CEF INSIGHTS | Alternative Income Opportunities in Private Credit Markets

Kim Flynn

CEFA was joined by Kim Flynn, Managing Director for alternative investments at XA Investments. The following Q&A recaps a discussion about how institutional strategies in alternative income investments can be accessed through closed-end funds. Less liquid investments and the private credit markets provide additional income as well as diversification from traditional bond exposures. As part of CEFA's CEF Insights podcast series, the podcast audio can be heard here.

CEFA: **Welcome to CEF Insights, your source for closed end fund information and education brought to you by the Closed End Fund Association. Today we are joined by Kim Flynn, the Managing Director for alternative investments at XA Investments. Kim, welcome to CEF Insights.**

Kim: Thank you for having me.

CEFA: **So Kim, XA Investments has a focus on alternative income strategies, particularly in the private credit markets and you provide investors access to these markets through your closed end fund, symbol XFLT. Can you discuss the types of securities you consider and the benefits and risks they present for investors?**

Kim: Happy to do so. So our fund XFLT provides access to Institutional Alternative Credit and what I mean by that specifically is the portfolio management team at Octagon Credit is investing in CLO debt, CLO equity, first lien loans and second lien loans. And they invest in these different credit opportunities in a diversified way. More broadly at our firm we do focus on alternative income and the types of alternative strategies that we are interested in. We think advisors and their clients would also be interested in. Closed-end funds are uniquely able to invest in less liquid or even illiquid securities. And that can run across a wide spectrum of alternative strategies. So we like to make what was hard to access in other registered funds, like a mutual fund or an ETF, if not impossible to access, these are the institutional strategies that we like to make available in our funds because we think access is really interesting for advisors when they're trying to bring new opportunities to their clients.

CEFA: **Now, you mentioned that private credit investments have limited liquidity, do you find the closed end fund structure to be advantageous in managing a portfolio of private credit securities?**

Kim: Absolutely. So private credit can mean a lot of different things in the marketplace. With our closed end fund XFLT, we invest in less liquid securities including CLO debt, CLO equity and private credit. There are many different ways or types of private credit, so it's important to sort of think through the differences. Closed-end funds are able to invest without limit in less liquid or illiquid securities, and that's in sharp contrast to mutual funds and ETFs, which are not able, because of daily redemptions, to hold these less liquid securities. So in the marketplace today we're seeing more closed-end funds come to market that are giving investors access to private credit opportunities.

Private credit opportunities, which may include accessing direct lending opportunities or middle market private debt or loans as another example, business loans.

So there are a number of opportunities across the private credit spectrum that we think are worth considering. There are risks to investing in these less liquid securities, so we always advise investors to consider the trade-off that comes with these opportunities. Liquidity premiums are what tends to drive additional return for less liquid investments, but it comes at a cost and that cost is liquidity.

CEFA: Okay. So if we consider an investor with a diversified portfolio, how would you see an allocation to private credit best positioned, assuming they have long term investment goals?

Kim: Absolutely. So we talk with a lot of clients about asset allocation. Some clients think about alternatives in an alternative basket. So they might have an allocation of 5% upwards to 15 or 20% for alternatives. And that alternative basket might include things like real estate, they might include private equity, they might include private credit. And then we have other clients that are interested in investing in alternatives in a way to replace core positions or core exposures. And so an example of that in the private credit space is advisors are replacing more traditional allocations to, for example, investment grade bonds or high yield bonds, things that come with significant duration risk.

And so they're looking at alternative income opportunities, including private credit to diversify risk, maybe to add additional income and they're going to swap out a core traditional allocation for something that's alternative. And so allocations are something that advisors must speak with their clients about their risk tolerance. And we like that more and more advisors are using alternatives. These are just two ways in which advisors incorporate alternative income into a client portfolio. Either using the alternative basket approach or replacing traditional exposures.

But the reason that they're doing so is that they see value in evaluating these types of opportunities and they see value in changing up their more traditional asset allocation. And so what that means for some clients it might mean a 5% allocation to private credit. Maybe if they're more conservative or they have certain risk tolerances. We see larger allocations for certain clients who understand the risks and then also want or maybe are seeking more income so it just depends on the client and it's within these different ranges that we're seeing more and more advisors consider alternative income and in doing so they're considering using closed-end funds to accomplish that goal.

CEFA: I understand you're trying to navigate the credit cycle with XFLT. Considering the US economic expansion is about 10 years old and the Federal Reserve seems to be taking a pause after a period of raising interest rates. At what stage do you see us in the current credit cycle?

Kim: Our view at XA investments is informed by our partnership with our sub advisor Octagon Credit. Octagon views that while some technical factors drove volatility in late 2018 their view for 2019 is fairly constructive. When you're thinking about fundamentals for the credit markets, we do seem to be later in the credit cycle and so it's wise to continue evaluating where we are in the credit cycle. XFLT, we believe, is well positioned. Even though fundamentals remain strong and when I say fundamentals we're thinking about cash flows on the balance sheets of these companies who issue loans and these loans are what find themselves in CLO debt and CLO equity portfolios.

