CIFC Asset Management

CIFC 2023 View

Introduction

Steve Vaccaro,
CEO and Chief Investment Officer

The start of any new year often brings fresh hopes and expectations. Last year any positivity we had emerging from the pandemic was soon dashed by the sight of Russian tanks rolling into Ukraine.

The war there continues. And so does the battle against Covid. Meanwhile, interest rates are still rising, inflation is yet to be tamed, and fears abound that central banks will misjudge and mistime their actions, sending the world into economic crisis.

Yet I retain a lot of optimism and hope for 2023. In this report a number of my colleagues look at the year ahead for their particular areas of the market. A couple of recurring themes emerge.

- The recalibration of credit markets in 2022 means many areas are now offering more attractive returns than a year ago.
- Default risk appears to be higher than it was last January, and many of us expect volatility ahead. This makes many investors understandably fearful. But in risk lies reward; in volatility lies opportunity.

In this report we look at CLOs, structured credit, corporate credit in the US and Europe, direct lending and opportunistic credit.

The fact that we can give such wide coverage is a demonstration of how CIFC has grown over the past five years. We now have over $40 billion of assets under management[1].

Increasingly, our clients come to us looking for a multi-asset approach. We offer a professionally managed multi-asset strategy that works well for some. Others want something tailored to their own distinct needs. We can do that, too.

Occasionally clients who invest in a single strategy ask our opinion on how that fits within the rest of their current portfolio and approach.

We are happy to have these conversations. We see ourselves as credit partners rather than suppliers.

In that spirit of partnership, I wish all our clients – and potential clients – a healthy and prosperous 2023. I hope the insights you find within this report will encourage and inform you. I am not sure we can do much about your health, but I hope we will be able to help enhance your wealth in the year ahead!

1. AUM figures are approximate as of October 31, 2022. AUM includes committed capital.

Inside this issue:

Time to gather the low-hanging fruit?

Last year was a difficult one for practically all corporate credit, and CLOs did not escape the pain.

When you see a corporate bond trade from par to 75 it is usually because the borrower has credit issues. In the CLO space we saw triple-Bs and double-B-rated debt tranches move from being priced close to par to trading in the $70s and $80s almost across the board.

In our view, only a relatively small number of these debt tranches might face problems serious enough to put them at risk of impairment – even under our downside stress scenarios. We therefore believe a lot of the price action may have been driven by liquidity need among investors – insurance companies selling to fund other commitments or asset managers meeting redemptions.

This is a relatively small market, so the ripples from some large players making big trades can be widely felt.

In short, then, 2022 saw considerable dislocation in the market. This dislocation still exists at the start of 2023. This is not just about price volatility but about the price dynamics of the asset class diverging from the fundamentals of the underlying credit.

What will reverse this is when new capital comes into the market – we have been seeing an increasing number of investors beginning to recognize CLO debt tranches as the low-hanging fruit. Is now the time to gather the crop?

I see two main challenges in 2023:

- The first is that interest rates plateau and start falling. In this scenario floating rate assets are likely to become less popular, undermining demand.
- The second is that we hit a serious recession in the US and globally, leading to a rise in defaults. This fear hangs over the CLO market. In our view, this downside scenario is already priced into many CLO securities, making the market less worrisome for those with the luxury of being able to buy CLO securities now. Credit enhancements mean today's CLO debt tranches are generally higher quality than they were before the Great Financial Crisis – and even those experienced few impairments.

CLO debt tranches are generally priced to mature 10 to12 years from their respective issuance dates. However, the great majority of them have historically matured years earlier, sometimes in the context of three to five years from their issuance dates. Since many CLO debt tranches are trading in the $80s price range in the secondary market (with the potential of receiving $100 of principal years earlier than final maturity), we believe the convexity in investing in the CLO debt tranche market today is very attractive.

