'The Most Buyer-Friendly Market We Have Seen Since The Great Recession'

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Chuck Jaffe, in The NAVigator podcast, interviewed Andrew Kerai, senior credit strategist at RiverNorth Capital Management, portfolio manager for RiverNorth Specialty Finance Corp. Read the Q & A below as Andrew says that the difficult market has created strong opportunities for increasing a buyer-friendly opportunity unlike anything seen since the Financial Crisis of 2008.

Andrew Kerai

He explains how he has re-positioned the portfolio to take advantage of those conditions, and when he expects those decisions to pay off.

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Andrew Kerai, portfolio manager and senior credit strategist at RiverNorth Capital Management is here, and we're talking about improving credit quality in the COVID-19 marketplace now on The NAVigator. This is The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds and business-development companies. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry, from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. And today the direction we're pointing in is credit quality, and my guest is Andrew Kerai. He's portfolio manager and senior credit strategist at RiverNorth, where he's overseeing the RiverNorth Specialty Finance Corporation, that's ticker symbol RSF. Which, by the way, until recently was the RiverNorth Marketplace Lending Corporation. He's been part of the credit market for years, he also oversees some of RiverNorth's other credit oriented products, and if you want to learn more, RiverNorth.com. If you want to learn more about closed-end funds and business-development companies, check out the Active Investment Company Alliance online at AICAlliance.org. Andrew Kerai, welcome to The NAVigator.

ANDREW KERAI: Thanks for having me, Chuck.

CHUCK JAFFE: We are living in very challenging, interesting times. And although history is not repeating itself, there are plenty of folks who say, it's rhyming, we've lived through crises before. Typically in certain types of crises, people think the credit market is going to get into trouble, the credit market's going to have problems when business and the economy are faltering. And yet, you have been upgrading the credit quality in spite of the times we're living in. So explain that dichotomy, how it works, and what you're doing.

ANDREW KERAI: Sure. So I think the way that we saw it in our fund, RSF, we had been purposely positioning the portfolio largely away from unsecured consumer credit. If you go back, and we put this out as part of our recent announcement in the shift in our investment strategy, about a year ago our portfolio was 80% roughly unsecured consumer home loans. That number is now 20%, and is coming down further from there. I think our view is that, one, the risk-adjusted returns in unsecured consumer home loans weren't really where we thought it was justified, at least relative to the risk. And I think our view is that we wanted to rotate into other assets and higher credit quality. Perhaps a lower coupon versus unsecured consumer home loans, but also a lower risk level as well. We came into all this better positioned than we would have been in the past, and a higher level of cash to deploy into a dislocated market. So I think our timing was prudent. And as it turns out, I think we came into this better capitalized with a higher liquidity position than a lot of closed-end funds.

CHUCK JAFFE: At the same time, we've had a strange tide. But when it comes to many closed-end funds and BDCs, it has been a tide that has been running against them. So here you are improving your credit quality and making it that you believe the fund can perform better, yet the market hasn't necessarily been kind to you. Why is it, when you make these kinds of changes, and you've been making them ahead of even the things that we saw, that the market doesn't seem to recognize it? I mean, have you got any clue as to why the market hasn't rewarded you for the strategy that you think will pay off in time?

ANDREW KERAI: The short answer is that largely the market has penalized credit across the board, I think fairly indiscriminately. Hopefully that will change over time as the strategy hopefully proves itself out. Certainly the things that we put in place, meaning we have an active stock buy-back program, we have what we think is a pretty attractive level in terms of a distribution. We also have quarterly tender offers, which are fairly unique in the closed-end fund space. Our view is that we have liquidity that we're putting to work in a market where you can move up in credit quality, buy what we consider to be high-quality assets with very attractive yields. And I think and hope as that story plays out, that we'll be rewarded for that, and hopefully a narrower discount to NAV. I don't know how many investors currently have RSF on their radar, but I hope that that number certainly increases over time. And I think as we put that money to work, in our view prudently, that should hopefully narrow out the discount over the long-term.

CHUCK JAFFE: When you look at the market as it exists right now, as you pointed out, consumer loans, scary place to be. Small business loans, scary place to be. And even in some of the bigger business loans, well, these days watching things like the PPP would make a lot of people nervous about credit in general.

ANDREW KERAI: Sure. Yes.

CHUCK JAFFE: How can you be as comfortable as you are? Because Lord knows, nobody else seems to be comfortable in this.

ANDREW KERAI: It's a great point. Certainly, there is credit risk in our fund. We still have a portion in consumer credit and small business lending. So I think us, and other credit oriented strategies, certainly there is risk there. My view is that there obviously have been certain areas in terms of distress in terms of retail, restaurant, even dental practices, as an example of being a business that is seen as fairly resilient. Although right now in many cases, they're still recognizing no revenue because they're not seeing patients. So I think certainly to be clear, there has been, and I think there will continue to be pain across the credit markets. What we can control is how we deploy capital going forward. As an example, we called out purchasing investment company bonds in the secondary market as one of the shifts in the strategy in RSF. These are bonds that have typically about 30-50% equity subordination. Meaning these investment companies hold typically diversified portfolios of senior secured loans, have a minimum asset coverage requirement of 150%, or as said differently, at least one dollar of equity, but two dollars of leverage at the max. So I think in terms of those securities, we feel very comfortable. But yes, there will be likely credit losses in the underlying portfolios. But we've moved up in the capital structure ahead of the equity, and we're not first dollar loss, we're at a maximum looking at 35+% loss rates before the value of our bond is impaired.

CHUCK JAFFE: That's a massive loss before the value of your bonds is impaired. You mentioned your most recent commentary, which was released in April. And in it you used the phrase, "The most buyer-friendly market that you've seen since the great recession." By the way, I thought it was a crappy recession. It was just a horrible, brutal recession, but I guess we have to make it great. But the financial crisis of 2008. But the most buyer-friendly market. What that would tell people is that this is a time -- well, you didn't say it necessarily directly in the commentary -- but what you're saying is this is the time to be entering even though there's blood in the streets right now?

ANDREW KERAI: I think that's true. And I think the caveat to that is that you want to be entering, but you want to be very picky because you can be. Now is a time where, truly bottom-up, fundamental analysis across credit will be the key differentiating factor going forward. Frankly, there is paper that you can find at what I consider to be out-sized yields, wider certainly than B or BB paper right now, where the credit risk is meaningfully lower. So I think now is a time where some of the securities that perhaps didn't meet your yield bogey three months ago, that may have changed now. So I think right now you want to focus on higher quality paper that has just effectively been widening out as a result of market dislocation.

CHUCK JAFFE: Andrew, great stuff. Thank you so much for sharing it with us and joining us on The NAVigator.

ANDREW KERAI: Great. Thanks again for having me, Chuck.

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