Flat Rock Sees Big Value In The Trade-Off Of Liquidity For Return Potential

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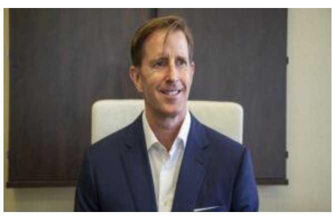
Chuck Jaffe, in this episode of The NAVigator podcast interviewed Robert Grunewald, chief executive officer at Flat Rock Global. Read the Q & A below as Robert and Chuck discuss how the interval-fund structure provides stability that allows a 'non-bank bank' – which is the way he describes his firm – to trade off some liquidity in pursuit of higher fixed-income returns.



Robert Grunewald

Operating in 'middle market credits' and investing in first-lien credits, Grunewald says that despite changing interest rate and inflation conditions it remains reasonable to expect a return in the 7 percent range for the year ahead.

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

CHUCK JAFFE: Robert Grunewald, chief executive officer at Flat Rock Global is here to talk interval funds, credit markets and more, and this is 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 it's pointing us in the direction of Robert Grunewald, he’s chief executive officer at Flat Rock Global, which runs the Flat Rock Opportunity Fund, FROPX, and Flat Rock Core Income Fund, CORFX. Learn more about the firm at FlatRockGlobal.com. Learn more about investing in interval funds, closed-end funds, and business-development companies at AICAlliance.org, the website for the Active Investment Company Alliance. Bob Grunewald, thanks for appearing on The NAVigator.

ROBERT GRUNEWALD: Oh, it’s a pleasure, Chuck. Look forward to our conversation.

CHUCK JAFFE: Bob, let’s start with interval funds and the credit markets. Because it’s really not, “Oh, here’s the structure,” it’s interval funds given what you do and the markets that you are investing in. It’s that match that we have to start with so that people understand why an interval fund in the credit market?

ROBERT GRUNEWALD: For starters we use the term interval fund, but let’s be clear, it’s just a mutual fund but a very specialized mutual fund. It has a daily net asset value, investors can invest in an interval fund any day, but if they want liquidity they can only get liquidity on a quarterly basis. And I realize that that gives some investors pause, that slight lack of liquidity. But it’s that structure that allows us at Flat Rock Global to invest in asset classes, in our case middle market debt, that’s less liquid and can generate, potentially for investors, more attractive yields than you can find in today’s marketplace.

CHUCK JAFFE: If you’re trading off that liquidity to get that more attractive yield, what does that do for the risk spectrum in terms of you’re looking at credits? Does it put you dramatically up the risk spectrum because, “Well, I don’t have to worry about money flowing out,” but where does that put you relative to junk and everything else in terms of what you’re investing in?

ROBERT GRUNEWALD: It’s a great question, and quite frankly the most critical question that investors ought to ask themselves. My answer is I don’t believe it does move you up the risk spectrum. And as an example, Flat Rock’s Core Income Fund has generated average annual returns since inception greater than 7%, and yet with the standard deviation of 3.1%. Think about it this way, over four and a half years we’ve only had two down months. Now why can you do that when during that same period of time the Barclays Agg, we’ve outperformed that Agg by over 2X, and yet had lower volatility. For investors that doesn’t make any sense, but the reality is that we’re able to do it because we’re investing in first-lien senior secured loans, average loan to value of 50%. So these are loans that have got strong collateral backing and low loan to value. Compare that to high yield bonds for example, Chuck, that are 10-year duration, fixed rate, unsecured, and today yield 4.5%. So I think the risk is quite frankly very attractive, but the reason you have that interval fund structure is that these middle market loans are less liquid. And so what investors are doing is picking up the illiquidity premium that exists in the marketplace for middle market debt.

CHUCK JAFFE: You're using the term middle market debt. If I use the term that the industry would use to describe Flat Rock Global, it would say that you guys are buying alternative credits. And alternative is a meaningless investment word at this point because functionally alternative is mainstream. It's the same way in music by the way, where they consider massive artists like Sting to be alternative. Well, we're talking middle market credits, we're not talking you're investing in Bitcoin or in gold or something along those lines. But help the audience understand, what are the asset classes and the industries, or the asset types that you're focused on to get these opportunities.

