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EP 174 | Opportunities and Watchpoints: A Deep Dive into Global Credit

[00:00:00] Kevin Minas: On this episode of The Art of Boring, I sit down with Brian Carney, lead portfolio manager of the Mawer global credit opportunities strategy. We start with a review of the positive performance we've seen in the credit markets this year, what drove that performance, as well as share some thoughts on the impact the recent U.S. election may have on the global credit markets. Next, we provided an update on the corporate new issues market, talked about fallen angels, and the blurring of lines between lower-rated public credit and private credit. And we finished up with a recap of our current portfolio positioning in the global credit strategy and highlighted a few of the positions we like, including several North American banks and Ford Credit Canada.

[00:00:43] Disclaimer: This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.

[00:01:01] Kevin Minas: Welcome back to the show, Brian.

[00:01:03] Brian Carney: It's wonderful to be here, Kevin. Thanks for having me.

[00:01:05] Kevin Minas: I think this is the third time so far this year. I think you and Crista, you're probably up there as the most visits on the show, so back by popular demand, I think.

[00:01:12] Brian Carney: Outstanding. Good to know.

[00:01:14] Kevin Minas: Why don't we start with a little update on the state of the credit markets, strong performance in the quarter, if you could talk a little bit about what happened with spreads. Also, if you could give us a sense of the, I guess, general risk tone in the market. Things have gone well, but I guess, how are we sort of thinking through where we stand at this point in the cycle?

[00:01:32] Brian Carney: I'll say it's been smooth sailing for credit investors this year. So spreads—that's the incremental yield you earn for lending to a company instead of the U.S. government or another sovereign—those spreads have been grinding tighter this year. As risk premiums compress, prices go up. I would say there's also been additional wind in the sails of credit investors from benchmark yields, which are much higher than they were a few years ago. Think of a U.S. 10-year yielding over 4% today. Not too long ago, that was just 1%. Spreads have been compressing, benchmark yields are higher, it's been pretty good for credit this year. Naturally skeptical—credit people—I always worry, and we worry here, our credit investor is going to sail off a cliff. If you think historically for lending to higher-quality companies, you typically earned about an extra 1.5%, and today investors are earning less than 1%. For lower-quality companies, historically, you got about an extra 5.5%, and today that number is less than 3%. Overall, those risk premiums are pretty skinny.

What are the compelling opportunities or what is the compelling opportunity today? We believe it's to protect capital. And what should investors absolutely not do? That's reach for yield. Reaching for yield could either be going down into the lower credit quality spectrum by buying high-yield bonds or extending out the yield curve into longer dated credit. We do not believe investors are being compensated for taking those risks, so protecting

capital allows an investor to earn a reasonable return and sets up the opportunity to take advantage of the next market dislocation, whenever that may come and whatever may be driving that.

I'm going to preempt a question that may be on your mind. Has the U.S. election changed anything? We would say, if anything, as a lender, we are more concerned post-election then we were going into it. We've got an expectation of higher tariffs, lower corporate taxes, deregulation. All of these things have given a further boost to the U.S. corporate sector in particular, and spreads are now tighter than they were before the November 5 election. A reminder: Two-thirds of the global credit market is denominated in U.S. dollars, and over half of the issuers at the global credit markets are domiciled in the U.S. There is a lot riding on the U.S., so if you think about higher tariffs, lower taxes, reduced regulation, in theory that should all be good for U.S.-based companies, and so all is good and kind of anything goes if you are inside the walls of the fort. But if I had to guess, the majority of higher revenues, net income cash flows, if and when they transpire, are likely going to accrue to the benefit of shareholders over lenders, so you think M&A activity, share buybacks, special dividends. It's not going to be cool to deleverage in Donald Trump's America. We're not expecting a lot of that. In this environment, post-election come January, we think protecting capital is going to be more important than ever. Then finally I would say, quality companies should be setting policy with more than just a one- or two-year horizon, and management team should both plan and expect to outlast any one administration and regulatory regime. We will be vigilant, and I know our equity colleagues are being vigilant as well, to watch for companies that dramatically change either their operational approach or their financial policies based on what may prove to be short-term, extreme changes in government policy.

[00:05:13] Kevin Minas: You covered one of the big events in the quarter—certainly start of this quarter—but nonetheless, big market-moving event in the election. Let's talk about a few other trends or themes in the market in the past quarter. If we could do a little bit of an update on the new issuance and was that substantial, did that move markets? There's a lot more talk, it seems, of fallen angels. As we kind of get late cycle, some of these companies that may be getting into a little bit of trouble, potentially moving out of investment-grade into high-yield, any other themes that you thought are worth highlighting in the quarter?

