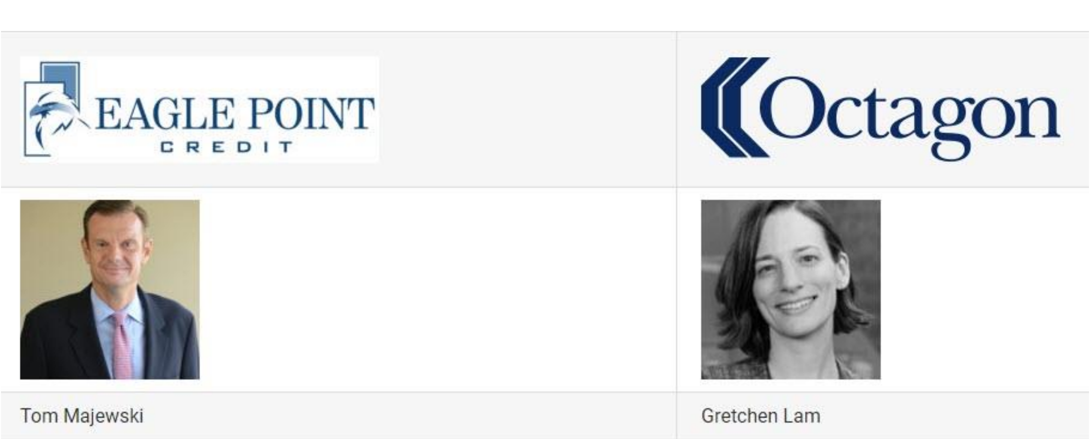
AICA Webinar on CLO Investing Post COVID-19 Octagon and Eagle Point

Thursday, April 30, 2020

On April 30, 2020 we held a webinar on CLO investing in the post COVID-19 world and followed with live and pre-submitted Q&A. Tom Majewski from Eagle Point and Gretchen Lam from Octagon Credit Investors were featured. Kim Flynn from XA Investments was the moderator



John: Good morning. John Cole Scott with the Active Investment Company Alliance. We're having one of our timely webinars covering the CLO sector. With us today as you should know, we have Octagon and Eagle Point, two of the best managers in this space that have both listed

closed-end funds that we know for our clients. If you're unfamiliar with any of their funds, you can see a free public profile page on CEFdata.com.

We're going to go through some prepared questions. We've also reviewed the registration questions that you guys have submitted during the registration process. I apologize if you submitted them after about 8 AM this morning, we have not had a chance to review them. Please ask those questions again. We're going to record this webinar and we will also transcribe it and post it to the Active Investment Company Alliance website, that's AICAlliance.org. And please go there for lots of content covering closed-end funds, BDCs, both listed and non-listed, both the sponsors and creators, the service providers, and the active users of those funds. With that, I'd like to kick off the conversation to Kimberly Flynn at XA Investments to moderate this panel. Thank you, Kim.

Kimberly: Thanks, JCS. It's terrific to be with you all this morning, and thank you Gretchen, thank you Tom for joining us. This is not the first event that we've moderated with Octagon and Eagle, so it's great to have them together. We're going to start with an easy question, and I'll ask Tom to address it first, and then we can hear Gretchen's perspective. You both manager CLO debt and equity investments inside of a closed-end fund structure, so what are the advantages of investing in this asset class in the closed-end fund structure, Tom?

Tom: Sure. Thank you very much for hosting and having us on today. Putting CLO assets in closed-end vehicles is really one of the most elegant and efficient ways, we think, to own the asset class, both for retail and institutional investors. Owning it within a closed-end vehicle gives us as the money manager, confidence that the capital will be there, and we can manage for the long-term. We're not focused on worrying about redemptions or short-term liquidity of funds coming in and out of the vehicle.

For investors in securities, stocks, or baby bonds, or preferred stocks, issued by the various vehicles, it offers them a very easy way to own the investment. There is daily liquidity on a public exchange, simple 1099 reporting, no complicated K-1s or anything like that. So, it takes owning investments which often have some pretty interesting tax reporting, and simplifies it for investors. So, they're able to get very quick liquidity, daily, and very simple reporting.

Gretchen: Yes, I would echo Tom's comments. If you look at how difficult it can be in times of volatility for managers to manage the credit risk in these assets, while at the same time managing flows. We've seen that there can be very real and permanent value destruction when asset managers are in a position where they are forced sellers as a result of managing outflows. And so, the closed-end fund structure really eliminates that risk.

Kimberly: Great, thank you Gretchen. Now I'm going to turn it back to you to give us the lay of the land in terms of the loan market. And if you could address some of the fundamental and technical factors driving the loan markets today. And then we'll turn to Tom to talk a little bit more about the CLO market factors. So, Gretchen?

