Levered Credit Demystified

September 30, 2020

Fixed Income

- Financial instruments that pay fixed distributions until maturity date
- Principal paid back at maturity
- Most common securities are government and corporate bonds
  - Government Bond – debt security issued by a government to support spending or obligations
  - Corporate Bond – debt security issued by a company. Generally backed by firm's ability to pay interest and principal back (unsecured bonds). In some cases, the company's physical assets may be used as collateral (secured bonds)

Bond Markets

- Bonds trade in the "Over-The-Counter-Market (OTC)"
- OTC Market
    - Decentralized network of dealers and brokers
    - Market participants trade directly with a 'market-maker' who buys and sells for their own inventory
    - Less transparent and regulated than exchange markets
    - Liquidity often comes at a premium

Bond Markets

- Primary Market – Where a company or government sells new securities to investors. Often referred to as 'new issue' market

- Secondary Market – where market participants trade existing securities

Risks of Fixed Income Investing

- Default Risk
- Interest Rate Risk
- Traditional fixed income investing exposes investor to both risks

Default Risk

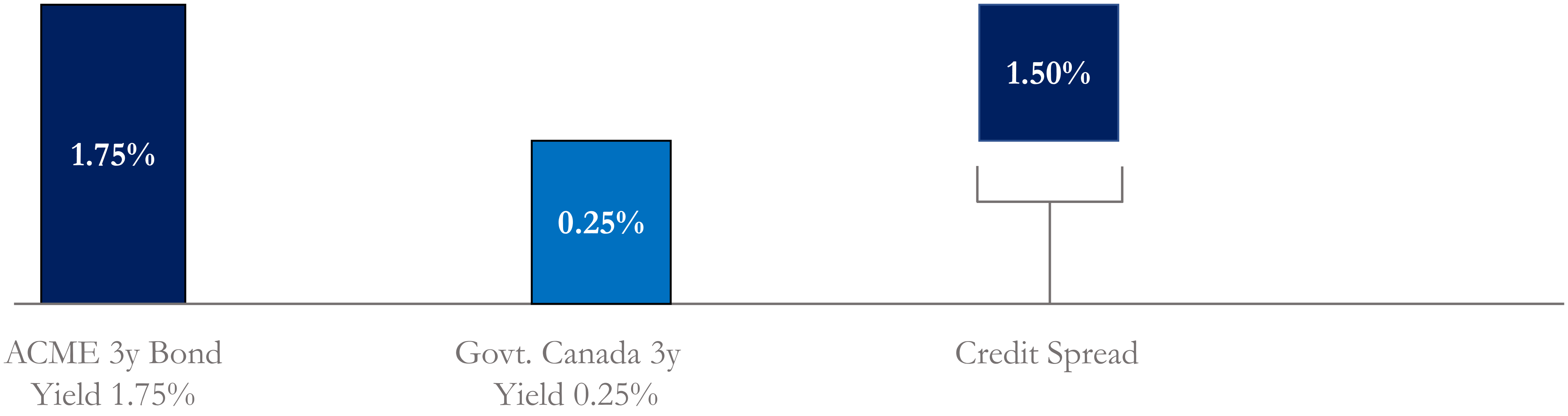
- Default Risk – is the risk that the issuer of the bond does not honour its obligation to make interest payments or pay the principal upon maturity
- Often referred to as 'credit risk'
- Sovereign bonds are considered to have the lowest default risk, while high yield corporate bonds generally have the highest risk of default
- Generally the longer the maturity, the greater the risk of default

Interest Rate Risk

- Interest rate risk refers to the potential for investment losses resulting from a rise in interest rates.
- Investors may be tempted to ignore this risk, claiming that as long as the bond is held to maturity that no loss will be realized
- This may be true for short maturity bonds, but it is unlikely an individual would be able to wait until maturity of a 30 year bond
- A bond's interest rate risk is measured by its 'duration' (i.e. sensitivity to interest rate changes)
- The larger the duration, the greater the interest rate risk

