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FOR PROFESSIONAL INVESTORS ONLY

Global Value and Income Dispatch

Beware of the liquidity illusion in the quest for higher yields



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We have seen significant growth in the private lending markets.

Investors should be aware that they are trading off both liquidity and collateral transparency for higher yields.

The trade-off in CLO structure is secondary market liquidity. Analysis by JP Morgan shows that on average a CLO is most often traded in its first year from pricing. As it seasons, it trades much less often.

Where are the risks building?

When our team is on the road, the most common question is “where are the risks building in this cycle?” Many have written about the explosive growth in leveraged loans as well as rising corporate leverage coupled with the lack of covenants (i.e. covenant-lite loans) that are supposed to protect investors’ claim value. In our view, while loosening lending standards are concerning, they are unlikely to create a systemic risk.

We believe the key risk instead lies in products that invest in less liquid assets that are leveraged and/or packaged into vehicles that offer either monthly or quarterly liquidity; hence, a “liquidity illusion.”

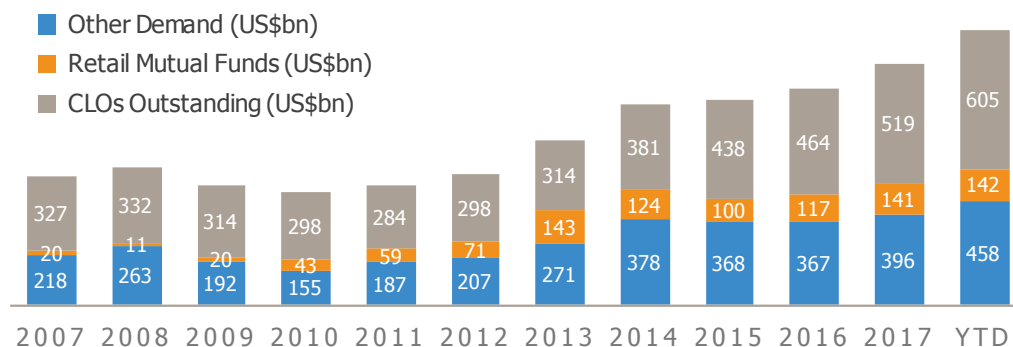
Credit markets exhibit less pricing transparency

Unlike the comparative pricing transparency of equity markets, credit market pricing is more opaque. This is particularly evident as you move down the liquidity and risk spectrum to Private Credit. Bid-ask spreads can notably move at times of stress, as they did in 2008 and most recently in December 2018, thus making it harder to price the underlying asset. This may be particularly acute for products where there is very little to no secondary market liquidity, such as middle market lending and Collateralized Loan Obligations (CLOs) funds. Let’s look at each of these products a little more carefully.

Collateralized Loan Obligations (CLOs) have been around since the early 1990s and can offer attractive returns to rating-sensitive buyers.

AAA/AA tranches typically compete with the Commercial mortgage-backed securities (CMBS) and Residential mortgage-backed securities (RMBS) markets. When yields worldwide are low, they become a very attractive investment for investors looking for higher yields without sacrificing credit ratings. Strong demand for CLOs has boosted the CLO market size to ~\$605 billion in the US, which represents ~50% of the leveraged loan market (see Chart 1).

Chart: 1 The CLO base has doubled since 2012 to \$605bn today.



Source: JP Morgan, data as of 18 December 2018.

For example, AAA-rated CLO tranches traded at an average spread of LIBOR+107 during 2018, and screened very attractively compared to A-rated corporate bond spreads at LIBOR+65 at the beginning of the year. Higher spreads reflect: a) the inability of the asset to be sold quickly; b) the changing maturity profile of the asset as loans are pre-payable at par at anytime i.e. shorter in a strong economy and longer in recessions; and c) less transparent collateral pool, as the underlying issuers are private and do not have publicly



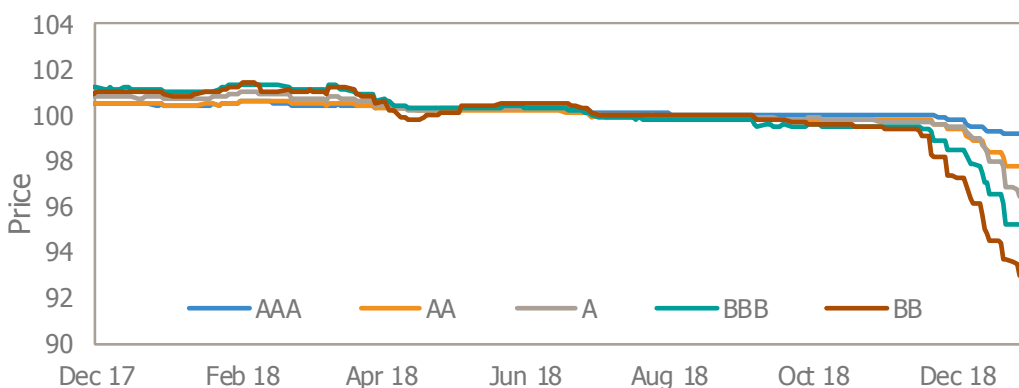
“The risk is that, in the event of a shock or a panic, investors will demand all of their money back at the exact time when the liquidity of the already illiquid underlying assets deteriorates even further. Investors may not anticipate or recognize this problem until it is too late--the so-called liquidity illusion.”