Gretchen: Sure, absolutely. It's certainly been a doozy of a rollercoaster ride over the last six weeks. March saw six of the seven worst daily return days for the loan market. But also, three of the four highest daily return days in the loan market. The primary catalyst for this volatility has of course been fundamental in nature. Which is the global health crisis that the novel coronavirus

has created; and in turn, the economic impact of the extraordinary efforts that governments globally are pursuing to contain it.

But we've also seen a number of technical factors drive secondary pricing in the loan market, and this was especially apparent in late March. First, we saw retail loan funds looking to raise cash to meet investor redemptions. Followed by levered structures selling to meet margin calls. And lastly, CLOs reducing exposure to lower rated loans given increased downgrade action on the part of the rating agencies.

As the first two technical factors have eased in April, we have seen loan prices rebound. They're up almost 10 points from the lows in late March. Even as the third factor, which is the economic and credit implications of prolonged social distancing measures bearing out in loan downgrades, even as that has accelerated.

Looking out over the medium term, we would expect loan fundamentals to be the primary driver of secondary loan prices. Technicals will affect the trading price of loans on the margin, but good old-fashioned credit fundamentals will continue to matter the most in our view. Is the business model relevant in a post-COVID environment? Does the company have sufficient liquidity, cash liquidity, to get from here to there? These are the things that will drive performance over the medium to long-term.

Kimberly: Thank you, Gretchen. So, the loans underly every CLO and constitute the collateral portfolio. So, when we think about CLO debt and equity interments, Tom, could you give us a market update in terms of what's happening in the CLO marketplace?

Tom: Sure. The loan market has certainly had its ups and downs over the last 45 days, and the CLO market has shared in that. Being the largest holder of syndicated bank loans, the CLO market owns, give or take around 60% of the loan market (perhaps a touch more of that right now) the two markets often work in tandem. Different factors may impact the performance, and pricing, and behavior of different securities between the two markets.

The CLO market also faced some technicals in late March, particularly with forced selling by a handful of investors, in many cases seeking same-day liquidity through public auction processes, run through dealers. Clearly there was some degree of people behaving in ways related to their vehicles, not necessarily related to their investments, which created some very interesting buying opportunities, particularly for those with closed-end funds, towards the end of March.

As we got through that month-end, quarter-end technical, coupled with all the efforts from the regulators in Washington and some activity out of Europe, we saw securities begin to rebound in price throughout, really the first half of April; from perhaps the 1st to about the 15th, or even maybe April 17th to be the exact day. As securities started moving up in price, in many cases CLO equity and debt (the market broadly), as loans started to recover and people were beginning to be able to figure out and form a view as to which loans were going to make it and which weren't, CLO securities kind of had that same rally.

Against that, at the beginning of the month and late in March, the rating agencies took quite a bit of corporate rating action. Perhaps putting 25% of companies give or take, (below investment grade companies) either downgraded or put on credit watch. Once that happens it takes a little while to flow through to the CLO departments at the rating agencies, but quickly enough, it did. On I think it was Friday, April 17th, we saw one rating agency put a significant number of CLO

securities (about 800 different CLO securities) on watch for potential downgrade. There have been a few further announcements since, and we've seen at least the junior part of the capital structure, in general, trickle lower. The top part of the CLO capital structure, where there were very few securities put on watch, frankly, has generally grinded tighter.

Kimberly: And Tom, maybe you could help us compare the market today to 2008-2009. Specifically, the loan market has become more covenant light. So, could you talk about that and the impact in the CLO market?

Tom: Sure. We have long said covenant light. A common question we get is, "What will be different next time versus last time?" Loans and CLOs worked out generally very well through the '08-‘09 cycle, and covenant light is one of the differences this time, versus last time. I can now say this time instead of next time because we're in the throes of it.

As we think about it, our covenant light, we think as a result of it there will be fewer defaults, defaults that do happen will happen later, but defaults that do occur will probably be more severe than they otherwise would have been. The recoveries probably are lower than last time. That sounds a little kind of counter-intuitive in some cases. How will covenant light bring fewer defaults? Many, many companies that defaulted in ’08 and '09 frankly, were technical defaults. They breached a covenant, were offsides on leverage or EBITDA coverage, or any of the on-going maintenance covenants. That had the effect of bringing companies back to the table, in some cases they worked out an arrangement with their creditors, in other cases they defaulted.

Frankly, in the loan market, quite a few defaults were, other-than-payment defaults, so those are off the table at this point. Now it's largely, can a company pay their interest or not? In March and April, when many loan payments are due at the end of the quarter or beginning of the next quarter, the vast majority of companies paid their interest fine, and many companies will be able to make their payments, we believe not all, but many, at the end of the second quarter.

However, had companies had financial maintenance covenants, we think we'd begin to see a surge in technical defaults certainly, at the end of the second or third quarter. In many cases companies that otherwise have enough liquidity to make it through at least a few more quarters, and hopefully to the other side of this. Everything companies need right now involves runway. To the extent they have cash or liquidity, getting tripped up with financial maintenance covenants, frankly, we think would be a bad thing. So net, we're actually quite happy and think this will be constructive for the market, and almost fear what the market would have looked like on June 30th or September 30th, had we been dealing with a slew of technical defaults.

