November 2022 Live Event-AICA Fall CEF/BDC/Interval Fund Bootcamp and Roundtable Panel #2; "Navigating Credit Risk in a Choppy Economy"

Wednesday, November 16, 2022

Jake Schultz, CFA, Partner & Director, Portfolio Oversight & Analytics with Destra, moderates the second panel of the AICA November 16th, 2022 live event; "Navigating Credit Risk in a Choppy Economy". Read the transcript below to hear the discussion among Mr. Schultz and panelists Charles Arduini, Partner and Portfolio Manager with Ares and Gretchen Lam, Portfolio Manager with XFLT-Octagon.

Jake Schultz

Charles Arduini

Gretchen Lam

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Jake Schultz: Good morning, and thank you all for being here. My name is Jake Schultz and I'm here with Destra Capital. Destra is a proud member of AICA and very honored to be here today and up here with two excellent panelists representing very well-known and respected firms in the industry.

So before I get started into questions, I will allow our panelists to give a little bit of time to present some background on their firm, their strategy, and the listed closed-end funds that they manage. But first before I do that, I'll do just a couple brief introductions on both of our panelists.

We have Gretchen Lam here from Octagon Credit Investors. Gretchen is a portfolio manager there and the portfolio manager on the XAI Octagon Floating-Rate and Alternative Income Trust. Gretchen is a member of Octagon's investment Committee and serves as a portfolio manager across CLOs, separately managed accounts, and commingled funds. She attended Babson College where she graduated summa cum laude with a BS investments, and she received her CFA charter in 2006.

Mr. Charles Arduini, Charlie is a partner and portfolio manager at Ares Credit Group where he focuses on alternative credit investments. Mr. Arduini serves as the vice president and portfolio manager for the Ares Dynamic Credit Allocation Fund, NYSE ticker ARDC. He also serves as a member on the fund's investment committee. He holds his BA from Bucknell University in mathematics, his MS from Stevens Institute of Technology and Mathematics. He also holds his MS in computational finance from Carnegie Mellon, and he also is a CFA charter holder.

So now without further ado I will join my panelists here in a more casual conversation. I'm going to start with Gretchen, and ask Gretchen to give us a quick three to five minute overview on Octagon Credit, the firm, the strategy, and XFLT.

Gretchen Lam: Thanks Jake, I promise I won't take five minutes, so maybe we'll catch up a little bit on the schedule. As Jake mentioned, my name is Gretchen Lam. Good morning, great to see you all. I am a partner and senior portfolio manager at Octagon Credit Investors. Octagon is a $34 billion asset manager whose primary focus is below investment-grade corporate credit. That comes in the form of broadly syndicated loans, high yield, CLO debt tranches, and CLO equity.

We manage those assets in the form of CLOs, where we are acting as the collateral manager. We also manage private funds, separately managed accounts, as well as XFLT, which is a closed-end fund where Octagon serves as the sub advisor managing the assets and I serve as the portfolio manager. The fund today is allocated approximately 50% in broadly syndicated loans, and approximately 50% in both CLO debt tranches, primarily the most junior debt tranches, the junior mezzanine tranches as well as CLO equity.

Jake Schultz: Excellent, thank you. Charlie, same to you.

Charles Arduini: Sure, thanks. And again, nice to see you all, thanks for coming. So I work at Ares Management. Ares is now about $340 billion of assets under management across five groups, the largest of which is credit. There's also businesses in private equity, real assets, secondaries, and strategic opportunities. I work on the credit group, in particular on CLO securities, but also as part of the portfolio management team of ARDC, Ares Dynamic Credit Allocation Fund. Which I believe is about on its 10th year anniversary, because I know I was on the road in Thanksgiving of 2012 meeting with advisors, so we're just about on that.

The fund itself invests in broadly syndicated loans, high-yield bonds, and CLO securities, CLO debt and equity. The fund uses the Ares platform and all of the information we get across all those businesses to try to make what we think are good credit decisions and investments that ultimately in ARDC accrue to the investors. We have what we think is a very solid 10%+

dividend right now, and we've been very earned completely by the income, very stable. So looking forward to the questions and away we go.