And so even if your view is that you see a recession on the horizon or even if your view is more negative in terms of where we are in the credit cycle, what investors should think about when they're evaluating opportunities such as investing in a CLO debt or CLO equity, is that these structures tend to perform well late in the credit cycle. And the reason for that is that there's a lot of flexibility built into the CLO structure. We could spend a lot of time talking about the integrity of the structure of CLO's and a lot of study has been done by S & P and Moody's with respect to credit performance for these types of investments over long periods of time.

And so we would encourage advisors to do their research and to really think about how certain asset classes are going to perform in different parts of the credit cycle. And so it's an interesting opportunity with CLO's because they are designed to perform well in that credit cycle and the reason that they are able to perform well is that they have an active reinvestment period for about five years, which even if loan prices decline, the portfolio manager can buy loans and that can benefit the CLO structure. And so there's a lot of opportunity with the investments in the CLO marketplace even if your view is that we're late in the credit cycle because of that active management and because of the structure of the CLO.

CEFA: **Interesting. And knowing that default rates are key consideration in evaluating below investment grade credits, do you see the relatively low level of default over the last several years continuing to be favorable?**

Kim: We do and the environment for corporate defaults is interesting. It's changing and part of it has to do with the documentation for loans that are being issued. In the loan market, most of the loans that are issued are considered covenant light, which will impact the default rate for these types of investments. When you're investing in below investment grade credit, a portfolio manager is trying to avoid defaults and then in the event of default, avoid losses associated with that default.

And so that's what you're looking for in an active credit manager is superior performance with respect to defaults and loss. And so it's a really important question to be thinking about given that the overall market for investing in loans and in investing in CLOs, the marketplace has moved to a covenant light market, which means that we actually expect basically lower levels of default because companies will have more time to fix something that's not working, but in the event of default, we do expect losses to be more severe.

So the credit environment that we're in now, as I mentioned, fundamentals are strong and healthy and so with the exception of certain sectors which have been problematic for a few years, such as the retail sector, other parts of the economy in the US credit market are fairly healthy and so it's smart to be thinking about defaults and losses and to be mindful anytime you're investing in below investment grade credit. And so that's why I think that it's hard to predict what the next default loss cycle is going to look like. It will be different because the loan market has changed and that's why we advise people to work with active managers.

CEFA: **Do you think the private markets present any additional challenges in this regard?**

Kim: I think that with private credit investments, the challenges are similar. When you're investing in the credit of public companies and when you're investing in private credit. If you have good fundamental credit research in terms of active management and the assessment of the default potential, I think that you're getting fairly good information flow and it doesn't necessarily change the level of fundamental analysis that the credit analysts can do. I think some of the challenges that come with private markets have to do more with the valuation of less liquid investments and the transparency perhaps.

So I'm feeling very confident about the investment decisions that can be made when you're selecting opportunities in the private credit markets. And I think what investors need to think about is that you can have valuation for less liquid or illiquid investments. It may not be that the valuations are changing on a daily basis and so there can be volatility with mark to mark valuation changes that should be expected and shouldn't be surprising to investors.

I think that we're all accustomed to investing in public equities and even investment grade or high yield corporate credit and you're not going to have that same mark to market valuation changes that you might see in the private markets. We just went through an interesting cycle for valuation with the volatility in the markets broadly in November and December. You saw that come over from the public markets into the private markets and you did see that drive some volatility there.

So that's one of the unique challenges when you're investing in private credit because of the less liquid nature, you have to think about those valuation changes. And sometimes these valuation changes can be negative, but they're not reflective of losses in the portfolio. They are declines in valuations that reflect unrealized losses. So we encourage investors to think a little bit about those considerations before they invest in private credit.

CEFA: Well, with this in mind what is your outlook for the opportunities in private credit markets?

Kim: Our view is that there are a lot of opportunities in private credit. These investments in XFLT are all floating rate in nature and when, and if rates do continue moving higher from their relatively low levels, investors will benefit as the portfolio will adjust with changes in level. And so some of the opportunities in the private credit markets, like our fund and there are other interesting alternative credit funds out there, that invest in other parts of the credit market, we think that the exciting part about the opportunity is that you can't access these alternative strategies in other ways. The only other way to invest in middle market private debt or in CLOs would be through a private fund.

And so what's exciting about our outlook is that more and more of these alternative strategies, which had only been available in private funds that had high minimums, they have K1 tax forms that advisors don't like to deal with typically. And so now they're available in a registered fund format, in a closed end fund format and many of them are available in listed, closed end fund formats. Which advisors like the fact that you can buy a closed end fund on the New York Stock Exchange and you can buy and sell that fund. It has liquidity in that sense, even though the underlying portfolio is giving you access to an opportunity and it's underlying investments that are less liquid in nature.

So we're really excited about what we see happening in the marketplace. We're seeing more and more interval funds, which are non-listed closed-end funds, come to market, which provide access to opportunities in the private credit markets. And we're also seeing more listed, closed-end funds come to market. And so there's now a conversation happening around alternatives and closed-end funds that had not been happening before. And so we're really excited to see advisors thinking and having fresh sort of ideas that are coming to them from the closed end fund arena.

CEFA: Well Kim, I want to thank you for joining us today and we appreciate your time and look forward to hearing from you again in the future.

Kim: Thank you so much. I appreciate the time today.

CEFA: And thank you for tuning in to another CEFA podcast. For more educational content, please visit our website at www.cefa.com.

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