Within that time span, I believe that now is a good buying opportunity. However, given the potential price volatility, it may be wise to drip-feed money in evenly over a period of, say, six to 12 months – as opposed to trying to time the bottom of the market. Diversifying your entrance point like this can help mitigate the risk of mark-to-market volatility while still capturing the bulk of the upside of the trade.

Jay Huang is Head of Structured Credit Investments at CIFC

Don't fight the Fed

As in previous years, the Federal Reserve was clear. It said it was going to raise rates, and it did. Many investors learned last year, to their peril, not to fight the Fed. Going forward, the Fed has said it will raise rates and keep them elevated. Many investors will most likely learn the same lesson this year. Don't fight the Fed...

"'Market timing' is impossible – managing exposure to risk is both logical and possible." – Benjamin Graham

The loan market was not fully immune to the macro-induced volatility of 2022. However, the relative outperformance of loans versus many other asset classes and markets more exposed to interest rates was stark (see figure one). Loans outperformed in dramatic fashion and provided the reduced downside risk that we regularly discuss with our investor partners. The resiliency was unambiguous.

Low quality certainly underperformed while dispersion increased and the push/pull between fundamentals and technicals and the haves and have-nots continued. Regardless, loans today still offer a value and an income profile not

Figure one
Loans outperformed in 2022

Return by asset class	
Index	**2022**
Morningstar LSTA Index	-0.60%
BAML HY Master	-11.21%
10-year Treasury	-16.28%
BAML High-Grade Corp	-15.44%

Source: Leveraged Commentary & Data (LCD); Bank of America Merrill Lynch. Data as of October 25, 2022; Bloomberg Data as of October 25, 2022. Please see the Disclaimer included at the end of this document for a description of the indices. Past performance is not an indication of current and future returns.

Figure two
Falling prices make potential forward returns look attractive

Leveraged loans forward returns				
Price barrier	3 months	6 months	9 months	12 months
$96	-0.43%	-1.01%	2.60%	5.02%
$95	-0.02%	3.01%	5.27%	7.19%
$94	1.14%	4.36%	6.98%	9.09%
$93	1.69%	4.75%	7.74%	9.53%
$92	2.78%	5.90%	8.86%	10.64%

Source: J.P. Morgan

witnessed in years. The J.P. Morgan Leveraged Loan Index is currently yielding c.9.92% at an average price of $92.83[1].These levels suggest robust forward returns (see figure two).

In our opinion, it is difficult to see performance from traditional equity and fixed income products beating these levels over the coming year.

Based on these numbers and the historic record of the index, we believe this is a once-in-a-decade opportunity. But do investors have the courage to take it? Unfortunately, many humans and organizations are not designed to make timely investment decisions. Daily media commentary dominated by headlines designed more to elicit a response – a click – than to inform can color perceptions and encourage excessive caution. Indeed, this gloomy coverage is helping to create the current opportunity. We believe loan price and yield levels today are factoring in far- and wide-ranging default and loss outcomes.

"The investor's chief problem – and even his worst enemy – is likely to be himself." – Benjamin Graham

Portfolios need to reflect future opportunities, not past realities

We do not deny there are good reasons to be fearful. Higher inflation, higher interest rates, lower growth and volatility are all causes for concern. This is a tough environment for companies with weak and rate-sensitive balance sheets. We believe defaults will inevitably move higher from essentially non-existent levels. But what might that actually mean?

The three-year average default rate for leveraged loans during the Great Financial Crisis was between 5% and 6% (depending on the index), while the three-year average recovery rate was 63.57%[2]. These levels suggested credit costs of approximately 3.5%. The memory of 2007/8 still lingers large, and we believe this has dampened investor sentiment. Yields and spreads have not been this attractive in years and currently compensate investors for far- and wide-ranging default and loss outcomes – more than 3.5%, in our view.

Furthermore, this may be the most predicted recession in my career. If markets are forward-looking, are companies, consumers and other economic actors not preparing?

