March 2022 Virtual Event-AICA Spring Closed-End Fund Roundtable Day 2 Panel #1; “Higher Quality Taxable Fixed Income”

Wednesday, March 16, 2022

Roxanna Islam, Associate Director of Research with Alerian, moderates the opening panel of Day 2 of the AICA March 15th & 16th, 2022 virtual event; “Higher Quality Taxable Fixed Income”. Read the transcript below to hear the discussion among Ms. Islam and panelists Samantha Milner from Ares, Paul Blomgren from Nuveen, and Cheryl Pate from Angel Oak.




Roxanna Islam | Samantha Milner | Paul Blomgren | Cheryl Pate

To view the rest of the conference events and panels go to:
https://aicalliance.org/aica-event/cefroundtablespring2022/

John Cole Scott: If we could just bring up the next panel to keep it as timely as possible, please join me on stage, and once everyone’s on for the next panel I will bow off stage. Samantha, you’re first, you win the prize. Cheryl and Roxanna, again, thank you so much. I believe there’s one more if my brain’s correct.

Roxanna Islam: Yeah, we have Paul. I see him down there. Paul are you having trouble?

John Cole Scott: Turn on your mic and camera, you should be able to join us. We’ve had a lot of Nuveen presenters as they’re members, so usually no issues getting on stage. Okay, so maybe Jennifer in the audience, if you can reach out and see if you can help Paul. As we’re running at 1:34, I’m going to get off stage and we’re going to see if we can help get Paul on stage and hopefully he’ll be joining you shortly.

Roxanna Islam: All right, let's go ahead and get started, hopefully Paul will join us soon. Thank you everyone for joining, hope everyone's had a good day so far. This is our first panel of the day and it's called "Higher Quality Taxable Fixed Income". My name is Roxanna Islam and I'm your moderator for today. I think we have a really selection of guests here today who I know will have some very interesting things to say. As you know, there's a chat box on your screen where you can ask questions. We encourage you to do so and we'll address those either throughout the panel or towards the end of the presentation.

So let's start off briefly with just some introductions. I can go ahead and start before we get to the more interesting people on the panel. My name is Roxanna Islam, once again. I'm the associate director for research at Alerian and S-Network Global Indexes, where I focus on research for our thematic and income indexes. I started off my career at Wells Fargo. I had a few different roles, one of which was on the ETF and closed-end fund research team there. After that I spent about six years at an investment bank on sell-side research where I covered individual freight transportation and logistics stocks. And about a year ago I came back to the indexing and fund world when I joined Alerian and S-Network Global Indexes. I'll go ahead and let the panel introduce themselves as well. Samantha, do you want to start off?

Samantha Milner: Sure, I'll go first. I was first on stage.

Roxanna Islam: Yeah, you're the winner. That's your prize.

Samantha Milner: Yeah, right. Samantha Milner, partner and portfolio manager at Ares, which is a $300 billion alternative asset manager. We manage a publicly traded closed-end fund called ARDC, Ares Dynamic Credit Allocation Fund, and it's really focused on three asset classes; high yield, leveraged loans, and CLOs, which are highly complementary to each other. I know John was just talking about this in terms of diversification and things of that nature, I think that really fit. And we have more than a decade track record of showing both our focus on downside protections, so for example, we had no defaults in 2020 or 2021, and really trading around the volatility and cycles that we've seen really pick up the last two years. So ARDC, well positioned, we have more than an 8% dividend yield covered by our earnings, low duration, 1.7 years, and over 50% floating rate assets.

Cheryl Pate: I can go ahead and introduce myself next. I'm Cheryl Pate, I'm a portfolio manager at Angel Oak Capital. We're a $14 billion asset manager based in Atlanta and we focus on predominantly structured credit and corporate credit. I focus on the financial-based strategies across our various funds ranging from daily liquid mutual funds to private credit strategies, as well as our two closed-end funds that are focused on financial sector credit.

The two funds that we have in the closed-end fund spectrum, FINS and DYFN, are both focused on niche market opportunities across community bank debt and nonbank financials debt, and we also take some tactical views on preferred and common equities within the financial sector. They are investment-grade funds, and really what we focus on is high income, low duration, and low volatility, and the distribution rate on the closed-end funds that we manage are both in the 8% range.