[00:05:41] Brian Carney: I'd say there are a whole host of things going on in the credit markets. We are monitoring both to identify individual investment opportunities, things we can buy in the strategy, or just as a gauge of overall risk—risks in the marketplace and overall risk-taking appetite. Specifically, you touched on new issues. It has been an extremely busy year in the new issue markets across the globe and across all credit markets, investment grade, high yield, leverage loads. You're seeing record amounts of issuance. A lot of that has been prefunding debt maturities. A lot of that was done in advance of the election, but a lot of companies have been prefunding debt maturities well into 2025. Substantial new issue calendars—we expect that probably to continue.

Fallen angels you touched on. Those are issuers who are on the cusp of moving from investment grade to high yield. There can be significant dislocation when that happens. One of the names we've been following very closely is Boeing, which if it is downgraded to high yield would instantly be the biggest high yield issuer in the high yield market, so something we're watching closely and we know other market participants are as well. I would say we've also seen what I would call the convergence of lower-quality credit markets: bank credit, high yield, leverage, loan, private credit. All of these markets are competing for transactions from lower-quality pour-overs, and I would say amongst all of those, private credit continues to be the shiny new toy for many fixed income investors. It's very intriguing. It's not very transparent. There's lots of big companies involved with big names. For us, as we look at private credit, we kind of think, well, that's kind of high yield with no mark to market, but that's not very cool to say. Suffice to say, we're watching that market, and that convergence is probably likely

to continue.

There's something called strategic risk transfers, which we've seen pick up in 2024. That's basically commercial banks seeking to free up capital by selling first loss pieces to insurance and private credit funds. This is a growing market. It's primarily been a European phenomenon, but with changes in regulation in North America, North American banks are getting in on it. It's interesting because risk is moving from a regulated market to an unregulated market, so something that people need to monitor very carefully.

Commercial real estate: There was a podcast done not too long ago by my colleague, Curtis Elkington, where we looked at risks in the commercial real estate market. There's a lot of loans outstanding, return to work, vacancy rates, higher cap rates, all having an impact on market values, impacting office different than retail and different than industrial. We currently don't have any exposure to commercial real estate in the global credit strategy, but indirectly through banks and insurance company holdings, we do, so that's a market we want to monitor very carefully.

Then just generally in high yield, defaults are well below historic averages. We're wondering if at some point that may change. There's a number of pending restructurings in Canada: Corus Entertainment might be interesting, DISH Network in the U.S., Thames Water over in the UK. We don't find any of the valuations compelling versus our estimation of recovery in those situations, but interesting situations, nonetheless. And then, it is actually possible to go bankrupt in spite of frothy credit markets, and we had Spirit Airlines announce they were bankrupt and filing Chapter 11 in just the last couple of days. All of that to say, we think it's very important to look across credit markets for opportunities and for warning signs. Along with our equity colleagues, we are monitoring a large swath of the investable universe across all of these various products and asset classes.

[00:09:39] Kevin Minas: Given those comments around valuations being relatively elevated across credit generally, it sounds like a lot of themes there are a bit late cycle: building risks, people extending, reaching for yield, that blurring between public and private credit. The obvious question then for investors would be: Why should they be thinking long term about an allocation to absolute return credit? It sounds like you're painting a bit of a bearish picture. How would you kind of square that?

[00:10:04] Brian Carney: I'm normally so optimistic, Kevin, I'm surprised that you said that. Let's go back and think: What are the challenges for fixed income investors? Investors don't expect to lose money in fixed income. For decades, they didn't lose money in fixed income because yields were falling from very high levels going back decades. That was a nasty surprise in 2021 and '22 when yields started to go up. Investors lost money. How could this possibly be? Suffice to say, not all fixed income is created equal. We believe an actively managed corporate credit strategy should be viewed as a source of diversification, a provider of income and—I think this is the most important part about it—an unconstrained strategy in volatile markets, a potential capital appreciation generator and in expensive markets, a vehicle for capital preservation. I think an actively managed credit strategy provides an investor an alternative to passive—or what I would call near passive—fixed income, which really let everybody down in 2021 and '22, and those years proved that those strategies often don't protect an investor from either adverse credit or adverse interest rate moves. And also, and very importantly, those vehicles are not designed to take advantage of the periodic—what I'll call market upsets that provide substantial capital appreciation potential. So, all fixed income products come with risk, and I would say that many that are marketed as safe products may well be taking substantially more risk than an actively managed credit strategy.

I think investors really need to understand what risks am I taking and ask those questions. What credit risk am I taking? How is it being managed? What duration risk am I taking? How is that being managed? And are those the risks that I want to take? Further to that, I would say the more markets move to passive, the more opportunity will

be created when the forced buyers—so, as money flows into passive—those vehicles have to invest that money. When money flows out, those vehicles become forced sellers. The more markets move to passive or into private, less liquid vehicles, I believe, the more extreme the distortions that inevitably occur will be and the greater the opportunity will be for an active, unconstrained credit manager. So, the more global credit opportunity strategy is managed with an absolute return focus, and we believe it's suitable for both institutional and individual investors with a long-term investment horizon. I will say if you're putting a down payment on a house in three months, this is not the strategy for you, but it could very well comprise anything from the entirety of a fixed income holding to a specialty sleeve within, or a complement to, a broader fixed income allocation.