Credit Spread

- Credit spread is the yield premium on a corporate bond relative to a government bond with the same maturity. Consists of default and liquidity premium
- Default premium – probability that the corporation will be delinquent on debt obligations
- Liquidity premium – ease and cost of buying or selling the asset

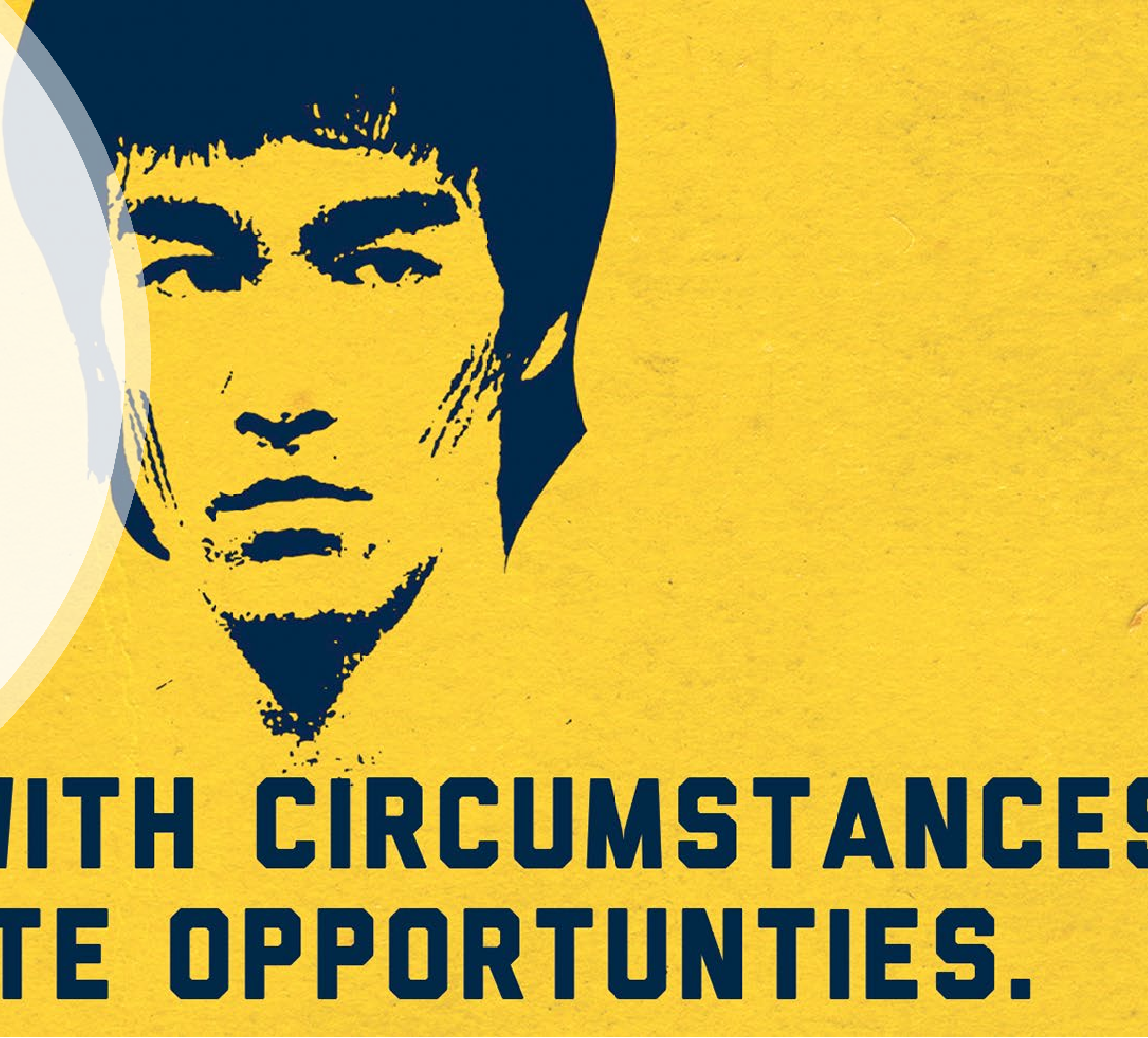


Credit Spread Components.