Jake Schultz: Wonderful, thank you. Thank you both. So I think kudos to John for quite an appropriate title that we have here. Obviously I'll save time for questions at the end but I think it'll be interesting to get a pulse from two very special world renowned credit managers on just what they're seeing in the credit markets. So we're going to start out with some thoughts on the economy, inflation, credit, defaults, et cetera, and then we'll get more into their portfolios later on as well.

So as I mentioned, it's been a very interesting year. A lot of volatility, central bank intervention, volatility and rising inflation. So just want to start with the first thoughts on inflation. How is it being felt by corporate borrowers, investors in loans, and then within the broader economy as well? So Charlie, we'll start with you on that question, and Gretchen, feel free to add any thoughts.

Charles Arduini: Sure. Well, there's two obvious answers. The first part on the inflation is how do you run the business to be profitable with your costs increasing and can you pass along revenues? Many companies have been successful on that but some have not. As an example, the healthcare sector where you have labor costs going up and you can't necessarily pass along those costs when you're in a regulated amount that you can charge through Medicare and such like that, so you've seen some pressures there as an example.

So inflation has certainly impacted the running of a business for companies, but then the other obvious part is the increase in rates. And so floating rates have gone up from effectively zero to over 4% now, and so there's a tremendous amount of focus on interest coverage, the amount of EBITDA or earnings that these companies have to cover the interest payments. And so again, I think that's been the primary effect.

There's obviously second order effects on the consumer itself and what that's done to the real estate market, what that's done to mortgage rates, what that's done to increasing credit card usage. And so I think that has yet to play out but those are the high-level themes I think that we're seeing as a result of inflation.

Jake Schultz: Gretchen, same to you.

Gretchen Lam: Sure, I largely agree with the comments. The interesting thing that sometimes gets forgotten is that an income statement is nominal, so inflation has actually been very good on a nominal basis for the top line. As Charlie said, it's the margins that we're watching. And so that dynamic paired with the fact that the purpose of the Fed rising rates is to slow the economy, which heretofore has not had a meaningful impact on demand, but certainly will and that's very much top of mind for 2023.

So we at Octagon invest directly in over 600 corporate loans, we track the performance of those loans and the earnings of the companies on a quarterly basis. In the second quarter, companies on average grew revenues 10% and EBITDA 8%, so very strong topline on a year over year basis, and in fact strong EBITDA but margins compressing. We're seeing more of that in the third quarter and evidence, while the earnings are still coming through so we don't have the full picture across the entire universe of our holdings, the early numbers suggest that while revenues are still positive and EBITDA is still positive, it's less than it was in the second quarter and it suggests more EBITDA compression than we saw in the second quarter.

And so I think that's really a theme that will continue through 2023, and that's a very real headwind for the vast majority of the 1,200 or so corporate borrowers in the broadly syndicated space. And then on top of that of course, not flowing through the EBITDA is the interest expense, which for some borrowers their dollar interest expense in 2023 will be double what it was in 2021. That's really meaningful and we can expect will be a very persistent headwind for many of the borrowers in the space, particularly for those that haven't put in place hedges or don't have fixed-rate financing in place like bonds.

Jake Schultz: Very interesting. So on that note of the, Charlie, you briefly touched a bit about the consumer, we just heard the thoughts on corporate borrowers and how that's affecting them. So taking that a step further, if you guys have any thoughts you want to share in terms of defaults, what's the outlook for defaults? Any downgrades? And what are we seeing in terms of valuations currently in the credit markets that you guys both navigate?

Charles Arduini: Sure, I think our focus right now is more on downgrades than defaults. If you think about leveraged loans for example, the B3 credit which has grown to about 30% of the market is the most exposed here. Because any sort of slowdown over the next 12 months which would affect your EBITDA is going to hit there, and they're the most exposed to the interest rates going up and their coverage going down. That's going to be a flag right away for the rating agencies. And so we've already seen the downgrade-upgrade ratio turn this year, and every month is gotten more and more.

It hasn't exploded. I'm not predicting a 2020 wholesale change like we saw CCCs go from three percent to 15% in three weeks. Although the CLO structure did perform through that one too, I will say. But I think downgrades are going to come next year regardless of what happens to defaults. I think defaults will pick up, but the benefit of the euphoria of 2021 was that most companies extended their debt and so there's very little maturities.

