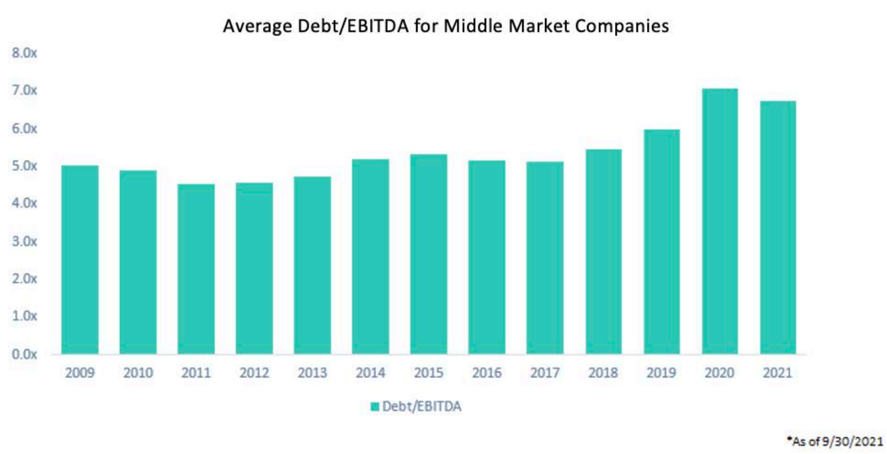
Buyer Beware

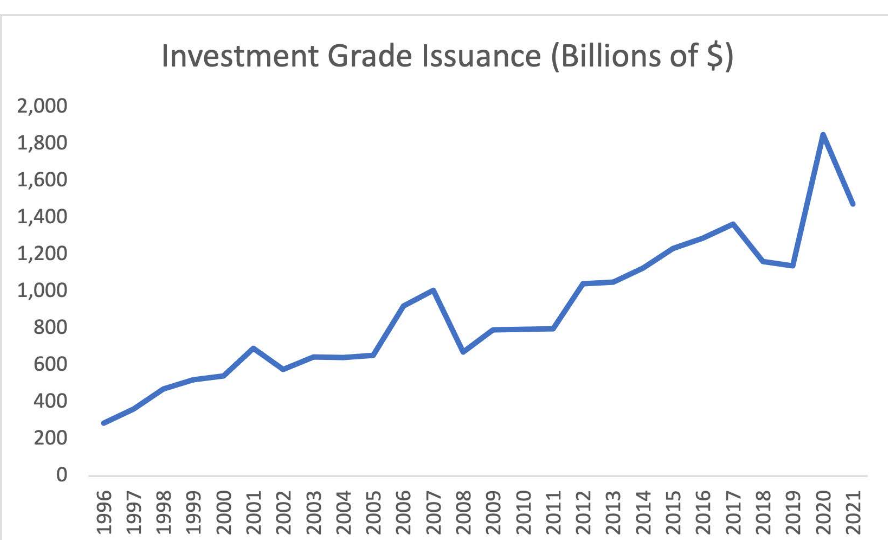
In today's markets, many investments are touted as "safe" by virtue of a credit rating or a label like "senior" or "loan". But many of the investments that are deemed to be secure are anything but, and buyers should beware, particularly insurance companies that, by virtue of needing yield combined with capital treatment considerations, have invested (and continue to invest) heavily in these assets.

Daniel Zwirn is CEO/CIO of Arena Investors, a global institutional asset manager that provides creative solutions for those seeking capital in special situations. Arena originates unlevered, privately negotiated, asset backed, senior secured investments in insurance capital efficient vehicles. Arena has deployed ~$3b into 270 credits in micro transactions ($10m-$30m) with superior risk adjusted returns relative to mega sized credit shops.

In that context, insurers should be reminded that markets are a clearing place for buyers and sellers, and incentives matter. Charlie Munger once said, "Show me the incentive and I will show you the outcome". Nothing is more important to emphasize in today's bubble. In that vein, our advice would be to recognize that return per unit of risk in many markets is at all-time lows, and for investors to avoid, as much as possible, further increasing their exposure to grossly overvalued assets.

On the seller side, ballooning balance sheets and incredible amounts of excess liquidity have turned investment managers into asset managers – that is, firms motivated to grow assets under management, which necessitate them offering products that are scalable (and "sell-able"), to the tunes of hundreds of billions of dollars. According to a joint study by the Thinking Ahead Institute and Pensions & Investments[1], the assets under management of the 500 largest asset managers in the world reached a new record in 4Q2021 of $119.5 trillion, a 14.5% year-over-year increase, and an increase of 85% over the past 10 years. Many of these managers have become so large that for those that manage hundreds of billions of dollars, doing deal sizes below $100 million (or even $250 million) today is just not economically justifiable.





