The Insight: Conversations – Full Return World with Howard Marks and Armen Panossian

Anna

Hello and welcome to a crossover episode of *Behind the Memo* and *The Insight by Oaktree Capital*. I'm pleased to be joined by Howard Marks, Oaktree's co-chairman and Armen Panossian, Oaktree's Head of Performing Credit and incoming co-CEO. Today we'll be discussing topics related to Howard's latest memo, *Further Thoughts on Sea Change*, and Oaktree's recently published *Performing Credit Quarterly*, which was co-authored by Armen. I'm excited to dive right in. Thank you both for joining me today.

Howard

Thank you, Anna. Great to be with you.

Armen

Thanks, Anna.

Anna

Let's start with *Further Thoughts on Sea Change*. Howard, why were you interested in writing a follow-up to your memo, *Sea Change*?

Howard

Anna, a lot of my messages are, A, inspired, and then B, shaped by discussions with clients. It's not a one-way street. And of course, the original *Sea Change* thesis came out of client visits that I made in October and November, and then the memo was released in December. But then of course I continued to meet with people, talk to them about the thesis, get their response, get their questions. And just more thoughts arose, and I wanted to share them.

Anna

Maybe before we move on, Howard, can you just explain exactly what the thesis of *Further Thoughts on Sea Change* is?

Howard

Well, the whole idea of the sea change is number one, that it's a significant, fundamental, possibly lasting development. I think this is a major change that interest rates have been low or declining since 1980, with the exception of 2022 when they were jacked up to fight inflation. And if you came into this business since 1980, and that covers a lot of people, here we are 43 years later, that's pretty much all you saw. And people tend, especially investors tend when they see something for a few years to think, "Well, that's normal." And that means that's the way it's always going to be. I think especially with regard to interest rates here in moderate single digits, I don't think you can say that declining an ultra-low interest rates will be the rule for the coming decade or so.

This is not a normal cyclical fluctuation like we're used to dealing with every year or two or three. This is for me and my commentary, really once in a lifetime. I've never written a memo before that talked about something of the magnitude of the sea change that I think we're going through. And this changes so much, it changes the outlook for GDP growth. It changes the outlook for the ease of financing for companies. It changes the outlook for defaults and bankruptcies and it changes prospective returns. A year and a half ago, high yield bonds yielded in the fours. Not very interesting. Matter of fact, we joked around here that they were actually medium yield bonds, not high yield bonds. Today they yield in the nines, which is more than enough for most client's needs. That's a big change and I don't think it's going to reverse in the immediate future.

Anna

Armen, what would you say are some of your key takeaways from Howard's memo?

Armen

I think a lot of investors look at 2023 and say, "It's not so bad." The consumer is doing okay, and inflation is heading towards generally in the right direction. Unemployment is quite low and there are reasons to believe that maybe we are going to get through this period of time without a meaningful economic impact from these higher rates. But I think that there's a tremendous risk in being backward looking on this point because the impact of higher rates has only just begun to take hold.

It's only been a few quarters, three quarters maybe, where the high base rates have had an opportunity to reset, have impacted company cash flows. And the unlevered free cash flow drying up for a very large portion of businesses as well as the consideration for additional capital needs for interest rate sensitive assets like real estate. In corporate credit, give it another year or two and you will see the need for refinancing capital. And so it's really a time to tread carefully and not to look in the rear-view mirror and say everything looks great. And we really ought to be careful because I think in the next 12 to 24 months, there will be a day of reckoning for some of the capital structures that were put in place that are now going to look inappropriate.

Howard

Anna, I'd like to interject here. In preparing for this recording session today with Armen and you, I thought about two things that I want to make explicit to our listeners about interest rates. Number one, the interest rate on debt is practically always less than the return people hope for on equity. Number two, short rates are almost always shorter than long rates. These are facts.

Now, the interesting thing is those two truths have a profound impact on people's behavior and tend to lead to the two biggest mistakes that people make. The first, the low cost of debt means that it's usually attractive to leverage. And if you're making an equity investment at a certain rate of return, invariably you can increase the expected rate of return by borrowing some of the capital. The more you borrow, the more you amplify the return. As they say in Las Vegas, the more you bet, the more you win when you win, but you don't always win. And the more leverage you have, the lower the chance you have of surviving a difficult period.

