2021 AICA Interval Fund Winter Manager Spotlight Day 1 Panel #2; “Alternative Investment Options in an Interval Fund”

Wednesday, December 8, 2021

John Cole Scott, CIO of Closed-End Fund Advisors, moderates the second panel of day 1 of the 2021 AICA Interval Fund Winter Manager Spotlight; “Alternative Investment Options in and Interval Fund”. Read the transcript below to hear the discussion among Mr. Scott and panelists Robert Grunewald from Flat Rock Global and Alexander Condrell from Cliffwater LLC.

John Cole Scott

Robert Grunewald

Alexander Condrell

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https://aicalliance.org/aica-event/intervalwintermanagerspotlight2021/

John Cole Scott: Good afternoon and welcome to the second panel of December 8th at our Interval Fund Winter Manager Spotlight. If Robert and Alexander can hit their mic and camera button they’ll join me on stage. Everyone’s here.

So with that again we’re going to do the second panel today. For those also able to attend the first session, kind of a different flavor on credit. I would say as I looked at the interval fund structure and how we mix portfolios of listed closed-end funds, BDCs, and interval funds, how really looking at that use of the structure and wanting to bring some managers that may not be as well known to light, but have some really cool offerings for investors and the advisors that serve them.

So my first question, I'm going to start with this to you, Alexander. For those that don't know you or your firm, talk about the firm, talk about the fund, and why you brought this fund to market and the intent in product development of the investment.

Alexander Condrell: Yeah, sure, thanks John. Thanks to everyone who's tuning in. My name is Alex Condrell, I'm a managing director at Cliffwater. Which for anyone who's not familiar, Cliffwater's both an institutional investment consultant where we advise on about $100 billion of assets, as well as an asset manager where we manage just over seven billion. Much of which is in middle market direct lending, which is the focus of the fund that I'll be discussing today.

One of the things Cliffwater observed many years ago, and this is why we brought forward this fund, was that middle market lending is a very consistent returning asset class. Which is great for institutions who have a specific bogey in mind and consistency is really the name of the game for them. We also recognize that it's really attractive relative to its risk. The return-risk characteristics are really attractive for individuals as well. Provided you can deliver it in a way that is very diversified which keeps down the specific company risk, and a way that keeps fees under control. And we've been able to do that and put a structure together that does accomplish that, and that's why we brought this interval fund forward and think it's a pretty attractive offering for individuals.

John Cole Scott: Great, so Robert, do the same things for our listeners, whether it's today or in the future. The firm, the fund, the wrapper, why did this come to market and what should people be focused on when they consider it?

Robert Grunewald: Sure, thank you John, and thank you for the opportunity to be here. I am the CEO and founder [inaudible]. We [inaudible] credit manager. We manage [inaudible] funds. The first fund is called the Core Income Fund, the ticker is CORFX. That fund has had a 7.6% average annualized return over four and a half years of its history. Doing something similar to Cliffwater, investing in middle market debt, but different in that our focus at CORFX is the lower middle market. So generally these are not small companies but they're companies with two the three hundred million of revenue and $10-30 million of EBITDA.

The second fund is called the Flat Rock Opportunity Fund. The Flat Rock Opportunity Fund invests in highly diversified pools of first-lien loans, but there's some leverage applied to those pools of loans and we invest in those pools of loans with leverage through CLO equity. And we invest in both middle market CLO equity, which we like very much, as well as broadly syndicated loans CLO equity. That fund's been around for three and a half years and has average annual returns of about 15%.

John Cole Scott: Okay, I think they have a good intro to the structure, and the firm, and where your roles are in each organization. So as I told you in my intro, we build portfolios of only all these funds, these closed-ended management companies if you're a 40 Act attorney, or a regulator, or maybe a fund sponsor. But why the interval fund for this portfolio? Why didn't you come out with the version 2.0 of a listed closed-end fund? Why didn't you come up with either a non-traded or private BDC or a listed BDC? Why the interval fund for the work you're doing? And for this one we're going to start with Robert.

Robert Grunewald: Yeah, so it's a really interesting question for you to ask me because the Core Income Fund, which is an interval fund today, actually started its life as a private BDC. And prior to this I ran a private BDC. So it's really the same strategy as a BDC, except we came to two conclusions about two years ago. The first is that the private BDC structure that requires paperwork in order to fill out is just quite frankly a hassle for investors. And it's not necessary if you're in an interval fund structure, so why not make it easier for investors to invest? So that's the first and foremost.

But the second reason, why the BDCs even exist today if it's easier to invest in an interval fund structure? The answer is that BDCs exist because they are allowed by the SEC to have higher leverage limits, significantly higher leverage limits than an interval fund which is governed by the same regulations as any mutual fund. So we came to the conclusion, particularly in looking at the results of 2020, in which many BDCs that were levered more than 1:1 debt to equity, quite frankly ended up getting themselves in trouble or having a difficult time. And so our conclusion is that in this asset class, that level of leverage is not necessary. And so those are the two driving reasons, ease of investing for investors, and quite frankly we think lower leverage is appropriate for this asset class.