Related to the above story, the average debt multiple on middle-market loans continues to increase (now at ~7 times, as shown in the graph to the left from Pitchbook data), ignoring EBITDA adjustments, which remain on an upward trend, and also ignoring that, as S&P Global recently cited, "marketing EBITDA generally doesn't provide a realistic indication of future earnings and … companies consistently overestimate debt repayment[2]. Together, these meaningfully understate future leverage and credit risk[3]. In fact, what is a "senior loan" is actually a combination of yesterday's senior loan plus a high yield bond.

The fact that buyers are taking comfort from ever longer lender advance rates, weak covenants, and low cost, while lenders are taking comfort from how much buyers are willing to pay (thus creating a falsely "comforting" low loan-to-value), reminds one of the two proverbial "drunken sailors" propping each other up.

Turning to "safety," issuers (the sellers) have taken advantage of the current times as well. For example, one can look at the annual amount of investment grade bond issuance[4], which is up about 5 times over the past 25 years.

As of 2019[5], the outstanding issuance in the BBB US bond market exceeds

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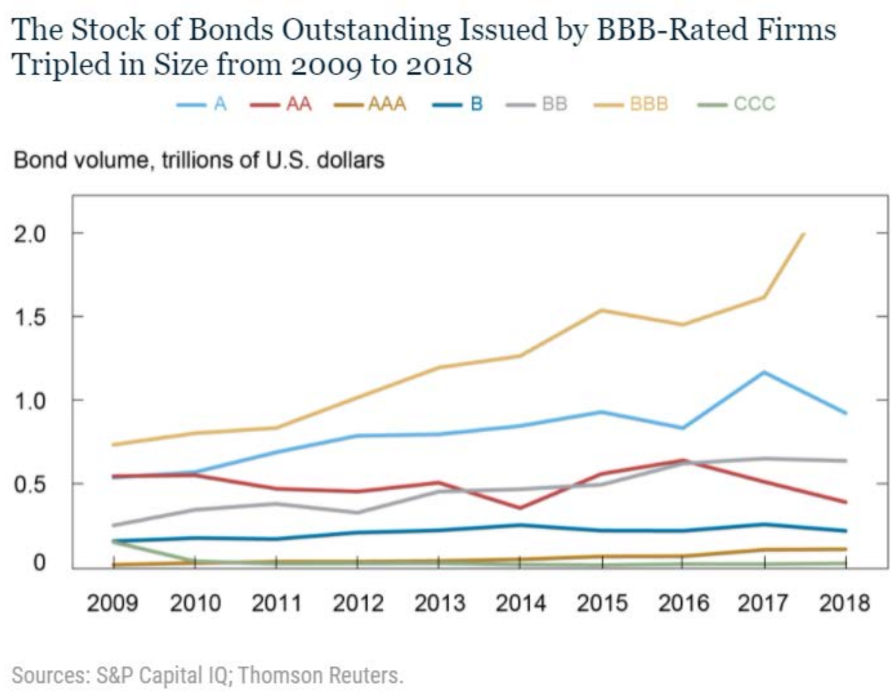
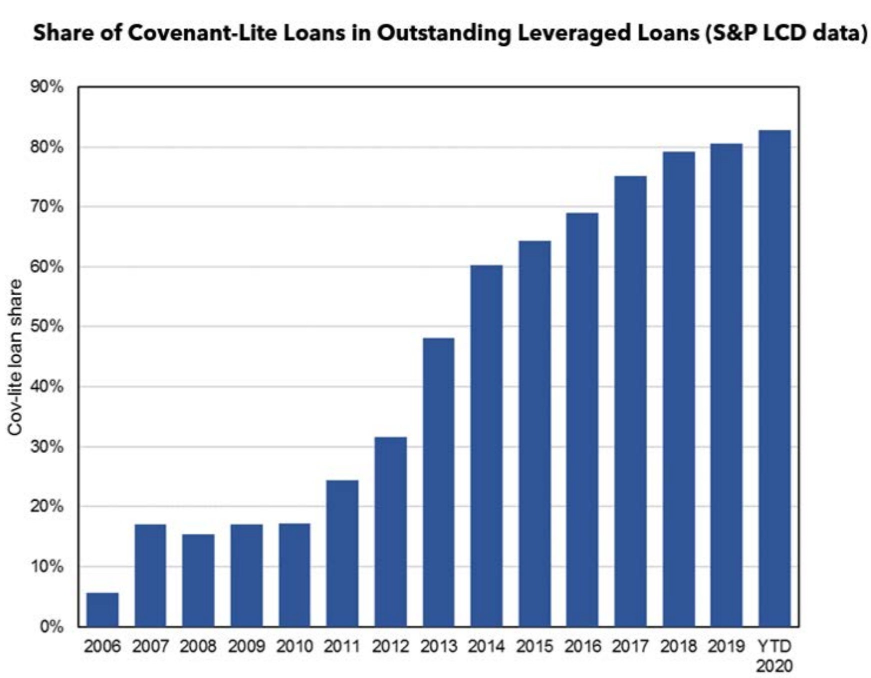
the entirety of the speculative-grade bond market. Given that BBB connotes “investment grade,” the correspondingly highly efficient capital treatment for these bonds on the balance sheets of insurance companies leads issuers to contort credits to fit agencies’ minimum standards for this label.

