CIFC Asset Management

Thinking ahead

Autumn 2023

CLO Manager of the Decade

Inside this issue:

CIFC
CLO manager of the decade

The respected publication Private Debt Investor recently awarded CIFC its “CLO Manager of the Decade: Americas” award. In this edition of *Thinking Ahead* we will perhaps do more reflecting than usual.

How did an organization only set up in 2005 garner over $40 billion in assets under management so quickly? Why has it earned this award? And, perhaps more importantly, what does the future hold for it?

This is not just CIFC’s story. Recent investors might appreciate learning some of the company’s background, but we recognize many will likely be interested in the history of CLOs and the state of the market today.

Veterans Steve Vaccaro (CIFC’s CEO and Chief Investment Officer) and Ira Ginsburg (MD and Head of CLOs) offer an overview of the CLO industry and how it has evolved since the Great Financial Crisis. CIFC’s Head of European Credit, Conor Daly, examines the differences between the US and Europe. Together, they discuss the current environment of still-rising interest rates and the impact it is having on the CLO market on both sides of the Atlantic.

Underlining the fact that CIFC is much more than just a CLO manager, Jason Horowitz, Head of US High Yield Bond Investments and manager of the CIFC Long/Short Credit Strategy, explores why we own long high yield bonds in several strategies at this point in the cycle.

As always, please contact me if you have any questions or comments.

Joshua Hughes is Managing Director, Global Co-Head of Business Development

Private Debt Investor

DECADE AWARD

CLO Manager of the Decade: Americas

Please refer to the last page for additional information about this award.

Where it began

When CIFC launched in 2005 its founders set out to create something different. **Steve Vaccaro** and other colleagues, mostly then working at JP Morgan, saw the opportunity to establish a credit management business that relied on the fundamental analysis and corporate valuation disciplines they had used as bankers. Steve says: “It may sound strange, but at the time we felt this approach was rare.”

“The global financial crisis helped define CIFC in the eyes of investors as a credit manager that truly understood credit and how to manage risk in difficult times.”

Steve Vaccaro
CIFC CEO and Chief Investment Officer

Steve was the original Chief Credit Officer, responsible for making day-to-day investment decisions. He ran the whole investment and risk side of the business from day one. Today, as CEO and Chief Investment Officer, he still keeps a close eye on the details.

It was an opportune time to launch. The CLO market was very active, and CIFC quickly garnered a respectable AUM. Then came the Great Financial Crisis (GFC).

The disciplines that had served the team well in their banking careers, before the era of banking excess, came to the fore. CIFC came through the GFC without violating an overcollateralization test, missing a payment to equity nor paying in kind a subordinated management fee.

Steve says: “Our focus on truly understanding credits and the valuation of companies helped protect investors. There was a large disconnect between price and value in a market that was broken by the draining away of liquidity. We navigated that well by understanding the value of what we owned versus what we were seeing priced on our screens. This period helped define us in the eyes of investors as a credit manager that truly understood credit and how to manage risk in difficult times.”

A period of consolidation within the industry meant that in the immediate aftermath of the crisis CIFC was able to grow through merger and acquisition.

CLO industry evolution

The GFC was a turning point for the industry, says Ira Ginsburg, who joined CIFC as Head of CLOs in 2011. He says: “After the financial crisis, long-term investors like pension funds, insurance companies and asset managers started to enter the CLO market. They were very different from the levered, smaller, quick-money type investors that tended to support new issue prior to the financial crisis. Today you’ve got investors in Japan, the US, and Europe buying at different points in the cycle. It means you can create a triple-A book syndicated among 15 to 20 investors – something that was impossible a decade ago. Since I joined CIFC, CLOs have grown from about 50% of the loan market to 75% today. The CLO market is now worth around \$1.3 trillion[1], while loans are about \$1.6 trillion[2].”

What has driven growth and maturity is performance. Steve says: “We believe our returns have been attractive. When you look at the very low default rates seen in CLO debt tranches, performance has been materially better than similarly rated corporate bonds. I think that is testimony not only to the structure but also to the quality of risk management – the credit selection that has gone into the structures themselves. This has been shown to be a consistent, high yielding product. Whether you’re in the equity tranche or whether you’re in the debt tranches, we believe you’re getting paid materially more than if you were invested in similarly rated corporates.”