Credit
Spread

Levered Credit

- Allows investors to separate interest rate risk and credit risk
- Means that credit can be treated as a distinct asset class
- An investor can choose to have credit exposure while minimizing sensitivity to changes in interest rates

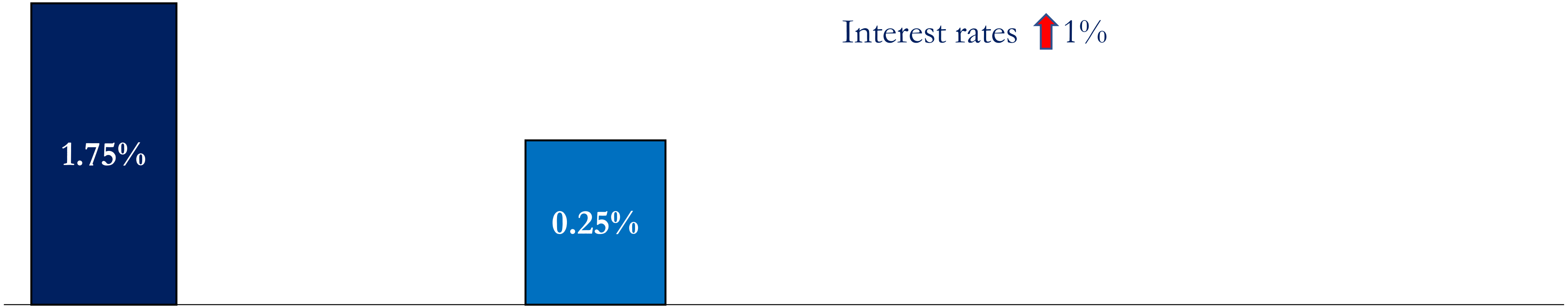


The Long and Short of Levered Credit

Buy: $100 ACME
3y 1.75% yield

Short: $100 CAN GOV 3y
0.25% yield

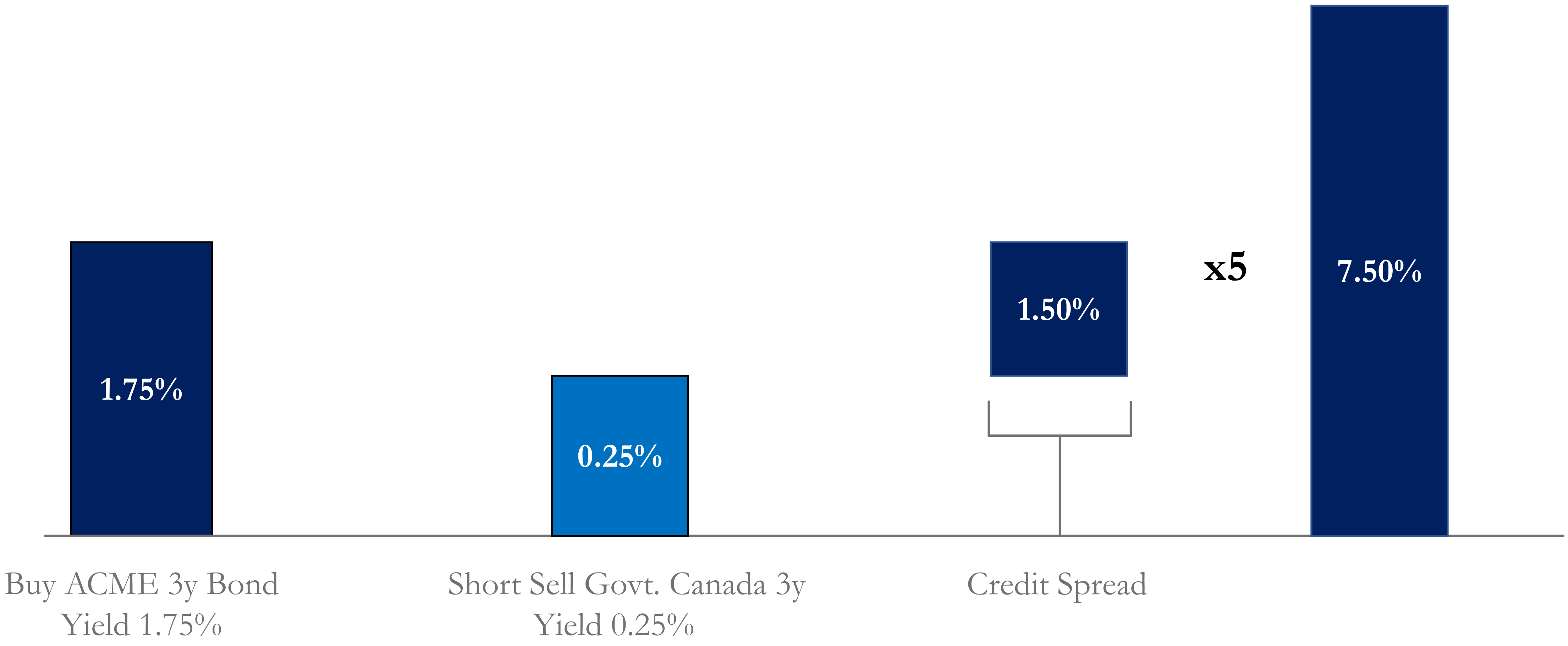
Interest rates ↑1%



The Long and the Short of It

