The Outlook For BDCs Is Strong Heading Into 2022

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Matt Kence, portfolio manager for the Aberdeen Credit Income Strategies Fund (ticker ACP). Read the Q & A below as Matt says that the headwinds facing high-yield investors – higher inflation and concerns over rising interest rates – can be overcome with diligent security selection from the wider range of options available now thanks to record levels of bond issuance. Kence notes that if the economy delivers inflation and growth at the same time, high-yield bonds should do well, but the worry is that if inflation stunts growth – which is not his base expectation – that's when real troubles could arise.

Matt Kence

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

CHUCK JAFFE: Matt Kence, portfolio manager for the Aberdeen Credit Income Strategies Fund is here, and we're talking high-yield bonds and bank loans 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's 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's going to point you in the right direction. And today, well, we're going in the direction of high-yield income strategies with Matt Kence, who runs the Aberdeen Credit Income Strategies Fund, that's

ticker symbol ACP. And if you want to learn more about the firm, it's ABRDN.com, and then for the fund itself, AberdeenACP.com. To learn more about closed-end fund investing go to AICAlliance.org, the website for the Active Investment Company Alliance. Matt Kence, welcome to The NAVigator.

MATT KENCE: Thanks Chuck, it's great to be here.

CHUCK JAFFE: These are some really interesting times when it comes to high-yield bonds and bank loans, because with inflation where it is and transitory not feeling so transitory right now, playing for yield is a little bit tricky. So help us get the lay of the land first with where we are in these markets in these conditions.

MATT KENCE: Certainly this summer we did reach post-crisis tights within the high-yield marketing, and since then the market has been buffeted a bit by inflation fears and obviously the increase in volatility we've seen in treasury yields, so it's obviously been something that we've needed to navigate. In addition to that, we've seen really strong supply within the market as well. So we're seeing supply that's going to probably be over $500 billion this year, which will be a record after the last year being a record as well. And so obviously the Fed is very focused on their dual mandate, one being full employment, the other being price stability. And it does seem like they are more focused on the full employment side of the things, which obviously has put fears into the market in terms of inflation. So really what we've been doing within the portfolio is really trying to understand on a name by name basis how well an inflationary environment or just supply chain challenges that are out there impact the credits that we hold.

CHUCK JAFFE: Does that mean that you're talking to the companies that are issuing high yield bonds, and you're trying to assess on an individual basis how they're going to be affected by inflation like are they caught in the supply chain morass? Is it drilling down at that level or is it just more broadly inflation generally? Because it's very different if you have a company, on the one hand they've got their bonds and bonds are bonds, but on the other hand there's inflation at all levels here.

MATT KENCE: That's a great question, and really it is a little bit of both. But we're very much credit pickers in how we manage this fund, and so we are talking on a company by company basis. Just to give you some examples, auto OEMs, we actually are relatively constructive on them because they've been able to take pricing. So even though some costs have gone up,

they've been able to offset that with pricing. Now you look at their suppliers, well, technically they have locked in prices that they sell to the auto companies, plus they're impacted by the lower volumes, so they're getting hit on both ends. Even within the auto sector there's some differentiation between companies based on where they compete within that market. Like cruise lines for example, which we like here and they've been seeing a very good recovery, they're pretty insulated by the cost increases. They generally hedge their fuel plus the very small portion of COGS, their costs of goods sold, and then most of their labor is sourced from developing countries. So they're not really seeing some of the labor increases that maybe a restaurant is seeing. So restaurants for example are getting it because they're getting higher labor costs plus they obviously have higher food costs as well, but they aren't necessarily in the competitive environment where they can pass all that on. So again it's very much a name by name basis in terms of trying to figure out how this is going to impact our portfolio.

CHUCK JAFFE: What has that done for the portfolio itself? Given what we've got with inflation concerns, and what's been happening with rates and everybody looking for yield, what has this done in terms of how you're building, or perhaps remaking or changing the portfolio?