Roxanna Islam: All right, thank you guys. Hopefully Paul will join soon, and whenever he joins we'll just let him introduce himself, but we'll go ahead and just start off with some of the questions that we had. So let's just start off with you, Samantha. Let's start off a little bit more broadly. Briefly can you just talk about what you think about the overall health of the US economy, maybe what the consumer or investor looks like right now. And obviously you can be brief, I know there's a lot to say about the economy right now.

Samantha Milner: Yeah, since some of it's backward looking and obviously the outlook has gotten a little bit different. So right now consumer and corporate balance sheets are strong. Fourth quarter earnings were very strong, we have over 30% increase, margin expansion, etcetera. Labor participation is lower but anyone who wants a job can get a job, that's very clear. And defaults are low. That being said, clearly inflation, close to 8%, including very high gas prices, are starting to impact consumer sentiment. Companies have been reducing their outlooks given some of the uncertainty, whether it's inflation or Russia-Ukraine, and clearly the Fed as well.

So today we did see weaker retail numbers, especially on the discretionary side, which isn't a surprise again given these factors the last couple months. The Fed, I'm looking at CNBC behind me, set to hike today, and looking at previous cycles the risk to recession does rise into a hiking cycle, but usually that's at least two years away unless the curve inverts early on. So if you think about just stepping back for a second, even with the volatility and geopolitical issues, we're still looking at 2-3% GDP growth, there is pent up demand. And while stagflation is a risk, it's definitely not our base case, and I hope the same with my peers on this panel.

Companies have pushed up maturities, plenty of liquidity. Defaults are below 1%, so even if they increase a little bit we're still in good shape. So I do think volatility will continue to be there and that's something we can take advantage of. That's something we've done through previous cycles as well. And there's certainly going to be an increase in credit dispersion, winners and losers. And so that does really speak to active management. We're seeing companies getting more punished on the ones that are missing numbers. And investors are getting, some are getting a little bit more nervous but some are seeing these opportunities and they're seeing the yield, they're seeing the funds that have protection from rising rates and they're putting more money in the market.

Roxanna Islam: Okay, great. And then I see that Paul has joined us finally. Hey Paul, good to have you here. Why don't we move to Paul, and just give yourself a brief intro, and then the question that we asked was just your thoughts on basically what's happening in the economy, what do you think the consumer or the investor looks like right now?

Paul Blomgren: For sure, thank you. So again my name is Paul Blomgren, I'm a client portfolio manager, so that means I sit with the portfolio management team, and then on a day-to-day basis I represent them with the investors, financial advisors, and consultants. I'm here at Nuveen, we have 100 year history, more than that, in fixed income, we manage about $1.3 trillion in assets, and about $65 billion in closed-end funds.

So with that introduction, I'd say our outlook sounds very similar to Samantha, and I think that most of us in the market are looking at it relatively the same way. The one thing I would say, and I draw a lot of attention to, is to say what the end state will look like. Because this lends a lot of insight into the path and what we expect from the Fed as well. So what I do is said, take a big step back and look at how we entered this pandemic. At the end of 2019 the Fed funds rate was at 1.25-1.5%, the 10-year treasury was at about 190. This sounds pretty reasonable to us. When you look at what the economy can organically generate from a growth standpoint.

So when we look at the outcome we would say very practically, you didn't go through a pandemic with linger effects and grow growth capacity or expand that. So the end state in best case would look like what we could generate in 2019. So we would say from that you would draw the conclusion that the Fed is not likely in our opinion to overly tighten. A lot of that has to do with, as you heard that the lynchpin is around inflation, but we would argue that a lot of those inflationary concerns can't be addressed with higher rates which are targeting slowing growth. So again, that would both combine to the fact that we expect that this Fed path and the end state is probably not a lot higher than we entered this. So again, in that 1.5-2%. With 10-year treasury we expect more in that 2.25%.

We would argue that the risk to this is exactly what you heard, and I think Samantha referenced that was, it's around inflation hurting consumption and ultimately damaging risk taking longer term. So from our standpoint we think that that diminishes some of the growth potential at the end, although we completely agree with the fact that fundamentally the issuers especially on the corporate credit side are extremely sound. And from that standpoint, and we'll talk a little bit later on I'm sure about the Fed and path from that standpoint, but it's still a very supportive environment from a corporate credit standpoint, broad picture.