What is not widely recognized is that such purported safety does not equal quality. Rather, today’s BBB corporate bond is yesterday’s BB[6]. Given the “investment grade rating” threshold of BBB, it is no surprise that issuance by companies deemed to be on the BBB threshold has boomed since the financial crisis, as shown in the graph to the right.

And with $7 trillion globally in “BBB,” one can only wonder whether the underlying credit quality matches such ratings, with yields[7] going from just over 10% in early 2009 to just over 3% today, and given that qualifying as investment grade today allows for 50% + more leverage (as measured by debt divided by EBITDA) versus 2008[8].



This phenomenon is also due, in large part, to rearview mirror analysis. For example, take CLO equity, which, “didn’t lose money” in the 2008 crisis. If you ignore the structurally better collateral and covenants at that time (versus today), and believe that investors will actually have “strong hands” to hold these securities if they go down 80-90 points, I guess one could make that case. But otherwise, it is hard to imagine this not being a bubble that will result in losses. On the former point re: covenants, note the graph to the left showing the share of “covenant-lite” loans.



The much lower asset quality (versus 2008) would necessarily imply lower recoveries. And then, further, even assuming a “V” shaped journey from trough to recovery, few current owners will hold all the way through like they did in 2008. A 2020 Federal Reserve note[9] cited that only about 7.5% of CLO equity tranches were owned by insurance companies, pension funds and depository institutions whereas nearly 50% were held by households and mutual funds[10].

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And then marry that with the extreme increase in issuance over that same period, as shown in the graph to the right. To us, this screams of supply driven by demand (caused by looking through the rear view mirror), and certainly not a trade we would pile into.

And finally, there is the fact that liquidity will not be there when you actually need it. Dealers no longer maintain liquidity in these securities, and even when they did (let's go back to 2002 and the WorldCom fraud), there was nary a bid, leading to the bank debt and bonds of other related (non-fraudulent) companies trading down materially. In today's post-Volker Rule world (where dealers do not maintain inventory and must have a closely matched book, and thus hold much less inventory, as shown in the graph by Deutsche Bank below), one can only imagine the pain that may come.

And again, this in the context of extremely compressed yields, as shown in the graph on p.10 for the last ~40 years across Baa, Aaa, 30-year mortgages and 10-year Treasuries.

All of what has been described may take a long time to materialize. After all, many of the holders of today's paper do not need to mark to market and are hence, "strong hands". As one example, according to AM Best[11], US Insurers' Holdings in Collateralized Loan Obligations Have Grown by 77% Since 2016 from $75.1 billion to $132.7 billion. And an even cursory search of CLO on LinkedIn retrieves 23,000 results – these are not people who wake up in the morning saying, "should I do a 180?" but are rather feeding the beast further and further and will only be displaced by an explosion (which they will work tirelessly to prevent).