So, interest rates on debt being lower than equities invariably encourages leverage, sometimes to excess. The second is that short borrowings cost less than long borrowings, and that tends to cause people to borrow short, sometimes to invest long, to make long-term commitments. That's fine, except in those brief periods when financing becomes harder to obtain and you have what's called a mismatch. You've borrowed short, you've invested or loaned long, your providers of capital ask for their money back. Your assets aren't saleable, you meltdown. Leverage and mismatch are two of the greatest ways to have a financial problem. And they are all encouraged by the nature of borrowing costs and the way people respond to them.

Armen

Maybe if I could add one more thing too. When you own a business, there are two ways to grow its enterprise value. There are taking on debt to invest in the company and building a manufacturing plant or doing some R&D for new products. That again, requires access to capital markets. The second way is just having a really good execution. Irrespective of how you're capitalized, if you're just really good in a particular sector and you have a secret sauce or a playbook to really expand enterprise value, that will show even if you have no debt.

Now the leverage buyout industry has participants that do both. I think what we will find as the next year or two unfold is which of those private equity firms have the subject matter expertise to have grown enterprise value even on an unlevered basis? And then which of those private equity firms really needed access to cheap and consistently cheap capital to realize their equity returns. To quote Warren Buffett, which when the tide goes out is when you find out who's been swimming without a bathing suit on. I think we will find that in spades in the next year or two, especially on the equity side and on the highly levered equity side.

Anna

So, Armen, this weakness you're talking about, do you think you're also going to see it emerge in private credit?

Armen

Yeah, in private credit, it's been a huge growth industry for the last 10, 15 years. A lot of private credit managers that are large today didn't exist before the Global Financial Crisis. They have grown with the growth of the private equity universe and an expansion of their lending practices and capabilities and assets under management have helped fuel private equity returns as well. Now, I think private equity will experience more of a challenge in the next few years than private credit will, but I think private credit transactions that were highly levered may have some problems in old vintages because when base rates were at 25 basis points and the spreads were at 550, that cost of that leverage was 6 to 7%. Today, that same loan, even without a refinancing, is now costing the borrower 11%.

And so, what is going to happen with that company? Can it make its principal and interest payments when it comes due? If it cannot, where will the incremental capital come in to de-lever the business? There is risk in the rearview mirror in private credit, but with that risk creates opportunity out the front window, which for fresh capital, for experienced investors having invested through cycles, there will be some great buys. There are some great buys even now, but I think it's going to accelerate in terms of private capital being deployed into a dislocated environment where there are banks and other private credit funds that were probably a little too long in their pro-cyclical lending and investment behavior. And now that's going to need to be retracted a bit.

Howard

I think the point is the tide has never gone out on private lending. It's never been tested. Credit analysis may seem like a pedestrian activity, but the truth is there is such a thing as superior credit analysis, average credit analysis, inferior credit analysis. And the people who did inferior credit analysis in the last 15 years and maybe who scooped up too many assets to invest in, in the interest of asset growth, we'll find out who they were, I think, and maybe the list will be winnowed.

Anna

So the last specific question I'll ask about this memo, Howard, is for you, and it's about capital allocation because it's obviously a big part of the memo *Further Thoughts on Sea Change*. And what you write in the memo is that you're not calling for investors to become more defensive, but instead talking about a reallocation of capital away from ownership and toward lending. I'd like you to speak about that distinction you're making.

Howard

Yes. I don't think that the markets, even the stock market, are so high that I would urge increased defensiveness. They're also not so low that one should become more aggressive, but I don't think too many people are tempted by that. Stocks are a little high based on historic parameters, but not so much so, I think, that it's worth significantly reducing exposure for defensive purposes. But the point is today that we can potentially get equity returns from debt. The S&P has returned about 10.2% a year for the last century, and that was enough to turn a dollar into something like 14,000. We can get prospective returns like that from credit today. On the liquid side from high-yield bonds and senior loans, close to 10. On the private side even the senior most loans to the best and biggest buyouts are offering 11 or 12 or a bit more.

