

# OAKTREE INSIGHTS

MARCH 2017

## SPECIAL EDITION: THE POWER OF CREDIT



OAKTREE



# THE POWER OF CREDIT

## FOREWORD

Oaktree recently hosted a panel discussion with a group of investment professionals to discuss the state of the credit markets and the key risks facing their investment strategies. Max Wong, Head of Marketing for Oaktree in the Asia Pacific region, moderated the discussion and was joined by Sheldon Stone (Principal and Portfolio Manager, U.S. and Global High Yield Bonds), Edgar Lee (Portfolio Manager, Strategic Credit), Keith Gollenberg (Managing Director, Real Estate) and James Turner (Portfolio Manager, European High Yield Bonds and Co-Portfolio Manager, Global High Yield Bonds and European Senior Loans). What follows is an edited transcript of the conversation.

**Max Wong:** In a previous Oaktree *Insights* publication, “Navigating Cycles,” we discussed the cycles that impact various asset classes. Where are we in the credit cycle for your investment strategies?

**Edgar Lee, Portfolio Manager, Strategic Credit:** In early 2016, the level of new issue activity in the capital markets was depressed; however, after the first few months of the year new issue activity and, more importantly, demand for new issues, were incredibly robust. To give you a sense of how much exuberance there is in the high yield bond market, today we see deals that are five to six times oversubscribed. For example, a \$500 million bond issuance today could see demand on the order of \$2.5 billion to \$3 billion dollars.

**Sheldon Stone, Principal and Portfolio Manager, U.S. and Global High Yield Bonds:** Similar to what Edgar points out, we see an almost insatiable appetite for yield, largely due to how low the risk-free rate and the yield on Treasuries are. Investors’ strong desire to buy instruments that earn five or six percent seems extraordinary relative to the past. These dynamics are signs of aggressiveness – one of the hallmarks of the later stages of a credit cycle.

**James Turner, Portfolio Manager, European High Yield Bonds and Co-Portfolio Manager, Global High Yield Bonds and European Senior Loans:** Europe generally continues to lag the U.S. in terms of economic growth, with annual GDP growth for the twelve months through 3Q2016 of 1.8%, as compared to 3.5% in the U.S. In addition, uncertainty in Europe related to Brexit makes it all the more difficult to gauge how the UK’s economy, and Europe more broadly, will perform over time. That said, I think the European credit market, including that for high yield bonds and CLOs, typically follows U.S. market trends, and thus, despite more anemic economic growth in Europe, I believe we’ll see similar demand dynamics for European credit in the near term.

**Max Wong:** Are there any key trends you’re seeing within your investment areas?

**Edgar Lee:** One of the most significant elements impacting the debt capital markets is the introduction of new regulations, including those related to Leveraged Lending. A knock-on effect of these regulations is a significant influx of capital into private lending funds, where capital providers are actually willing to provide greater leverage, leading to overall higher leverage levels in the financial system. These trends have resulted in the transfer of risk from bank institutions and public investors to private lenders.

**Sheldon Stone:** We’ve seen the regulations Edgar mentions contribute to more moderate leverage in the public credit markets, as well as to significant reductions in mega-leveraged buyouts, which historically have been more aggressively structured.

**Keith Gollenberg, Managing Director, Real Estate:** Another trend we’ve started to see is the proliferation of what’s referred to as a “preferred equity solution.” Preferred equity happens to be outside the scope of many of these new regulations. As a result, companies that issue a preferred equity instrument along with more traditional debt instruments (which *are* subject to the regulations), are effectively able to increase their overall leverage profile. This solution lessens the impact of the regulations, and it’s particularly useful for private equity buyers, as it enhances potential returns (along with risk, of course) thanks to the additional leverage.

**Max Wong:** What is the number-one risk impacting the market or your strategies in particular?

**Keith Gollenberg:** We are living through an unprecedented worldwide experiment in quantitative easing, and so with rates as low as they are globally, investors continue to seek value in the real estate markets. One

of our chief concerns is the impact that foreign capital is having on the price of real estate assets. We've seen increasing demand from international investors, with the influx of foreign capital into the U.S. market resulting in significant upward pressure on hard asset values.

