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CIFC Asset Management

Finding opportunities in a maturing credit cycle

In the first of two interviews, CIFC Deputy Chief Investment Officer Stan Sokolowski discusses the continuing opportunities in floating rate senior secured loans and whether we have reached the later stages of the credit cycle.

You and CIFC have a long track record in credit markets and floating rate, senior secured loans in particular. What is the continued attraction for clients who invest in the loan asset class?

We believe loans address many of the key investment challenges faced by investors today, including volatility risk, interest rate risk and valuation risk. The historical performance of the loan asset class demonstrates lower volatility as well as solid performance in rising rate environments, and in today's world of high prices across many financial markets, loans continue to provide excess spread return to investors. Additionally, loans perform in low-growth and even slightly recessionary environments. We think these attributes and performance metrics support holding loans in a diversified portfolio as either a complement or even replacement for traditional fixed income exposures. This view is being more regularly expressed by many investors as credit moves from what has traditionally been a tactical allocation to a core portfolio component.

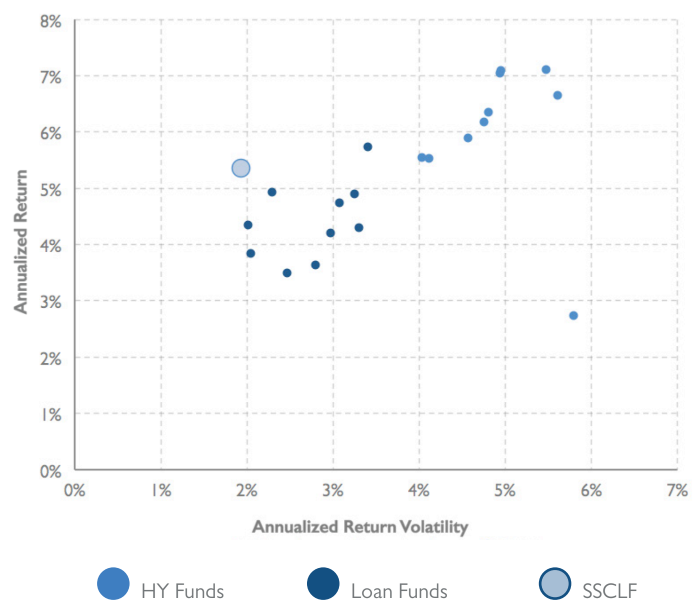
The loan market has grown substantially over recent years and many new loan funds have sprung up. How do you differentiate CIFC's investment management approach from the competition?

Consistency and discipline. There are a number of competitors in the space with varying return and volatility profiles. We believe our performance is not only a function of our credit underwriting and risk management approach but, of rigorous attention to consistency and discipline. As our Chief Investment Officer regularly reminds our team, picking credit at times can be easy, discipline is always hard.

Managing credit is a multi-dimensional process in the post-crisis world. Being effective at one element of credit investing is not enough today. Consistency and discipline mean being meticulous about quality, maintaining a keen eye on relative value, knowing when to harvest profits, when to protect capital and acknowledging when you are wrong. Unfortunately, we cannot trade the market we want, we have to trade the market we are given. Being consistent and disciplined allows us to better navigate the market and credit cycle.

As it relates to our underwriting process, our team of professionals (from the front office to the back office) consistently applies the same rigorous standards. Also, part of credit investing is that sometimes things do not always meet expectations. At CIFC, we harness a collection of various experiences, skill-sets and diversity of thought from well-seasoned colleagues who have worked on the buy side and sell side for many years. We collectively use this knowledge and actively collaborate to better understand potential hazards and how we can manage situations that may not meet initial projections. Lastly, we combine our deep fundamental credit picking with dynamic relative value analysis and active risk management. We believe our approach creates lower risk, better performing portfolios than our competition.

Return vs. Volatility – SSCLF vs. 10 Largest Loan and High Yield Bond Mutual Funds



Source: CIFC, Bloomberg, 3 years rolling performance, data as of August 31, 2018. Ten largest funds ranking in each asset class with daily NAV reporting available on BBG. HY funds include VWEAX, BHYIX, FAGIX, PRHYX, PHYQX, LAHYX, FIHBX, IVHIX, EIBIX, and SPHIX. Loan funds include OOSCX, LFRAX, EBBLX, EAFAX, BKLN, SAMBX, RPIFX, HFLAX, GFRAX, and BFRAX.

With the 24-hour news cycle, trade wars and politics it's sometimes difficult to separate the noise from relevant fundamental and policy trends. How does CIFC view the current macro environment?

Great question. Unfortunately in our world today there is a lot of emotion and opinion that substitutes for facts and analysis. This makes separating fact from fiction and fantasy from reality challenging, especially when making risk decisions.

Our view, based on economic data and more specifically by our ecosystem of over 500 credit investments across the CIFC platform, is that earnings performance and economic fundamentals are generally solid. On the policy front, the U.S. Federal Reserve Bank and the Bank of England have recently increased their base rates, however, it is a stretch to argue that central banks globally are being restrictive. As for the geo-political backdrop, markets seem to be doing a good job of ignoring the noise which, to us, seems indicative of underlying economic health.

I guess it's difficult to pinpoint where in the credit cycle we are, but there is certainly a lot of discussion that the economy could be at a late stage in the cycle. Where do you see us?