Why do you default? You default because you have to refinance or you have to pay back your loan, or you run out of money. And right now, the first one where the maturity is not going to cause you the problems. If interest rates go up to 6% or 7% and stay there, you could see defaults hit four or five, six percent, but other than that I think it'll be increased but modest.

Gretchen Lam: Yeah, I totally agree. And I think that defaults, if you just take the J.P. Morgan projection, which I think has historically been among the better of the sell-side research projections, they're calling for 2.75% defaults in the broadly syndicated loan market in 2023. Now that's a significant step up from the 83 basis points that we are seeing today on an LTM basis, but it's right about the long-term average. Long-term average for the loan market for annual defaults is 2.6%.

It's going to feel worse than just an average year because we've been in a low-default environment really since the pandemic, but I do think downgrades will be a real challenge, certainly not the tsunami that they were over the 10 weeks in April and May of 2020 when S&P downgraded almost a third of the market. They're much more slow and steady. It's sort of a steady drip, at least thus far, and really centered around earnings releases. So I think as long as those downgrades are slow and steady over time, it will be a little bit easier for managers to manage around those downgrades.

But certainly, look, CLOs hold 65% of all outstanding loans, and all of those CLO structures have very similar guidelines and covenants with regard to average ratings and exposure to CCCs after which point it becomes punitive in terms of overcollateralization covenants, et cetera. And so it certainly feels like today all of the loan market is running to the same side of the boat, which is both a risk and an opportunity, particularly for managers of loans that aren't as restricted in their covenants as CLOs are.

Jake Schultz: Excellent, thank you. So you mentioned the risks, you mentioned the opportunity as well. So in light of all these headwinds and market factors that we're seeing, how are you positioning your portfolios today? Perhaps maybe how has that changed from 2020 through Covid and now here into 2022? Gretchen, we'll start with you.

Gretchen Lam: Sure. I think this is a market where we've seen extraordinary dispersion of performance and pricing. The market is certainly acknowledging that dispersion, that fundamental dispersion. I shared some statistics of earnings, and revenue, and EBITDA growth over the last couple of quarters, what's interesting is that I think the real story is not in the averages, it's in the averages it's in the tails. And in both the second quarter and the third quarter thus far, we've seen about 30% of companies actually experience declines in EBITDA year over year despite the fact that the averages look quite robust if you look at the full universe. And so that's a big focus for us, is avoiding the landmines, avoiding the underperformers, and I think that's the best path for a manager to outperform in the current market.

I do think that the risk is priced in. Certainly there are areas where I think on a relative basis are a little bit more rich and a little bit more cheap, but I mentioned the projected default rate of 2.75%. If you look at the current spread and price where loans are trading, back into a 5% default rate next year, and I don't think that will ultimately come to pass. I think there are reasons why the loan market has fallen more than perhaps the forward default expectations would suggest, but to me that suggests that loans are attractively priced relative to the future outlook for 2023.

Jake Schultz: Excellent. Charlie, to you.

Charles Arduini: Yeah, I think the year to date, if you will, was start off with rates and then turned into credit, maybe April or so. And for us, we were worried about rates and inflation really in the fourth quarter of last year, that things were just priced too much that it was transitory and that there would be muted rate increases. And so from a positioning standpoint we were certainly underweight fixed relative to historic levels heading into the year. But really starting in February certainly, the events in Ukraine and others I think got us worried about credit in that February/March timeframe. It wasn't just a rate sell-up anymore, there was potential credit headwinds, and so really the last several months have been about going up in quality.

The one good thing about the market selling off is it gives you opportunity to still have really attractive returns and forward returns and take what we think is less risk by going up in quality. And so we've been positioning the portfolio now to take advantage of those opportunities that the market has given. Both markets, high-yield bonds and loans, and CLOs for that matter, I think are at least fairly priced right now. Maybe they're cheap in a way.

When you look at where high yield bonds are, and again it's mostly been rate driven, their selloff because they're fixed rate, but the 12 month forward returns when they hit these levels is historically very, very strong. It might not happen in three months or six months, but on a forward basis it's quite good, and similar for loans. So I think that again now it's when do rates flatten, when do they come back down? But I think the credit story has yet to play out, and that's what we're still positioning ourselves for.

