



Octagon's Lam: Rising Rates Are Creating An Opportunity In The Loan Market

Friday, October 21, 2022

Chuck Jaffe, in this episode of The NAVigator podcast interviewed Gretchen Lam, senior portfolio manager, Octagon Credit Investors, sub-adviser on the XAI Octagon Floating Rate & Alternative Income Term Trust. Read the Q&A below as Gretchen says that while economic conditions are challenging and that a recession will be bad for the credit markets, collateralized loan obligations and other loan products have held up relatively well during the current period of rising rates. They haven't been able to avoid the downdraft, she says, but they have outperformed



other forms of credit, maintaining a historical pattern of superiority in tough conditions. Coupled with low default levels – which she expects to rise a minimal amount despite higher interest rates – it creates an opportunity for credit investors now.

Gretchen Lam

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CHUCK JAFFE: Gretchen Lam, senior portfolio manager at Octagon Credit Investors is here, we're talking about how the loan market is responding to today's sharply higher and still rising interest rate, welcome to 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. The NAVigator's brought to you by the Active Investment Company Alliance, which is 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 we're heading in the direction of the loan market and collateralized loan obligations with Gretchen Lam, senior portfolio manager at Octagon Credit Investors. Octagon is the investment sub-advisor on the XAI Octagon Floating Rate & Alternative Income Trust, ticker symbol XFLT. You can learn more about the firm at OctagonCredit.com You can also learn more about closed-end funds, interval funds, and business-development companies at AICAlliance.org, the website for the Active Investment Company Alliance. Gretchen Lam, welcome to The NAVigator.

GRETCHEN LAM: Thanks Chuck, it's great to be here.

CHUCK JAFFE: Gretchen, interest rates are moving much more than anybody thought they would. This year has been one of, when we entered it, it was like, "Oh, we'll have little steps, they'll be incremental." And now it has been big steps and how many increments are we going to have? How has that in general affected the market for collateralized loan obligations, and senior loans and the rest?

GRETCHEN LAM: The technical effect of the increase in interest rates is positive on loans and CLO debt. Both are floating-rate assets, so broader rates moving up, and specifically LIBOR and SOFR moving up is mathematically a positive for these asset classes. LIBOR for example on January 1st of this year was 22 basis points, today it is 4.25%. So investors are getting over 400 basis points more to own loans or CLO debts than they were in the earlier part of this year. But when you look at why the Fed is needing to raise rates, persistently high inflation, that of course has had in most cases a very negative effect on the operating environment and resulting financial performance of corporate loan borrowers in the broadly syndicated market. So when you look at why the Fed is needing to raise rates, which is persistently high inflation, that of course has had in most cases a negative effect on the operating environment and resulting financial performance of the corporate loan borrowers in the broadly syndicated loan market. Furthermore, an increasing number of economists now expect the Fed's rate hikes will ultimately put the US in a recession in 2023, and that will obviously have a negative effect on the credit markets. Nonetheless, if you look at historical periods when the Fed has raised the fed funds rate, and excluding this current period since we're still in the midst of it, in the last 30 years there have been four such periods of rising fed funds. If we look at these historical periods, the last was in 2016 to 2019,

loans have outperformed not only a high yield, but also investment-grade corporates, municipal bonds, TIPS, and the 10-year treasury. Looking year to date at performances across asset classes, that dynamic has certainly played out thus far in 2022. Loans, while they're down about 3.25% through 9/30, have nonetheless outperformed high yield which is down over 14.5%, investment-grade corporate which is down over 18.5%, the S&P which is down almost 24%, and treasuries which are down almost 17%.

CHUCK JAFFE: There were sirens in the background when you were talking about that. For much of this year it's felt like, wait, wait, wait. We're all racing to the scene of a crime or an emergency or a fire, that's what our portfolios feel like. But when we wind up seeing loan rates change, it impacts the consumer, it also impacts the corporate borrower. How have rising rates separately affected them? Because typically when rates are going up, one person's bad news is somebody else's good news.

GRETCHEN LAM: You know, it's interesting. Looking back over Covid we saw the consumer purchasing habits shift away from experiences, away from travel, away from restaurants, etcetera, to products. So in the summer of 2020, you skipped your vacation but you may have bought a new couch or put in a swimming pool in your backyard. So during Covid, more product purchases, especially products for the home. Now we're seeing a reversion to more experiences, so airlines, amusement parks, casinos, are all seeing improvements in demand. However, more recently with the increase in rates, we're seeing that that is having an impact on consumer behavior, and certainly I think the best example of that is what is going on in the housing sector. The rise in rates has been very dramatic, as I said, over 400 basis points so far this year on LIBOR, and if you look at the forward projections for three month LIBOR, you would see that the markets are anticipating that LIBOR reaches over 5% in 2023. Now what does that mean for corporate borrowers? If you were to look at the average coupon for corporate loans in 2021, it was about 4.25%, so that's the rate that on average corporate borrowers in the market were paying. If you look at the forward LIBOR curve in 2023, that number is between nine and 9.5%, so these companies are seeing their rates potentially double in the span of about two years. Now the good news is that interest coverage today among loan borrowers is starting from a very high level, it's over 5.5 times EBITDA among publicly reporting loan borrowers as of 6/30. But surely the longer rates remain high, the more pressure this will put on corporate borrowers.

CHUCK JAFFE: With rates going up as much as they have, one of the fears has been we'd wind up seeing defaults creep back into the market. How much do you worry that defaults are going up? And how much is that for you more a function of, "Hey, if we manage actively properly, we're not worrying about defaults even if they are going up"?

GRETCHEN LAM: It's not a controversial statement to say that defaults are highly likely to move up in late 2022 and into 2023. On an LTM basis, defaults in the loan market are 90 basis points. That's still quite low, even as it has crept up over the last couple of months. Over the course of the last 25+ years in the loan market, the average annual default rate is 2.6 to 2.7%. So even as we've seen defaults increase more recently, we are still on an annual basis at a very low level. So most participants in the loan market would expect that given the macro uncertainty, given the increase in reference rates and interest rates that we're seeing, it's reasonable to expect that defaults are likely to move up, as well as downgrades across the loan market. Now I think it's worth noting though that even in the face of increasing defaults and increasing rating downgrades, CLOs, which hold about 60% of all outstanding loans, have very good cushions to their most important covenants today. CLOs as a reminder are non-marked to market vehicles, so their governing tests do not, with limited exceptions, look to the market value of the underlying loan assets. The most important test in a CLO is its overcollateralization test, and the cushions to that test, which regulate the CLOs ability to pay out its quarterly distribution, stand today at about 4.5% on average. And that's actually up year to date by about a half of a percent. This creates a significant cushion against future defaults or realized losses. The percentage of reinvesting CLOs tripping this test today is quite negligible, it's very small.

CHUCK JAFFE: Gretchen, this has been great. Thanks so much for joining me, helping us get a little more insight into the loan market, and I look forward to doing this with you again down the line.

GRETCHEN LAM: Thanks so much, Chuck. Been great to be here.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. Yes, that's me, 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 Gretchen Lam, senior portfolio manager at Octagon Credit Investors, which is sub-advisors on the XAI Octagon Floating Rate & Alternative Income Trust. That's ticker symbol XFLT, and you can learn about Gretchen, the firm, and the fund at OctagonCredit.com. The NAVigator podcast is new every Friday, follow along on your favorite podcast app. And until we do this again, happy investing everybody.

Recorded on October 20, 2022

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