**Sheldon Stone:** I am less concerned with economic growth, geopolitical risk, or the regime change in Washington. Additionally, I believe the market has priced in the effect of the tremendous shock that has occurred in the commodity space. The risk that matters most from my perspective is that of a company's inability to generate enough cash flow to service its debt. Currently, however, we do not believe there are many companies facing the fundamental risk of default.

**James Turner:** I agree with Sheldon, but I do believe geopolitical risk has the greatest potential to unsettle the market, and it happens to be very difficult to price in. The threat of terrorist attacks will continue to be relevant, and there may be a time when the market gets panicked, but recently, it has not been a catalyst for significant volatility. In fact, I feel the markets have become inured to it.

**Max Wong:** How are these risks impacting your investment decisions?

**Sheldon Stone:** I think Howard [Marks] summed it up best when he said, "Move forward, but with caution." That became the mantra that we've been operating under for the past five years. This isn't the time to grab risk for risk's sake, and I would say that risk is generally something that's not desirable; return is desirable. Sometimes risk bearing is a wise way to pursue return, but not now.

**Max Wong:** How are you managing the aforementioned risks?

**Sheldon Stone:** Oaktree is focused on fundamental credit research and practicing prudent diversification. In credit, you rarely benefit from making concentrated investments or taking outsized risks. As a result, we seek to maintain a large sampling of bonds from issuers that have strong fundamentals. We assess those fundamentals through a detailed proprietary credit analysis that includes extensive downside sensitivity modeling.

**Keith Gollenberg:** Sheldon's comments apply equally to evaluating private lending and public securities in the real estate space. Additionally, in real estate, there's

clearly no actual ability to move an asset from one jurisdiction to another, so a fundamental understanding of exactly what rights and remedies exist in a particular jurisdiction is critical. We are also extremely focused on the covenants that exist within a debt instrument.

**Max Wong:** Given current trends and risks present in the market, where are you seeing opportunities?

**Sheldon Stone:** In high yield bonds, we focus on two areas: the secondary market and the new issue market. We usually find the best value in the secondary market when there is forced selling—or, said another way, when capital is exiting the asset class. This has not been the case recently, so we are finding better value in new issues.

**James Turner:** I agree with Sheldon. However, we have found some attractive secondary market opportunities in Europe, particularly with fallen angels (downgraded former investment grade names). Another, more unique, opportunity we see is the purchase of euro-denominated debt of U.S. companies. Often these U.S. issuers are less well known in Europe and, as a result, they may offer wider spreads compared to a U.S. dollar-denominated bond that sits in the same place in the capital structure. Thus, we're able to achieve a slightly better return for effectively the same credit risk.

**Edgar Lee:** Outside of more idiosyncratic risks (sector or company-specific risks, for example), we have been looking at senior loans which trade at a discount to par, and CLO debt. Senior loans tend to be more senior in the capital structure and usually provide floating-rate exposure. If credit markets remain strong and economic growth picks up, there likely will be some benefit from convexity, given the discount. Additionally, with interest rates rising in the U.S., floating-rate instruments should provide upside. CLO debt, particularly triple-B rated tranches, is another area we have focused on recently, though the opportunities are less attractive than they were in early 2016.

**Keith Gollenberg:** We are seeing more and more opportunities to invest in bespoke, private lending structures. About half, or \$1.3 trillion, of all U.S. commercial real estate loans are maturing in the next four years. Many of these loans cannot be refinanced at par by traditional lenders such as banks, insurance companies or CMBS lenders. As a result, financing alternatives from private lenders like Oaktree are becoming more and more prevalent.

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*"We are living through an unprecedented worldwide experiment in quantitative easing..."*

*– Keith Gollenberg, Managing Director,  
Real Estate*

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## BIOGRAPHIES



### SHELDON STONE

*Principal and Portfolio Manager, U.S. and Global High Yield Bonds*

Mr. Stone is the head of Oaktree's high yield bond area. In this capacity, he serves as co-portfolio manager of Oaktree's U.S. High Yield Bond and Global High Yield Bond strategies and has supervisory responsibility for European High Yield Bonds. Mr. Stone, a co-founding member of Oaktree in 1995, established TCW's High Yield Bond department with Howard Marks in 1985 and ran the department for ten years. Prior to joining TCW, Mr. Stone worked with Mr. Marks at Citibank for two years where he performed credit analysis and managed high yield bond portfolios. From 1978 to 1983, Mr. Stone worked at The Prudential Insurance Company where he was a director of corporate finance, managing a fixed income portfolio exceeding \$1 billion. Mr. Stone holds a B.A. degree from Bowdoin College and an M.B.A. in accounting and finance from Columbia University. Mr. Stone serves as a Trustee of Colonial Williamsburg Foundation and Bowdoin College.