Roxanna Islam: Cheryl, what about you?

Cheryl Pate: I think we all broadly agree on the comments on where we are from the economy and the strength that we have entering this hiking cycle. I think when we think about the forward-look ahead, it's sort of a balancing act of headwinds and tailwinds. Clearly the consumer in particular is coming into this very strongly positioned with excess savings, growth has been generally low-rate debt areas, mortgages, and auto versus credit card, and we have real wage growth. From a headwind perspective, clearly the balance is inflation and how well we manage that down to more normalized levels, as well as in the face of slowing growth of disposable income as a lot of the stimulus programs roll off.

So for now I think we are expecting a fairly orderly path from here. At the margins, I think the concern is at the lower income and lower credit consumer. I think we saw some of the normalizations start to happen. If you look at the credit card trust data out yesterday, seen some normalization in charge off and delinquency rates, and also payment rates coming down. So that's an area we're focusing on, but incredibly health economy going into this cycle overall.

Roxanna Islam: All right, great. And I know that we touched on a lot of this in your guy's previous comments, but if we could just touch again on some of the interest rates and inflation outlook that we might see with the Fed and what path you think that they're going to take, and how that's affecting the way you position your portfolio or your strategy. And then just for fun, if you can add what either your favorite or your top few performing asset classes or strategies are in this sort of environment. Paul, let's start with you this time.

Paul Blomgren: Great. Yeah, so from an interest rate standpoint I think what's really interesting, we get a lot of questions, I'm sure everybody here has fielded a ton of questions about the Fed and the adjustment in Fed policy. The one thing we've really looked at and said, and I know I'm the oldest person in the market that still remembers when they did 75 basis points between meetings, which was terrible for the markets, and the Fed clearly remembers that piece of it. So we're expecting the path to be determined by the Fed, which is going to be in our opinion very methodical.

I think what does not get a lot of attention, I'll bring this up later too as we talk about risk factors, is the balance sheet adjustment. But staying with the interest rate piece of it, I would say that as they move through this, they're still very supportive. But make no mistake, we're starting, and as I said, last year was only the fourth year ever with a negative return on the agg, dark and brooding bond people. Don't take any comfort in that because you're going to be here at ground zero when you're very likely to print it, the only time you've done two negative years in a row. What it tells is when you're looking at the application of the macro to the fixed-income markets is that it's an extremely challenging environment for lower yielding high-quality assets. So that makes it very difficult.

And this is sort of getting to the answer that you were asking about your favorite sectors, your least favorite sectors and that provide the least protection are the high-quality aggregate sectors that have a tremendous amount of duration with very little yield cushion. So clearly ways that you can attack that, and you heard all of us were in agreement about the strong fundamentals, so it's about taking what we would argue still is taking credit risk over duration risk, looking for yield. And again, I try not to throw too many stats at anybody but the idea that the aggregate index, 94% of the total return since inception was due to income. It dominates over time. So finding yield strategies is really critical to solving that problem, if that makes sense.

The one thing I would take away from that too is that adjustment in Fed policy, it does move, we would argue it goes from zero emergency policy to normally accommodative. Meaning it's still supportive, but we would argue again as rates move up, those returns become more challenged. So sectors we like, from our standpoint when you ask and say we're going to go yield seeking, preferreds is one of the first things we talk about. Going down on the capital structure with probably, and Cheryl would know this far better than me, but the most fundamentally sound sector we think in the US banking sector is about 85% of the preferred issuance. So that's an area we really like to get yield and take advantage of those, we would argue, beneficial credit environment.

Roxanna Islam: Okay, you've provided a good segue to Cheryl. So Cheryl, why don't you tell us what you think next?

Cheryl Pate: Yeah, absolutely. And I think we probably all have fairly similar expectations as to the near-term path here, but I think we're in the camp that the Fed's clearly going to prioritize price stability over growth in the short term here. And expect that we can see four consecutive rate hikes on the front half of the year, and then a little bit more of a data dependent stance moving forward on the back half of the year. I think we have a higher commodity prices clearly driving higher inflation in the near term, but tighter financial conditions at the margin will put some downward pressure on that as we move through the year.