Credit instruments, debt instruments are by definition less volatile, less uncertain than equity. Our returns are contractual. We have a note from the borrower who says, "You give me some money, I'll give you interest every six months. At the end of the term, I'll give your money back. And by the way, if I don't give your money back, you can have my company." Now, that's implicit in the bankruptcy process, and I'm overgeneralizing and oversimplifying. But the point is these are contractual returns. And when I switched from equities to debt in 1978, I was wowed by the fact that there's this promise to pay. Around Oaktree, we call it the power of the coupon. And you're clipping coupons every six months and the pendency of the next coupon payment tends to keep the price of the asset up. If something's going to pay you, let's say 11% interest a year, its price can only go so low as long as its fundamental credit worthiness is not impugned.

And you have to recognize the turning points in the investment business. In 1980, my stepmother proudly announced at dinner one night that she had taken out a CD at 16%. And I said, "Oh, that's great." I said, "How long?" She said, "A year." I said, "You should have done 10 years." She says, "Well, 10 years, you only get 11." And I couldn't convince her that 11 for 10 years was better than 16 for one year. The point is the higher rates go, the more you should want to tie them up as a lender or investor. One of the ways I try to think about correct actions is by saying, "Well, what's the mistake one could make today?" And I believe that the mistake would be failing to take advantage of these rates today.

Anna

Now let's shift gears a little bit. Already in our discussion, we've been talking about some of the risk that has been building in markets in the economy because, Armen, of some of these capital structures, as you said, that were put in place at a time when interest rates were extremely low, now they're becoming unsustainable. So you and your co-author recently put out a *Performing Credit Quarterly* piece in which you talked about tail risks that we're building in markets today. So to begin, can you just explain your main argument in that piece?

Armen

Well, if you look at averages, if you look at the average fixed charge coverage of a company, what is its income versus its interest expense. The averages look fairly healthy. The averages look like they are, I would say unchanged at least from a materiality concept over the last several years. But if you were to look at the tail, the weak tail of issuers, borrowers in the market, what you would find is, and a growth of that tail of weak positions, and that tail really is not able to pay its principal and its interest as it comes due.

Now, why would that be? It would be because two or three years ago, only the weakest companies, the most impacted by COVID or the most impacted by inflation had trouble in terms of maintaining their cash flows relative to their interest expense. But now with a rise in rates and the commensurate reduction in the forward growth of these companies and just of the economy overall in such a high-rate environment, you are seeing a flatlining or even a decline in cash flows before consideration of debt, and you're seeing a rapid escalation in the cost of maintaining that debt.

And therefore, a growing number of companies are now entering that tail, that tail that is EBITDA over fixed charges of one times coverage or less. And that tail is fattening. The averages may look okay because on the other side, there may be a company that actually did really well during COVID or really well under inflation. And so the average will be misleading. The average is misleading currently. It's really, I think you have to look at how big the tail is getting and how severe the problems are in that tail. And I think directionally and orders of magnitude-wise that it's becoming very concerning. And I think you really need to think about the tail and the size of that tail today versus the size of that tail during the Global Financial Crisis.

The markets today are four times the size as they were during the Global Financial Crisis. You could have a quarter as many defaults or a quarter as much stress and still have the same dollars of pressure weighing on the markets. And therefore, from an opportunistic investor standpoint, a very attractive investment opportunity even without a massive recession or a double-digit spike of default rates. You don't need all that to create pretty big dollars of dislocation in the market and investment opportunities because of this growing tail.

Howard

One more comment, Anna. There's an old saying that the worst of loans are made in the best of times. And we had an economic recovery in a bull market that exceeded 10 years. And as the good times roll on longer and longer, people, as I said before about normalcy, tend to think that the longer it's gone on, well, the longer it's going to go on. Well, normally I would say it's exactly the opposite. The longer the good times have gone on, probably the closer we are to a downturn. But people don't act that way.

And so, since they think times are good, they tend to compete to make loans by accepting lower returns and reduced safety. I discussed this in a memo called *Race to the Bottom* in February '07, which unfortunately turned out to be right in the Global Financial Crisis. And certainly aggressive lending has taken place in the last 15 years. And when tested by more difficult conditions, it's not all going to make it.