John Cole Scott: Great, so Alexander, of course we met when you were at a BDC. So tell us why you are excited to be in this fund versus this approach through the other potential structures.

Alexander Condrell: Yeah, and the BDC is kind of a nice improvement when you're comparing it to a partnership, long lockup and a fund that can only accept what they call qualified purchases, large individual investors, large in terms of wealth. And so moving to a BDC allows you to take smaller investors, have shorter lockups generally speaking, and there's some features about it that are better. But the interval fund kind of goes even one step further in my view, in terms of ease of use, everything Robert said.

But also is a nice blend between having a private fund structure where loans are held and valued based on their fundamental value, they don't have to trade. But more liquid, you can come in on a daily basis with a ticker symbol, no sub dock, all those things, and into a structure that does not require a lockup or need to be large, accredited, or qualified purchaser. So those features really make it easier for advisors, in my view, to size the position they want to size it, it can be applied across as many of their investors as they see fit, and they don't need to convince investors that they should be willing to part for their money for seven years or even three years in order to pursue something like middle market credit. So the structure works in a lot of ways if you can make it work operationally, and be able to meet the liquidity and deal with valuations, so on.

Robert Grunewald: Alex, you also are reminding me that the other ways folks are investing in private credit of course is through publicly traded BDCs or bank loan ETFs. I'm sure you would agree with me that I think an interval fund is superior to those for two reasons. One, compared to publicly traded BDCs, it sounds like a great way to get exposure to private credit, except as you saw in 2020 you end up exposed to the volatility of the equity markets. So you have an underlying portfolio that supports the private credit thesis, except that your investors end up

exposed to undue volatility, very significant volatility. And in fact the publicly traded BDCs were probably twice as volatile as the equity markets in general.

And then also if you compared it to bank loan ETFs, which a lot of folks are convinced, okay, we've convinced them private credit's a great place to go, but let me be in a more liquid vehicle. The weakness of that structure in my opinion is that you're investing in a highly liquid vehicle but the underlying assets are less liquid. And again in 2020, if you looked at bank loan ETFs, you saw undue volatility because they were forced sellers of less liquid private credit at exactly the wrong time. So I do think the interval fund really is the perfect structure for private credit because you can get in and out at net asset value, you don't ever trade at a discount, you don't ever trade at a premium, and you don't have the equity volatility.

John Cole Scott: Absolutely. And so I would say as we think about your funds, questions we often get from clients or other advisors we partner with is, are you guys, your mix of assets and opportunities, and then what you can select, is it US, global, is it one type of sector? What is the landscape? So convertibles is more technology and preferreds are more finance, banks. What's the flavor of both your opportunity set, and then how you use your lens to make your decisions in building the portfolio? So this is really a question about diversification and underlying investment structure and style. And first we're going to go with Alexander.

Alexander Condrell: Yeah, thanks John. Broadly speaking, we want to be like the US middle market, US middle market senior loan focused I should say. So something within the middle market, about a third of the transactions, maybe a little bit less now, are something other than senior loans. They're mezzanine, second lien or some other type of transaction. So we focus for conservative reasons to be on senior transactions. But that really runs a pretty wide gamut. Lenders tend to be economic bears, I'd guess you would say, like we've got to categorize them that way. So they tend to do fewer transactions. And we use our middle market lending partners, Cliffwater itself is not a lender. But those lenders that we are utilizing tend to be pretty careful, I guess is probably a better way to say it, about economic exposure.

So what that means is you see a lot fewer, many fewer transactions that are done with restaurants, or transportation businesses, or energy companies, things that have historically been quite sensitive to a down economy. And you get more of things like healthcare, technology, manufacturing that tended to be more resilient. So kind of big picture, it's not a huge tilt, but if you were going to compare to something like the equity market, it's more tilted that way. A little bit more economically resilient driven by the fact that lenders are going to hold the loans, and therefore want to have an extra sense of comfort around what would happen if you start to enter an economic downturn. Which are hard to predict but I think everyone would agree they're coming at some point.

John Cole Scott: Good, and Robert?

Robert Grunewald: Yeah, so there's a couple things that I think are unique about our funds. First specific to each fund, the Core Income Fund or CORFX is focused, as I mentioned, on the lower middle market. So we found that number of the mega funds have grown rapidly in the middle market, and what I'll call the upper middle market, that space I think has gotten more

competitive. And we like the lower middle market, the transactions take longer to pull together, I think they require tremendous amount of due diligence to make sure that you're doing a quality transaction. But at the end of the day we're finding in the portfolio that we've created that we're getting bigger equity checks from private equity sponsors. Generally we're looking for equity checks of at least 50%, so that we're in or around 50% loan to value.