Kimberly: Understood. Gretchen, could you share Octagon's views in the near term your expectations around downgrades and defaults? Tom touched on that, but I was just hoping to have a little additional commentary from you.

Gretchen: Sure, absolutely. So certainly, the rapid pace of loan downgrades has mirrored the swiftness with which the wheels of the global economy have slowed. About 30% of loans in the syndicated loan market have been downgraded in 2020, and about two thirds of that number have occurred in March and April. And to put that in context, we have already exceeded the highest trailing three-month downgrade percentage we saw in the great financial crisis by a fair margin. And we're surely going higher from here.

Continued loan downgrades in CLOs are clearly an ongoing challenge for collateral managers, and I know Tom's spoken about that, and I think we'll speak more on that later. Of note, we have not yet seen a large increase in the number of loans defaulting. But we surely will over the coming months, and likely into 2021. In terms of how high defaults go, we are seeing a range of projections, generally in the range of 5 to 9%. And again, for context, we saw a peak in the great financial crisis of about 10% on a trailing twelve-month basis.

These projections are clearly not cause for celebration, but I would point out two things to perhaps be hopeful about. The first is, we have observed that there has been an extraordinary amount of dislocation, liquidity financing type capital that's been raised over the last six weeks in particular. And on top of that, a large quantum of capital that's been raised by distressed funds and PE funds, even prior to the COVID period. It is our view that good companies with relevant business models will have access to this liquidity, and that there are a number of investors who are looking for opportunities to provide liquidity in this environment.

The second thing I would note is that if you look at the 5-9% default expectation range that we're seeing across sell-side research analysts and other industry analysts, most of these projections are based on the number of facilities that may default, as opposed to the notional value of their debt. And if you look at the percentage of CCCs in the market today, that exposure based on facility number is about twice the exposure if you look at the notional value of the company's debt.

In other words, it is, on average, smaller companies and smaller facilities that are being downgraded. And it's a disproportionate share of the CCC exposure. If you believe that today's CCCs are tomorrow’s default, then there is some support to the notion that while the number of defaults might be in the range of 5-9%, the notional value of that debt could be far less. Which would be a net positive, or less of a negative if you will, in terms of impact that those defaults might have on CLOs.

Kimberly: Okay, so Gretchen's talked about the CCCs. Tom, I've been hearing and we've been seeing articles about CLOs having to sell the CCCs. Is that really true? Could you comment?

Tom: Sure. I suspect many of the funds that Gretchen mentioned that are getting raised, often have a provision that says, "Everyone knows CLOs have to sell CCCs." That is, in my opinion, one of the least true or most misconceived construed statements in the market. There is no forced sale requirement for CCCs in CLOs. CLOs, many regular way or kind of traditional CLOs will have what's called a 7.5% CCC bucket or basket, and what this means is the collateral manager can buy up to 7.5% CCCs over the life or at any given time in the portfolio. If the basket exceeds 7.5%, which in many CLOs it is at present due to downgrades from the rating agencies, there are some consequences in what's called 'the over-collateralization test', in that there are some haircuts or sort of early warning triggers that reduce the value of the collateral when evaluating an OC test.

CLOs start their lives with ample amounts of OC cushion, typically 4% or 5%. So, to use a generous assumption, holding all else constant, you could have double-digit CCCs in many CLOs before there'd be a risk of failing the over-collateralization test. If you were to fail the over-collateralization test, the primary consequence is if you're failing on a day of determination, which happens only four days a year. Money that would have been paid to the equity or potentially junior tranches, is diverted to repay the senior debt of the CLO.

Some collateral managers in the CLO world may choose to sell CCCs. They certainly should sell them if they think they're going to fall in value further or ultimately default and recover less on their trading price. Some may also do it for window dressing in terms of, "What does their portfolio look like?" In more benign markets we saw some collateral managers perhaps sell a marginal CCC that maybe they shouldn't have, simply to keep their buckets and reports looking better, but importantly, there's never a requirement in a CLO to sell a loan based on it being rated CCC.

Kimberly: Okay, good to know. I know that your firms are both active managers, and active management's very important when investing in CLO debt and equity. Gretchen, could you talk about opportunities for active credit managers in volatile markets like the ones we've been experiencing recently?

Gretchen: Sure. Certainly, as a collateral manager of loans within a CLO, the fact that CLOs are closed, non-marked-to-market funds with relatively cheap long-term financing is a huge structural advantage in periods of volatility. As we've discussed, we saw in late March that there were many large retail funds that were selling to meet redemptions. And they were doing what retail funds that are open-ended often do, which is sell their best assets first. So, there was a unique opportunity to buy very high-quality loans, in the mid-80's in some cases, and that was certainly an opportunity that was more easily exploited by CLOs given the closed nature of those funds. Over the longer term, CLOs can certainly take advantage of loan prepayments and amortizations, and use that cash, those principal proceeds, to recycle into discounted loans in the secondary market.