I do agree completely with Paul, financials is our key focus. When you look at what outperforms in a rising rate environment, it's banks and diversified financials. So when we think about how we position our closed-end funds, I think we have seen opportunities at the margin into some newer parts of the financial debt market. So we've seen opportunities across insurance companies for example, smaller cap insurance companies that are also highly regulated, very strong balance sheets coming in with some excess yield and on a shorter duration senior note type offering.

But really I think the bulk of where we have been deploying funds in the current environment is in the banking space, whether it's subordinated debt which qualifies as tier two capital, and is really to that point a capital instrument versus a financing tool. And again an area where we're able to get excess yield over and above similarly rated IG credit, again for a very low duration profile given the fixed-to-floating nature and the declining capital treatment. We've also tactically added on some preferreds in this environment as well.

Roxanna Islam: Okay, Samantha, what do you think about that? Any favorite sectors or areas or asset classes that you have as well?

Samantha Milner: Absolutely, I agree with the rest of the panel. We've been definitely willing to take more credit risk, as Paul said, versus duration risk. And the asset class that we traffic in is perfect for that, so it's leverage loans, CLO debt and equity, and also high yield, but we're really buying the short-duration high yield. So again, the fund is 1.7 years in terms of duration, which is very attractive when you think about investment grade and other asset classes.

And then also we're thinking about from a bottom's up perspective, what sectors are getting harder hit by inflation, don't have the purchasing power to pass along these rising costs. And also with this Russia-Ukraine situation, also looking at US-centric businesses. We do think you're liable to get harder hit in terms of rising energy costs, so we're really looking at relative value between the two geographies and making sure we're well positioned from that perspective as well.

Roxanna Islam: It's a very interesting point. We talk a lot about the inflation and interest rate risk, but there's a ton of other risks that are potentially out there. What other sort of risks are you looking at in the near term and where do you see fixed-income investors changing their strategy in order to position themselves better within these sort of risk environments? Paul, we can start with you again for this question.

Paul Blomgren: Great, thank you. Yeah, risks, right? That's what we're really good at, all the bad news. I'd say the one thing on the inflation piece of it, our analysts have been talking about this before, that commodities globally were on a long-term trend higher that was demand driven.

This was not related to supply chains, etcetera. So what Samantha hit on was, I would definitely agree and take a look at, which is industries that are susceptible to not being able to pass along those higher costs. So that's one risk that doesn't get a lot of attention.

But the more important risk that – I feel like a broken record, I've been talking about this since 2009 – the Fed took out the broker-dealers. That created a huge change in the fixed-income markets in the sense that they're not as deep or as liquid as they have been. They can mask this by flooding the market with nine trillion dollars in liquidity, but at the end of the day the market is not as liquid which results in increased volatility. And so ways to attack that, and I've talked a lot about it, again we would argue that the shot clock started on this as the Fed is going to start to drain liquidity out of there.

If there's something that was very concerning in the last couple weeks, month maybe you'd say, the markets have been extremely illiquid. That's pretty concerning if you consider that the Fed hasn't even started to drain liquidity out. So what I've been talking to clients about is saying, "Think of this going forward, how are you going to attack this?" We've been talking about it before, they papered over it, but closed-end funds play an important part in that. Because as a portfolio manager, I'm not forced ever to transact, I can ride that out. I'm not forced to react to investor flows, I don't have to monetize losses. To some extent SMAs have that same sort of an advantage. But that's one of the things that I really think is an important piece, and changing dynamic in the market that hasn't been addressed and it's a risk going forward, and I would argue, on an ongoing basis.

Roxanna Islam: Anyone else have anything to add to that? All right. So let's talk a little bit about that closed-end fund structure or maybe active management aspect of things. What are the benefits of the active management approach in this sort of environment? Samantha, let's start with you this time.

Samantha Milner: Yeah, as Paul just touched on, there's definitely increased bouts of volatility given the change in the market. And we're seeing them happen quicker, more frequently, and also steeper. You saw this happen in March 2020, if you didn't act fast enough it was over. And so we've been through many cycles at Ares, we have the playbook. Each cycle's a little bit different, but having that flexibility to move across asset classes, move across sectors, credits, we turn the portfolio over I would say between 50 and 100% depending on the volatility. And there's been so many opportunities to take advantage of relative value. Because the market has more volatility you can.