That first-lien focus, we won't do second lien or mezz, we're just not comfortable with that risk. And then we're quite frankly agnostic with regard to industry, but within industries what we find is that they sort of self-select because we want that 50% loan to value. So for example, we are more than happy to look at energy deals, but we've never done an energy or energy related loan because we've never been able to get to that kind of 50% loan to value that we want.

In the opportunity fund, FOPX, as we call it, we're investing in both broadly syndicated loans, CLO equity. Again highly diversified pools of broadly syndicated loans with some leverage applied to it, as well as middle market CLO equity where there are highly diversified pools of middle market loans. When you raise this question, maybe the short answer is what kind of investments do you make and not make? And hopefully the answer is we don't make bad ones. Although you can never be perfect. But the answer with FOPX, when you're investing in these highly diversified pools is to focus on pools of loans that are generally higher quality, meaning lower yield, lower spread managers. One of the common themes that we have in our funds is that we don't want to be stretching for yield. I think the one place we've seen people get in trouble in the private credit sector is when they're stretching for yield at the wrong time.

John Cole Scott: It is, and I was thinking about both of your answers, and I want to do a little bit of a vocabulary check. So maybe if you could explain. Imagine there's a kindergartener in the room or a financial advisor new to BDCs, new to interval funds, new to CLOs. What is a CLO? What is a first-lien loan? What is a mezzanine loan? If you guys could maybe take that in tandem to educate the folks so we're on the same vocabulary language? You start, Alexander?

Alexander Condrell: Yeah, sure. So the basic capital structure, most of these companies that are looking for a loan have equity, in some cases they already have some debt. But it's a pretty simple capital structure typically with just equity and one debt provider. If there's a new transaction happening, it generally will take out all the old debt that existed. Sometimes also there will be multiple layers of debt, where there'll be a first lien or a senior lender who gets first to get paid back, and then there may be some junior capital which could take several different forms. It's not so important to know all the terminology, but you could have a complicated capital structure with multiple layers or it could be more simple.

And generally we are dealing with transactions that are simple in concept. They're a lot of work as Robert mentioned. There's a lot of underwriting and there's a lot of verification of items that goes into it, but it's not difficult to follow how it works. It's very similar to a mortgage loan that you might get yourself and the bank is making you a loan. And they are taking the security of the home to protect them if for some reason you're not able to pay them back. So a very similar type of transaction except a corporate borrower.

CLOs take that same concept and take many, many loans into one pool. And then take the cash flows that come out of all the loans and re-divide them into a new set of securities. Some of which are more conservative and some of which are not as conservative. They take a little bit more risk but have a potential for higher return. I think that's the shortest, easiest answer for that question.

John Cole Scott: Good. We could have a whole session just on the guts of these investments, but it's good to make sure no one's scratching their head. Anything to add to that, Robert, or do you feel like Alexander covered it?

Robert Grunewald: Alexander touched on I think the best analogy, which is the thing that every individual investor knows, which is their home mortgage. So if you're doing a first-lien loan, from our perspective imagine that it's a mortgage loan against your house but you're putting 50% down. That's the type of loan that we're looking for, except we're making that loan to a business, a substantial business with several hundred million dollars of revenue. So first-lien loan, first right to that home. If you didn't make a payment and then you wrote a 50% check, you're likely to make that payment and make good on that loan. So I think that's an excellent analogy, Alex.

John Cole Scott: Good, so the next question. That kind of reminds me, Alexander, when I got to know your previous firm, Monroe Capital. When I was interviewing them I go, "What investment you don't like to make?" And they said, "We don't like things that float or eat. Because if you take control of the asset, they're a pain in the butt to sell later." And so with that, this has been probably six years since I heard that comment, it sticks with me. What are the things you avoid? What would be the lessons learned in history or from the firm? What's the interesting story you can hopefully share with our attendees from your selection and experience? And we're going to start that one with Alexander as well.

Alexander Condrell: Yeah, sure. I think what Cliffwater has learned is that the asset class overall is pretty good if you could own every loan, and so there's certainly an alpha approach and a case to be made as Robert's describing. Cliffwater's kind of taken the opposite approach to say, we like this asset class, let's work with the senior transactions, senior loan transactions to avoid some of the risk that comes with junior capital. Let's work with the best managers that we can find and arrange to work with. And then let's diversify to a very meaningful extent at over 2,000 transactions. So that any one or five or 10 companies that may struggle, which can certainly happen, is not going to really derail us. That's really the main takeaway I think for our approach to the space.

John Cole Scott: Okay. Robert, any follow up on how you approach things you truly avoid?

Robert Grunewald: Yeah. Look, I've been doing this for over 30 years and I think the conclusion I came to, and this is supported by J.P. Morgan research that shows on average first-lien loans, when there is a default, the recovery rates are 65% or great. While if there's a second lien and there's a default, on average recovery rates tend to be kind of in the 20% range. So that's a radical difference. So for us and our firm, our decision was let's focus on first-lien loans,

that's the first thing. But to your point about language and vocabulary, what do we mean by that? Because that word can mean a lot of things to a lot of different folks.