And lastly, while the primarily loan market has not been particularly active thus far, we have seen a trickle of loans come to market, and they have by and large been extremely attractively priced. Both in terms of coupon, in terms of issuance price, and in terms of structure. So that's also an opportunity for CLOs to take advantage of this period of volatility, which tends to increase the market coupon of any new loan coming to market.

One other sort of more fundamental opportunity for loan managers is, not withstanding the high level of uncertainty of the depth and duration of this downturn, there is real value that managers can provide in looking at some of the most exposed and most impacted sectors, doing good credit work and picking the survivors. We're seeing the market is in many cases painting entire sectors with the same brush, and there is value that can be added by picking and choosing, and determining places to invest in sectors under siege.

Kimberly: Tom, changing directions just a little bit, I would like to talk about income and cashflow. If the prices of loans are off or down so much, how is that CLO equity cashflows or distributions are up? Could you describe what's going on there?

Tom: Sure, now that's a very good question, and it's quite a common one. If the loan index is down significantly, perhaps over 10% depending on which index you're looking at (mindful that CLOs are levered vehicles) many people would ask: "Well, isn't the equity wiped out? Or even the junior debt wiped out? How can they still be getting cash flows? That goes to the structure of CLOs, that they're called, in fact, cashflow CLOs. What matters is whether or not the loans are paying, is the ultimate driver of the distributions, and then the ratings on the loans and any realized losses related to these OC tests in CLOs.

The marks on performing collateral do not impact the structure of a CLO, and that's very, very important. Obviously, we like it when loans are at par or even a premium. Once in a while they get there, whether a performing loan is at par or at 90 or 80, as long as it's making its interest payment and not rated CCC, the price of the loans has no impact. So, as we look back even through the financial crisis, roughly 55% or 56% of CLOs missed one or more payments to the equity. The other 44% never missed any payments to the equity. The price of loans fell to 60 cents on the dollar at the very low, and equity was impaired. Frankly, even AAAs were under water on a mark-to-market basis, yet there was not a default on any AAA security in the CLO market, simply because the vehicles have long enough runway.

Every loan that doesn't default pays off at par. It's a binary outcome for every credit instrument, to the extent the numbers that Gretchen talked about playout from the street estimates of 5% to 9% defaults and hat suggests 91% to 95% of all loans will pay off at par. We have the runway within each CLO and within a permanent life, closed-end vehicle, frankly, to hold those CLOs to the ultimate outcome of every credit, if we choose to.

Kimberly: Gretchen, could you talk about the upside and the downside? I think Tom has mentioned that higher CLO equity yields is a potential upside benefit of the volatile period that we've been going through. So, you could you just talk about that upside, downside, and some of the risks here?

Gretchen: Sure. Certainly, the entry point today creates opportunity, particularly for CLO equity, and just given the leverage inherent in the structure and the result when the price of loans falls as dramatically as it has. So, I would say that the biggest potential upside is just the entry point where we are relative to the price of loans and the price of CLO equity just a few months ago.

But more fundamentally, if you look at what collateral managers have been able to achieve in periods of volatility, we can point to several historical periods of volatility where CLO managers have added long-term value by looking to buy discounted loans by taking advantage of increased prevailing market coupons for loans in the market. But we've also seen that the performance across the CLO universe tends to be more diverse and we see more dispersion in periods of volatility. And so, it's very important to invest in CLOs that are managed by collateral managers that not only know how to manage loans, but know how to manage loans within the CLO construct. That does have its own particular nuance and constraints, and idiosyncrasies, and I think that's very important.

In terms of risks, as Tom has discussed, the biggest current challenge for collateral managers is the pace of CCC downgrades, and the impact that that has currently on the calculation of over-collateralization. I think of that impact as not necessarily permanent. It can be very temporary. And it is temporary if the manager has ultimately picked the right credit. And if they've picked the right credit, then at some point in the future, the performance of that company will rebound, and the rating will either no longer be CCC or the rebound will be reflected in an increased trading price. In that case, any negative impact on the over-collateralization test will ultimately be lessened or go away.

If the manager has not picked the right credit, today's CCCs will be next month's or next quarter's defaults. I think that is the big uncertainty in CLOs today. Is as we've seen downgrades, we've seen more CCCs, we haven't yet seen an uptick in defaults. And I think it remains to be seen how much we do ultimately see, and what level of that OC deterioration becomes permanent as a result of permanent losses that are taken on the loans and the underlying CLO.

So, I think you'll see the good managers perhaps see CCC excess amounts that may result in equity being shut off for some period of time, but ultimately see that equity come back. And you'll see some deals and some managers where their CCCs will become future defaults, and in which case there will be more permanent deterioration in their NAVs, and you'll see longer OC trips and longer equity distribution shutoffs.