Jake Schultz: Wonderful. On the note, we've talked about rising rates and the first panel certainly talked about different areas of leverage getting quite high in closed-end funds. With rates rising today and certainly the securities in your portfolio are majority floating rate, so income is rising there, but on the right side of the balance sheet what are you looking at in terms of leverage? Has your perspective changed at all there? I know Ares, there was a preferred offering for leverage, I believe last year or in 2020. Any thoughts that you guys have to share there would be wonderful for the audience.

Charles Arduini: Sure. I think obviously it's something we're always aware of. As the first panel was talking about, the ability to use leverage from a professional investor is something that we take seriously and try to make sure that we're maximizing the value of that for our investors. We were very fortunate, lucky, whatever you want to call it, last year to issue that preferred fixed-rate 2.8%, and so it's just a great asset now, even though it's on the liabilities side is the way we view it.

And so we did that for two reasons, one was to reduce the regulatory leverage so we're now at 16% versus the statutory 33%, so we've got a lot of cushion. Don't have to worry about being that person that has to sell when markets are really cheap but instead we can actually go and play offense. So it's given us that stability and it's given us the ability to use that and actually go out and we think earn a really good spread. So liability management is critical. We're not taking that leverage up right now. The markets, there still is I think risk, it's not the right time to go towards the, if you will, 25% as opposed to roughly 16%, which is where we're at now. So that's where we're at.

Jake Schultz: Gretchen, any thoughts?

Gretchen Lam: Sure. I would just underscore a couple of things that Charlie said, which is leverage is a very effective yield enhancer. This is not a market where I'm particularly concerned about generating an attractive yield on the unlevered asset portfolio. And so I would agree that our positioning has been one of more defensiveness, both in terms of the asset quality as well as the fund leverage.

Where we do not want to be is in a position where we are a forced seller at the wrong time in order to stay in bounds, either with guidelines at the fund level or covenants at the financing level. And so we I think have been prudent in managing that on an ongoing basis in light of the recent volatility in the markets. And I would also say that having a floating-rate portfolio, certainly we've benefited over the course of the year with a component of our debt being fixed.

Jake Schultz: Great. So we touched a bit on the health of corporate borrowers, et cetera, but getting into specific sectors and themes, we mentioned a little bit earlier in terms of the consumer, maybe some of those factors have not played out, things we're seeing in real estate. Certainly energy has been a very hot topic this year with inflation and all that's going on in the Russia-Ukraine war. Are there any sectors or these that you're seeing maybe as attractive today, and then maybe sectors that you're staying away from in your portfolios? Gretchen, we'll start with you.

Gretchen Lam: Sure. One theme that we've seen really over the course of the last year plus is the shift away from goods, particularly goods used in and around the home, towards travel and services. I'm sure everyone here has bought a couch or a grill or put a pool in their backyard over the course of 2020 and 2021. Well, now you're going to Disneyland or you're going to Vegas. And so we've definitely seen a shift, some of the building products or home discretionary purchases have seen pressure. And then on top of that you obviously have the impact of rates which is driving new home purchases down, which in turn often drives spending on new homes. So that's a trend that I think will continue to play out.

The other trend that we're seeing is what I'll call a reversion to the mean of 2019. Many companies saw a boon over Covid, I'm thinking of the furniture companies or Joanne Fabrics for example, everyone was sewing facemasks and other stuff. Those revenues are going back to Earth. So we're seeing the impact of that, we're also seeing the impact of companies like a movie theater company for example which saw its EBITDA go to zero overnight, many of them were able to raise liquidity to get through 2020. Now are not seeing their revenues at the same level as 2019, and are sort of muddling along but with a boatload more debt than they had pre-pandemic.

And so I think we will see a number of credits with that profile come to a head, particularly in light of what's now an increasing interest burden. I think that'll be in the 2.75% default rate in 2023. I think we'll see a number of those types of credits.

Charles Arduini: I think you hit on almost all of them. The other one I'd mentioned, where we're seeing some cracks is in technology. And so there was a tremendous amount of issuances over the last several of years to where it's grown to be the largest sector in the high yield space, loans, or certainly leveraged loans. You see it certainly on the equity side and what's happening with SoftBank, NVC, and all of these companies. Well, many of them access the market in the leveraged loan market and we're starting to see some of them, those business models not necessarily play out.