For us it means a private equity sponsor, so a private equity firm is coming and buying a middle market business and they're going to write an equity check of about 50%, so we're in it 50% loan to value. If you look at the private equity world, a lot of private equity sponsors make their money through financial leverage. Those are not the private equity sponsors that we'll work with. We're working with private equity sponsors that today are buying a middle market business and they're looking at it strategically. And so they're willing to write a big check because they want financial flexibility to make acquisitions down the road, to make operational changes, etcetera. So the overarching foundational principle for our firm is to get that big equity check and be in at a really low loan to value.

Now to Alex's point, the challenge for us in that, if we're going to be really honest and transparent, is you can only find so many of those deals. So as a result of that, for both of our funds, we've made both of those what we call capacity constrained. And so both funds we've capped at $500 million of equity under management, we will not grow them beyond that. And the result of that is that we can be highly selective, we don't have to put a lot of capital work. In the CORFX fund we'll probably do six to 10 loans a year, and that average loan will take us 60 to 90 days to underwrite. And then in the Flat Rock Opportunity Fund, we only have 30 positions. Now within those 30 positions we have over 2,000 underlying loan investments, but the strategy again is to be capacity constrained and very selective when you're taking the approach that we're taking.

John Cole Scott: Fascinating. I love getting to the heart of the NAV, and the style, and the different pieces inside of the funds. But as we were having our planning call, your funds offer as interval funds tend to, that daily net asset value. And yet a lot of the other funds that we discussed in the call, the listed CLO funds do at best in my experience, pretty much estimated monthly as most of the funds involved. And BDCs do a quarterly NAV. And so if you could just talk, we had a chit chat about this earlier this week, how do you guys look at that daily NAV and what is driving that for investors? And how have you built that infrastructure around daily pricing of net asset value? And the first one here will be Robert.

Robert Grunewald: It's a critical question. Because if you go back to the history of BDCs, there have certainly been some noteworthy short attacks on BDCs where they thought that the underlying valuations were not accurate. And BDCs historically, if you go way back, did all the valuations themselves. Then they started, because of wanting to have that investor confidence, doing a valuation maybe once a quarter. I think there's a way to do it better and I think both Cliffwater and our firm do that, which is we have independent firms. For us either IHS Markit or an accounting firm called Cherry Bekaert, evaluate every single one of our investments every single quarter. I'm sorry, for Flat Rock Opportunity Fund, IHS Markit is actually evaluating every single investment every single day. And then for the Core Income Fund where we have the less liquid middle market loans, in between the quarterly valuations we have created a connection, an algorithm between where the broadly syndicated loan market is trading and where we think middle market loans trade.

So I think the data's critically important, and Alex, I think Cliffwater's done a fantastic job of that as well. Creating investor confidence that when I look at that net asset value, which I can invest any day in either of these funds, that I have confidence that it's accurately depicted. By the way, as a reminder, not only do we have these independent valuations, but ultimately our independent board of directors need to sign off on these valuations, and of course these interval funds are SEC registered and reviewed as well.

John Cole Scott: Alexander?

Alexander Condrell: Yeah, that's a good point, Robert. These are certainly more well governed structures which we didn't mention earlier but it's worth noting. than would be a private institutional fund, a partnership especially. Not that the partnerships are run in a poor way by and large I don't think, but interval funds really do have quite a bit of oversight.

Yeah, as Robert mentioned, we also make estimates on a daily basis to ensure that we are as close as can be to a fair value. We also accrue the daily income, daily expenses, and the NAVs tend to be very stable. This is a hold till maturity, pretty low volatility asset class. Middle market credit, that is. And so you don't tend to see a lot of movement. But we did go through Covid and we were down, and we marked down. Not just in a jump step fashion, but daily as the loan market was moving, we were making our estimates and moving our NAV down accordingly and then up accordingly. And we think it's worked out quite well.

And as the manager marks come out every 90 days or so, we look back and we get to see how were our estimates. And they've always been very, very close. Even through Covid we were only off by two basis points. I should say through the first quarter of 2020. And so that doesn't guarantee that we'll always be that close, but we feel it's certainly much better for investors to have the idea that we're going in the right direction rather than buying shares at the previous quarter's price. That's really the intention.

John Cole Scott: Great, and so the next piece, we have talked about that, many of the credit interval funds use leverage. I mentioned that they tend to have less leverage than as Robert mentioned the BDCs do. Both by mandate and even exemptive leverage as you're probably all familiar with. But let's talk about how you've modeled leverage, the portfolio. We hear some managers say we've levered this piece or at this range. How much leverage do each of your funds currently have publicly and what are the reasons you changed it over time? And what would drive you to change the leverage? And we'll first start with Robert.

