Gretchen Lam, Senior Portfolio Manager @ Octagon Credit Investors LLC on Loan Market Conditions

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Gretchen Lam sat down with Jane King on August 30th, 2023 for a NAVigator Interview and discussed the Loan Market conditions.

Gretchen Lam

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Gretchen Lam, Senior Portfolio Manager @ Octagon Credit Investors LLC on Loan Market conditions - AICA (aicalliance.org)

Jane King: Gretchen Lam is a member of Octagon's investment committee and serves as the portfolio manager across collateralized loan obligations, separately managed accounts, and commingled funds. She also oversees the firm's structured credit and investment strategies, and is a member of the firm's ESG committee and is a senior portfolio manager at Octagon Credit Investors. So great, I'm going to get an education today, Gretchen, about all this. So let's start with some simple questions.

Gretchen Lam: Sure.

Jane King: What is a senior loan?

Gretchen Lam: Sure. A senior loan is just a loan that is issued by typically a pretty large corporation, usually over $100 million in EBITDA, and the loans are usually somewhere between $200 million to oftentimes several billion in size. And these corporations, while they're not small companies, they are typically rated below investment grade by the rating agencies.

Two things that make loans different than high-yield corporate bonds, for example, is that first these loans are typically secured by the assets of the company, so the working capital, the PP&E, the inventory, et cetera, the intellectual property, those all secure the loans. The second thing is that these loans pay interest on a floating rate, and that's different than is typical for high-yield bonds, so they pay a spread over a floating rate, a resettable rate that today is typically SOFR.

Jane King: Interesting. What does the loan market look like, and has this increase in interest rates had an impact?

Gretchen Lam: Sure, absolutely. The loan market has grown in size quite materially over the last couple of years, as I said, it just recently overtook the size of the high-yield market. And the other thing to point out, it's a market which is active in the secondary, so these loans are issued but then they trade actively thereafter over the life of the loan. As rates have moved up, the loans have really benefited from that floating rate profile that they have, and so the reference rate today, which is SOFR, sits at about 5.4%, and then loans pay a spread over that.

If you were to go back to January of 2021, that reference rate was under 25 basis points, so it was less than a quarter of a point back in early 2021. Today it sits at almost five and a half points, so pretty material increase. And loans all-in are yielding about 10%, so really historically a very high rate to own senior secured loans today.

Jane King: Okay, very interesting. Now we talked about collateralized loan obligations, so these are fund structures which finance the purchase of these senior loans through issuing debt as well as equity. Explain the characteristics of these CLOs.

Gretchen Lam: Sure. So CLOs, as you rightly said, they're special purpose vehicles, they're typically about $500 million in size or so, and these vehicles and the managers that manage them, they go out and they buy a portfolio of senior loans and they finance that purchase by raising both debt, which we call CLO liabilities, and equity. And the really cool thing about the liabilities that are raised is that this debt is tranched, and what that means is that there are varying degrees of seniority, and therefore risk and return, associated with the different tranches of liabilities.

So for example, the most senior tranche, which is rated AAA, may appeal to investors who are perhaps more risk-averse and are willing to earn a lower return for their investments. And CLOs also have the equity tranche, which may appeal to investors that have a higher return expectation but are also okay being exposed to more credit risk as they are at the equity level, the first loss position structurally within the CLO.

Jane King: Now what are the benefits and the challenges of investing in CLOs and senior loans?

Gretchen Lam: Sure. So the great thing about loans and CLO liabilities today is that they are floating rate and they have benefited from that really meaningful rise in rates. Loans, as I said, are yielding 10%, the BB-rated tranche in CLO liabilities is yielding even higher, that's about 12+%. And second, these assets today are currently trading at a discount to par value, so loans today on average trading about 95 cents on the dollar, BB-rated CLO tranches trading even lower, about 90 cents on the dollar.

Now if all goes well, both those loans and those CLO liabilities will ultimately be paid back at par, at 100 cents on the dollar. And so for those assets, there's not only a very high current yield opportunity, but also over time the potential to see a pull to par where those assets that are currently trading at 90 or 95 cents on the dollar accrete towards 100 cents on the dollar.

Now on the challenge front, certainly the unclear macro picture is creating some challenges for these assets. The financial performance of these corporate borrowers will rise and fall with the US economy, so we do expect some uptick in the number of corporate defaults that will certainly and has currently impacted both the loan and the CLO markets over the course of 2023, as well as likely into 2024.

Jane King: Very interesting. How does Octagon analyze these CLOs, both debt and equity? How do you manage the risk on those?

Gretchen Lam: Yeah, there is a lot of data out there in both the loan and the CLO markets. There are about 1,400 loans in the broadly syndicated loan market, there are well over a thousand CLOs in the market. At Octagon we have a full team, over 25 folks, who do nothing but look at the sectors in the loan market, the different industries, and the various companies whose loans we are invested in, and even companies whose loans we don't currently own.

We also have really extensive technology, much of which is proprietary to Octagon, which allows us to really look down into, for example, a CLO tranche, and drill into every position. There may be 400 or even 500 individual loan positions held within a CLO, and we can look through to those positions and determine how the CLO-level cash flows might be impacted if any of those individual loan positions default or don't prepay at a certain rate or if rates move. We can look at any number of different macro factors and determine how that might impact the actual cashflows and performance of the CLO.

Jane King: So there was a lot of talk late last year, early this year, about a recession, it's going to be mild. Never really happened. We are seeing some slowdowns, China, Europe, the job market seems to be softening a little bit. Is there anything that you see in what you do that has either reacted to the threat of recession, the easing of the threat, or any clues about the economy going forward?

Gretchen Lam: We certainly think a lot about the risk of recession still, though I think we certainly acknowledge that that risk has abated over the course of 2023, which is good news. I will say over the last year and a half though, we have seen very high levels of dispersion of performance across the 1,300-1,400 borrowers in the loan market, where some borrowers are doing quite well and others are really struggling.

This elevated level of dispersion has continued, but what we have seen is that certainly the loan market and the CLO market has become a little bit more comfortable with risk given the fact that the left tail, if you will, and the risk of that coming to pass has diminished. So folks are still concerned about recession, but maybe a little bit less than they were earlier this year. And so what we've seen very recently is that risk in the loan and CLO markets has actually rallied, and that's the first time that we've seen that dynamic really since 2021.

And so we've seen CCC-rated loans rally year to date, five points, but BB-rated loans which are higher quality loans have only rallied about one point, and so what we're seeing is that managers have done quite well in the last year by avoiding risk. It would be interesting as we move forward to see what is the profile of manager that might outperform over the next six to 12 months?

Jane King: Yeah, that will be interesting. Okay, so finally, what has been the financial performance of investing in these loans in 2023?

Gretchen Lam: You know, in recent quarters we've seen that both revenue and profit growth has been positive, though decelerating sequentially. So that's good, we feel pretty good about that. But we are seeing again a lot of dispersion of performance, a lot of winners but still a lot of losers, and so it's really those underperformers that we're very focused on. Again, we want to, and we want to see CLO managers avoid those defaults, avoid those losses, but at the same time it's our view that over the next 12 months it's going to be those managers that can take really thoughtful, disciplined, selective risk that are likely to outperform.

Jane King: Okay. Well, that is going to be very interesting, and so interesting to hear your insight into this area. Thank you so much, Gretchen.

Gretchen Lam: It's a pleasure to speak to you, Jane.

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