But if there is a race to the door (which doesn't have to be macro or even

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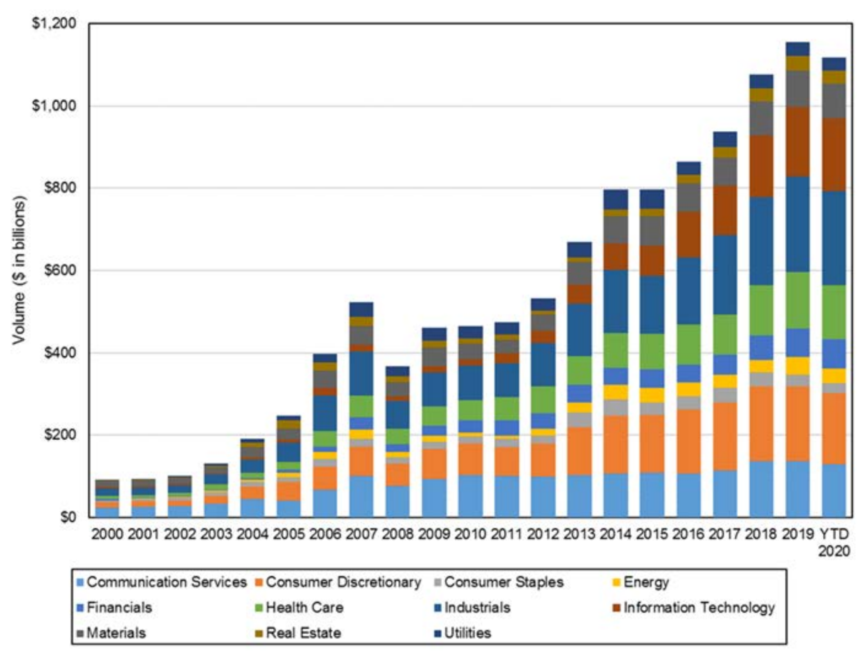
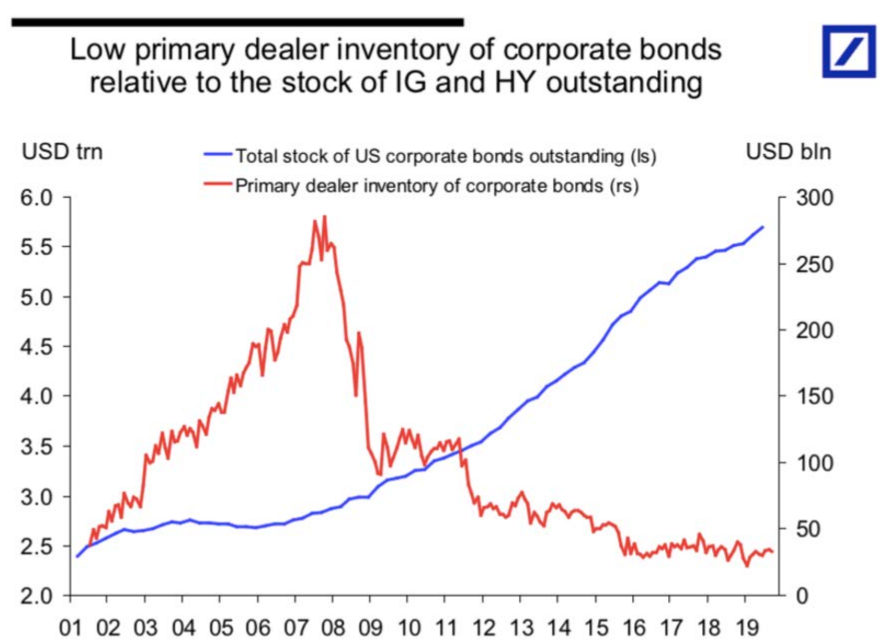
Outstanding Leveraged Loans by Sector 2015–YTD 2020 (S&P LCD data)





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economically driven – e.g., WorldCom), it will be a stampede of epic proportions. That's not to say there aren't investments that are uncorrelated, or even negatively correlated and can be defensive in such times, and that is also not to say that one cannot find investments that are both uncorrelated and can create upside convexity. Such opportunities are, by their nature, limited in supply and require their own expertise to source and manage, but can be found through the right partners and are worth the effort to find, particularly in today's environment. May you stay safe in these bubbly times… ☐

[1] https://www.thinkingaheadinstitute.org/research-papers/the-worlds-largest-asset-managers-2021/

[2] Note, assuming 20% EBITDA adjustments and 80% cashflow conversion, this would imply true leverage (debt to unlevered free cash flow) of 11x.

[3] https://www.spglobal.com/ratings/en/research/articles/220208-ebitda-addbacks-continue-to-stack-12264363

[4] Source: S&P Global

[5] https://www.spglobal.com/en/research-insights/articles/the-bbb-u-s-bond-market-exceeds-3-trillion

[6] Zwirn, Daniel, Kyung-Soo Liew, Jim and Ajakh, Ahmad. "This Time Is Different, but It Will End the Same Way: Unrecognized Secular Changes in the Bond Market since the 2008 Crisis That May Precipitate the Next Crisis." The Journal of Fixed Income, Fall 2019. https://eprints.pm-research.com//17511/21697/index.html?27788

[7] https://fred.stlouisfed.org/series/BAMLC0A4CBBBEY

[8] https://seekingalpha.com/article/4259460-increasing-share-of-bbb-rated-bonds-and-changing-credit-fundamentals-in-investment-grade

[9] https://www.federalreserve.gov/econres/notes/feds-notes/who-owns-us-clo-securities-an-update-by-tranche-20200625.htm

[10] This compares to insurance companies, pension funds and depository institutions owning over 60% of the senior tranches.

[11] https://www.businesswire.com/news/home/20210126005820/en/Best%E2%80%99s-Special-Report-Rated-US-Insurers%E2%80%99-Holdings-in-Collateralized-Loan-Obligations-Have-Grown-by-77-Since-2016

Upcoming Events

1. The CICA International Conference in Tucson, Arizona is coming up on March 6th-9th. Carl Terzer and Travis Terzer will be in attendance. We hope you stop by booth #20 to see us.

2. CapVisor will be attending the NCCIA annual conference in Durham, NC from May 1st-4th. We will also be exhibiting.

Carl E. Terzer, Principal & Editor in Chief CapVisor Associates, LLC

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