We believe CLO structures have become more conservative than they were before the GFC – something that may reassure more recent investors.

Ira says: “Coming out of the crisis, the ratings agencies overhauled their assessment criteria. This resulted in cleaner CLO portfolios, no structured credit, fewer bond baskets and higher credit enhancements. That has helped to create a product that is better equipped to cope with conditions like today, with two cycles in quick succession – COVID and a high rate/recessionary environment."

Of course, the past decade has been characterized by low interest rates. Many may wonder how the loan market is coping with a very different environment today.

Ira says: "Year to date, loans in the marketplace have had to deal with dramatic macro events, growth scares, inflation, a bank crisis, and debt ceiling debates. Through all that they've generated returns in the region of 9%[3]. That's despite a default rate of between 1.6% and 2.3%[4] and lower-than-average recoveries."

He continued: "In a high-rate environment there is a cushion, helping to sustain returns to withstand credit pressure. We foresee higher defaults ahead, but we believe they'll be within a manageable range with respect to the coupon that loans are paying today."

Rising rates have presented a challenge this year for CLO issuers – there has been a significant drop in issuance since late May. Ira says: "Investors want to participate, but the cost of capital hasn't moved in line with improving loan prices. We call it the arbitrage. The yield on the portfolio, less the cost of capital, hasn't come back in line to make the equity returns desirable. You can currently buy double-Bs at yields that are higher than equity. We need to see the cost of liabilities come down."

This has created volatility and dislocation in the market, but Ira expects this to correct itself. He says: "You have about $150 billion of loans maturing between now and the end of 2025.[5] We need buyers for those vehicles that are coming out of the market. Any new money is being created at a very high yield. If you're opening a warehouse today you can create a portfolio generating a step shift higher yield. Perhaps that higher yield will create an arbitrage that works a little better. In addition, as these CLOs start to repay and amortize, you'll have significant amounts of money returned to triple-A investors – and their desire to invest could increase. I believe you'll see the arbitrage converging once again later this year. Historically, it has righted itself."

CIFC opened its London office in 2018 and now employs 12 people there. Conor Daly, CIFC's Head of European Credit, joined in the second half of 2022. He says the US and European markets share many similarities.

"I think a lot of the dynamics, such as the challenges around arbitrage, the impact of higher interest rates on security prices, the price of liabilities and how that all works are similar. The differences lie in terms of scale and the profile of the assets. Broadly speaking, the European loan market is about a quarter of the size of the US market. We tend to see one deal in Europe for every three in the US."

He added: "US corporates are much more frequent issuers in the capital markets. Europe is still a very heavily banked economy. That's changing – we've seen the emergence of deeper high yield markets, deeper leveraged loan markets, and deeper private credit markets. But banks are still the predominant source of capital to European corporates. If you look at the US and the portfolios Ira can construct, for example, a lot of double-B corporates frequently use both the US leveraged loan market and the US bond market, whereas in Europe they tend to go to banks. Therefore the collateral pool we can build in Europe tends to be slightly more single-B heavy and slightly more private equity heavy."

"Year to date, loans in the marketplace have had to deal with dramatic macro events, growth scares, inflation, a bank crisis, and debt ceiling debates. Through all that they've generated returns in the region of 6%."

Ira Ginsburg
CIFC Head of CLOs

“I believe there’s a much stronger collateral base for our investors now than there was...”

Conor Daly
CIFC Head of European Credit

Over his career Conor has also seen big changes in the CLO industry in Europe. He says: “I think Europe has come an awful long way since the immediate post-financial-crisis era, when there were probably only 15 to 20 CLO managers here. We’re now more than 60. Ultimately, the industry has attracted capital flows, which is good for all participants. Asset managers have seen it as a good business and have presented a compelling case to investors to allocate capital to the space.

“There has also been a big change in underlying investments. I believe there’s a much stronger collateral base for our investors now than there was during the GFC. In Europe you tend to have smaller businesses compared to the US. Back then European CLOs were lending to what you might call single-country, single-product businesses with less than €100 million EBITDA. Today they tend to be larger, cross-border enterprises with somewhere between €250 million and €300 million EBITDA, which means the collateral pool we’re constructing for clients is ultimately more robust than was the case.”