Kimberly: Gretchen, with that said, how do you manage a closed-end fund that uses leverage? If you could just speak to leverage management in terms of your experience. So, Gretchen, could you just address how you navigated managing leverage in this environment?

Gretchen: What I always try to keep in mind with leverage is, you're supposed to use the amount of leverage that you need, not the amount of leverage that you can get. And on top of that, I think the ideal leverage is that which can flex up and down as needed. Because as a manager, we're always thinking about the puts and takes of the risk that we are investing in directly by virtue of the assets that we own, the CLO and the loan assets. And then the risk that we're overlaying on the fund by virtue of the fund level leverage. And so, we think about both of those holistically in terms of the overall risk to our investors, and so we like the ability to flex up and down. But then also the best type of leverage is financing that has the least number of constraints and restrictions that I as a manager do not have control over. So as few marked to market and other constraints that I don't control on a day-to-day basis, if you can minimize that, that's ideal.

Tom: Oftentimes when issuing securities like that the bankers will say, "Oh, well, if you do five years it's an eighth less or a quarter less," and I always pounded the table and said, "Ten years, how much more to go to 15?" They frankly never came back on a 15 number, but whatever that price would have been, I probably would have paid it. That tenor today, in my opinion, is the most valuable thing you can have in your debt. Flexibility and tenor, being unsecured in our case, is very, very valuable. While we're very mindful of our creditors and obviously plan to repay at our convenience, we don't have a situation where creditors can come in and force us to do things.

The principal risk of leverage, in my opinion, is that it forces you to do something on the day you don't want to. With long-term unsecured financing, we've certainly done our best to minimize that risk. That goes to the same, within a CLO structure. No one forces a CLO collateral manager to sell a CCC-rated asset. This is what term of every loan is inside the life of the CLO. Such that every loan, we can see the ultimate outcome. So, leverage certainly increases volatility when NAVs move up and down, no question about it. The number one thing we seek to avoid is having leverage that can make you do things on the day you don't want to do them.

Kimberly: Right. Thank you very much. I think we're going to pivot now to audience questions. So, if you do have a question, please use the question box in the GoToWebinar screen. We did have a few audience questions that came in before the webinar started, so I'll start with one. Coming out of New York, the question says, "To me, it seems like some of the hardest hit CLOs

are managers who have no idea what they're doing. Maybe they're managing one to eight CLOs, but they lack experience, they lack critical details, or maybe they're just new. Are you all seeing this as you evaluate CLO managers?" Gretchen or Tom?

Tom: Want to go first?

Gretchen: Sure. I think that's a fair statement. We have seen a pretty rapid growth in the number of CLO managers over the last couple of years since risk retention has been ripped up. I would argue the CLO market does not need 125 managers, which is about where we are today. And I think that I would repeat my earlier comment, which is many managers know how to manage loans, a far fewer number of managers know how to manage loans well in the CLO structure. And I think that in this period of volatility, we are going to see very wide dispersion across the performance universe, across managers.

Tom: We would agree with that, with perhaps the provision that to the question the investor asked of, "Does having a small number of CLOs indicate they're less capable?" The count of transactions under management is far less important than the experience and skill of the people managing CLOs. Frankly, it's funny to see people with 30 years experience in the credit market, if they go to a new firm and set up a CLO platform, they're called a new manager, despite in many cases having managed loans before the person buying the CLO debt was even born. So, it does kind of cut both ways.

Some of the other things are, looking at the platform, the firm, and the individuals. Do they know how to manage loans and do it within the CLO framework? CLOs have 200-300 page indentures with rules after rules after rules, kind of the opposite of running an unconstrained fund, or even a closed-end fund, where we might set up some broad investment guidelines. The tight restrictions required managing a CLO are very different than managing loans in a mutual fund.

At the same time, having too many CLOs might also be a problem. And some of the CLO managers that did very well through the financial crisis managing CLOs, they might have five to 10 CLOs at that point. Maybe today they have 30 or 40 CLOs. Some might have gotten too big, for the literal blocking and tackling required to manage each vehicle. In many cases the groups have scaled and they have many more analysts and many more CLO portfolio managers, but if they've grown too fast, frankly they may have too many CLOs.

Kimberly: We have a number of questions from folks in Illinois and New York, just regarding CLO equity distribution shutoffs. Could you speak to your thoughts about distributions? Whatever you're comfortable addressing in terms of the link between the closed-end fund distribution cuts and potential CLO equity distribution shutoffs.

Tom: Sure. I'm just looking at a live story that popped up on Bloomberg during the course of our webinar, so I'll use this as most recent data. According to a Wells Fargo report, Nine percent of CLOs that had payments in April missed their minimum over-collateralization test. In many cases due to excess CCCs causing reduction in the numerator, such that money that would have been paid to the equity was instead used to repay senior debt. So that means 91% didn't miss payments and paid the equity either in part or in full.

