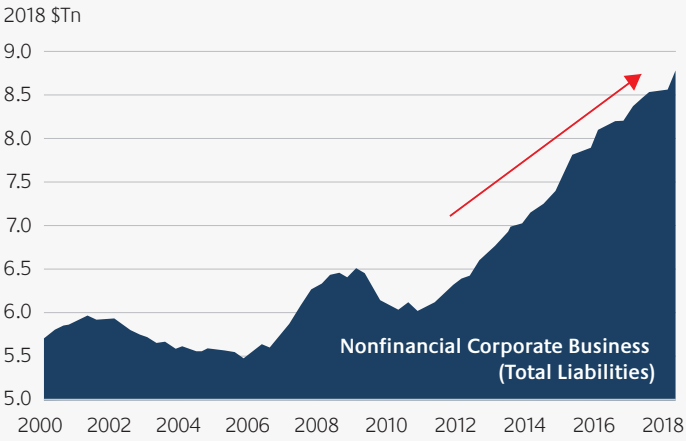
Analysis: Private "Free Lunch" Funds

In our "Thoughts on the Market" we pointed out that we find the investment management industry predictable, if nothing else. Investment managers never let a bull-market go to waste in pursuit of higher fees via financial engineering.

Every market participant has their own views as to the relative value and suitability of the myriad of investment alternatives offered in the markets. We do not aim to force our own views on anyone else. Rather, we hope to point out some simple trends others may find "food for thought."

As a starting point, most every reader can probably agree that corporate debt has experienced a noticeable increase over the past 5 years, or so. We reference the following graph as representative of this overall trend, in the U.S. alone. Fans of data crunching can reference table L.103 in the Fed's most recent Z.1: Financial Accounts of the United States.

Exhibit 2: By contrast, non-financial corporate debt has meaningfully grown



Source: Federal Reserve Board, Goldman Sachs Global Investment Research

Armed only with Bloomberg and Google we can observe some interesting corporate debt trends, we think. Consider the approximate growth of select market segments over the past ~5 years:

Asset Class	Source	2013	2018	% Change	$ Change
U.S. High Yield	BofA	1,082.9	1,128.8	4%	45.9
U.S. Leveraged Loan	BofA	682.6	1,148.5	68%	465.9
		1,765.5	2,277.3	29%	511.8
U.S. High Grade Corp	BofA	4,672.3	6,400.3	37%	1,728.0
U.S. BBB Corporates	*BofA*	*2,120.8*	*3,207.0*	*51%*	*1,086.2*
BBBs / Total HG Corps		*45%*	*50%*		***63%***
Private Debt **	Prequin	457.0	769.0	68%	312.0
Direct Lending	*Prequin*		*252.0*		
Distressed Debt	*Prequin*		*231.0*		
Mezzannine	*Prequin*		*163.0*		
Special Situations	*Prequin*		*109.0*		
Venture Debt	*Prequin*		*14.0*		
Private Equity	Prequin	2,177.0	3,411.0	57%	1,234.0
Hedge Funds	Prequin	--	3,526.0	--	--

*** Prequin data as of Jun-2018*

We usually point out that High Yield bonds seem to be most market pundits' favorite punching bag; which makes sense to us since most market pundits seem to be negative barometers. We believe 30+ years of High Yield market history make a strong case for High Yield without much commentary, however we find some information from the table above to be very interesting:

- The cumulative 5-year growth rate in the face amount of the BofA **High Yield market** is only +4% = +46 billion
- The cumulative 5-year growth rate in the face amount of the BofA **Leveraged Loan market** is +68% = +466 billion
- The cumulative 5-year growth rate in the face amount of the BofA **High Grade Corporate market** is +37% = +1.728 trillion
- 63% of the growth of the BofA High Grade Corp market has been due to a +1.086 trillion increase in ***BBB-rated bonds***.

We don't know all of the reasons the High Yield corporate bond market has been approximately unchanged in size over the past 5 years, at a time when overall corporate debt in the U.S. has been exploding higher as shown in ***Exhibit 1***. However, it seems reasonable to assume one reason is that the leveraged loan market has been more attractive to, and/or more accessible to non-investment grade issuers.

Another likely explanation is the "shadow banking system"!

A term so apparently disturbing that the Financial Stability Board (FSB) announced on Feb, 4 2019: *"With the 2018 Report, the FSB moves away from the term* ***"shadow banking"*** *and adopts* ***"nonbank financial intermediation" (hereafter NBFI)..."***
FYI: The FSB monitors and makes recommendations about the global financial system and is hosted and funded by the Bank for International Settlements in Basel, Switzerland.