Beyond CLOs

CLOs remain the biggest part of the CIFC business today – it manages around $30 billion worth. But the business has diversified in recent years. “All toward areas of credit that we feel are complementary,” insists Steve. “So, in addition to CLOs, we manage corporate credit funds, structured credit funds and opportunistic credit. And we also manage direct lending – a business that we acquired in late 2021.”

He adds: “Credit is credit, and understanding cash flows, valuation and a company’s ability to service its debt is the same essential skill set – whether you’re applying it to loans that go into a CLO or into a loan fund or a credit opportunity fund. We’ve been careful to stick with businesses that really rely on the same fundamental skills that got us here.”

Building and diversifying the business has meant building the team, too. For Steve that has meant getting the culture right.

He says: “Culture is very important for us. You can talk about credit culture in terms of our investment discipline, but it’s also about how we treat each other and interact as colleagues. It’s about teamwork – how the verticals work together. We’ve hired people who we think share our skills and focus on risk but who are also willing to leverage each other to grow the wider firm. We have lots of cross-ocean interaction between the US and Europe. And we leverage off the same investment committee, whether we put names in a CLO or a loan fund. We rely on our research team to complement the high yield group in their efforts. The members of the structured credit team depend on the research group to understand the very granular nature of the portfolios and the bonds they buy. The way I look at it is this: the more products we have, the more information we have. And the more we share that information – the more we discuss it together – the better decisions we’ll all make.”

1. Source: Bloomberg, as of 6 July 2023
2. Source: FitchRatings, as of April 2023
3. Based on Morningstar LSTA Leveraged Loan Index and Credit Suisse Leveraged Loan Index YTD numbers as at 31 August 2023.
4. Based on the Morningstar LSTA Leveraged Loan Index and JPM Leveraged Loan Index default rates 31 August 2023
5. LCD All US loans from 8 September 2023 to 31 December 2025

The importance of quality bespoke technology

CIFC was an early adopter of technology to enhance productivity, employing in-house programmers to develop a cutting-edge database. But mergers and acquisitions in the early years created challenges. CEO and CIO Steve Vaccaro says: "We took on a number of CLOs across various other platforms. And what I found was that our credit database was largely often disorganized piles of paper in the bottom drawers of people's desks.

"We knew that as we grew – and as our business became more complex – there needed to be a way to access that data, at the very least to enable us to make sound decisions in the absence of the person holding the information. But we wanted much more than that. We wanted to harness that information and use it across the business to help all the portfolio managers make good decisions and to understand trends within our portfolios."

"We were faced with essentially five separate systems and five different general ledgers," says Ira Ginsburg, Head of CLOs. "It took the better part of a year to consolidate that on to one platform and one front-end system."

CIFC morphed its debt credit database on to an institutional platform soon after Ira's arrival in 2011. But it continued to employ in-house programmers to customize the database.

Ira says: "Having the in-house programmers sitting next to us and involved in our workflow allowed us to cut out many bottlenecks that present to most managers."

Today everything CIFC knows about a credit – including financial information, analyst views and external commentary – is accessible by the whole team through the database.

Steve says: "We don't just have the ability to access that information and use it in efficient ways – we can also look across our portfolios and stress-test different scenarios. In our Structured Credit business, we run over a million simulations a night across nearly all the bonds in the marketplace and see how they might perform in different economic scenarios. Our analysts and portfolio managers can wake up to these portfolio reports and see what's in their coverage and where the outliers are. It stratifies the data for them every which way needed."

Ira adds: "It means that when something like COVID hits we know our restrictions and what we can trade. This real-time information allows us to be on top and proactive in managing portfolios."

Conor Daly, Head of European Credit, who joined the business last year, thinks CIFC has retained its technological advantage. He says: "What I love about the technology is that the data comes through your phone on an app. We do a lot of meetings; we take calls and see many clients. Being able to access this data so cleanly and quickly at your fingertips is very valuable. It's one of the reasons I was keen to join the firm. This is technology that's purpose-built for us. It allows us to make better decisions, and I believe it can help us as we seek to achieve better risk-adjusted returns for clients."

Mitigating risks in high yield credit

Jason Horowitz, Senior Portfolio Manager and Head of US High Yield Bond Investments, explains why we still use long-only high yield credit in multi-asset portfolios at this point in the cycle and how investors can mitigate risk.