- Pairing a short sovereign bond with a long corporate bond minimizes interest rate risk
- The investor is agnostic to both the level and direction of interest rates

Capturing the Spread.



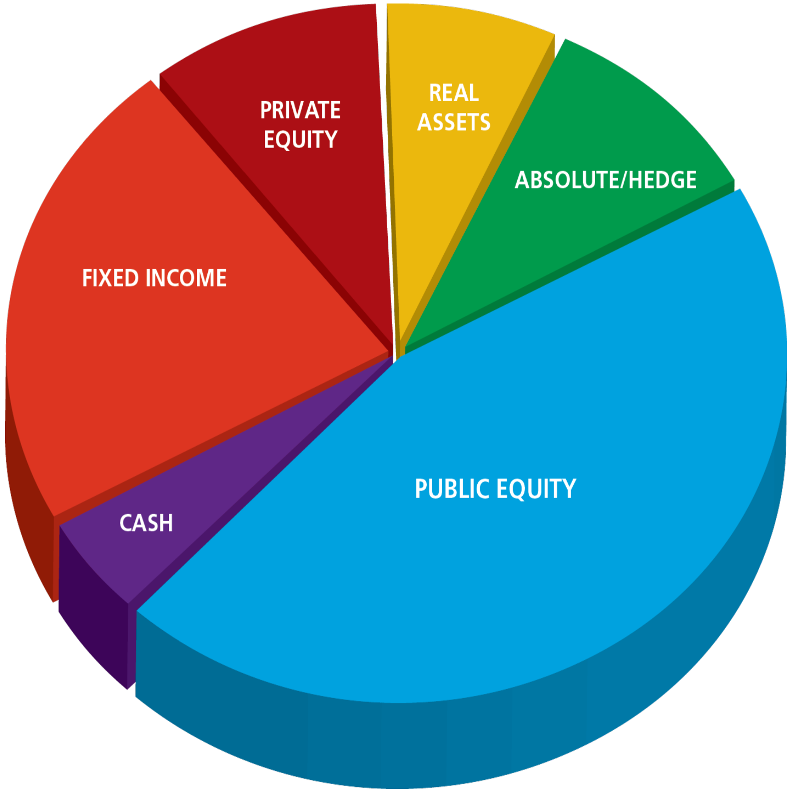
Applying Leverage

- Credit spread is an attractive risk premium
- Investment grade credit default rates are very low at <1%
- Spreads are far less volatile than equities
- Hedging interest rates lowers portfolio volatility
- Judicious application of leverage can be appropriate