So broadly, one of the things that happened this time, which I don't recall ever happening in the market, is there was a surge in corporate downgrades, appropriately so, at the very beginning of the month, or in very late March. That is when CLOs have determination dates. I mentioned OC

tests only matter four days of the year, unfortunately it kind of matters on or around April 5th for many CLOs. Talking to a few collateral managers, you might have gone home the night before with plenty of cushion on your test, come in the next morning, see the rating actions overnight from the rating agencies, and all of a sudden you are offsides on your test, literally overnight.

Some were able to trade the portfolio and make adjustments, and sell loans and buy other loans to get back on sides. One collateral manager mentioned that they felt like they were going to pass, and then more downgrades came out later in the day, on the day of determination. Not only does it matter just four days a year, it matters at 5 PM, on four days of the year. So, it became really almost hand-to-hand combat for collateral managers to keep their deals on sides. Many did a great job. Not everyone was successful.

One of the things that we think is important, is some of the 9% we believe that missed payments in April will be able to get back on sides by July, because they'll have 89 days in which to sort things through by not managing in the eye of the storm. At the same time, others that maybe made a payment, perhaps will have more decay and might miss payments in the future. So, the variability on payments market-wide has been isolated to a single digit percentage, and I think what we'll see is some come back on sides, and yet others go offsides. The price of loans falling and the price of CLO securities falling unto itself doesn't have a direct impact on the CLO cashflows.

Kimberly: Okay. Gretchen, a question for you. How are defaults handled within a CLO? And who handles any work outs?

Gretchen: Sure. It depends manager to manager. Within our firm we have a dedicated resource team of two investment professionals, under the oversight of the portfolio managers, oversee all our distressed and restructuring and work out situations. So that process is really done by this team of two individuals in concert with the sector analyst who continues to be the expert as it relates to the industry. That's where the company operates.

Kimberly: Tom, how is the secondary market liquidity for CLO mezz and equity right now?

Tom: Sure. Trading volumes are actually up pretty significantly, certainly for CLO debt. Up and down the capital structure from the AAA class to BBs, there's an open and active market. You're seeing in some cases, certainly hundreds of millions of dollars in securities trading every day and in some cases into the billions. This is according to trace data, which is published by FINRA.

At the same time, we've seen some changes in the market. It is both efficient but functionally cumbersome, in that in most cases some investors are buying and selling semi-directly with a broker in-between, but through what's called a 'BWIC process'; bids wanted in comp, and every morning we turn up and there's a list of securities that will be for sale throughout the day. The nice part about it is you're not paying a meaningful bid-ask spread to a broker, whereas loans in many cases are a two or three point market today, where the bid and offer price on a dealer's run sheet would be a couple points apart.

In the CLO market, when you're buying via these BWICs, the buyer and seller are paying very similar prices, or transacting at very similar prices, but the broker taking just a small fee in between, so it's really quite cost-efficient. The challenge with that is you don't know if the seller's really going to sell, or "Is it just a pricing exercise?" Maybe they have unrealistic expectations, and you might work and study and analyse the security and be very convinced it's a very good

security, but then have a seller who's unrealistic. So, you don't have a lot of bid-ask friction in our market, but you do have a lot of wasted time friction. That's I guess borne by the investment managers.

CLO equity, unfortunately, has been less liquid than many in the market would like. Many holders of CLO equity today are the right type of holders; professional, dedicated investors focused on the space with long-term holds. So, we're not with long-term capital. So, we're not seeing panicked or forced selling by and large of CLO equity. Frankly, we wish there were more, weaker hands in the market, and while prices are down, it's hard to invest a lot of money at these current levels. There are definitely opportunities in the market, but there are not hundreds and hundreds of opportunities in the CLO equity market.

Kimberly: Gretchen, are there opportunities in both CLO debt and equity? Where are you seeing opportunities right now?

Gretchen: Sure. I mean, as Tom just stated, the volume of CLO equity trading in the secondary is very low, very limited today. I think there remains a very wide bid-ask between buyers and sellers in CLO equity. And also, as Tom pointed out, we're seeing relatively steady hands among folks who own CLO equity today.

We are seeing far more volume in junior mezzanine tranches, in BBs and BBBs. As well as over the course of the last month, quite a bit of trading volume in the AAA and other investment grade tranches. But I would say the BB tranche in particular, and to a similar extent the BBB tranche, has seen fairly liquid, fairly active trading, mainly via BWIC as Tom had indicated. And we are seeing, as the dust has settled in April, we are seeing more of that BWIC volume actually trade, and less being effectively a pricing exercise. Which makes it a little bit easier to spend the time and do the work knowing that even if you aren't the high bidder, at least the bond traded. Which was not always the case in late March.

Kimberly: A couple of new topics. Are either of your funds using TALF, benefiting from TALF? And are either of you investing in some of the newer static CLOs?