MATT KENCE: So I did mention the supply that we've had, and that's actually been a positive in terms of generating ideas for the portfolio. In the initial part of this recovery we saw a lot of supply but most of it was for refinancing. So we were able to take advantage of some bonds, particularly right after the crisis, at very high coupons with a lot of security. So those have done well, but those have effectively played out so now we're in the next stage. And obviously this portfolio needs yield, and so what we've seen, it's a little bit of a resurgence in the issuance of CCCs and LBOs, some M&A financing which is a bit lower quality. So we've been able to take advantage of this, the amount of supply, and while being selective we have been able to pick up some bonds at a higher yield than what we would have been able to capture even earlier this summer. And again that's twofold, one is because the market is a little bit wider, and secondly it's just sort of the nature of that issuance. Ultimately though we aren't looking at add a tremendous amount of additional yield, we do feel like there is going to be volatility in the market going forward. A lot of it to do with what we just talked about, the market trying to figure out, is this inflationary environment – obviously the word of the year has been transitory – is it transitory? But I think even more importantly is what does growth

do within that? If you get inflation and growth at the same time, typically high-yield performs reasonably well. It is still very much a credit-driven asset class, particularly at the lower end, which is where we typically traffic in this fund. So as long as you get some growth with that increased inflation, we're not too worried about it. What we're really worried about and focused on is if you get a situation where you have inflation and then obviously growth really slows or lags a bit – obviously referring to a stagflation – that's not definitely our base case at this point. But we do expect there will be volatility around as the market's trying to divine which is really happening here, and so we want to be well positioned to take advantage of that.

CHUCK JAFFE: Does the structure of running this money in a closed-end fund, does the closed-end fund structure help you out? Does that give you any sort of edge?

MATT KENCE: Absolutely. The real advantage of a closed-end fund is the fact that that money is capped, so we don't have to deal with flows in and out of the fund like you would if you're running an open end regular way mutual fund. Really what that allows us to do is it allows us to buy stuff that might be less liquid, allows us to buy stuff that we know could be volatile, however we know that at the end of the day it's money good. And so really as long as we don't crystalize losses within the fund by defaults or selling something well below where we paid for it, it doesn't really have much of an impact, and so we can be very patient. So that's why we sort of are holding off to some degree in adding risk and waiting for these opportunities.

CHUCK JAFFE: And lastly, these are times when high yield is challenged. There are parts of the high yield world where, hey, congratulations, you're getting a high yield on what other people call junk bonds and it's barely keeping pace with inflation or lagging inflation. So what do you say to folks who maybe are worried that they should be in high yield or not be in high yield now?

MATT KENCE: Really the thing that's going to kill you in high yield is defaults, and right now the default rate is extremely low, it's around 2%. And the percent of the market that's distressed is at record lows as well. The amount of distressed names obviously is usually a precursor to defaults. So we feel really good about that, and there's a few reasons for that. One is what we talked about earlier, it's just that high level of issuance that occurred. So companies have been really proactive in taking advantage of these low rates and they've

come back to the market. So they've locked in low interest costs, so their covers, the ability with their cashflow to cover interest is in very, very good shape. And then secondly, because they've come to the market they don't have any near-term maturities, all that's been pushed off to the right. And so you have this long runway for these companies to be able to absorb, if we do end with periods of relatively weak growth for example, they're very well positioned because there's not necessarily a trigger. So based on that, particularly within the closed-end fund, as long as we feel like these companies are well positioned to absorb some near-term weakness in the economy or what have you, we feel pretty good about those names.

CHUCK JAFFE: Matt, thanks so much for joining me on the program and sharing the information.

MATT KENCE: It's a pleasure to be here, thanks Chuck.

CHUCK JAFFE: To learn more about interval funds, closed-end 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, Matt Kence, portfolio manager for the Aberdeen Credit Income Strategies Fund, it's ticker symbol ACP and you can learn all about it at AberdeenACP.com. You can learn about the firm at ABRDN.com. The NAVigator podcast is new every Friday, ensure you don't miss anything by subscribing on your favorite podcast app. And if you like us, please leave a review, they really do help. Until we're together again, happy investing everybody.

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