### EDGAR LEE

*Portfolio Manager, Strategic Credit*

Mr. Lee serves as the portfolio manager for Oaktree's Strategic Credit strategy. Mr. Lee was also an investment professional within the Distressed Debt group and has led a number of the group's investments in the media, technology and telecom industries. Prior to joining Oaktree in 2007, Mr. Lee worked within the Investment Banking division at UBS Investment Bank in Los Angeles, where he was responsible for advising clients on a number of debt and preferred stock restructurings, leveraged financings, buy-side and sell-side M&A, mezzanine financings and recapitalizations. Before that, he was employed within the Fixed Income division at Lehman Brothers Inc. Prior experience includes work at Katzenbach Partners LLP and the Urban Institute. Mr. Lee received a B.A. degree in economics from Swarthmore College and an M.P.P. with a concentration in applied economics from Harvard University. Previously, Mr. Lee served on the boards of Nine Entertainment and Charter Communications.



### KEITH GOLLENBERG

*Managing Director, Real Estate*

Mr. Gollenberg joined Oaktree in 2008 as a senior member of the real estate team and focuses on the investment and management of its real estate funds. Mr. Gollenberg has extensive experience in the commercial real estate debt and equity markets, having originated, purchased or issued billions in B Notes, Mezzanine, Preferred Equity, Equity, CMBS, CDO, REIT, and other debt and equity investments. Prior to joining Oaktree, Mr. Gollenberg led the creation of and spent three years at CBRE Realty Finance, Inc., where he most recently served as Chief Executive Officer and President. Before that, Mr. Gollenberg spent over 21 years at CIGNA Investment Management, where he most recently served as senior managing director of Capital Markets, responsible for investing in and issuing all types of real estate debt products. Mr. Gollenberg received a B.S. degree in business administration with a concentration in accounting and economics *cum laude* from the University of Hartford. He is a CFA charterholder and served as Chairman of the Commercial Real Estate Finance Council.

## BIOGRAPHIES (CONTINUED)



### JAMES TURNER

*Portfolio Manager, European High Yield Bonds and Co-Portfolio Manager, Global High Yield Bonds and European Senior Loans*

Mr. Turner joined Oaktree in 2001 and serves as portfolio manager for the European High Yield Bond strategy, co-portfolio manager for the Global High Yield Bond and European Senior Loan strategies and assistant portfolio manager for the European CLO strategy. Over the years he has covered a wide range of sectors and invested through a number of financial cycles. Previously, he was employed by Schroder Salomon Smith Barney as an associate in both the Mergers & Acquisitions and Financial Sponsors divisions, working on a number of high profile public transactions. He qualified as a Chartered Accountant with Deloitte & Touche and is an honours graduate of the University of Nottingham, England.



### MAX WONG

*Managing Director, Marketing & Client Relations*

Mr. Wong joined Oaktree in 2014 from Franklin Templeton where he served as head of Institutional Business where he was responsible for managing business development, client servicing, consultant relationships and marketing for the Greater China region. Prior thereto, he served as a client relationship manager for Alliance-Bernstein and began his career at PCCW where he most recently served as a product marketing manager. Mr. Wong earned a B.Eng. degree (first-class honors) in electronic engineering from The Chinese University of Hong Kong. He is a Certified Financial Analyst and a Chartered Alternative Investment Analyst. Mr. Wong is fluent in Cantonese and Mandarin.

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### **High Yield Bonds**

*Securities in the lower rated categories and comparable non-rated securities are subject to greater risk of loss of principal and interest than higher rated and comparable non-rated securities and are generally considered to be predominantly speculative with respect to the issuer's capacity to pay interest and repay principal. They are also generally considered to be subject to greater risk than securities with higher ratings or comparable non-rated securities in the case of deterioration of general economic conditions. Because investors generally perceive that there are greater risks associated with the lower rated and comparable non-rated securities, the yields and prices of such securities may be more volatile than those for higher rated and comparable non-rated securities. The market for lower rated and comparable non-rated securities is thinner, often less liquid, and less active than that for higher rated or comparable non-rated securities, which can adversely affect the prices at which these securities can be sold and may even make it impractical to sell such securities.*