- Jerome Powell (18 February 2015)

available financials.

With that said, CLO spreads are not entirely divorced from the overall trends in more liquid markets such as investment grade and high yield. As credit spreads widen, so do the levels on the CLO tranches. For instance, CLO spreads widened in December in tandem with the broader credit markets, with spread widening erasing returns for A-rated tranches and below (see Chart 2).

Chart 2: CLO prices fell sharply in December amid market volatility



Source: Palmer Square CLO indices, Bloomberg.

Here's what Fed Chair Powell had to say back in 2015

“CLOs and other stably funded investors continue to be the primary owners of leveraged loans. But in recent years, mutual funds that invest in fixed income assets have seen large inflows and have become more significant investors in this market. Some of these funds, including those holding syndicated leveraged loans and high-yield bonds, provide investors with what is called liquidity transformation--providing daily liquidity even when the underlying assets are relatively illiquid. **The risk is that, in the event of a shock or a panic, investors will demand all of their money back at the exact time when the liquidity of the already illiquid underlying assets deteriorates even further. Investors may not anticipate or recognize this problem until it is too late--the so-called liquidity illusion.**” (Jerome Powell, 18 February 2015)

Not all CLOs are created equal!

We would be remiss if we didn't acknowledge that post-2008 regulation has led to more strict collateral pool requirements as well as higher collateral quality tests. These improvements can dampen loss expectations and are net positive developments versus the pre-2008 structures.

In summary, given the significant issuance of CLOs, picking a manager that is appropriately staffed to review each CLO collateral and indenture appropriately to assess the right risk premium is of utmost importance. After all, not all CLOs are created equal!

Private market lending, particularly middle market lending, has also been around since the early 1990s as an avenue to provide capital to smaller and mid-size companies that may not have access to traditional commercial bank loans. After the financial crisis and the subsequent withdrawal of commercial banks from certain markets, there has been notable growth in this area.

According to Preqin, private market debt markets have grown 2.7x since 2008 to \$666 billion in 2017 (see Chart 3). With the growth of the market, risk has effectively moved from the banks' balance sheets to private lenders (retail investors, insurance companies, sovereign wealth funds and pension funds).

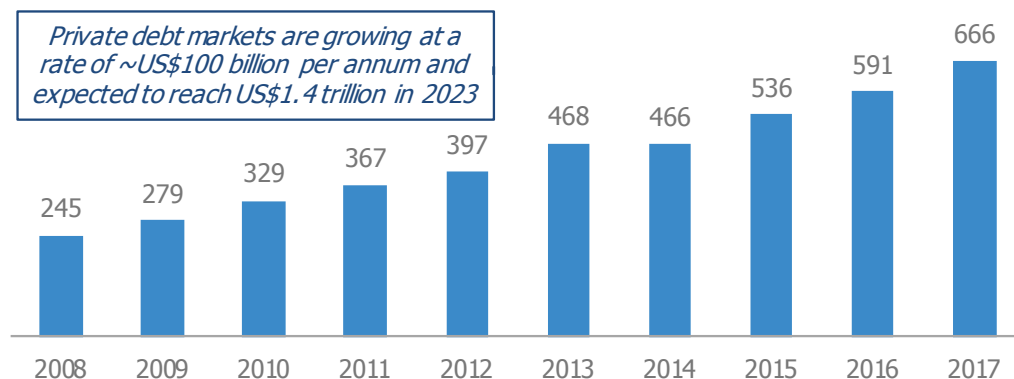


As the name suggests, the private debt market is not very transparent, making it very hard to track trends.

Recent news that a large middle market lender changed advisors and subsequently suffered a ~25% mark down in the collateral perhaps highlights the challenges that come with rapid growth in the industry and the pressure to deploy capital quickly.

Investments in interval funds span distressed credit, mortgages, real estate and reinsurance, which can offer higher yields relative to the public liquid markets. Understanding the drawbacks of these structures and the underlying investments is critical.