In 2020 we were buying high yield and investment grade, and then as that rallied first, when the Fed came in we were rotating into loans, and then that rallied and then we were buying CLO debt and equity. So following the best risk-adjusted returns is certainly a way to generate alpha. And then of course on the bottom's up credit perspective, that's another way. And given this change in liquidity, you have to be ahead of the curve. You have to sell a credit before they invest. Because when they do miss, you're looking at definitely five, 10 points of downside on the initial and it's hard to sell at that point. So you have to be ahead of the game.

And I think at Ares we have a really big team but we also have a big platform. So in our direct lending business we're getting monthly financials from hundreds of credits, and so we can see who has the purchasing power, what sectors are getting hit harder? I think that really gives us an advantage when it comes to credit selection. So we welcome the volatility, don't need a Covid situation again, but I think active management is certainly critical in these types of markets.

Roxanna Islam: Cheryl, do you have anything to add on your side?

Cheryl Pate: Yeah. No, I agree. I think this is really the beauty of the closed-end fund format, is not being a forced seller into volatility. If we go back to early days of the pandemic, there were funds in the space that were levered that were forced sellers, that active management component and being active in the secondary markets on what is primarily primary market sourced issuances, in our funds in particular, allowed us to trade out of several bonds at par type prices and put on new opportunities in the mid to high 80s. So it was just an incredible opportunity. And again, I think that's what this closed-end fund format really allows you to deliver, is lower volatility and very opportunistic investments in times of volatility.

Roxanna Islam: Paul, do you have anything else to add to that?

Paul Blomgren: I think what we heard a very similar theme from all of us, which it is about active management. As you move through this, it becomes even more apparent as the Fed does need to try and normalize and take out some of that liquidity. But it's not just small advantage. What it is, you heard Samantha and Cheryl talking about taking advantage of opportunities as opposed to suffering consequences.

If you're a passive strategy, we run all sorts of different types of strategies, but dedicated strategies, March of 2020 you sold good assets when you had outflows. Period. You didn't have any alternative. You sold those assets you owned when you had outflows. In closed-end fund structures you do not have that risk. Well, there's some deleveraging piece that can cause some, but it's very minor compared to the magnitude of the investor flow of which had become increasingly volatile in reaction to the markets as well.

Roxanna Islam: Yeah, definitely true. I have an interesting question for all of you. I know in the past people have talked about the 60-40 investment portfolio when you're looking at everything as a whole, as an investor, 60% equities, 40% fixed income. And then the environment sort of became weird, for lack of a better word, over the past couple years, and everyone started diving into more equities, more high-risk growth stocks. Do you have any sense of how the perception towards fixed income has changed among whether that's retail investors, institutional investors, financial advisors? Any sort of insight you can provide on that? Paul, why don't you get us started again since I know Nuveen has such a wide range of clients they speak to.

Paul Blomgren: Sure, and I will tell you the most common answer, I used to talk to financial advisors and I'd ask them what you're doing in fixed income, the most common answer I would get would be as little as possible. The approach to it would be, "I don't want to do fixed income. I want the easiest possible solution I can do and then get back to managing individual equities."

Which of course hurts my feelings as a fixed-income guy for 30 years, it's all I've done. But I would say they've come kicking and dragging into more broad-based solutions and having to think differently about it. And having to attack it instead of saying, "I can put it into two core funds and call it a day." They have to think, okay, this is what I'm going to do for offsetting equity volatility. Here's what I'm going to try and do to try to manage income.

And so it has forced for sure on the retail investor advisor side, a more thoughtful approach to it. And really answering the question, what's the role of fixed income on my portfolio allocation? It's not just the 40, it doesn't just sit there and I don't know what it is, I just put it over there and I'm done with it. You have to be trying to do something with it, which are those questions that I'm sure Cheryl and ask them as well, "What problem am I trying to solve for you?" If all I hear you talking about is dampening equity volatility, I'm probably not going to talk to you about a closed-end fund. I might talk to you about a core strategy or something like that.

But that's what I would say is to me the big change has been, they've been forced to do more with fixed income, forced to think more about it and look more broadly. And what you've seen more recently is even on the yield seeking side they've had to think differently about that as well. I mean, frankly preferreds and loans were a niche product that were never mentioned when I started in the business, you did not hear them. And so now it is much more commonplace and it's a broader marketplace. So I think that's really the change that I've seen in my time in fixed income.