The economic cycle is maturing but not ending yet. In the United States, growth is above trend, employment is robust and inflation is not overshooting. Earnings data points from companies such as Walmart, Target and Costco also demonstrate a healthy environment. Away from the United States, economies are also growing, albeit at a slower pace.

Many assume that recessions generally occur at regular 5 to 7 year intervals. However, we think it is important to ask "why?" when presented with this argument. Time patterns are unreliable as modern GDP recessions appear to be triggered by interactions between shocks and financial imbalances. Australia, an economy that has not experienced recession since 1991, is a case study.

To quote/paraphrase Churchill: "Now is not the end. It is [probably] not even the beginning of the end. But it is perhaps, the end of the beginning."

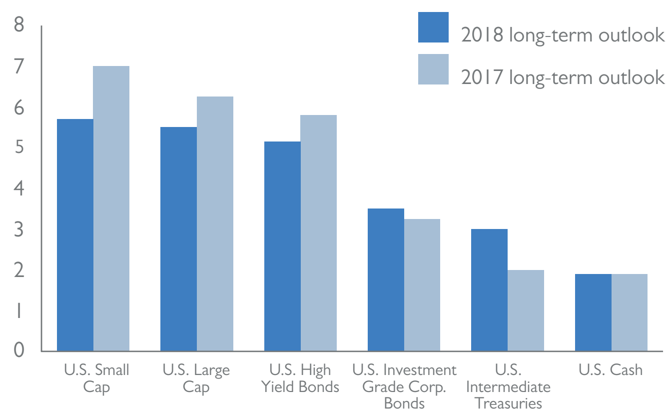
But don't you see threats ahead?

Of course, however we think it's worth thinking what the end might look like too. It doesn't have to look like what's occurred in the rear-view mirror. The Japanese experience could be one possibility. If you consider the history of Japanese growth and recession over the past 25 years, notable are low levels of declining growth followed by progressively shallower periods of contraction, followed by low growth again. Of course, Europe and the US are not Japan but there are similarities including declining rates of growth, lower inflation, shrinking working-age populations and growing life expectancy. Loans should perform well in this kind of world.

Credit may not be as dangerous as many people fear but nor is it delivering returns?

Its relative and return expectations need to be placed into perspective versus other risk alternatives. Let's start with defining return expectations. J.P. Morgan's long-term capital market return assumptions (which is a ten-year view) projects US small caps to be among the highest returning asset classes at nearly six per cent. U.S. high yield is expected to deliver an equivalent amount. In a relative value world, we believe a yielding, cash generative asset class that is more senior in a capital structure is a better investment proposition than many equity and higher beta choices.

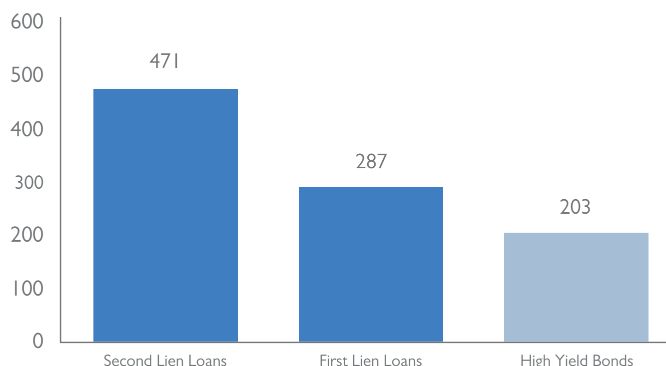
J.P. Morgan Long-Term (10 – 15 Year) Capital Market Return



Source: J.P. Morgan, data as of December 31, 2017.

Another way to view returns is through excess spread. Said another way, how much is an investor being paid after expected credit costs (i.e. losses given default) for the risk being assumed? Viewed from this perspective, senior secured, floating rate loans are the cheapest house on the block today and pay more excess spread than fixed rate, unsecured high yield bonds.

Excess Spread



*Source: Bloomberg, J.P. Morgan, data as of August 31, 2018. Excess spread is calculated using the difference between current spreads and credit costs (product of default rate and historic loss). *Yield shown for HY represent yield to worst and yield shown for loans represent 3-year forward to maturity.*

Furthermore, defining and delivering returns is not a one dimensional endeavour. As such, and alongside our efforts to provide the best solutions to our clients, we ask three questions: "What is your risk tolerance? What are your liquidity needs? And, what is your target return?" We are also seeing a similar view being expressed by many large pools of capital around the world including pension, sovereign, endowment and private wealth investors. This sophistication goes hand in hand with a growing view that credit is becoming a core portfolio holding.

Finally, I would love to get 10 per cent returns in an unlevered, liquid format however, it isn't likely to happen in the investing environment in which we exist today. With that said, and for those who have a higher risk tolerance and lower liquidity needs, there remain idiosyncratic opportunities in credit to generate double-digit returns. Structured credit or portfolio leverage are a couple of examples.

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

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.

About CIFC

CIFC Asset Management is a corporate and structured credit investment firm serving institutional investors globally. The firm manages over $20 billion in assets* across collateralized loan obligations, corporate credit funds, structured credit funds and separately managed accounts. CIFC's investors include pension funds, sovereign wealth funds, endowments, insurance companies, banks and family offices. The New York-based firm has 28 investment professionals. An emphasis on fundamental credit analysis has helped the firm deliver outstanding returns since its launch in 2005. The firm opened its London office in June 2018.

*As of September, 2018.

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