Jason Horowitz is Senior Portfolio Manager, Head of US High Yield Bond Investments

Rising interest rates are helping lift future returns for credit investors, but do investors worry that central banks are trying to slow the economy – perhaps to the point of recession?

Default rates within the high yield market have been tremendously low for a long time. We expect them to rise in the coming months. It is important to remember that the US high yield market is a complex collection of ~1,900 bonds from ~1,000 individual companies that are very different from each other[1].

If you are in the right bonds – and, more importantly, in the right part of the market – we believe you can mitigate many of the risks and still be well rewarded.

As a portfolio manager of a long/short portfolio, I believe this strategy offers more opportunities to mitigate risk. But I understand those who are happy to have a well-managed long-only portfolio. There are many reasons why we and other investors include high yield within credit portfolios now – even amid the economic uncertainty.

1. Yield cushion
The high yield market in aggregate is offering investors 8.5%[2]. This means that for investors who hold the bonds for a full year the market would have to be so bad that the average high yield bond yield lifted to approximately 10.25% and prices to 80 before they lost money.

2. The pull to par
As bonds trading at a discount near maturity, the discount closes for companies that will not restructure. The average high yield bond trades at $88.80 today[3]. The average maturity of our markets was only 5.3 years in April – the lowest on record (see *Figure one*). That is a fairly rapid move to par for those companies that will not default – it is worth about 3% return a year. We believe it means duration risk is not currently a serious concern for most issuers.

3. Strong technicals
The high yield market has been shrinking. The size of the market was $1.6 trillion at the end of 2021. At the end of July this year it was nearer $1.4 trillion[4]. During COVID many companies that were previously investment grade were downgraded to high yield. We call these "fallen angels". A handful of these big companies have seen their credit rerated upward this year already. When this happens, we've seen many investors – particularly passive investors – sell these bonds and squeeze their way back into the high yield market, helping to support prices.

4. New issue opportunities
For many years, when the market was on fire, companies wanting to issue new bonds could do so on favorable terms. Now that things are more challenging, more companies need capital. The investor now has the leverage. We may want a bigger coupon. We may want bonds to be issued at a discount or with greater security, with a five-year maturity instead of a 10-year maturity. We might insist there is no ability to call the bond early – we call this a bullet bond. I think the market is going to be able to generate some more alpha from the primary market.

5. Improved credit quality
Almost half of the high yield market is double-B grade. A decade ago it was 41%[5]. That may be changing.

Figure one:
The weighted average life of the FTSE US High-Yield Market Index hit record lows in April

Source: Bloomberg, data as of March 31, 2023

As the fallen angels get their wings back, we will see this number come down. But for now there are plenty of options for a manager looking for better-quality high yield bonds. Many people say the yield and the spread have been better in previous eras, but we are in a better market today than we were. We have a record amount of secured debt in our markets – 31%, which is twice what it was from 2015 to 2020. And before 2009 it was often under 10% (see *Figure two*).

The triple-B/double-B part of the market – the highest rated – has gone from a typical 25% to 43%.[6]

How to mitigate risk

As an active manager, the goal is to avoid defaults. Good credit selection is important. We are staying away from certain triple-Cs. The triple-C end of the market offers a big spread of risk and returns. Where we have bought triple-Cs they are lower risk, yielding nearer 9%, rather than those yielding over 20%. Over 80% of our long portfolio is in BB- or higher. The average yield of our long book at the end of July

> "For now there are plenty of options for a manager looking for better-quality high yield bonds."

was 6.78%[7], including our low vol credit book. We think that is a sensible risk/return balance. The average yield of someone's portfolio will give you a sense of how much risk they are taking.