So how do we mitigate the risks to maximize investment potential? Last year, in our view, dispersion was a key theme within the market as low-quality risk delivered significant underperformance. For us it was a year to focus on resiliency – quality companies with high profit margins, pricing power and less rate-sensitivity, as well as sectors less susceptible to any wider economic malaise. Cash flow and liquidity were king. As I expect the risk of prolonged economic and/or rate stress as well as liquidity shocks to remain in 2023, the prudent strategy seems to us to be more of the same. Additionally, at today's yields and spreads, there is no need to stretch for more risk/return as the economy further adjusts to new realities.

"Far more money has been lost by investors preparing for corrections – or trying to anticipate corrections – than has been lost in corrections themselves." – Peter Lynch

ROMO

It is common for people to talk about FOMO – the Fear Of Missing Out – but today, more rationally, it is perhaps time to focus on a new phrase: ROMO – the *Risk* Of Missing Out.

Dislocation has created some attractive entry points in the loan markets. Income and yield in credit provide a historic opportunity if capital is deployed intelligently (avoiding the weaker of the herd) and with purpose.

It may still be too early to invest in a wholesale manner, but it may not be too late to start nibbling at asset classes that are priced for downside protection.

"Investment is about discipline and patience. Lacking either one can be destructive to your investment goals." – Benjamin Graham

Stan Sokolowski is Managing Director and Deputy Chief Investment Officer at CIFC

1. J.P. Morgan: Leveraged Loan Daily Update as of December 30, 2022.
2. J.P. Morgan & Morningstar/LSTA Leveraged Loan Index. Three-year averages were calculated using the J.P. Morgan Leveraged Loan Index default and recovery statistics at the end of December 2008, 2009 and 2010 and S&P/LSTA Leveraged Loan Index default statistics. Past performance is not indicative of future results.

Driving in fog

As the new year gets under way, it feels like we are driving in fog. The numbers – and, more importantly, the trends – are far from clear. This matters, because nervous markets are extremely sensitive to economic data.

Inflation looks to be coming down. Shipping and material costs are falling, and supply chain issues are resolving themselves. All this has been positive for corporate bond markets, which picked up meaningfully toward the end of 2022. Yet wage inflation looks sticky. There are still supply problems. And the wider political environment remains uncertain.

I believe that getting inflation down below, say, 4% is going to be hard. And that makes the Fed unpredictable. Remember, it is also trying to unwind the balance sheet. There is a vital supply/demand component to the price of financial assets. There has to be an impact when you have the Fed allowing $1 trillion of bills to run off its balance sheet.

To me it makes the odds of a "soft landing" much lower than many investors seem to assume possible. In the soft landing scenario the Fed times applying its foot to the brakes of the speeding economy to perfection. The economy carries on motoring but at a gentler, safer speed.

The odds, I believe, look much more likely for the alternative scenarios.

A sudden change of mind: The first is that the Fed takes its foot off the brakes too soon and realizes the economy is still speeding dangerously. It has to brake suddenly and hard again – a jolt to the system. Many expect the next two rises to be about 25 basis points, and they are pricing assets on the assumption that rates are plateauing. I can see a scenario where rates do plateau but inflation remains stubbornly high. The Fed then has to lift rates more sharply again. Its credibility will have been shot. The markets will react accordingly. It is unlikely to be comfortable.

Deep recession: Another possibility is that the Fed lifts rates too far and fast. It brakes too hard, sending the economy into a spin and into a ditch. We find ourselves in a severe recession.

Because 2022 was a bad year for markets, many people believe this year will be better. But we still have some way to go before we emerge on the other side of this recession. We have experienced relatively little of the pain that marks a true slowdown, so it feels too early to be assuming recovery is just around the corner.

Positioning portfolios

I am therefore cautious. We think there is more downside to come. However, we are comforted by the fact that average credit quality has improved in recent years[1], 90% of the high yield market is now trading below par (versus 20% at the end of 2021)[2] and the tailwind from the coupon is powerful.

We have been trading where we see opportunity to take advantage of some momentum from time to time. And we have been preparing for volatility.