Chart 3: The growth of the private debt market (US\$bn)



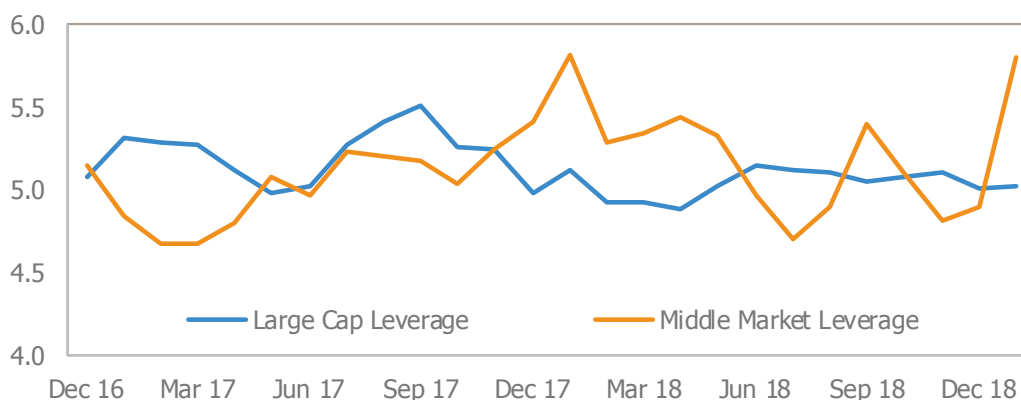
Source: Preqin.

Strong market growth attracted new entrants

Preqin estimates there are now 322 managers participating in the direct lending market, a quarter of which debuted in the last five years. As such, they have not been tested through the full credit cycle.

Increased fund competition in the market has also led to looser lending standards and higher leverage, just as we have seen in the broader syndicated leveraged finance markets (see Chart 4).

Chart 4: Total leverage has also increased in middle market deals



Source: LevFin Insight.

What does all this mean?

CLOs and private debt markets combined could add up to ~\$700 billion to \$1 trillion in size, equating to the size of the US leveraged loan market, 60 to 80% of the US high yield market or 10-15% of the US investment grade market. This is clearly large enough to pay attention to.

Having said that, the buy and hold nature of the assets may prevent fire sales at times of stress, but investors will need to take a long-term view through market volatility.

To be clear, we are not saying investors should shy away from all private market lending and CLOs. We simply want investors to be aware that these are **structures where the investor is sacrificing liquidity and, at times, pricing transparency of the collateral for higher yields.**

Interval funds – read the label carefully!

In order to attract a diverse pool of capital into broader investment opportunities, Mr Market has come up with interval funds. Interval funds are closed-end funds registered under the Investment Company Act of 1940, but also share some common characteristics of open-ended mutual funds. The funds price NAVs daily but are not listed on an exchange. They do not offer daily liquidity, but redemptions are available through the fund repurchase programme that is offered either quarterly, semi-annually or annually (though for only 5% to 25% of the

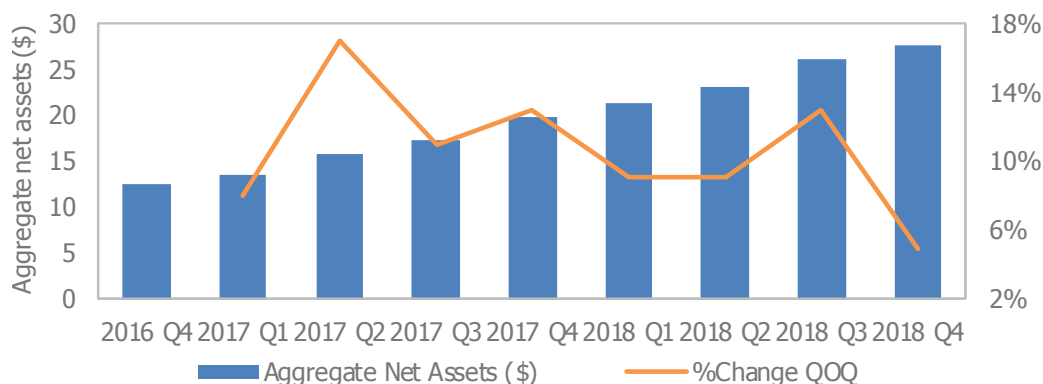


We are likely at late stages of the credit cycle although cycles don't die of an old age. It is nearly impossible to predict the end of a credit cycle, but we believe that caution is needed at this stage.

fund's shares): This liquidity control mechanism ensures that the fund can invest in less liquid assets.

Redemptions are priced at the NAV of the closing day of the repurchase period, which can be up to 14 days later than the time when an investor submits a redemption request. This clearly exposes the investor to volatility in the NAV, which in our view can be exacerbated by the nature of the fund's investments. These may be illiquid and perhaps more difficult to value. Interval funds have grown 41% year-on-year to \$27.5 billion, as of 4Q2018 (see Chart 5).

Chart 5: Net asset growth in interval funds



Source: Interval Fund Tracker.

Capital markets are engineered to solve investors' problems, whether these are low yields, income, or access to illiquid asset classes that have historically only been available to institutional investors. **Understanding what you own, and why you own it, will always be a key pillar of risk management.**

We seek to offer attractive income without sacrificing credit quality and liquidity – we are not reaching for yield.

The business and credit cycles generally move in tandem, which at times leads to market runs across asset classes in the search for liquidity. Those are the moments when typical correlations between asset classes can break and liquid assets begin to offer significantly more attractive returns, as we saw after 2008. These may also be the periods when investors truly test the opportunity cost of investing in illiquid assets.

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