation. Is this a concern?

Yes, and it depends. A number of pundits and media types have suggested these trends are evidence that the cycle is maturing and the end is upon us. These developments, however, are not unique to the loan market. They exist in the traditional fixed income and equity markets as well. In our view, these shifts are better indicators of supply and demand than they are timing mechanisms for trading risk into the end of the cycle. The evolution in structures also shows the transformation of the buyer base away from banks who now represent less than 5% of the $1tn+ market. As Peter Lynch famously said: "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."

The fact is that covenant-lite loans did relatively well versus covenanted loans during the last downturn, defaulting at a rate of around 350 bps less and recovering approximately 800bps more. This can in part be attributed to the generally larger size of covenant-lite issuers among other factors. Ultimately, and as our Chief Investment Officer regularly reminds our team, covenants don't pay you back, cash flow does.

Cumulative Default Rate by Principal Amount (2008 – 2015)



Source: S&P LCD.

Only the contour – the depth and length – of the next recession is going to tell us how impactful these characteristics will be on performance and capital. As such, structural considerations remain a key element of successful credit analysis, especially today. Should the next recession look like the last, there could be significant value destruction. However, there is an argument that suggests if the next cycle turn is shorter, shallower and/or more traditional than the last, these features might actually allow a number of issuers to avoid bankruptcy and preserve investor capital as they muddle through the slowdown while servicing their liabilities. In either case, investment managers today need to be very aware of what they own and be active risk managers of their portfolios.

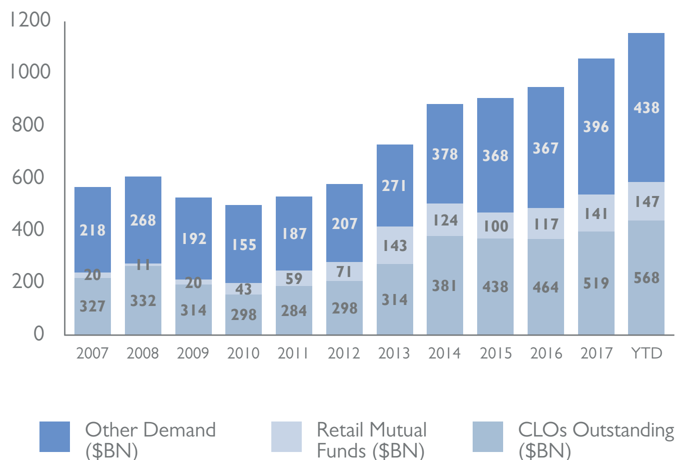
Some investors believe that liquidity in the loan market is fleeting. What is your perspective?

In a post-crisis world, the structure and liquidity profile of many markets has been altered due to among other things regulatory change. Today, understanding liquidity is a key component of risk management. As it relates to the loan market specifically, it may be the case that liquidity for middle market or direct loans is less robust however, the $1tn+ broadly syndicated loan market is very liquid. In our experience, there is no material difference in loan market liquidity versus the traditional fixed income credit markets these days. Could that change? Of course. Our most recent case study with market indigestion was during the first quarter of 2016, a time when many referred to markets as less liquid. During this period, liquidity existed for loans albeit at lower levels and at prices that lived at the bid side and even a point or two below. However, loans were tradable nonetheless. Howard Marks wrote a letter (March 2015) in which he discusses the myths and truths of financial market(s) liquidity. In an effort to paraphrase him: Is liquidity being able to sell or being able to sell at a price that one finds agreeable at the time you wish to sell?

In terms of loan market structure, not many appreciate that approximately 50% of loans are held by closed end, non-mark to market vehicles called Collateralized Loan Obligations ("CLOs"). These funds are analogous to banks. They issue equity and debt securities and purchase loans with the proceeds. The nature of the CLO structure has CLO managers focused more on credit

and less on price action. Therefore, these investors are a stable base of capital in the loan market. Another 38% of the market is owned by institutional investors in fund and separate account formats. Another 12% of the market is represented by retail mutual funds. In our view, retail flows are less impactful versus other credit asset classes where retail investors represent a higher proportion, and less stable base, of these markets.

Loan Market Investors



Source: J.P. Morgan, data as of July 31, 2018.

Another issue that comes up is the effect of higher interest rates on the loan markets. Will higher rates make it more difficult for companies to sustain current levels of debt?

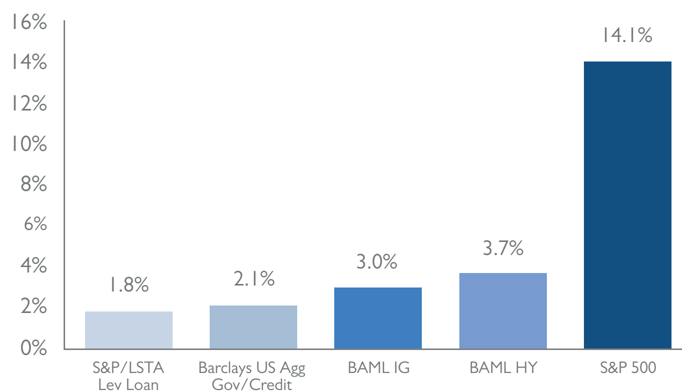
Generally, at this juncture, we believe rising rates are a tailwind for the asset class given floating rate coupons. As it relates to debt levels, an issuer's ability to sustain debt is not so much an element of leverage but more a function of debt service capacity (i.e. cash flow). Cash flow is what pays you back. Today, cash flow (and generally cash on balance sheets) remains healthy. Rising Libor (the base rate associated with the majority of loans) has historically had a limited impact on default rates. In fact, during the last hiking cycle (2004 to 2006) rising rates had virtually no impact on defaults. The business cycle has been a more influential driver of default risk. In the future interest rates could increase to a point where margins may become compressed however, at this stage we believe we are far away from that point.

Despite your perspectives, isn't there a case for market timing and holding money back?

We did a market timing study not long ago looking at five asset classes – equities, high-yield bonds, investment-grade bonds, the Barclays Agg and loans. The purpose of the study was to determine an investor's performance outcome if, instead of buying at the lows, they regularly purchased at the highs. We collated performance data back to January 2000. We analyzed one-year, three-year and five-year outcomes.

On a one-year basis you could have lost about six and a half per cent investing in loans. Essentially, an investor could have wiped out their coupon and had a flat / slightly down year. Not a good result but you would most likely still be employed. Equities were much more painful. An investor who was a bad market timer could have lost ~30% (and their job) trying to time equity investments. High yield? Bad timing could have cost you ~15%. The study confirmed similar outcomes for three- and five-year efforts as well. Interestingly, on a five-year basis, incorrectly timing loans could have cost your portfolio ~1.8% (versus ~14.1% for equities). The message from the study: If you want to be a market timer, do it in equities and high yield bonds, not loans or the Barclays Agg.

Portfolio Costs Associated with Poor Market Timing (2000 – 2017)



Source: S&P LCD, BAML, Barclays, data as of February 28, 2017.

About 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.

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*As of September, 2018.

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