In any case, Alternative Asset Classes, including "Private Credit Funds" (PCFs) have attracted a seemingly massive amount of investor money over this same 5-year period, ("massive" means we really don't know how much). We suspect PCFs have also displaced some High Yield issuance in those instances where a consortium of investors split a larger direct lending loan. The largest use of direct lending proceeds over the last 5-years has been for funding LBO's. Yet with the "sweet spot" of direct lending loans only $20-50 mm in size it's uncertain how significant the displacement of High Yield financings has been.

However, the topic of PCFs in general, and Direct Lending credit funds in particular, does afford the opportunity to circle back to the core topic of pursuit **financial engineering in the pursuit of higher fees.**

We have previously opined on **Direct Lending credit funds** (1Q'18) and the growth of that market has continued, unabated. The mantra of direct lending proponents remains: significant yield premium, secured loans, stronger covenants, shorter average maturities and no mark-to-market "nuisance."

The inherent risks have continued to increase, as well, we think.

- **Demand for Deal Flow.** We observe too much capital raised relative to the size of the quality opportunity set of the asset class. Money on the sidelines doesn't pay for a Hamptons house. The less scrupulous managers search for loan supply as a miniature reminder of the demand for subprime-MBS, pre-GFC. Even the scrupulous managers compromise on covenants, security etc.

- **Mark-to-Market?** The vast majority of High Yield bonds are priced each day based on realistic broker-dealer markets. Because this is not true for most direct lending loans the temptation and ability to hide credit problems exists. A borrower can't pay? Restructure the loan: reduce or suspend coupon payments or push out maturities. If the lost coupon problem presents a problem, add a little more leverage to the portfolio. Investors who don't think this is common may be too "trusting." We don't know, "for sure."
- **Terms.** We are hearing of 10-year lock-up periods? It seems to us a full decade is pushing the limits re: *"sooner or later"* is *"late enough."*

  Direct Lending also presents a couple of inherent structural disadvantages, through the lens of our High Yield investment process:
- **Average Loan Size.** Our High Yield investment process begins with a mechanical screen that would immediately eliminate most direct lending from consideration. We typically avoid High Yield issuers with less than $150 mm of bonds; not primarily because of trading liquidity concerns, but rather our experience that such issuers tend to be less strategic in their industries; in terms of market share, costs or other sustainable competitive advantage.
- **Illiquidity.** The general lack of tradable liquidity in the direct lending market would also eliminate one of the critical advantages of our investment process. We are typically light on credit risk when our market corrects from relatively full valuation levels. Our ability to rotate into higher total return credits on market breaks is our key opportunity to position for our strongest total return periods.

We don't single-out Direct Lending credit funds for any reason except they operate in a non-investment grade world we know something about. We readily assume that the flood of investor money into every flavor of PCFs has produced general excesses across the board.

Our message to investors is that now, more than ever, **Simple is Good!**

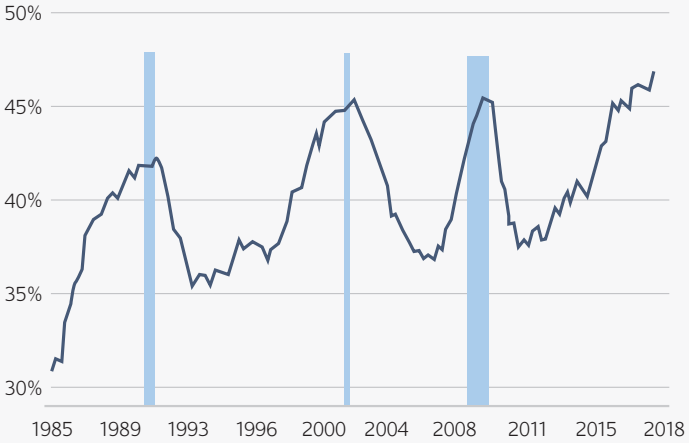
Our High Yield investment process is designed to handle market volatility and downside corrections. As PMs we have a proven record of calmly taking advantage of the opportunities they present while remaining focused on the preservation of capital.

We respect the power of GCBs and massive monetary stimulus. We also respect a record amount of nonfinancial corporate debt and the shadow banking system's strengths and weaknesses. The following cheerful graph accompanied a recent article in Forbes that highlighted David Rosenberg's prediction of a recession in 2H-2019; NOT a view we share. Nevertheless, the graph is at least worthy of consideration if investors are making a de facto bet that GCBs can indefinitely keep ***"sooner or later"*** at bay.

Exhibit 3:

Nonfinancial Corporate Debt-GDP Has Exceeded Record Levels

Through November 2018



Source: BBVA Research, Federal Reserve, U.S. Global Investors

Perhaps this time IS different. If so, the critical question then becomes HOW different.