Armen

Howard, you're 100% right. And actually, if you look at the loan market today, the broadly syndicated loan market, which about 70 to 75% of the issuance has been in support of leveraged buyouts as opposed to the high-yield bond market, which really was not the financing mode of choice for private equity firms because high-yield bonds have call protection. So they liked floating-rate liabilities. They liked the callability of broadly syndicated loans. And so that market rapidly grew over the last 10, 12 years because of the leverage buyout boom.

Now, if you look at that market today versus what it was 12 or 13 years ago, it's meaningfully lower in quality. 12, 13 years ago, about 30% of that market was double B rated. Today, it's closer to 20%. In addition, today, close to 50% of that market is a weak single B. That is the highest it has been in at least 10 years. Now, that tells you about the tail. The tail is no longer an immaterial amount of debt. It's 40 plus percent of the market that's rated weak and on the verge of becoming even weaker in terms of rating. It's an important risk to monitor because the ownership of broadly syndicated loans in large part are in the form of collateralized loan obligations or CLOs, which are rating-sensitive buyers of those securities.

If a loan becomes CCC, effectively there is almost no bid in the market for that loan other than from a distressed player, not from a CLO. And so if you become a forced seller for whatever reason of paper that has become downgraded or is at risk of downgrade, it will not take much in terms of selling pressure, in terms of dollars of selling pressure, to drive down a loans price, 5, 10, 20 points because of the technical that is tied to the ratings, which are then impacted by this tail risk that we're talking about now.

Anna

So the environment that you're describing here, I think it can make sense why this could potentially be a good environment if you're an opportunistic investor. But I'm also curious if you're on the performing side, what does that mean in this environment?

Armen

It's a credit pickers market. We're talking about the tails, but the average is not so bad, which means that there's another tail. There's an extreme other tail of high quality that could be trading at attractive yields just because the overall market is a little choppy. So you can look at the percent of the loan market that is BB. You could look at a very large portion of the high yield bond market and find pretty good buys. Now, why high yield? High yield is the highest quality it's been in 15 years. It is the highest rated it has been. In addition, the borrowers are generally larger in the high yield bond market than they are in the loan market. Both markets are about 1.5 trillion, but there are close to double the number of borrowers in the loan market versus the high yield market.

In addition, the debt-to-EBITDA of the average high yield issuer is actually lower than the first lien debt-to-EBITDA is on the average loan issuer. So less levered, bigger business. And then the most important thing, I think, is that these companies did a great job of extending their maturities in 2020 and 2021 when the markets were wide open with QE supporting those markets, the quantitative easing. And because of that, if you're a big business and you have the benefit of time and a fixed dollar liability for the next several years in terms of the interest that you owe, you might actually benefit from inflation to the point where when you do have your maturity four or five years from now, you might have actually grown and you might have actually delevered until then. I think bigger businesses are benefited therein with inflation. Smaller businesses are in trouble usually, especially when the cost of their liabilities is rising real time.

So there are opportunities. You have to pick and choose. You have to do your underwriting. You have to look in the right places. You could buy a basket of high-yield bonds now in the 80s in terms of a dollar price, 86 to 88, that have been performing well and have the benefit of time. They're trading at that price mainly because of rates and technicals rather than fundamentals. And we really like buying securities that are trading down because of technicals and that have strong fundamentals. There are also great buying opportunities in newly issued private credit because again, the banks have stepped away. Direct lenders are finding a growing watch list of securities in their portfolios. So if you do have dry powder and a clean portfolio and the capability to handle a volatile economic period, then there are great buying opportunities, but you have to do the work.

Anna

Howard, one of the things that you often say, it's obviously a mantra here at Oaktree, is this idea of trying to avoid the losers. And this environment we're talking about, there are probably going to be more losers than there have been in previous years. And I'm curious what you think this means for the types of strategies that maybe well-positioned to outperform moving forward and how they may be different than those that have outperformed, say, in the last 10 years.