The Mechanics of Leverage

- Shorting government bonds not only hedges interest rate risk, but also raises cash
- Cash raised is invested in corporate bonds
- Prime broker charges a fee to manage the short position
- Fee is tied to balance sheet usage - not affected by level of interest rates

Portfolio Fit



- Levered credit is an ‘alternative strategy’
- For funds utilizing higher leverage i.e. 5x
  - Typical portfolio weight is 2% to 5% of a portfolio
  - Not suitable for investors with a low risk appetite
- Some advisors may view ‘liquid alt funds’ as an extension of fixed income
  - May consider this strategy to be on par with high yield and make weight allocations on that basis

The Risk of Levered Credit Funds

- Two major risks
  - Default – permanent loss of capital
    - Most funds only leverage investment grade bonds
    - Care should be taken with funds that leverage high yield bonds
  - General widening of spreads – mark-to-market-loss
    - Can result in permanent loss of capital if
      - Securities are sold prior to maturity
      - Investor redeems while fund is in a loss position
    - Not unusual to experience losses of 0.5% to 1% one or two months a year
      - March 2020 saw levered credit funds lose between 7% and 24% in a single month
    - Depending on maturity of holdings, time to recovery may be fairly short

Other Considerations

- Most managers only allow for monthly redemptions/subscriptions
  - Notice periods for redemptions can be as long as 45 days
- Size of fund matters
  - Due to market liquidity constraints, a large fund (>$1B) is more difficult to manage than a small fund

The Portfolio Metrics that Matter

- There are many metrics to consider, however the following represent some of the most commonly used ones:
  - Percentage of portfolio in securities with a high yield rating
  - CR01 – this is a measure that explains the impact on the portfolio if all credit spreads widen by 1 bp i.e. a CR01 of 15bps, means that if credit spreads widen 1bp, the portfolio will lose 15bps
  - Gross leverage of long positions – provides an indication of default risk
  - Net Credit Leverage – because the risk of a bond with 1 day to maturity is much less than a 30 year bond, Net Credit Leverage is used to normalize positions. This measure is generally used to compare how much leverage a manager is using