### **Bank Loans and Participations**

*Bank loans and participations involve the risk of invalidation as a fraudulent conveyance, lender liability claims, environmental liabilities with respect to collateral and limitations on the holder's ability to directly enforce its rights with respect to participations.*

### **Nature of Bankruptcy Proceedings**

*Investing in companies involved in bankruptcy proceedings presents significant risks, foremost of which are the lack of control over certain events, the bankruptcy filing itself may have an adverse impact on the company, the duration of the proceedings are difficult to predict and may be further impacted by delays, the costs inherent in the process are frequently high, creditors can lose their priority and ranking in a variety of circumstances and representation on a creditors committee may subject the creditor to various trading and confidentiality restrictions.*

### **Foreign Investments**

*Investments in securities or obligations of foreign entities involve certain special risks, including social, political or economic instability; the possibility of unfavorable foreign governmental actions; price fluctuations and market volatility; differences in auditing and financial reporting; adverse taxes; and different laws and customs. These factors may increase the likelihood of potential losses being incurred in connection with such investments. Further, because such investments in foreign entities are likely to be denominated in multiple currencies, the fluctuation in currency exchange rates may have an adverse impact on performance.*

### **Convertible Securities**

*Many convertible securities are not rated investment grade. Securities in the lower-rated and non-rated categories are subject to greater risk of loss of principal and interest than higher-rated securities and are generally considered to be predominantly speculative with respect to the*



issuer's capacity to pay interest and repay principal. They are also generally considered to be subject to greater risk than securities with higher ratings in the case of deterioration of general economic conditions. Because investors generally perceive that there are greater risks associated with lower-rated and non-rated securities, the yields and prices of such securities may be more volatile than those for higher-rated securities. The market for lower-rated and non-rated securities is thinner, often less liquid, and less active than that for higher-rated securities, which can adversely affect the prices at which these securities can be sold and may even make it impractical to sell such securities. The limited liquidity of the market may also adversely affect the ability to arrive at a fair value for certain lower-rated and non-rated securities at certain times and could make it difficult to sell certain securities.

### **Stressed Credits**

Any deterioration of underlying market fundamentals could negatively impact the performance of investments in stressed companies. Changes in general economic conditions, tax rates, operating expenses, interest rates and the availability of debt financing may also adversely affect the performance of such investments. For these or other reasons, investments in stressed companies may become "non-performing" after their acquisition, and during an economic downturn or recession, stressed investments are more likely to go into default than securities of other issuers not experiencing financial stress. Securities of stressed companies are also often less liquid and more volatile than securities of companies not experiencing financial difficulties, often involving a higher degree of credit and market risk.

### **Real Estate Investments**

The value of real estate-related securities can fluctuate for various reasons. Real estate values can be seriously affected by interest rate fluctuations, bank liquidity, the availability of financing, and by regulatory or governmentally imposed factors such as a zoning change, an increase in property taxes, the imposition of height or density limitations, the requirement that buildings be accessible to disabled persons, the requirement for environmental impact studies, the potential costs of remediation of environmental contamination or damage and the imposition of special fines to reduce traffic congestion or to provide for housing. Income from income-producing real estate may be adversely affected by general economic conditions, local conditions such as oversupply or reduction in demand for space in the area, competition from other available properties, and the owner provision of adequate maintenance and coverage by adequate insurance. Furthermore, certain investments in mortgages, real estate or non-publicly traded securities and private debt instruments have a limited number of potential purchasers and sellers. This factor may have the effect of limiting the availability of these investments for purchase and may also limit the ability to sell such investments at their fair market value in response to changes in the economy or the financial markets.

### **Illiquid Investments**

Certain strategies will involve the use of illiquid securities or securities which are restricted as to their transferability. Such restrictions may limit the ability to sell such securities at their fair market value.

### **Leverage**

Certain strategies may engage in activities that involve the use of leverage. While leverage presents opportunities for increasing the strategy's total return, it may increase losses as well. Accordingly, any event that adversely affects the value of an investment would be magnified to the extent leverage is used.

Investments in companies whose capital structures have significant leverage are inherently more sensitive than others to declines in revenues and to increases in expenses and interest rates, posing a greater possibility of bankruptcy or default.

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