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Opportunities in CLOs Amid a Low-Rate Environment

TRANSCRIPT

Jenna Dagenhart:

Hello and welcome to Asset TV. Today we're talking to Weitz Investment Management director of fixed income research and portfolio manager Tom Carney and portfolio manager and research analyst Nolan Anderson. Tom, Nolan, thanks for joining us.

Tom Carney:

Good afternoon Jenna. Glad to be here.

Nolan Anderson:

Hello Jenna.

Jenna:

Great to have both of you. Let's start with the Fed. As most people who follow the bond markets know, the Federal Reserve has expressed that it will look past inflation and keep rates low to help the economy continue its recovery. The most recent Federal Reserve beige book showed that the U. S. economy grew faster than expected and inflation also picked up. Tom do you see the Fed sticking to its stated path?

Tom:

Yeah, Jenna, I'd say this path that the Fed is pursuing at the present moment is something we've all or most of us have experienced before. It's a version of - Welcome Back ZIRP - which is zero interest rate policy that the Fed is embarked on before and is doing again where the front end of the bond market yield curve is set at zero. And if it was, if it was a b-rated movie, it might be called *Attack of the Money Market Return* or *Short-Term Savings Killers*. Because we've seen the first movie, this ZIRP, zero interest rate iteration, back at the beginning of the credit crisis in 08-09. And it certainly seemed to have a long stay at the investor box office because it was there for seven years - December of '08 to December of '15. And this sequel that started in March of last year seems poised to have a pretty long run as well, particularly given the Fed's new policy framework that was announced in August of last year, whereby the Fed intends to allow inflation to run moderately above 2% for some time as the economy continues to recover and maximum employment is achieved. So, from our seats, it seems quite likely that this ZIRP sequel will easily run through '22 and far, possibly far into 2023.

Jenna:

Well, it's tough to top that analogy, but Nolan, anything you would add to the big picture here.

Nolan:

Yeah, I mean I think bigger picture, it just seems clear to us that both fiscal and monetary policy regimes have shifted in a way that is more conducive to inflationary outcomes. There's a quote from Mary Daly, who is the San Francisco Fed chief that really dovetails into what Tom took talked about – the Fed's new policy regime that they enacted last August. Before that, in February 2020, Mary gave a speech in which she said, "we have exercised the muscle of pushing inflation down for so long that changing direction feels unnatural, but that is exactly what we need to do." That's a pretty strong statement if you take her at her word. So, there is a new regime in charge, and I think investors do need to be mindful of that risk.

Jenna:

Now, Tom, investment-grade bonds just had their worst first-quarter performance since 1980. In this kind of environment, how do you continue to find opportunities for your fixed-income portfolios?

Tom:

Well, a little background, in our fourth-quarter correspondence with investors for our Core Plus Fund, for example, we highlighted the risk/return imbalance that we saw that investors faced in the corporate bond market. At year end, the broad corporate bond market recorded a 20-year high sensitivity to movements in interest rates, measured by duration, while also clocking in an all-time record low forward-return measure of one-and-three-quarter percent, 1.75%, which is using the yield to worst calculation. So, we were not too surprised that the corporate bond, the corporate bond market and investors, particularly those with longer duration assets, experienced a rough quarter given what we perceive to be an increasingly return-free-risk environment.

However, the real culprit of the worst first quarter for corporate investors in decades was the action in the Treasury market, as investors swiftly began to handicap and price in via higher interest rates, stronger economic growth. 10-year treasury rates doubled in the quarter, while 30-year Treasury rates increased almost a full percent. The price impact of Treasuries was large and naturally spilled over into all sectors like corporate bonds who get their pricing cues from Treasuries. Despite all this though, corporate bonds actually outperformed Treasuries. In other words, they went down less – may be small comfort as credit and credit spreads continue to decline from year-end levels. Overall, though, as we sit here today, we would still not view today's corporate landscape as a target-rich environment. Broad credit spreads, for example, ended the first quarter at levels rarely seen over the last 10 years – in fact, less than 2% of the time. But even if the investable universe isn't currently target rich, there invariably are opportunities active managers can identify by looking one security, one sector at a time.

Jenna:

Nolan anything you would add?

Nolan:

Yeah. I think it's market conditions, like we just experienced this last quarter, that really showcase the benefits of our flexible investment approach. We invest in a wide variety of assets, not just corporate bonds, not just Treasuries. You know, we spent a lot of time and have a lot of exposure to securitized products broadly, which includes asset-backed securities, commercial mortgage-backed securities and corporate CLOs, which is an area we've spent more and more time over the last year. And these sectors actually performed quite well during the first quarter.

Jenna:

You mentioned CLOs. In the past, you've written about distinctions between the packaged loans from the broadly syndicated market versus those from the middle market. Your primary interest has been in the middle market. Why is that, Tom?