At the end of 2022 we spent a lot of time and resources building a list of 30-40 higher-risk names that we feel have the resilience to cope with severe stress. We believe their bonds will go lower if markets hit a rough patch, and at that point we will be ready to buy to participate in the upside when it comes.

Being cautious now does not mean we are always cautious. We are willing to take risk. But we want to do so when we think it is the right time.

Jason Horowitz is Portfolio Manager of the CIFC Long/Short Credit Strategy

1. J.P. Morgan research, data as of December 31, 2020.
2. Barclays Global Credit Outlook, December 1, 2022.

European high yield credit – a new era

In our opinion, European high yield bonds look attractive now that the free money era has ended and fixed income rewards investors again. This is expected to draw new money to the asset class, driving long-term market growth.

The BofA Euro High Yield Index yield to worst is 7.6% – almost as high as it has been in 10 years. The option-adjusted spread is 494 basis points with a modified duration of 3.2 years above the average 10-year spread of 401 basis points. This compares favorably with the US market, where the spread is 465 basis points and duration 4.3 years[1].

We believe this is an attractive entry point to start allocating capital into the asset class. Spreads do not appear to be pricing in a deep recession so could temporarily overshoot. But predicting the bottom is impossible, and sitting on the sidelines and waiting for a better time to invest could result in missing significant opportunities. Markets can rally fast on the first green shoots. We saw this coming out of the Great Financial Crisis, when the index total return jumped to +75% profit following the previous year's -34% loss.

Credit selection is key to mitigating risks and preserving capital. There is no compelling value to be found going down in credit quality. In 2022 we focused on selling cyclical, consumer discretionary and vulnerable high floating rate risk names and went overweight in defensive sectors such as TMT – the last thing people do when tightening their belts is to cancel their mobile phone subscription. The focus remains on stable companies with proven cash flow generation and sufficient margin of safety and liquidity to bridge any downturn.

The many inefficiencies in the high yield market and volatile conditions can result in elevated dispersion. Sudden price spikes provide opportunities for active managers with strong credit and technical analysis to enter or exit names well outside their fair value and create further outperformance. Meanwhile, new issuance will likely require a premium to clear, potentially resulting in attractive entry points.

2022 was a challenging year for European high yield. Europe remains in the eye of the storm with tail risks from the war in Ukraine, especially relating to energy and other input prices. Even though global central bank policy has begun tilting to the dovish side, inflation is likely to prove resistant. We do not think that interest rates are coming down soon. For inflation to fall meaningfully in Europe, we believe consumer demand needs to fall – and that, in turn, means earnings reducing.

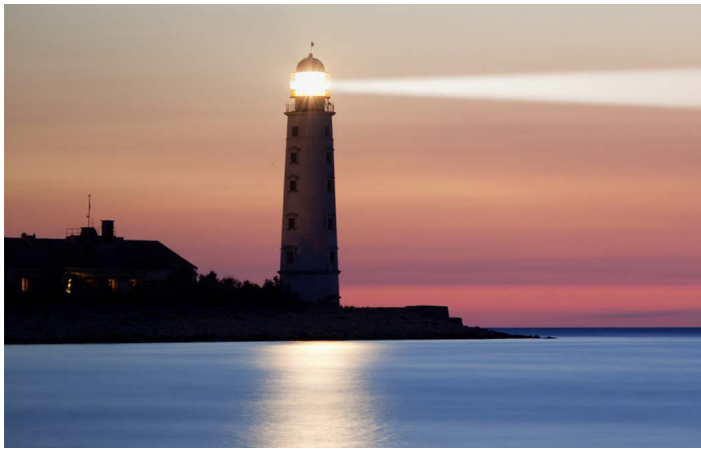
This may imply increasing defaults – above the near-zero levels[2] experienced recently. Helpfully, many companies refinanced their debt when they still had the opportunity to do so cheaply, pushing out maturities. Only €55 billion – or 14% – of high yield debt is due to mature in 2023-4, according to Barclays research[3]. Coupons at the end of December 2021 were on average 3.5%, compared with 4.3% in December 2017. These provide a buffer going into any downturn and imply a shallow default rate.