Robert Grunewald: Yeah, so we talked about the BDCs. Again, we were a private BDC and we created the structure because we thought going up to 1:1, with exemption even 2:1 leverage, could be valuable. And we were under levered going into 2020, and if you look at two of the reason we performed so well – our max drawdown was just a little bit over 4% – was lower leverage and that first-lien focus. Where private equity firms were coming in and supporting their businesses even when they had a bump in the road. And so we concluded, and I really believe strongly that less than 1:1 leverage at a minimum is appropriate for this asset class. For us that means if you put it in debt to equity perspective, it's 0.2 to 0.25 times for both of our funds. So we believe in using minimal leverage in the funds and I think that greatly reduces risk.

And just as importantly, we manage for both returns and volatility, significantly reduces volatility.

John Cole Scott: Again, so for those that are more familiar with closed-end funds, we tend to use 25%. I know you're using the BDC framework for leverage, and you guys both know that range, but for our other folks that sounds like a 25% leverage if I'm doing the math right.

Robert Grunewald: Yes, correct. That's correct.

John Cole Scott: Okay. And Alexander, maybe talk about your current use of leverage and how it can, has, or could change over time.

Alexander Condrell: Yeah, not too different of a story. The interval fund structure is capped at 50. We could borrow 50 cents for each dollar of equity, and we generally about half of that. So about half of that half term, which is about a quarter or 25% as you said. We like having that underutilized facility because it helps us. We don't think we need to maximize the leverage because really what we're trying to maximize is consistency.

But also it's a helpful tool in the sense that taking daily flows that you don't always know ahead of time what they will be, and having to line up loans against that means there are times when you have a little bit more cash than you have loans or you have more loans available than you have cash. And so that leverage facility is a nice tool to help bridge the gap and really kind of just smooth out the opportunities for us. And so it fluctuates, so it's not a fixed 25% by any means. It could go down as low as maybe 15%, and on the high end maybe goes up to 0.3 or 0.35, but the intention is to keep it around a 25% or so.

John Cole Scott: I know during Covid we saw some listed closed-end funds where their inferred leverage based on dollars known and current NAVs breached the 50% which caused some challenges. We always talk about closed-end funds, or any BDC, closed-end, interval fund, you don't want to be a forced seller at the wrapper level. And for a listed fund at the holding level. We always want to be a patient, thoughtful investor, not an urgent, required investor for margin calls. So definitely not fun to see those pullbacks, or great opportunity if you're people-- I'm sure you guys picked up some loans in Covid that other people were puking. And I know that we picked up some closed-end fund listed shares other people were puking as well.

Next piece, so looking at, these are income focused funds, and so you have dividends or distributions paid to shareholders. Let's talk about the policy. Let's talk about how it was built, and either where it is now or where it may go in the future. Because obviously people never want to lose money, but they typically give-- we put interval funds in portfolios to build quarterly average dollar income to clients. And we have good tools to build that for our clients and we love doing it. We know no dividend is perfect, that's why we own more than one fund, right? So talk about each of your policies, how investors should understand it, how it's thought of at the firm level. And we're going to first start with Robert on that one.

Robert Grunewald: Yeah, so [inaudible], well, let's take one at a time. The Core Income Fund, we set a dollar distribution rate when we founded that one four and a half years ago, and that

distribution rate has not changed. The yield can change a little bit with changes in net asset value, but again the fund is at only two down months and very little changes in net asset value, so the yield is right around 7%. But we don't peg the yield, what you're going to get is the same distribution check dollar amount every month, and we pay that distribution every month.

The same is true for the Flat Rock Opportunity Fund, except that in that case we've actually increased the dividend yield three times this year. Again, our approach in terms of setting the dividend in both funds, and this is critically important, is to set it at a level that we're very confident over the long run we can earn it through operating income. I think the worst thing I've seen in this industry if I were to throw a blanket over the industry, is a dividend paid through a return on capital. That's just not fair to investors.

So the key to doing that is first to set the dividend at the right level. And then the second thing that we've told investors is that we're actually going to waive our advisor's fees as necessary to ensure that that dividend is paid through operating income. And we've done that, mostly earlier on when we were scaling the portfolio. But I think it's right that the advisor takes that hit, not investors. Over the long run a dividend should not be paid through a return on capital. No sense giving someone their own money back.

John Cole Scott: Good. Alexander, maybe you can chat about the distribution policy at your fund.

Alexander Condrell: Yeah. We have a similar, instead of paying out a fixed dollar amount, we do pay out at a fixed rate. But as our NAV has been pretty stable it ends up not being such a big difference from what Robert's describing. So we pay out a 7% annualized, which is a rate that we're comfortable that we can earn. Not paying back principal as Robert was saying. We pay four times a year, and if needed on that fourth distribution, if we have extra distributable income we can pay it out then. So that's the general approach we take.

John Cole Scott: And so in theory that fourth dividend can be larger because of similar requirements of the 40 Act, for your fund to pay out 90% of the income to maintain the tax-free. This is the 40 Act attorney part, right? Yeah, so sometimes there's special dividends. So I guess that basically you guys have a larger year-end to clean up excess.

Alexander Condrell: Right.