Samantha Milner: Yeah, I've definitely seen investors want us to manage their fixed-income exposures. Instead of just giving us a loan book or high yield it's, "Here's capital, we want you to allocate within fixed income where you see the best relative value." And ARDC was established 2012, so it's been doing that for 10 years, but we're certainly seeing that in the SMA business in terms of let the manager allocate across these asset classes in fixed income for you. Because it takes too long, when you see high yields sell off 10% or loans sell off, it takes too long to get an SMA up and running, let us toggle for the client. It's much faster, and these dislocations, as we've said, don't last as long as they used to.

Cheryl Pate: I agree. I think it's really all about providing clients income-driven solutions, and not in a particular bucket but where you can find the best relative value and minimizing risk and volatility.

Roxanna Islam: Yeah, all very good points. I come from mostly an equity background. I actually started off in fixed-income research for about a year or so in my career, so I know a little bit about it but it's a lot different how equity researchers look at equities versus how fixed-income researchers look at fixed income. So it's very interesting to hear all of your perspectives. I know one thing that we talk about personally in equities a lot is the ESG perspective. I was just wondering what sort of role that has in fixed-income portfolios and whether your specific strategies have any sort of ESG considerations within them. Cheryl, why don't we start with you?

Cheryl Pate: Absolutely. I would say ESG has really always been at the heart of what we do at Angel Oak, and really from lending to investing to our securitizations, and it's been something that we've been really deeply devoted to for a lot of years. We became a signatory to the UN PRI back in 2017, and just speaking to it from the financials lens that I operate under, I think the banking sector in particular lends itself really well to an ESG type focus. We've developed a proprietary scorecard in-house that we supplement with externally available data. I think the challenge is with our sector there's not a lot of externally available data, which really drove us down this path to engage and drive impact with management teams.

So as part of our diligence process, we engage management teams, we ask them a series of questions related to a variety of factors. For example, you could think of the banks as to well, what type of alternative energy lending do you do? Or community engagement and financial literacy programs from the social perspective? And that's sort of how we've teased out the E and the S. And really the G, the governance part I think is what's most obviously aligned with the banking sector given the high degree of regulation and corporate governance required in the system.

So that's sort of how we think about it. Every bank in which we invest goes through our ESG process and it's complementary to our diligence process. And I would say the number one reason we decide not to invest in a bank typically tends to be the management team, and we don't like how they're aligned. And that again would loop right back to that governance piece. So really integrated in our own process. And again, we do try to be impact investors as well, so we try to have at least annual follow ups and measure how progress is being made in those banks in which we're invested.

Roxanna Islam: Samantha or Paul, do you have any other things to add to that ESG perspective?

Samantha Milner: Yeah, absolutely. ESG's definitely been a part of our underwriting process for a long time, but certainly we are getting more data now. I think data is very important to track and we have 30 analysts that are doing their own proprietary scores, and we're tracking the changes and making sure certain analysts don't have certain biases if they're always having better scores. So we actually have our quant team that runs analytics to uncover any biases within the analysts scores. But I think it is important to engage, as Cheryl said, with the sponsors, the management team, the banks. We do have an engagement tracker where we're seeing if they're delivering on what we've been talking about. And it comes down to transparency as well. We really want to be able to share these numbers, where we are and where we want to be with our clients and investors so they know where we are.

Paul Blomgren: Yeah, I think you hear and you've seen it's been incorporated in. And I'd say part of it is that it's always been incorporated in fixed-income management, a good analyst was always making qualitative forward-looking assessments of board quality, etcetera. But yeah, here at Nuveen obviously it's one of our core pillars along with income and alternatives, is responsible investing. We have a 20-person responsible investing team that works alongside the portfolio management team with the same thing you were hearing as far as incorporating the ESG factors across all of the asset classes and really incorporating it from the ground up.

I'd say it's not something that I think when done correctly it is something that has enduring, long-lasting quality differences in fixed-income management and makes a difference in returns. When we look at it, we do not have to sacrifice returns to really make an impact. And I think that's philosophically how we do it and we have the dedicated impact strategies that prove that over time. I think it does lend itself very well, especially to high quality asset classes, a little easier. Just because again in my opinion it's a forward-looking qualitative assessment which is just another layer of quality I would argue.