We believe success this year will lie in positioning in the right sectors – using bottom-up credit analysis to avoid companies that default and to preserve capital – and taking advantage of volatile market opportunities. This suits CIFC's deep research and active portfolio management capabilities.

Rinse Terpstra is a Senior Investment Analyst and leads CIFC's European Research Team

1. BofA Euro High Yield Index and BofA US High Yield Index data as of December 30, 2022.
2. J.P. Morgan HY Talking Points, December 2022.
3. Barclays Global Credit Outlook, December 1, 2022.

Shelter and rewards



Our strategy is direct lending into the lower middle market of the US. The borrowers typically have EBITDA of between $5 million and $50 million, so they are not particularly small. Inevitably, though, investors want to know if companies of this size are more vulnerable in times of economic turmoil.

I would point out that most of these companies are domestically focused and the US is one of the strongest economies in the world today. That means they are avoiding many of the headwinds battering other regions. Of course, rising interest rates – which have benefited lenders – are an issue for some. Naturally, there is heightened risk of defaults.

I believe that this is a market with more stringent lender terms than many. Leverage is lower, too. It could be one to two turns lower when compared to the upper market.

Should we experience elevated defaults, we believe the more stringent terms – which typically include financial covenants – should allow us to maximize recovery. One of the advantages of this market is that we are very close to the borrowers. Because of the loan covenants, we can engage with them much earlier. We therefore believe loss rates will be lower.

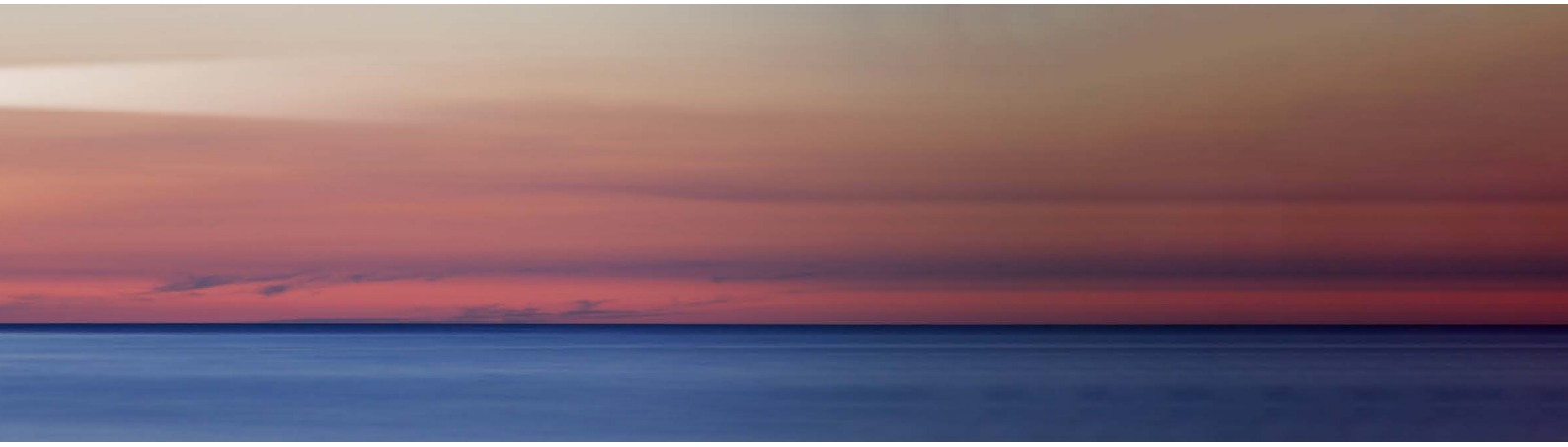
Let's look at the Cliffwater Direct Lending Index (CDLI). The CDLI is one of the few available data sets for direct lending with information back through 2008-9. As you can see in the chart on the following page, the realized losses have been relatively low historically, with the exception of the Great Financial Crisis (GFC). Even then these losses were more than offset by income gains. Loan losses in the same format for the Morningstar LSTA Leveraged Loan Index (LLI) are not available, but the volatility of the LLI is much higher than the CDLI during these periods.