John Cole Scott: And Robert, at least on your CLO focused fund, you've just said you saw cushion expand, the firm and the board have just grown the base, baseline. Both are done actively. I can't say one is right or wrong, but the goal is as you guys know, you want to do your best not to reduce the dividend. Or if you are, do it when everyone else did it more. Like MLP funds in Covid, they did the worst, the best dividend cut was only 47%.

All right, so we have talked about Covid some, and we're running a little ahead but this is always a good conversation. I put times in there to help keep me on pace. But Covid happened. I know it's further away and I'm not watching the Covid data daily like I was in 2020, but it's definitely in the headlines. And I know when we have our client reviews, people always ask me, "The next

wave, what should we do? Should we buy more or should we sell off?" Again, that's the behavior we try to avoid in investors, why they should all have great advisors to hold them in the market as appropriate for their policy and their portfolio.

But how did Covid impact? And what would be the difference in December of 2021 in the way you approach the portfolio versus the way you were thinking about it in December of 2019? So think before we all learned to Instacart and DoorDash. And the first person for that question will be Alexander.

Alexander Condrell: Yeah, I would say not much has really changed in terms of loan opportunities or type of structures. At that time going into Covid, I think markets were pretty competitive. Now I'd say they're still pretty competitive. In the meantime, what's happened? Well, the immediate impact was loan valuations declined, but not much actual losses. Companies struggled because their customers are not showing up as much. They don't usually just die immediately, they're going to cut costs and they're going to try to do some things. Some businesses were more affected than others.

As it turned out, middle market conservative lending worked pretty well and there's avoidance of things like transportation and generally cyclical businesses that tend to be more sensitive. That worked pretty well and middle market overall about 2% realized losses for the four quarters after Covid. We were fortunate, we did quite a bit better than that. We did not have any realized losses on a net basis. We had some gains and some small losses but overall it was a small positive. But even for the whole middle market overall, about 2% realized loss, which was well below the income.

So I think that should give investors comfort that, even in the space middle market which can seem unfamiliar, didn't do poorly. In fact it did well and generated positive returns through that difficult time. So as we've seen today, I think that should give more comfort. Some people say, "Well, what if the cycle begins now, down cycle, or equities are too rich?" or whatever case to be made about something scary, I think there's reason to take comfort in private credit for the reasons that we've been talking about.

John Cole Scott: Great. Robert, do you have anything to add to that perspective?

Robert Grunewald: Yeah. For starters by the way, going back to the interval fund structure, one of the things that we discourage clients from spending too much time thinking about is trying to answer the question, is now the right time? And I think Covid is an interesting example of that. You could look back to late 2019 and some of the headlines, and it felt like maybe private credit was a little bit overheated. But done right, and Cliffwater's track record is fantastic in that area, having a highly diversified pool.

For us our track record was max drawdown 4%. We've not had a defaulted loan in our portfolio, in four and a half years we've only had two down months. But I think it's critical that investors be long-term investors. So if you're a tactical investor and you're thinking, oh, I want to tack into private credit right now and I'm going to get back out of it, quite frankly I don't think an interval

fund is a great structure to do it. It's a great structure to be a long-term investor in an asset class that has performed very well over long periods of time.

So again for us specifically if you go back to Covid, one of the interesting things that came out of that is we looked at the performance of both of our funds, let me take 'em one at a time. The Core Income Fund performed beautifully. Now when I say beautifully, that doesn't mean we didn't have a few moments there where we were wondering how a certain credit or two might turn out. But again as I mentioned, that low loan to value private equity sponsor, we found that the sponsors ultimately supported these businesses.

But when we look back a year later, maybe it wasn't quite a year, but in the fall we did a full analysis, what I'll call post-mortem. But did it more with an eye towards, okay, what did we do right as opposed to just saying, "Hey, we got lucky or we're brilliant"? And I don't think either of those is true. We ended up really coming out of that with an algorithm for our underwriting that really reinforces many of the things we were already doing. But one of them is the loan to value that I've already mentioned. Another is we like middle market loans where the management team has been in place for a long period of time. The consistency of the management team, to see experienced management teams, they know how to react, of course do what they need to do when tough times come. That really paid off.

Another thing that I mentioned is the lower leverage the fund, higher margin businesses is another example. So all of that now feeds into reinforcing the underwriting discipline that we have at CORFX. And when we look at where we are today, quite frankly the fall has been a very robust period for us in terms of loan origination. Spreads seem to be holding in in the lower middle market. And I think it continues to be quite frankly a sweet spot of a time to be investing in private credit. Because while the equity markets can move around with some volatility, whether or not there's another wave of Covid, being in private credit gives you a buffer against that volatility.

In the opportunity fund, in the depths of the crisis that opportunity fund, the Flat Rock Opportunity Fund investing in CLO equity as I mentioned, you have some embedded leverage. And the result of that embedded leverage is that that fund was down 20% max drawdown. So I mentioned that it's at 15% average annual returns since inception, you don't get that 15% versus 7% at our CORFX for free. You get it with a little bit more volatility. So it's important that investors know that. But the flip side of it is by the end of 2020, the fund was up 14.5%. And year-to-date it's up 27%.