Tom: Maybe I'll jump in there. There was even an article on Bloomberg a week or two ago talking about TALF and the impact on a number of the public CLO vehicles. The current term sheet for TALF, which to set the first point, no money is actually transacted yet, related to TALF. People are setting things up, but nothing has actually happened.

I see a question just popped up, "What is TALF?" Maybe we take a step back and define that. This is the Term Asset-Backed Loan Facility, which is one of the programs announced in late March by the Fed and the Treasury, which provides for government financing to buy the senior most tranches, the AAA rated tranches of any number of forms of securitization. Be it auto securitizations, credit cards, now commercial real estate, student loan and CLOs were actually not included in the initial term sheet from March, but a subsequent amendment to it was put out in April, and certain types of CLOs were included in that.

However, there were a number of restrictions that I think many in the market would form the view that it would have limited impact on the CLO market, in that some of the restrictions include that the CLOs need to be static. We'll come back to some of the pros and cons of that in a

minute. Another restriction is that the vehicles need to be newly formed, after March 23rd and yet another restriction is that at present, all of the loans need to be newly originated. I think if we tried to do that, we'd have two casino operators, a gaming maker, and maybe Delta Airlines. I think that would be just about the grand total of loans that we could put in that CLO. So unfortunately, the requirement that these be new loans makes it -- all of the above, any one of those kind of knocks it out.

We, in general, have an aversion to static pool CLOs, not saying a blanket aversion, but a general aversion to them. In that I'll go so far as to say that if all of the pre-crisis CLOs were static pools, we wouldn't be having this webinar today. The ability to reinvest when no one else is buying loans, proverbially, is the number one asset that CLOs have. These are living, breathing entities, not static pool securitizations. Whereas essentially every CMBS securitization took realized losses at the junior parts of the capital structure through the financial crisis, essentially every CLO had a positive return to the residual class. This was not by virtue of having no defaults. Everyone had defaults, but by the ability to keep reinvesting when few others were.

So, while we appreciate the efforts of the regulators to begin to include CLOs in TALF, hopefully there will be more amendments to the term sheet. The LSTA, the Loan and CLO Trade Association, has put in a comprehensive letter to the Fed. Other groups are working on sending in letters to continue to help shape and guide that. We're pleased to see the efforts from the regulators to help facilitate the reopening of credit markets. Unfortunately, in the case of CLOs, I would say most of the market would agree they've probably missed the mark in terms of what will be attractive to many investors. Short answer, “No”.

Gretchen: I would agree. And I would just say as it relates to statics, in any environment we have an aversion to static deals. In this environment in particular, given just how much uncertainty continues to surround large swaths of the U.S. economy and the global economy, we want our managers evolving and repositioning the portfolio as there's more clarity over the coming months. So now more than ever, we would not be comfortable investing in a static deal.

Kimberly: Okay. We have a question from the audience about cashflows for CLOs relative to GAAP earnings, and there can be a disconnect sometimes between cashflow and GAAP. Let me read the detailed question to you and give you a chance to reflect. "In the past, under more normal circumstances, cash yields on CLO equity and the reinvestment period have been a lot higher than GAAP estimated yields." The GAAP accounting includes potential defaults and loss just for the audience.

"So, taking into account typical life cycles and historically low default rates, so now we know that the economy is expected to have a horrible second quarter with the CBO projecting a 12% contraction. But we're beginning to see signs that things could improve in the second half of the year. Obviously, there's uncertainty. Could we see a situation this year where CLO equity GAAP estimated yields are actually higher than cash yields?" What are your thoughts on that? The note says, "Cash yields should reflect what is happening in the near term, but GAAP estimated yields take a longer term view and may have assumptions that are not as harsh as what we're experiencing right now. So, Gretchen or Tom, thoughts on GAAP versus cash?

Gretchen: You want to take that, Tom?

Tom: Sure. Thanks Gretchen. I'll throw a third one, don't forget taxable income as well. That question was too short perhaps, and could have had even more in it. There are three numbers that come out every year, as a CLO equity investor. There's your cash flow, which, in my opinion, at the end of the day is the most important one, there is GAAP income, which you record, and I'll walk through how it's recorded, then your taxable income, which in many cases sets a functional floor for folks who want to keep the RIC tax pass-through status, to which you actually have to distribute. Over the life of a CLO, those numbers will total to be the same. They, in my experience, have never been the same in any given year. We have an example on Eagle Point Credit Company's website; if you go to EaglePointCreditCompany.com, back in 2015 or 2016, we actually published a GAAP vs. tax vs. cash reconciliation for a representative CLO, and that's probably our most clicked on link of all the things on our website, so we encourage people to pull that, if you're so inclined.