Whether it’s ad spending not being what it was, or competition, or technology, things become obsolete overnight. Apple changes the way that they’re going to sell, and then your business that was set up one way doesn’t quite operate the other way. And so we’ve begun to see some of those, so I think that’s just another area that we’re focused on in making sure that our underwriting is correct. That you underwrite everything when you look at those credits, and then sometimes you’ve just got to make a decision to just sell. And so I think that’s the area.

But I think the other thing I’d say about sectors is, again, you can go up now to BB, you can go high quality and really pick up-- one of the interesting things that happening is a lot of the high-quality companies that have low cost of debt, let’s say it’s LIBOR plus 150, but they’re coming up to a maturity. They can’t let it run, and so they’re refinancing into LIBOR plus 450, or SOFR, now the new base rate. So you have real-high quality companies where you could buy that at 96 or 98 cents on the dollar, get a pop, and get 300 extra points of income.

Certainly in these funds that’s going to flow through to investors. In CLO funds that’s fantastic for the CLO equity, who all of that benefit accrues to the equity investors. And so that’s why in ARDC for example, when you look at our BB and BBB, we’ve gone from about 30% up to 45% over the year. Just going up in quality across sectors regardless of the specific sector that are challenged or opportunistic.

Jake Schultz: Very interesting. On the note of issuance, Charlie, you just touched on it briefly, technology, you saw a lot more issuance 2020 and ‘21, a lot of issuance in high yield. What are you seeing in terms of issuance this year, and volumes this year as well? Charlie, we’ll start back with you.

Charles Arduini: Sure. I think on CLOs, issuance has been some would say surprisingly strong, last year was a freakishly high year. I know our team was tired every night because of the volume. But this year will probably end up being the second largest issuance year in CLOs, despite conditions that some might have thought it otherwise.

That’s on true new issuance. CLOs also have this feature where they can refinance themselves, and that has gone almost to zero. Because anyone who locked in last year’s rates or rates from two years ago or three years ago has no interest in refinancing themselves since it’s 12-year locked up money. But CLO issuance has been quite strong. I think that’s been a support for the loan market. Maybe I’ll leave the loan market saga to you, although I’m sure we could both talk about it.

Gretchen Lam: Yeah. I think both high yield and loan issuance is down 80% year over year in terms of new issuance. Number of reasons for that, first off, any discretionary refi is off the table. There are some loans that have come to refinance with near-term maturities, but a very modest amount. Given the fact that the capital markets were so open last year, most companies did refinance and addressed any near-term maturities. But we also saw early in the year, large deals that were underwritten in late 2021 or early 2022, found themselves, those underwriting banks found themselves in a very uncomfortable position once the market dropped in the spring of this year.

And so I won't name names, but since you all read the paper you could probably guess, those are massive realized losses that those banks will take or already haven taken. And many of them are still licking their wounds, many of them are still holding those loans on balance sheet and so don't have a ton of capacity to underwrite new large loans, even if there was demand for them. And so ultimately that overhang needs to be addressed, in the meantime we're seeing dribs and drabs in terms of addons of existing loans and small acquisitions being financed with moderately sized loans.

It hasn't really impacted our ability to source attractive loan assets, and the reason for that is the secondary market is fantastically attractive right now. There are few periods of time in history where you can invest in the loan market and earn on a current basis, mid to high single digits with really meaningful price convexity. And we are in that environment right now; the average price of loans is +/- 92.5 cents on the dollar, LIBOR today is 460 something, SOFR a little bit below that. But if you're buying a LIBOR plus 350 loan, you're earning 8+% on a current basis, which is pretty attractive relative to history.

Jake Schultz: Great, thank you. Well, I do have a few more prepared questions but want to make sure we save time for the audience to ask any questions that they have specifically to our managers. You'll certainly have time afterwards but I know some might have to jump. But anything from the audience in the meantime? Otherwise I'll give you some time to think over some questions and I'll be coming back to all of you, but anything right now? No? All right.

So Gretchen, you were on, JCS mentioned *The NAVigator* podcast that AICA does each week with Chuck Jaffe. I know you were on a podcast recently with Chuck discussing the benefits of the rising rates certainly to the loans and CLOs and the opportunity that you're seeing there. Just in terms of maybe how the portfolio has positioned, anything in terms of CLO debt versus CLO equity? How are your teams looking at that specifically?

