RiverNorth's Kerai: Yield-Hungry Investors Should Look To Private Capital Market

Friday, December 18, 2020

Chuck Jaffe, in The NAVigator podcast, interviewed Andrew Kerai, senior credit strategist and portfolio manager at RiverNorth Capital Management. Read the Q & A below as Andrew says that investors looking to improve fixed-income returns should consider middle-market corporate credits and other issues in the private credit market, but he notes that investors should be attuned to downside risks, noting that they make more with a manager who does better avoiding defaults than one who chases higher yield but takes on more risk.

Andrew Kerai

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

CHUCK JAFFE: Andrew Kerai, senior credit strategist at RiverNorth Capital Management is here, and we're talking about yields and whether you should stretch for more now on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. 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 it's pointing us at Andrew Kerai. He is portfolio

manager and senior credit strategist at RiverNorth, and if you want to learn more, well he is portfolio manager for the RiverNorth Specialty Finance Corporation, RSF. He's been in the credit market for years and we're going to be talking about credit. And if you want to learn more about what RiverNorth does, you go to RiverNorth.com. If you want to learn more about investing in closed-end funds, check out the website of the Active Investment Company Alliance, it's AICAlliance.org. Andrew Kerai, welcome back to The NAVigator.

ANDREW KERAI: Great, thanks for having me back Chuck.

CHUCK JAFFE: Investors understand that lower for longer is a reality, and they are looking for other places to see if they can't get some yield. Other places for the average investor is what you call breakfast, it's where you live your life. Because your life is not 'Hey, let me spend all my time focused on treasuries and government bond funds,' you're doing the corporates and some of the other stuff, and some of the things that are a little bit more esoteric. So give us first a bit of an overall picture of where you think the interest rate model is right now, but then let's talk about what you specialize in and the timing of that right now for investors who are looking to maybe goose their returns a little bit.

ANDREW KERAI: Yeah. No, I think it's a great point. I mean certainly if you look across the liquid markets, yield is tight. You have base rates, at least at the front of yield curve, basically at zero, and you have yields within high-yield corporate credit at all time tights. So I think investors certain have a desire and a hunger for yield, but it's frankly tough to find quality yield in this environment in the public markets without stretching to a large extent. I think where we found value frankly is looking at some of the private credit managers and mandates. I think an environment like this one, it really shows what managers have the expertise both on underwriting and origination, the platform scale, and those I think we're seeing in real time drive a lot of alpha or excess return across credit. So right now if you're an astute credit investor, when you look across the menu for liquid syndicated credit, it's tough to get excited about high-yield syndicated loans at 4% and then the unsecured bonds at about 4.5%. However, I think if you look at some of the private credit managers that have done well in the past, have scale or top tier underwriters, they've been able to navigate this environment quite well. And be opportunistic and nimble in how they've been able to deploy capital when a lot of other managers frankly have been in a more defense position.

CHUCK JAFFE: But when you talk about private capital, you scare off a lot of individual investors. I mean, a, they don't entirely understand it because it's not a market that they necessarily have been exposed to. B, they kind of recognize that, 'Hey, if I do it through a closed-end fund or I do it through a traditional fund, I'm getting there with a public vehicle but I don't quite understand that mix.' Obviously it's going to be easier for the average investor or even the sophisticated investor to delve into private credit and be safe about it using a fund or a business-development company, or whatever it might be. But how do you help them understand, a, what's the private credit market that we're talking about, and b, private credits in a publicly traded fund, does that offer a level of protection incase they're nervous about what private illiquid kinds of credits are?

ANDREW KERAI: Sure, so I think when people talk about private credit, that's certainly a wide array of assets. It's middle market corporate credit, some real estate and other classes as well. The vehicle I think you talked about, Chuck, that really does give an access point, are BDCs or business-development companies. So when you're an investor looking to access the private credit markets, or this case middle market corporate credit, you've got to look at a number of things. I think the most important thing when you're looking at a BDC in particular is, how has that manager done in the past? Not only within its publicly listed vehicle, but if you have access to other mandates from that manager as well. If you do your homework and look at what managers have done well in the past, and how they've performed. And better yet, if they've had even performance across a previous credit cycle, I think that can lead to confidence in the future and certainly seeing how their performance is played out basically from Q1 forward. So I think a good starting point to understanding what's in the portfolios is looking at what is their mix of loans, meaning what is senior secured versus subordinate, and some have equity as well. And then even within that, how has the manager performed from a loss perspective looking in the rearview mirror? What kind of liquidity does the vehicle have? What's the reputation and scale of the manger as well?