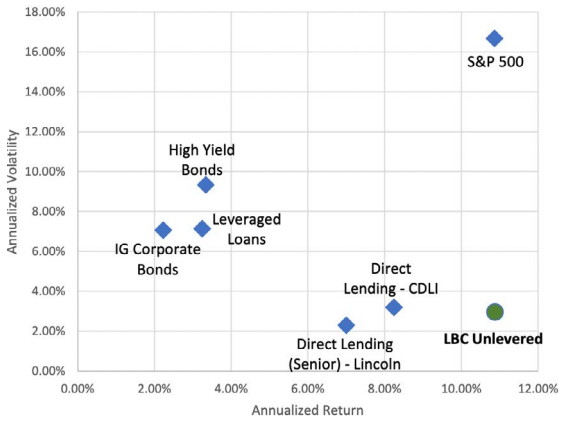
> "Direct lending has historically exhibited higher returns per unit volatility."

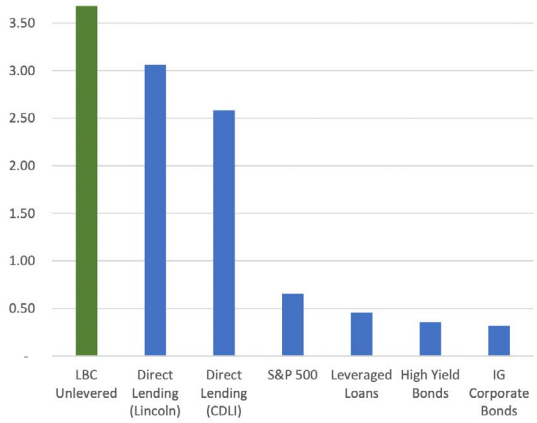
Finally, we are rewarded with a pricing premium per unit of risk in our market. With regard to relative performance, we have done some analysis on the returns and volatility of different asset classes. As you can also see on the next page, direct lending has historically exhibited higher returns per unit volatility. The Lincoln International Senior Debt Index is included in this analysis as well and also provides a good proxy for direct lending (unfortunately, this data does not go back through the GFC).

I believe direct lending to this part of the US market will be an attractive place to be in 2023. There are no guarantees, but it offers some opportunities and shelter in times of turbulence.

John Brignola is Senior Managing Partner of CIFC's direct lending platform, LBC Credit Partners