Gretchen Lam: Sure. So approximately, I believe it's 36% of the portfolio is invested in CLO equity and about 12% in CLO debt. Obviously the CLO equity has very attractive distribution attributes which we continue to like, and feel that despite some short to medium term headwinds that are really driven by the basis between one-month LIBOR and SOFR and three-month LIBOR and SOFR, longer term we feel good. And we feel pretty confident that at least over the course of the next four quarters, CLO distributions, there won't be large numbers of funds that trip their covenant that would prevent them from paying a distribution.

So while we have certainly seen a lot of price volatility in the portfolio of CLO equity, we have continued to see robust distributions. CLO debt has absolutely benefited from the movement up in rates. As I said, three-month LIBOR, which is the reference rate for any CLO debt issued before 2022, SOFR the reference rate for anything issued in 2022 and beyond, is 4.5+, depending on whether you're looking at SOFR or LIBOR, it was 22 basis points in January.

So you're getting paid a lot more to own CLO debt. It's +/- in the mid-80s, it's really attractive. On a current basis, 12% current with convexity upside. So we like both. I think gun to my head, if I had to say right now, I think CLO BBs are more attractive than equity given the more defensive nature structurally of those assets.

Charles Arduini: The other thing about CLOs, and this is beneficial for both debt and equity, is the loan price environment that Gretchen mentioned earlier where the average loan price is 92 is fantastic for CLOs. CLOs have a revolving period, the liabilities are locked in, and the ability to maneuver your portfolio, either buy a loan at 92 and sell something at 96 and what they call "create par". Or just to risk manage your portfolio and sell a credit you don't like at 88 and replace it at 92, effectively a future potential default, you got out at 96.

And so CLOs absolutely took advantage of this environment from 2008 to 2011, and that was by far the best performing vintage of CLOs. But in 2015 and '16 when loans sold off, good loans were still 99 and it was just the bad loans that sold off. And so you really couldn't do this maneuvering of the portfolio. And in 2020 everything went down to 88 but it lasted about a week, and so you didn't have time to take advantage of it.

And so now we've had this sustained environment where the whole market has sold off. And good managers, and if you do the work and you look through it, and certainly Octagon and Ares do that on the CLOs that we manage and on the investments we make, you've seen this steady building of par in CLOs throughout the spring and summer and now into the fall. And that only benefits the debt holders because it gives them extra credit protection, and it benefits to the equity holders because that ultimately extra payments they're going to receive at the end of the deal. So we actually really like this environment right now for both types of CLO investments.

Jake Schultz: Excellent. Very insightful, thank you. It is an event around closed-end funds, interval funds, and BDCs. Anything in terms of the why the closed-end fund structure specifically? Each of your firms maybe have an interval fund or other type of products, why do you think the closed-end fund structure is very beneficial outside of leverage we already touched on? Either of you want to add any benefits that you see in the structure?

Gretchen Lam: I'll weigh in. You can tell me if you disagree, Charlie. Look, I think that the CLO structure has been proven out time and time and time again. And yes, it starts with a C and ends in an O, but it's actually performed as modeled consistently through multiple recessions and periods of volatility.

And so on the one hand we feel very confident that the structure works, that it will function to protect debt holders in periods of high realized losses, that it will function distribute net interest margin to equity holders and all the other environments, but it also can be volatile from a price perspective. And when we are structuring funds that hold either CLO debt and equity, we're very careful to not put ourselves in a position where we are a forced seller at the wrong time. And so I think closed-end funds really support, they're the appropriate fund for assets like CLO tranches.

Charles Arduini: Yeah, I was going to use the word appropriate and you stole it from me, so thank you. They're the appropriate structure for the appropriate asset, which is what CLOs are for loans and closed-end funds are for CLOs. So I think it makes a lot of sense, and to be able to offer that to a different channel than the typical investors that maybe Octagon or Ares is dealing with, we think we're very happy to be able to do that and we like the structure for folks.

Jake Schultz: Great, thank you. Again, only a few more minutes. We don't need to use the full time but again, any questions from the audience while we have the managers up here?

Audience: Can both of you give us a comment about what losses you're modeling?

Gretchen Lam: In the CLO?

Audience: Yes.