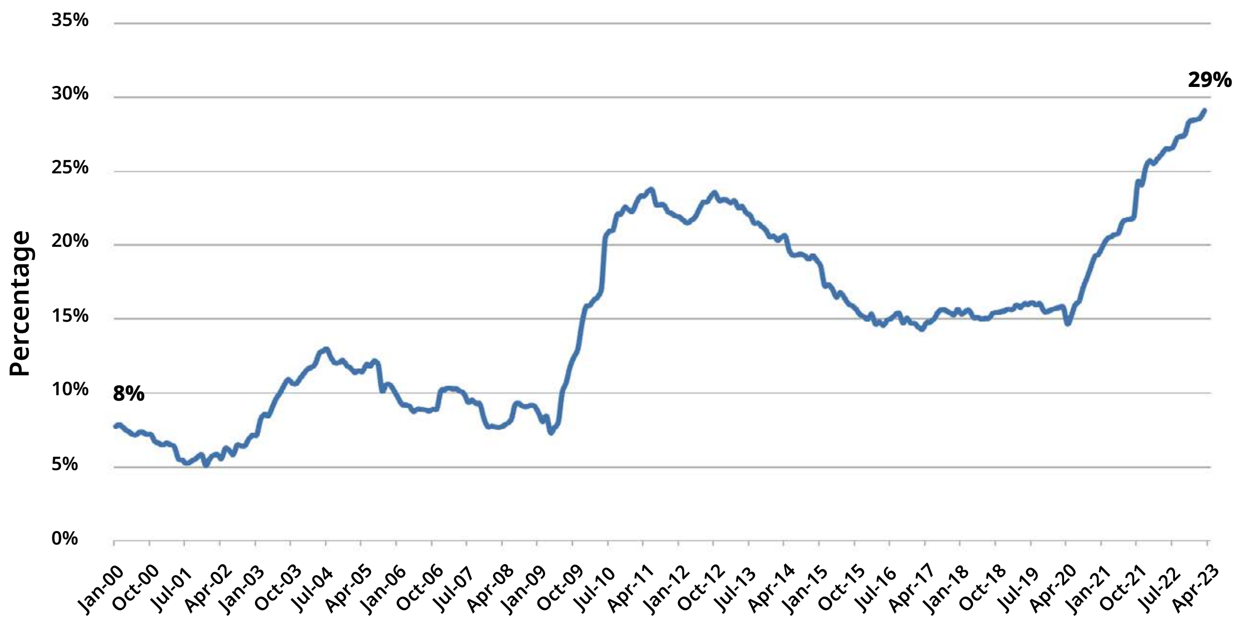
There are many ways to play the high yield market. Credit analysis of individual companies comes to the fore in some parts of the cycle, but in my experience often the greatest impact on performance can come from making smart tactical decisions. We seek to identify opportunities on at least a dozen themes.

Last year duration mattered a lot; in 2015 few probably cared. I believe that this year the cyclicality of the borrower's business model will matter; last year it probably did not matter so much. In the first half of 2020 you did not lose money if you were in certain sectors; if you were in the wrong sectors you could be down 20%. In 2019 double-Bs did much better than triple-Cs. If you were involved in anything that was affiliated with Italy or Spain during the Euro crisis you were crushed. And so on. Where you are in the market really determines what your return is as much as the quality of the company.

We have a strong team of credit analysts and deep experience that starts from the top with our CEO and CIO, Steve Vaccaro. In uncertain times, our hope is you rely on us for advice and expertise.

1. BofA Merrill Lynch US Cash Pay High Yield Index (J0A0) 11 Sept, 2023
2. BofA Merrill Lynch US Cash Pay High Yield Index (J0A0) 11 Sept, 2023
3. Source: Bloomberg, as of 28 Aug, 2023
4. BofA Merrill Lynch US Cash Pay High Yield Index (J0A0) 11 Sept, 2023
5. BofA Merrill Lynch US Cash Pay High Yield Index (J0A0) 11 Sept, 2023
6. Source: JP Morgan research, "US High Yield and Leveraged Strategy", data 31 Mar 2023.
7. CIFC – 30 Jul 2023

Figure two:
The high yield market has high levels of secured debt yield



FTSE US High-Yield Market Index secured

Source: Bloomberg, data as of March 31, 2023

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The Morningstar LSTA Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. 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.

The Credit Suisse Leveraged Loan Index tracks the investable market of the U.S. dollar denominated leveraged loan market, consisting of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.

The FTSE US High-Yield Market Index is a US Dollar-denominated index which measures the performance of high-yield debt issued by corporations domiciled in Australia, Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.

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About the Private Debt Investor Manager of the Decade awards

Each year the editorial team at the Private Debt Investor publication identifies a shortlist of contenders for "manager of the decade" in a range of categories and across three regions – the US, Europe and Asia. Those shortlisted are likely to have featured strongly in the publication's annual 12-month awards over that period. The shortlist is then voted on by thousands of readers. Awarded 9 June 2023. The award covers the decade to June 2023.