Roxanna Islam: That's very interesting how all of you have been really deep into that, that ESG analysis. I know for me personally coming from a transportation background for a long time, the environmental part was really focused on for a while. But as you said, Paul, a lot of the governance and social issues are something that analysts have always looked at. We've always looked at the management teams, we've always looked at how the companies are run. So it's very, very interesting to hear how crucial that ESG component is, whether it's equity investment or a fixed-income investment.

So just a question, throwing it out to any or all of you who want to answer. This panel technically it's on high quality taxable income, but obviously all investors sort of want yield. No one really goes out there and says, "I don't really care about that much yield, I want something extremely conservative." Most people want some sort of yield. So how do you balance the perspective of grabbing yield but not getting too far into the riskier investments? Anyone, up for grabs.

Paul Blomgren: I can start. To me though, the one thing that you can do is , and we haven't hit on this yet, but the use of leverage. And so that does allow you to add and improve yield and income on a higher quality bend, and that's one thing we look at it. And it remains beneficial in the vast majority of situations because the credit curves are almost never inverted. And so again it's one thing if the yield curve is inverted, but that benefit of borrowing short and lending long really remains beneficial in credit, even high-quality credit.

And so that does provide a way, and again another advantage of the wrapper to give us an advantage when using and accessing high quality. I will say we have a high-quality fund that's quite long in duration right now, those haven't been very fun conversations. I will say that we've had an awful lot of those. Because when you add leverage on it, obviously the leverage adjusted duration is quite long as well. But again, getting back to the buy and hold approach mentality you can kind of have.

Cheryl Pate: I'll just jump in. From our perspective I think what we try to do is focus on less trafficked, niche-ier portions of financial credit. So obviously anybody can go out and buy J.P. Morgan bonds and it's fairly tight yield and fairly available. Where we spend most of our time is on the community banks subsegment of banks of $50 billion and below in asset size where deal sizes range from probably $50-75 million. And so you're not going to get massive investors, just the bite size on the tickets so it's going to be too small. And so there is a bit of an illiquidity premium that comes along with investing on the smaller end of the size spectrum there. Again, these are investment-grade credits as well, but when we're looking relative to big bank counterparts, probably in excess of 200-300 basis points of additional yield comes from focusing on that smaller subsector.

And I would agree with Paul's point as well, is the prudent use of leverage within the closed-end fund strategies. We actually went out and issued senior notes last summer and locked in fixed-rate financing for five and seven years at a very attractive rate. And we layer that on with some small degree of repo funding, which is obviously a little bit more cost effective today, but it allows us to be nimble and pivot where the opportunity set is while also being prudent from a leverage perspective.

Samantha Milner: Yeah, we did a similar thing in terms of tapping the market with preferreds in July and September of last year and just being very prudent with our leverage, which is also governed from a regulatory perspective so it was a very small use of leverage. And I think on the risk side, being obviously very disciplined when it comes to credit selection in terms of the lower quality credits, there is a place for some risk assets. With our track record of very low defaults, we feel comfortable that we have been successful and we'll continue to be in choosing those credits.

But also another tool in our toolkit is our use of collateralized loan obligations, CLOs, where you're picking up spread and income in a more diversified way with more subordination. So we don't have to reach for the broken, stressed captures when we do buy Bs and CCCs. And also second liens are also an attractive place to find yield. You're looking at software businesses that generate lots of cash and they're really the last thing that a company is willing to let go is their mission critical software. So seeing some attractive liens, second liens in that context, call it between 7 and 9%. So certainly it's something that you can't stand still and we have no problem selling a credit if our thesis has changed as well.

Roxanna Islam: So you all mentioned leverage, and I know personally I've talked a lot about that in my research. It's probably one of the most interesting aspects of closed-end funds but it's probably still highly misunderstood. Have you found that the perception of leverage has changed over time? Or do you think a lot of people are still very afraid when they see a leverage ratio? And once again, anyone feel free to answer.

Samantha Milner: I think also it depends on what kind of leverage. So if it's mark-to-market leverage that may cause more concern for investors just given what we've seen sometimes how that ends. So I think you can get investors comfortable that it's a modest amount of leverage and it's locked up, so I think that gives more comfort.