Howard

The short answer is very simple. In the 10 years you're talking about, Anna, 2010 through 2019, it was an easy period, safe period. There wasn't much pain felt. When there are no defaults, when it's 99-1 instead of 90 to 10, you don't have to worry too much about avoiding the losers. You can be soft on your credit analysis. And in a good environment, the potential defaulters don't default and everybody looks the same. The person who played golf instead of reading prospectuses does as well as the person who was glued to his green eyeshade. The bottom line is that risk taking was rewarded. And for the most part, if you dip down in quality, you made more money because there were so few defaults in bankruptcies in particular. But that doesn't mean it's always the case. Sometimes the lower you dip down in quality, the more money you make. Sometimes the more you dip down in quality, the more you lose.

And now as Armen says, you're going to have to do the work. Now, the period that we're looking at ahead is going to be more of a normal period, I believe. Well, one of these days we'll have a recession. And in those, the weak credits are exposed, the tide goes out. And in that period, the person who did better credit analysis and maybe took less risk is rewarded. And I think that the period ahead is more like that. The period just behind us was an unusually easy period in which risk taking was rewarded, as I say. And if you learn the lesson that the more risk you take, the more money you make from time to time, that turns out to be a very dangerous lesson.

Anna

So to finish up today's conversation, I wanted to look back a little bit. This podcast is going to be coming out in early November of 2023, and this has obviously been quite an eventful year after a few other eventful years. So, question for both of you, what would you say were some of your biggest surprises from this year thus far?

Armen

I have been surprised about how resilient the economy has been. This year, I would've expected for bigger cracks to form sooner. Now the cracks are forming now, so maybe I'm cheating a little bit, but I am seeing the cracks now. I am seeing certain consumer-facing businesses roll over a little bit, seeing credit card and other consumer finance charge-offs starting to tick up. So I just would've expected it sooner. I think the reason it did not surface sooner was because there has been a tremendous amount of stimulus over the last several years that, frankly, had a longer halo effect than I thought would be possible. Obviously, you had the helicopter cash of the COVID era, but since then you've also had the CHIPS Act, the Inflation Reduction Act, the Infrastructure Act. Even though one is called the Inflation Reduction Act, they're kind of inflationary because they do support economic growth and are therefore inflationary over a short period of time. So that is, I think, the explanation for the surprise. But I am, frankly, just surprised about how resilient it has been.

I'm also surprised that several investors look at that strong performance and say everything's just fine. And I do think, to use basketball terminology, it feels like a head fake. Over the next few quarters, those folks that have thought that everything's going to be just fine, or think, are going to be proven quite wrong because it's only a matter of time that these cracks that are already forming really widen and swallow up some companies.

Howard

And I think following on from Armen's favorable surprise on the performance of the economy, I'm surprised to see so much optimism emerge in stock market investors. The market is a tug of war between the optimists and the pessimists. And 2023 is a year in which the optimist won. People who believed that there won't be a recession or there won't be much of a recession or that the Fed will pivot towards dovishness, so far these people have won in the stock market in the sense that they have caused prices to go up as opposed to when the pessimists win and the prices go down. So it's been a strong year in the stock market. Yes, maybe concentrated in a few stocks or stock groups, but a very positive year.

The good news about this, Anna, is as you know, our investment philosophy says that our investment decisions are not based on our macro expectations or our market timing. One of the sayings we have around here is, it's okay to have an opinion. It's just not okay to act as if it's correct.

Anna

So before we end today, do you have any final thoughts?

Howard

Merely to say that at Oaktree and for cautious investors, the period under discussion in *Sea Change*, '09 through '21, was a difficult period. Risk-taking was rewarded. Borrowing was subsidized. Lending, which is what we are, was penalized. Bargain hunting was difficult because you get the big bargains when other people are depressed, panicking, and they want out. So from 2012 through 2020, credit investors were investing in a low return world. The yields were unattractive and the process was dreary.

We're very excited about this new world. Now we're in a, I describe it as a full return world. People talk about whether we're going to have higher for longer. We don't have high rates today. We have normal rates today. They may go higher, they may not, who knows? But the point is, we're not in a low return world anymore and we're very excited about the potential returns that can be earned from credit.

Anna

Well, I think that's an excellent point to end on. Thank you both so much for joining me.

Howard

Thanks as always, Anna.

Armen

Thanks, Anna.