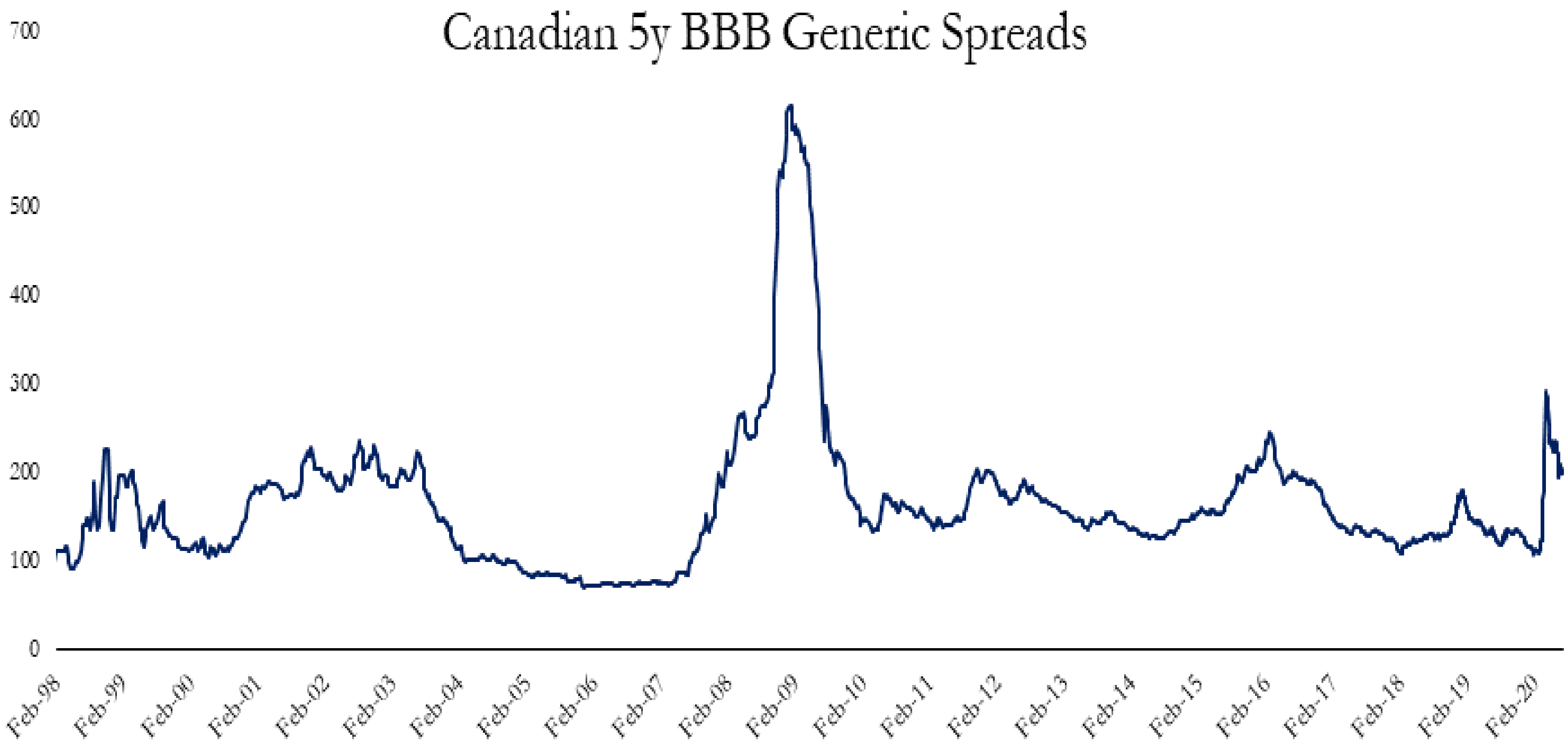
Questions to ask the Manager

- This is not an exhaustive list, but you should discuss the following items with the manager prior to reaching an investment decision:
  - Geography of fund's assets
  - Breakdown of portfolio by
    - Credit rating
    - Maturity
  - Subscription/redemption terms
  - Concentration restrictions
  - Amount of leverage typically employed and leverage limits
- Discussion of how they manage excess margin
- Experience of manager employing levered credit strategies

2020 – A Case Study

- COVID 19 resulted in a sharp widening of credit spreads for two reasons
  - The widespread use of 'stay-at-home' orders sent the global economy into recession and increased the risk of corporate insolvencies
  - A surge of demand for cash buffers lead to a dramatic increase in the sale of short-dated bonds at discounted prices
  - BBB spreads in Canada widened from 104bps to 273bps in approximately 4 weeks
  - The move was caused by a combination of increased default risk and a widening of the liquidity premium
  - We estimate that the liquidity premium moved from 50bps to 250 bps

Canadian Option Adjusted OAS Spread



Performance of Levered Credit Funds

- In March 2020, funds experienced losses between 7% and 24%
- Magnitude of loss varied across funds due to
  - Amount of CR01 a fund was exposed to
  - Level of exposure to high yield or BBB-low issuers
  - Fund weighting in hard hit sectors such as energy and real estate versus weighting in resilient sectors such as telecommunications and grocers
- Central bank easing and liquidity programs coupled with fiscal stimulus served to alleviate liquidity crunch and insolvency risk
- Within six months most funds have either fully or are nearly recovered

Benefits of Investing in Levered Credit

- Able to treat credit spreads as a distinct asset class
- Minimal correlation to interest rates
- Opportunity to earn attractive returns
- Barring a default, drawdowns are largely mark-to-market events and time to recovery is easier to estimate