CHUCK JAFFE: Obviously we have to speak in generalities here, but help someone understand this is the expectation for this asset class compared to other asset classes, and why it's not that much riskier for the extra return.

ANDREW KERAI: So I think it comes in two forms. First and foremost it's what managers do you think are going to protect your downside better? I mean focus on protecting losses

versus their public counterparts. So if you were to say a reasonable level of defaults net of recoveries for the high-yield market, and I think depending on who you talk to, you're going to get somewhat differing answers in terms of what losses ultimately shake out with bank loans and high-yield bonds. But let's say just as an example that number is three to five in this environment. And can you then go out and pick a manager who is going to generate somewhat of a higher yield, but I'd say even more importantly, a lower loss rate and a lower loss experience? Right now I think it's not a wise environment to stretch in for yield for a number of factors. So I think right now instead of necessarily focusing on maximizing their excess return, it is really maximizing their risk-adjusted return. And I think the prudent way to do that right now is allocating the strategies that should prevent more downside than what's offered in the liquid credit markets.

CHUCK JAFFE: You mentioned defaults in there. We of course are living through extraordinary times, and we haven't necessarily seen a tremendous amount of defaults yet. There is still a lot of fallout coming as the stock market and the economy try to get back in sync and we see what's going to happen. How worried are you generally that we're going to see default rates? And maybe it extends beyond the corporates and even goes to things like municipalities, because municipalities often rely on tourism taxes and things like that that they're not getting. How bad is it going to get when it comes to defaults going forward?

ANDREW KERAI: So there's a couple of things that I think I'd highlight in terms of corporates, in terms of why you haven't seen defaults pick up yet in my opinion. One is, within the high-yield bond market these tend to be large, well-capitalized business generally speaking, and I think they've had a lot of help through the Fed policy, and through stimulus and all those different things. If you go up into the bank loan market, these tend to be smaller companies from an earnings perspective, but they tend to be sectors that are less directly affected by what's happened through lockdown. So I think frankly the lack of defaults that have come to fruition so far has been a combination of Fed support, stimulus, and the fact that if you're looking at the high-yield market, these tend to be larger companies. And within the bank loan market broadly speaking, the sectors that would be overexposed to lockdown measures are a relatively small part of that market. I think within the corporate credit market broadly speaking, assuming that we get back to some sort of a normalized level of economic activity next year, I wouldn't frankly expect defaults to pick up all that meaningfully. You

raise an interesting point with the muni market, because there are a lot of states that are suffering due to just a tremendous shortage of tax revenue because companies aren't open, unemployment has picked up, etcetera. So I guess the main driver there is going to be, do they end up getting some help through some sort of stimulus? Can they somehow raise additional liquidity through refinancing bonds, etcetera? That I think frankly is more of a question market to play out, because from a fundamentals point of view, the picture in many cases doesn't look great. However, there are some levers that they can potentially pull to get them out of the situation, or at least get them enough liquidity in the interim until they can recognize more tax dollars once things get back to normal hopefully. But I think frankly fundamentally on the corporate credit side, broadly speaking I think I feel fairly optimistic that you don't see defaults hit a level like they did back in 2009.

CHUCK JAFFE: Andrew, great stuff. Thanks so much for joining me to talk about it.

ANDREW KERAI: Thanks Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I am Chuck Jaffe and you can check out my show on your favorite podcast app or at MoneyLifeShow.com. To learn more about closed-end funds, interval funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest, Andrew Kerai, senior credit strategist at RiverNorth Capital Management, the firm is online at RiverNorth.com. The NAVigator podcast is available every Friday, please subscribe on your favorite podcast app and join us again next week to learn more about investing in closed-end funds. Until then, please stay safe.

Recorded on December 17th, 2020

To request a particular topic for The NAVigator podcast please send an email to:

TheNAVigator@AICalliance.org

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

Disclosure: *Listed closed-end funds and business development companies trade on exchanges at prices that may be above or bellow their NAVs. There is no guarantee that an investor can sell shares at a price greater than or equal to the purchase price, or that a CEF's discount will narrow or be eliminated.*

Nonlisted closed-end funds and business development companies do not offer investors daily lliqudity: often on a small percentage of share on a quarterly or semi-annual basis. CEFs often use leverage, which can increases a fund's risk or volatility. The actual amount of distributions may vary with fund performance and other conditions. Past performance is no guarantee for future results.

Website: AICalliance.org ◊ **Phone**: (888) 400-9694