Now the reason for that is that is what we call the self-healing mechanism of CLO equity. To take a second and describe that, what it means is that when you're investing in CLO equity, you have all of this locked in debt that is financing this pool of loans. And in the midst of a recession, you have the ability to reinvest some of those assets in higher yielding assets. And so when you may have higher losses, you can actually pick up even higher yielding loans in the midst of a recession. So the spread between the assets and liabilities can actually increase, more than offsetting, not guaranteed but potentially more than offsetting higher losses. That's what we saw in 2020 and '21, and why the opportunity fund has performed so well.

John Cole Scott: Good, thank you for that. So I guess really the last question be the end, if the audience members have questions, I've been watching, none have come in. If you've thought of one, please feel free to submit it now and we'll do our best to get to them, but also try to end on time as well.

The other topics we haven't directly covered are in the financial news we hear a lot about inflation and rising rates. And I know that I've been talking about rising rates with managers like you since 2009. And they did rise a little bit since 2009, but as you think of, and again part of it's the asset mix, this is me giving you a bit of a softball. What about your portfolios deals with inflation and rising rates? And we know they're related but not the same thing. And then how should we be thinking about them as we allocate dollars to it? And we're going to start with Robert.

Robert Grunewald: Yeah, so that is a softball question in the sense that both of our portfolios are 100% floating rate, so both are essentially zero duration. So as rates rise, generally speaking, our income will rise with that. Now there is one caveat and that is that both funds benefit today from the fact that many of our loans have LIBOR floors. But I really like that. I actually think again that's sort of a sweet spot to be. Because as you've said, John, people have been worried about rising rates since 2009. And rates may rise a little bit off of the floor it's on right now, but I'm not really sure that we're going to see significantly higher interest rates maybe again in my lifetime because of the nature of demographics and the sheer amount of debt that the US and Western governments have.

But that macro comment aside, the benefit of those floating rate loans is that they're going to benefit as interest rates rise. But the benefit of those LIBOR floors is that if rates don't rise we're getting some extra yield right now that otherwise wouldn't exist. Our typical loan has a 1% LIBOR floor. So if rates do go up investors should know that there'll be a little bit of stickiness for what I would describe as the first three Fed raises, and then after that our funds float with increases in interest rates.

John Cole Scott: Alexander, counter point?

Alexander Condrell: Yeah, I would just add, it's not really a counterpoint. I would add to that, similar structure for us. The way I like to think about it and explain to investors that I talk to is that the investment here is really not about interest rates, it's really credit. And so interest rates are pretty well neutralized. You're not as concerned about what happens to the treasury yield curve or CPI, it's really about getting paid back on each transaction. So that's the creditworthiness of that underlying borrower. Again, we do our best to mitigate that risk by being diversified, but it's really about that, not about what happens to inflation or the Fed tightening, etcetera.

John Cole Scott: Good, I'll let you start to answer Trevor's question which is about RIAs, like me but not me obviously, because we're sometimes 20% interval funds. For the average under 5% to alternatives, and alternatives is a large bucket. That's probably both interval funds and as well as private funds, versus 40% for those much larger allocators of capital. Why do you think

in your experience is there such less adoption of nontraditional stock and bond allocations through the regular investment advisory channel?

Alexander Condrell: Yeah, I don't know the answer. We see quite a few RIAs that do invest I would think more than 5%. But I think there's a lot of hesitation on the due diligence side and for advisors who don't necessarily have a big team to allocate to managers. It may seem like an overwhelming number of managers to choose from. And not to mention, do I do private equity, private real estate, do I do private debt, do I do hedge funds, other things? So it's a daunting task if you are a small shop. I would say we'd certainly tend to see more from the $500 million, billion plus RIAs, not as much from the smaller ones. But I think it's growing, is my personal feeling.

John Cole Scott: I think part of it has been closed-end funds, they're great for active management, prudent use of leverage, and the ability to just really analyze a sector and a manager and not be a daily transparent passive ETF or an open-end fund. So much of the sector was built, and there's nothing wrong with these funds, there's some great, interesting funds that are liquid and designed to be very liquid for exposure or active managers. But I just think so few of the advisors using anything that's closed-ended, whether it's a traditional closed-end fund, or a BDC, or an interval fund, or a tender offer fund.

Why did I start AICA in July of 2019? It was to try to create more content, to educate more advisors, More than just me banging my head against the tree trying to get more people to say yes. We used to have a newsletter service, which was nice, 10 interviews a year. But now we've done 44 presentations in 26 months, panels, presentations. So hopefully we're doing more of that. I guess unless you want to add something, Robert, I just think it's more education to be comfortable with the wrapper, and more education, how its used. And get more platforms to allow more funds to exist. I'm sure each of you have one or two platforms you're not on yet that you'd love to be on.