Gretchen Lam: We run a number of cases. We run standard cases and then we'll run bespoke cases depending on the CLO and the manager that we're looking at. But generally speaking, we are running overlaid defaults in the 1.5-2.5% range, and then on top of that, applying defaults between 5-10% for any loans trading between 50 and 80 cents on the dollar. The market's saying a loan is trading at or is worth 60 cents on the dollar, it has a very high risk of default because the historical recovery rate for loans is actually above 60 cents on the dollar. So we're applying a pretty onerous default rate to those loans, any loan trading below 50 cents on the dollar we default day one.

And depending on our view of the collateral manager and the environment, we will also make assumptions as to the prepayment rate of the underlying loan portfolio, which has varied historically from just under 10% on the very low end to an excess of 40% in more benign credit environments. And then we'll also make an assumption on how those prepayments are recycled in the fund. As Charlie said, an environment like we're in today, you can take a prepayment that you just received at par and recycle it into a loan at 95 cents on the dollar. That is accretive, builds par as they actually say, and actually offset some of the impact of the defaults that we're modeling.

Charles Arduini: Yeah, the other thing I'd add, I think, Gretchen, we all do defaults I think similar where there's the known portfolio and you default a cohort of that depending on your criteria, and then you run multiple base lines on top of what looked like clean assets. But the other part of losses are recoveries, and the thing that we've added over the past few years is loans can be issued in what are called loan-only structures or loans and bonds together.

And that data is starting to prove out that the loan-only structures have a lower recovery rate. And so we look through the portfolios and a typical CLO can have anywhere from 40 to 60% loan-only, and so you are supposed to appropriately stress recoveries down if somebody is overweight loan-only structure. So ultimately that means that we're running probably lower recoveries than we have historically, and we're factoring that into our structuring and into our analysis.

Audience: So just to get a sense, at what default level would that be [inaudible]?

Gretchen Lam: It varies by seasoning of the underlying portfolio; age, vintage, et cetera. But the market convention is to look at a constant default rate for that analysis, which of course is not realistic but that's what the market does, and you would typically see the equity hit a 0% yield around 4%.

Jake Schultz: Another question right here?

Audience: I was just wondering how relevant duration is in managing your portfolios? I realize credit is the overwhelming concern, but do you structure the portfolios with duration in mind?

Charles Arduini: I think we're, I would say, duration aware. Loans are floating rate, CLOs are floating rate, the bonds are fixed, and so in our fund which goes across all three, we just naturally have a lower duration a little inside of two years because of the 50% on average is going to be floating rate.

That said, I mentioned that we kind of took down duration as a concern about rates in fourth quarter of last year, and we actually have started to raise it a little bit, just by the nature it just kind of falls out where we think rates are for high yield right now and liking that. But to me it's a second order effect of after credit we then look through and say, "How do we want to position for rates?" and on the margins we'll make those kind of tactical adjustments for us.

Gretchen Lam: Yeah, and I would say in the loan market, obviously in stark contrast to the bond market, loans are prepayable at par at any point in most cases, so the market doesn't really price duration well. And the reason for that is you may buy, on average a new primary issue loan will be seven to eight years to final maturity, but the reality is that on average loans come out in two and a half to three years.

So the market isn't really distinguishing, at least the vast majority of markets isn't distinguishing on duration. But certainly high yields is a really important tool in many funds' toolboxes to trade off credit risk for duration in a way that preserves the principal value. So if I'm selling a loan at 80 cents on the dollar that has real default risk, I can cycle into a bond that may have an entirely underwhelming coupon but where the credit risk is much lower.

Charles Arduini: Historically high yield, the studies going back many, many years talk about how trades almost like a blend of equity. And if you think about Apple, they will never refinance that 30-year bond they issued at 0.5%, right? They're not worried about accessing the market, that's just going to sit there forever.

If you're a high-yield company that was fortunate to issue at 4.5%, there still may be reasons why that gets taken out. They may get acquired, they may want to sell themselves. At some point the CFOs going to say, "I got three years left or four years left. I'm not going to run this to maturity and take the risk that I'm stepping into a 2020." And so in the high-yield space, again, duration is less of an issue. And in markets like this where the market just trades on full duration, loans are going to go to maturity, bonds are going to go to maturity, that's what creates that convexity opportunity that Gretchen was speaking about earlier, where you can actually have significant gains as soon as that reverses back.

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