Tom:

Maybe a little background here also might be helpful. CLOs, or collateralized loan obligations, are portfolios of senior secured, typically first-lien floating rate loans to businesses, both big and small. These portfolios of loans are securitized and sold to investors like our other ABS, asset backed security investments, across senior to junior to equity segments. The overall CLO industry is divided into two broad segments: BSL, which stands for broadly syndicated loans, and MM, or middle market loans. What distinguishes the two are company size. The middle markets' base is generally those companies whose annual cash flow is under $75 million dollars a year. While the broadly syndicated loan is everything larger. And as we've spent time conducting our due diligence in the broader CLO area, we found that the much more granular, rigorous and company-specific level approach to lending by sponsors in the middle market segment that tend to align much more closely with our overall investment process and philosophy. And in addition, the middle market space, despite being a much smaller segment of the overall CLO market, presents a large investable opportunity for us. Namely – might be interesting to note that the U. S. Middle market, if it were an economy on its own, it'd be the third largest in the world behind, of course, the United States and China, but ahead of what would otherwise be the fourth-place economy, Japan. And in that particular segment of the economy, which are the smaller companies throughout America, 200,000 companies that represent approximately one third of U.S. private-sector GDP and 48 million jobs or about a third of total U.S. employment.

Jenna:

Those are some pretty eye-popping numbers right there. Nolan, what do you think?

Nolan:

Yeah. From a shareholder perspective, we think there are three primary benefits to middle market CLOs. First, the diversification benefit to our funds. Each CLO that we own underneath of that security is, alone, 50 to 100 companies spread across a bunch of different industries. So, we get instant diversification benefits in that one securitization by really truly lending underneath to dozens and dozens of companies. Second, they are very well structured, and from a risk-of-loss standpoint, actually compare quite well or, or even favorable to the broadly syndicated market. And then last but not least, because they are a little bit more complex in the due diligence – it takes a little bit longer, and liquidity is not as strong, you get paid more. So, the coupon income that we pass along to our shareholders is superior to that what you receive in the broadly syndicated loan market.

Jenna:

Although what market conditions, if any, might have you steer away from investing in CLOs?

Nolan:

Yes, we have two charts here on the left there is just a bunch of different spreads laid out on the screen, including AAA CLOs versus investment-grade corporates, and then BB CLOs versus high-yield. As you can see, the spread that investors can receive today in AAA CLOs is higher than what you can receive in a corporate bond. And then on the right, it shows the relative value between the two. And when CLO spreads are in a period like today, above the line, they are actually quite attractive on a relative basis to the corporate market. So, we're not, today, we actually think they're quite favorable. But our investment framework is based on risk and reward. So, if the valuations of CLOs get to a point that they are unattractive relative to other areas that we can invest, or the underlying securities or the structures something that would cause the risk profile of the CLOs to change, then we obviously would act and make adjustments.

Tom:

It really boils down to phrases that we've used in previous correspondence with investors, and that is that price is what you pay, value is what you receive. And our job is certainly heed that and always seek out the best risk/reward opportunities wherever we can find them.

Jenna:

Well finally, we can't get through this conversation without bringing up the “I” word. So many fixed income conversations today turn to speculation over the return of inflation. Nolan, what would a rise in inflation mean for the fixed income markets, and would it be prudent for bond investors to take a defensive approach?

Nolan:

Sure, yeah. A rise in inflation would be something the bond markets haven't experienced in a very long period of time. We've been fighting deflation, really, for a long period of time. So, it's really difficult to know how the market would react. For us, we try to focus on downside protection and getting paid to take risks. We just had an April CPI print of 2.3%, and if you look across the entire Treasury curve today, there is not a place that you can lend money to the government at a yield above that. So, whether it's, you know, one-year bond or a 30-year bond, the whole curve is below the inflation rate. So, you know, earning a negative yield isn't a great starting place for us thinking about risk and reward. And even assuming inflation doesn't go materially higher from here, which some speculate it could, we don't think we're getting paid to take significant interest rate risk at current yield levels.

Jenna:

Yeah. Tom what are your thoughts on that?

Tom:

Well, Nolan well highlighted the likely mood of many, or most, of the current Fed members with the comment by Miss Daly earlier. But I can't help but be reminded of a quote by the Gipper, the 40th President of the United States. In 1978. Ronald Reagan said, “inflation is as violent as a mugger, as frightening as an armed robber, and as deadly as a hitman.” Former President Ronald Reagan certainly knows the dangers of allowing inflation to become too embedded in an economy having served during the country's last serious bout with inflation. Overall inflation is very much like toothpaste. It's hard to put back in the tube once it's been squeezed out. Our job has been and always will be following the sage advice of Seth Klarman of Baupost that we will worry top down on issues like inflation, but we’ll invest bottom up one security, one sector, one industry at a time.

Jenna:

Well, Tom, Nolan, thank you so much for all the great quotes and for sharing your time and your insights with us today.

Tom:

Thank you, Jenna.

Nolan:

Thank you very much, Jenna.

Jenna:

And thank you for watching. That was Weitz Investment Management director of fixed income research and portfolio manager, Tom Carney, and portfolio manager and research analyst, Nolan Anderson. I'm Jenna Dagenhart with Asset TV.

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