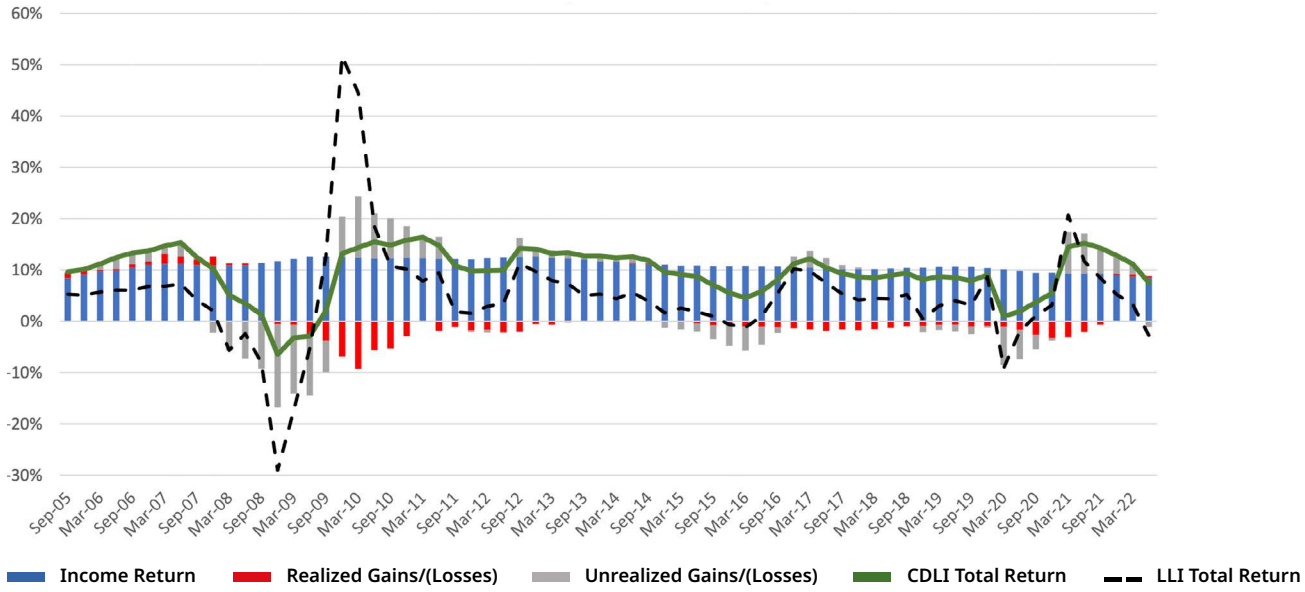






Source: Based on quarterly data from December 2014 through June 2022. LBC: Per LBC internal data, average returns for funds and SMAs closed since 2013; Direct Lending: Cliffwater Direct Lending Index and Lincoln International Senior Debt Index; Leveraged Loans: Morningstar LSTA Leveraged Loan Index; IG Corporate Bonds: Bloomberg US Corporate Bond Index; High Yield Bonds: Bloomberg US High Yield Corporate Bond Index; S&P 500: S&P 500 Total Return index, per Bloomberg.

Cliffwater Direct Lending Index Yield Decomposition



Source: Cliffwater Direct Lending Index; Morningstar LSTA Leveraged Loan Index. Components are annualized individually and may not sum to annualized total return. Data covers half-yearly periods from September 2005 to March 2022.

Time to find a chair?

Since the Great Financial Crisis (GFC) the leveraged finance market has seemed like a game of musical chairs where the music never stops. It might be time to find a chair.

Corporate leverage now exceeds pre-GFC levels, and we are in the midst of an unprecedented confluence of events: rising rates, slowing growth, persistent inflation and geopolitical instability. Any one of these issues alone would justify increased credit market stress. In our opinion, together, the combination of deteriorating fundamentals, historically high leverage and hawkish Fed policy creates a perfect storm for capital markets. We believe simple math suggests that slower growth (or recession) combined with higher interest rates and inflation will result in both valuation multiple compression and earnings disappointments.

As deep value investors, we could not be more excited about our investment prospects in 2023, despite the ominous-sounding paragraph above. If our market view proves correct, investor mindsets will shift from FOMO to actual fear – creating an increasingly attractive opportunistic credit environment. We already see evidence of this change, with both secondary market bonds/loans and special situations new issues offering equity-like returns with fixed income risk profiles.

Many of today's capital structures were built for a world of permanently low interest rates. Even modestly higher rates can turn a free cash positive credit upside down. For our strategy, rising rate environments create the ideal investment landscape – good companies with bad balance sheets. In such markets we can focus on market-leading businesses and find attractive entry points within sustainable debt levels based on run-rate cash flow.

Balance sheets and fundamentals are not the only risks facing credit investors today. The underlying credit documents governing most loans and bonds contain limited or non-existent covenant protections. Liability management, a nice way of describing separating creditors from their collateral, has become an art form. Investors must carefully navigate these document landmines or risk watching a safe credit become incredibly risky with a few strokes of a pen.