ROBERT GRUNEWALD: Yeah, so you've hit on a key issue that is something that I'm very sensitive to, which is that I actually hate the word "alternative''. Because it suggests to investors that you're investing in something funky and potentially riskier, and I don't think that's the case. Now you are investing, if you want to think of mainstream assets as equities or traditional on-the-run fixed income, this is an asset class that's different from that. But increasingly, particularly in today's current interest rate environment, investors are going to need to look beyond those two traditional asset classes in order to find returns, in order to avoid correlation with the markets and develop a highly sophisticated, if you will, and diverse portfolio. In terms of what we're investing in, it's not complicated, it's the same thing banks do. We're in fact a non-bank bank. We're investing in the debt of companies with $200-300 million dollars of revenue that have 10 plus year track records, and these companies need debt financing that maybe is just a little bit outside of what a bank was otherwise willing to provide. So it's the same type of financing that a bank would provide with maybe just a little bit of a twist to what the borrower needs.

CHUCK JAFFE: I have to say, just hearing the phrase "non-bank bank" gave me acid flashbacks to the early days of my career as a journalist in the 1980s when, oh by the way, non-bank banks were frequently in the news for all the wrong reasons. When people hear me say that, well, you're looking at different types of credits, you are in the non-bank bank side. But we're in an environment where banks or other lenders, that's a non-bank bank, are looking at dramatic changes in interest rates potentially, and inflation coming into the play as well. So what's your outlook in terms of credit markets and what does that do for expectations?

ROBERT GRUNEWALD: It's interesting again, the non-bank vocabulary that we use certainly tends to generate quick visceral reactions. And one of the most important things that we felt we needed to do at Flat Rock Global and one of our foundational elements is that we only do first lien loans. So when people say non-bank banks and sometimes when that gets in the press and people suggest that there's risk there that they should be aware of, that can be partially true. Because someone who is lending, that could be a first-lien loan, meaning they have all of the company's assets as collateral, but it could also be a second-lien loan, which is a very different risk profile than a first lien loan. So there can be risks in non-bank lenders and investors need to be aware of that. My number one red flag to them, in the past and certainly looking into 2022, would be wary of non-bank lenders that are generating an attractive yield for you that have second-lien exposure or exposure that's non-first-lien exposure. But the history of first lien-exposure within the lending industry is outstanding. I mean, even when a loan runs into trouble and there's a default, on average according to J.P. Morgan, the recovery rates are nearly 65%. That's why at Flat Rock Global, within the lending sector, what we want to do is exclusively focus on first lien. And I think to answer your question more specifically, we're very optimistic about the current environment for first-lien debt.

CHUCK JAFFE: What kind of return expectations do you have in these conditions, and how has that changed from what we've seen in the last year or two?

ROBERT GRUNEWALD: It hasn't changed dramatically. I mean, the Core Income Fund, which is our fund that invests in middle market first-lien debt generated 9% returns last year, today is has approximately a 6.7% dividend yield. What I would tell people in terms of return expectations is probably to expect something in or around that dividend yield, so right around 7%. That's basically what we've generated since our founding in terms of our average annual returns, a little bit higher than that, but my expectations would be in or around 7%. We saw loan spreads widen dramatically in the spring of 2020 and stay fairly wide through much of 2020. In 2021 spreads tightened again and that's gotten some press. But quite frankly from our perspective they tightened back to traditional levels which is still allowing us and I think folks in general in the private credit space to generate attractive returns.

CHUCK JAFFE: Bob, really interesting. Thanks so much for joining me on The NAVigator.

ROBERT GRUNEWALD: Oh, it's my pleasure, Chuck. I look forward to continuing our conversation.

CHUCK JAFFE: You've been listening to The NAVigator, a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yep, that's me, you can check out my show on your favorite podcast app or at MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies check out AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest Robert Grunewald, chief executive officer at Flat Rock Global, which runs the Flat Rock Core Income and Flat Rock Opportunity funds. The firm is online at FlatRockGlobal.com. The NAVigator podcast is available for you every Friday, ensure you don't miss anything by subscribing via your favorite podcast app, and if you like us please leave a review because they really do help. Until we're together to do this again, happy investing everybody.

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