Robert Grunewald: Yeah. I think you've said it really well. The thing I would add to it though on the private credit side, Goldman Sachs recently came out in a research piece and estimated that the private credit market was a trillion dollar market. The comment I would make to advisors is, can you really ignore a trillion dollar market and not give your clients exposure to it? And then look at the numbers. Folks typically when they're looking for yield are like, "Okay great, I'll go to the high-yield market." Well, high yields yielding 4% with long duration, fixed-rate assets that are unsecured. Both Cliffwater's fund and our fund will give you an opportunity to get zero duration, secured loans with 300 basis points more of yield. This is a class if you're not taking a hard look at, you really need to because I don't see how you can avoid a trillion dollar asset class.

John Cole Scott: It is. And I'll say when people say your preference, this is my advisor hat going back on now, not my AICA hat. We have been underweight high yield even through to other even interval funds or traditional closed-end funds. Not out but underweight, and have chosen to listed and non-listed loan based funds and BDCs. Because again, we can be very tactical in BDCs. I definitely appreciate your comments.

We did a session last month about BDCs. When you pick the right spots at the right time, there's some beautiful things that can happen. You definitely shared some good perspectives, but I really don't like duration and I don't like unsecured credit. So as I think about what I want for my clients is, can I blend to that number that's like the traditional high yield of 6% for long duration unlevered and give it to them through different managers, different structures, and more resiliency? That's how we've approached it.

So good, we are getting close towards the end of time. I guess the last thing, any more audience questions we're very well received. But I was going to let each of you kind of give a final thought, a PSA for those conversations you have in your career about your sector, your structure. Or even that one thing that you meant to bring up to me on the prep call we didn't get to. And for that final thought, unless there's another question, this will be our final question. Let's start with Alexander for what would you love to end this conversation with? There's been such a deep and broad perspective on the sector, the structure, and your firms.

Alexander Condrell: Yeah, I think the big picture, sort of adding to what Robert said, big picture here in this asset class, middle market lending that is, is that it has historically generated better than cash, better than bonds. And if you can find a structure you're comfortable with, and I would argue the interval fund structure works well, and if you can have a manager you feel comfortable with, there should be a place in a portfolio for something that can be an income-focused conservative. And over time should be arguably better than cash and bonds with a lot of consistency. That's kind of the big picture.

I think many people are less familiar with this space and that makes it seem difficult. But I think as you start to dig in you realize the returns aren't generated through complexity, they are really just generated by being in this space where it's less competitive and it's a less liquid market, and there's some tradeoffs there but there's a lot of opportunity.

John Cole Scott: Very well said. Robert?

Robert Grunewald: Yeah, I would probably just use this moment to pivot and focus on the Flat Rock Opportunity Fund. So again we've talked about private credit, this is a way to get exposure to private credit through something called CLO equity, which is maybe even significantly less understood than traditional private credit if you will. I would just encourage the folks who are here to take the time to learn. We've got a great e-book on our website at FlatRockGlobal.com, written by the CIO of our fund, Shiloh Bates, it's a great primer on it.

But when you look at the returns in the asset class, which have averaged double digit returns, if you'd invested in 2007 at what theoretically was the worst time you could possibly have invested just before the Great Financial Crisis, you ultimately would have come out of the backend with IRRs for 2007 vintage CLOs of over 20%. It's something worth taking the time to understand, and I would just encourage folks who are here, who are interested, to learn more.

John Cole Scott: Very good. And I'll remind everyone that we do have profile pages on every interval fund at AICAlliance.org. It's powered by CEF Data which has been covering interval

funds since 2018. Been covering closed-end funds since '11 and listed BDCs since '14. And so that's a place for you to go for more information on all these funds as we grow resources.

We also have the regular weekly podcast with a diverse mix of managers, and products, and service providers, definitely please check out *The NAVigator* podcast. Just really want to thank each of you for joining me this afternoon to help us close out day one of our Interval Fund Manager Winter Spotlight. I'm not going to do the effort of going to the floor and coming back. If you would take me appreciation and turn your mic and camera off, I'll do the closing remarks and thanks. And then we'll let people mingle or get about their Wednesday.

Alexander Condrell: Thanks John.

John Cole Scott: Again, thank you both for helping out this afternoon.

Robert Grunewald: Thank you.

John Cole Scott: All right, again John Cole Scott with the Active Investment Company Alliance. Thank you for attending day one of our Interval Fund Manager's Spotlight. I really cannot stress too much that we could not do this without members, without sponsors, without moderators, other bearded moderators named Chuck Jaffe or tomorrow with help from Vadim.

Really hope that you come tomorrow and we'll work with the presenters to get the content in replay mode as quickly as possible this time of year so that you can share it with your friends. We transcribe and record and repost everything. It is in replay conference for about four to six weeks, and then will become open and public for all to use and offer that. And so with that said, my notes look done. I'm going to take us out of this presentation mode and let you have a chance to say hello to me or anyone else before you go home. Thanks so much.

Recorded on December 8, 2021.

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