Paul Blomgren: I'd say from my standpoint what I've seen, it's almost like the derivatives. I was trading mortgage derivatives in '94 and '95 and it just got such a bad name. It was like if you said "derivatives" people were like, "I'm out." And then for a while it was the same with leverage. And now it's almost like people are a little too cavalier about it. Where they're like, "Yeah, leverage I'm okay with it." Again, getting the idea, well, this is going to give you increased volatility in those asset prices. Again, so having to explain to them and making them somewhat comfortable is like, "Okay, but we're not having to monetize that, it's volatility but here's why we can look through it."

So in some respects, Roxanna, I would say almost trying to make them a little more worried about it is to think a little more critically about the use of leverage and what the implications of that are. But yes, I said I still explain it, I still talk about the volatility it will introduce and whether or not that-- you hear Samantha talk about it, is whether it results in something as far as when you're talking about quality, I just think this is a bit off. But I think the same thing, you were talking about high quality, a treasury is extremely high quality, but if it's very likely to have a negative return, how are you defining quality? So from that standpoint it gets into the investor expectations and understanding of I would say performance going forward, so that's kind of how I talk about it.

Roxanna Islam: Cheryl did you have anything to add to it?

Cheryl Pate: I'll just make one last point. I think it's been covered but obviously closed-end funds operate under the 40 Act and by definition leverage on closed-end funds is low at 33%. Our philosophy internally is to run well short of that too, we have a soft target of 30%. So I think the structure of the funds is also something to highlight.

Roxanna Islam: And then just for fun, anyone have any thoughts on the premium/discount environment right now with closed-end funds? You can answer however you want, whether that's within fixed-income funds, within the total universe, or just whatever you have to add about it would be interesting to hear.

Paul Blomgren: One thing I would layer on this is again I'm a terrible personal trader. And I say that my wife does all the personal trading. But I will say as a caveat, every fixed-income desk I've ever been on, there's always one person who is extremely good at trading their portfolio. And everybody asks that person for advice. That personal always trades secondary closed-end funds in my history. Which I think is interesting is that the prudent investors come in and say, "I can buy a known bucket of assets at a discount." Again, we're all bond geeks so they're like, "That's unusual to happen in fixed income." And so to me that's always a testament of what that discount means.

It does get into of course whether or not you're earning the income, that kind of thing. But if it's a known bucket of assets, that's the key I think. Is that if you go in there and you know that, buying them at a discount is an unusual opportunity. It's sort of not as widely appreciated. It's like the income piece, right? Income works holidays and weekends, it's known and positive. Your return starts at that level. That's the same thing with a discount. You're adding to the known part of your return expectations which is pretty remarkable. So that's what I would say. I've definitely seen some dislocations. Some of them deserve them recently, but some of them I would say has definitely been thrown out and has presented really good individual investment opportunities.

Cheryl Pate: I agree, I think this is an incredible opportunity. We always look at the NAV relative to the market price performance. And to Paul's point, when you look at a portfolio of assets that are high-quality, investment-grade in our case, securities, and buying them at a 5-10% discount depending on the day and what the equity markets are doing I think presents a good long-term opportunity. But again, the fundamentals of the underlying portfolio and the NAV performance and covering the distribution, all of these are clearly important considerations.

Samantha Milner: And these assets are getting marked every day, so that transparency is critical. And when you're getting yeah, 10-11% discount, we view that as very attractive. Paul, you should tell your wife that today.

Roxanna Islam: Yeah, it's funny you mention it because I'm terrible at personal trading myself too. I just realized how different research is from trading and it's a lot different. So we've actually reached the end of the time limit, so thank you everyone for joining. I see John Cole Scott's already on to kick me off.

John Cole Scott: No, no, I'm not here to kick you off, I'm here to thank you guys for doing a great job. Again, as you know I've been doing this a long time and I still learn something new every single panel. And we could not get that perspective without each of your participations and your help, Roxanna, herding all the cats. Anyway, thank you guys so much for the help. Hopefully you can expedite compliance approval so the people that weren't here today can see this in replay mode and then you can share this with your folks as well after. You'll hear from us tomorrow with more information.

With that, everyone else, we're going to take a 10 minute break. We're going to start the next session right at 2:30, and so feel free to mingle at the tables or grab a quick break before the next session.

Recorded on March 16, 2022.

Click the link below to go to the home page of Active Investment Company Alliance to learn more:

https://AICalliance.org/