> "As deep value investors, we could not be more excited about our investment prospects in 2023."

The credit markets are in the process of evolving from a period of endless liquidity to a normal business cycle. In such a world, underwriting will revert back to a cash flow basis from an LTV focus where low interest rates supported increasingly higher multiples. Sponsors and lenders will take advantage of weak documents to improve their respective positions. Large, influential credit platforms will be able to exploit this transition for the benefit of their investors. Critical mass and market influence will be key drivers of outsized future returns when the music stops.

Steven Gendal is Head of Opportunistic Credit at CIFC

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The J.P. Morgan Leveraged Loan Index is designed to mirror the investable universe of USD institutional leveraged loans, including US and international borrowers.

The S&P/LSTA Leveraged Loan Index is a market value-weighted index designed to measure the performance of the US leveraged loan market based upon market weightings, spreads and interest payments. The index is reviewed weekly to reflect pay-downs and ensure that the index maintains its characteristics. The index returns are calculated daily as described in S&P Dow Jones.

ICE BofA US High Yield Index, which tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. To qualify for inclusion in the index, securities must have a below investment grade rating (based on an average of Moody's, S&P, and Fitch) and an investment grade rated country of risk (based on an average of Moody's, S&P, and Fitch foreign currency long term sovereign debt ratings). Each security must have greater than one year of remaining maturity, a fixed coupon schedule, and a minimum amount outstanding of $100 million. Original issue zero coupon bonds, "global" securities (debt issued simultaneously in the eurobond and US domestic bond markets), 144a securities and pay-in-kind securities, including toggle notes, qualify for inclusion in the Index. Callable perpetual securities qualify provided they are at least one year from the first call date. Fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. DRD-eligible and defaulted securities are excluded from the Index.

The ICE BofA Euro High Yield Index (HQSC) tracks the performance of euro-denominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P, and Fitch). Qualifying securities must have at least one year remaining term to maturity, a fixed coupon schedule, and a minimum amount outstanding of €100 million. Original issue zero coupon bonds, "global" securities (debt issued simultaneously in the eurobond and euro domestic markets), 144a securities and pay-in-kind securities, including toggle notes, qualify for inclusion in the Index. Callable perpetual securities qualify provided they are at least one year from the first call date. Fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. Defaulted, warrant-bearing and euro legacy currency securities are excluded from the Index.

The Cliffwater Direct Lending Index ("CDLI") seeks to measure the unlevered, gross of fees performance of US middle market corporate loans, as represented by the underlying assets of Business Development Companies ("BDCs"), including both exchange-traded and unlisted BDCs, subject to certain Eligibility Criteria. The CDLI is an asset-weighted index that is calculated on a quarterly basis using financial statements and other information contained in the US Securities and Exchange Commission ("SEC") filings of all eligible BDCs.

The Lincoln Senior Debt Index ("Lincoln SDI") measures the changes in the total return of illiquid senior debt facilities issued primarily to sponsored (i.e., private equity owned) companies in the US. The total return of loans in the Index is decomposed into two parts: income return and capital gain return. In addition, the Lincoln SDI captures a multitude of descriptive statistics, including yield and spread, of the underlying loans and issuers. While the private debt industry continues to grow, there remains little visibility into the returns and characteristics of the senior debt securities in middle market capital structures. Lincoln International's ("Lincoln") Valuations & Opinions Group ("VOG") compiles the Lincoln SDI based on the population of companies' fair valued every quarter.

The Barclays Capital US Aggregate Bond index (LBUSTRUU) measures the performance of the US investment grade bond market, which includes investment grade US government bonds, investment grade corporate bonds, mortgage pass-through securities, commercial mortgage-backed securities and asset-backed securities that are publicly offered for sale in the US.

The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

The S&P 500 Annual Total Return is the investment return received each year, including dividends, when holding the S&P 500 index. The S&P 500 index is a basket of 500 large US stocks, weighted by market cap, and is the most widely followed index representing the US stock market.

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