To kind of the specific question of what will play out or what could play out over this coming year, certainly, if we take anywhere in that 5%-9% range that we've seen published from many dealers of corporate defaults, that's certainly higher than the base case expectations used by many in how they evaluate CLO equity. Against that, one of the other things when people evaluated CLO equity, frankly, is that reinvestments are made at or near par, often between 99 and 100 cents on the dollar. Those two things are unlikely to be the case in the very near term for the CLO market. Defaults will likely be higher than many contemplated. Prepayments will probably be slower, and reinvestments will generally be more attractive than contemplated, under most people's estimates from the fourth quarter of this year.

So, to the extent a CLO is missing its payment, certainly it's very possible it could have a GAAP yield still that's positive, in that the cashflows forecast in the future. To the extent they exceed your amortized cost, you'd have a positive yield on that investment, although you might not receive cash. At the same time, other CLOs would continue to have higher cash than the estimated yield in any given period. Mindful that each residual payment to the equity is functionally, partially a return of capital over the life of the investment.

Taxable income will be yet another wildcard. Even if we knew GAAP and cash perfectly, then the trading within the CLO, if a collateral manager sells a loan at 90 and buys a better loan at 90, creates a tax loss. CLOs are set up as PFICs, which allow taxable capital losses to offset ordinary income. It's a very unusual provision in the tax code that could actually shelter taxable income. Actually, we'll have lower income across many CLOs this year than we might have otherwise had, even if we see the spreads in cashflows going up, simply because collateral managers will be able to shelter some of that income this year through losses generated through portfolio trading activity.

So, the answer to that very complicated question, probably every scenario you could think of, higher cash versus GAAP, higher GAAP versus cash, I think each of those will play out across different CLOs depending both on how the CLO performs, and equally importantly where you bought it. If you bought it at new issue at full price, you could be looking at a different situation than if you'd bought it two weeks ago in the secondary market.

Kimberly: Good. We're running close to time, so what I thought I would do is turn it over to Gretchen and Tom just with one last question in terms of your current focus in the market today. What signs of hope are you seeing? What's constructive and positive in the loan markets in the CLO markets? I'd like to end on a high note, so I'll turn it to Gretchen.

Gretchen: Sure. I would say there are a number of things to point to to be hopeful. I think first off, from a secondary perspective, both in the loan market as well as in the CLO debt market, we're seeing a functioning market. We're seeing trading. We are seeing bid-ask spreads that are certainly wider than they were two months ago, but are not prohibitive. We're seeing both good two-way flow, both buyers and sellers. So, I would say the markets are functioning in a period of pretty extraordinary economic uncertainty. That's the good news. We can put capital to work. We can invest. We can find opportunities. And we're continuing to do so.

I think what we would like to see is more data points that allow governors to look to how to open up their economies again. I think before that can happen, we'll have to see a much more expansive testing capacity in the U.S., and globally as well. Both in terms of testing for COVID as well as testing for antibodies. We're not there yet, and I think that that is the most important thing. Because regardless of whether your state is officially continuing social distancing restrictions or not, the consumer is not going to go to a restaurant or a movie theater, even if they are technically permitted to do so, unless they have a high degree of confidence that it's not going to put them at risk. So, I think we still need to see some heavy lifting there in terms of just expanded testing capacity, and a greater level of confidence that U.S. citizens can have when they set foot outside their homes.

John: Wow, guys this was amazing. As I envisioned the non-profit last year, how to connect the creators of closed-end funds to the users, while we prefer to do this in person at events, thank you so much for your valuable insight. It reminds us of why our firm loves closed-end funds. You have the active managers and the fixed capital structure in either the listed or non-listed access points, and it's so great to get the granular information.

We had more questions than I ever imagined possible. We had a 90% attendance show up rate, which is amazing. Which speaks to the two of you guys, so thank you for your time. Thank you to our members and our audience. Thank you, Kim, for moderating. You did a wonderful job in supporting all of us here.

Remember to go to AICAlliance.org. We have a weekly podcast. We have ongoing webinars like this. We had a conference which we videotaped last November in New York City. This is a replay; we will transcribe it. We'll give it to the presenters to review for accuracy and compliance purposes as they're publicly traded funds, and then we'll post that to the AICAlliance.org website. So again, thank you guys so much. This was super educational and very appreciated by everyone in our ecosystem

To access a recording of the webinar please click here:
https://register.gotowebinar.com/register/3680659560726170637

Click the link below to go to the home page of Active Investment Company Alliance to learn more:
https://AICalliance.org/

Disclosure: *Listed closed-end funds and business development companies trade on exchanges at prices that may be above or bellow their NAVs. There is no guarantee that an investor can sell shares at a price greater than or equal to the purchase price, or that a CEF's discount will narrow or be eliminated. Nonlisted closed-end funds and business development companies do not offer investors daily lliqudity: often on a small percentage of share on a quarterly or semi-annual basis. CEFs often use leverage, which can increases a fund's risk or volatility. The actual amount of distributions may vary with fund performance and other conditions. Past performance is no guarantee for future results.*