[00:13:01] Kevin Minas: Just to tie back to the fallen angels comment, and then it's interesting you were mentioning around passive and being a forced seller or forced buyer. That would probably be a good example of where tracking something like fallen angels is relevant because, to your point, those passive index funds, if you get something that's downgraded from investment grade to high yield, they have to sell because they have to follow the index and the index doesn't hold that security anymore. Conversely, if something's being upgraded to investment grade, they have to be a buyer of that given it's now in the index, so, an interesting connection there. That's a good explanation for why credit, generally speaking, it's just sort of where within credit you want to be over the course of the cycle, depending on market circumstances. It sounds like what you're saying is there's a cyclicality to the credit markets. You should be opportunistic when there's opportunity, when spreads have basically blown out, and you should be a little more defensive when spreads have come in. The next question would be naturally, why should investors not wait for when those spreads blow out to actually allocate to a strategy like this? Why would this be something that you should be in over the long term as a strategic allocation?

[00:14:01] Brian Carney: I think you're right. Investors may be tempted to say this strategy sounds opportunistic. And why not? Because you guys did name the strategy global credit opportunities. You put it right in the name. So, if it is, I as an investor should just be opportunistic moving in and out of the strategy to coincide with those major market moves, global financial crisis, the pandemic, etc. So, a few points to be made here. First is shorter market dislocations. If you go back to the pandemic, our most recent significant dislocation, the window to buy really cheap securities during the pandemic was measured in days, not months. If you weren't buying in the middle of March 2020, you missed the best opportunities. First point: An investor needs to move quickly.

The second one—and this is a little bit more psychology—although I'm not a psychologist: In a market panic, I would say even the coolest of customers panics. Kevin, maybe you didn't panic, but you may be the exception. Most people won't pick up the phone to move money into this type of strategy—global credit strategy—when they think the world is ending. That's just natural human behavior. If I'm nervous, I'm unlikely to do something. Now, if you are calm and sage enough to move money in the middle of March 2020, unless you had cash in your mattress, you were likely to be moving money out of a strategy that itself had already corrected. You've missed the opportunity because what you had is down significantly. You're just trading that to buy something else that is down significantly. This strategy is absolute return-focused, and we hope to generate positive returns in all markets. We believe there is a low opportunity cost to being a long-term investor in the strategy and undoubtedly a much higher opportunity cost to trying to market time it.

[00:16:02] Kevin Minas: Why don't we shift gears a little bit and get back to the portfolio a little bit. You kind of painted the picture of what's been going on in the markets. How are we currently positioned, given this backdrop?

[00:16:11] Brian Carney: The portfolio characteristics within the global credit strategy are simply the sum total of a series of individual credit assessment determinations. We're not managing top down; we're very much managing bottom up, and so individual determinations—if we're doing our job correctly, executing our process—should

insulate the portfolio from risk in expensive markets like we're in today and then activate into opportunistic situations in those dislocating markets. So, we don't want to diversify away return potential, but we don't want to bet the farm either. Today, the cumulative result of those individual credit decisions results in a strategy with a duration just slightly longer than one year—so very short—and a very high-quality strategy with zero high yield. The last point I'll make on portfolio positioning—just to remind people: We've talked about that the majority of the credit markets are denominated in currencies outside of Canada, so we use three-month currency forwards to hedge any non-Canadian dollars back to Canadian dollars. We're not speculating on currency; we're using currency as a hedge. We know our investors are hiring us to manage credit risk, not currency risk.

[00:17:33] Kevin Minas: As you were mentioning, individual credit determinations: that produces the portfolio, not top down. Can you just flesh that out a little bit? How do you actually ensure sufficient diversification, given it is all bottom up? What are the guardrails or sort of ways that you kind of build that resilient portfolio? Even if you're comfortable with individual credits, how does that work at a total portfolio level?

[00:17:52] Brian Carney: Our expectation is over time, the strategy would have somewhere between 20 and 30 names and we've got a maximum issuer cap of 10%. At the moment, the largest holding within the strategy is approximately 7.5%. It's a multistep process with two very important outputs. First is a Mawer credit rating, so an individual independent credit assessment, which ties into probability of default, which ties into valuation. Then the second is margin of safety. What happens to that security to the capital structure in a worst-case situation? You can see a scenario where if we think something is worth 75 cents on the dollar in the worst-case scenario, and it's trading at 50 cents on the dollar, it probably wouldn't surprise you that we might have a significant weight in that security. If the flip side is true—we think something's worth 50 cents and it's trading at 75 cents—it would have a significantly smaller weight in the portfolio. Those two key outputs drive our valuation discussion and our portfolio waiting discussion. But suffice to say, the portfolio (20 to 30 securities) can be fairly concentrated, but keep in mind, we also talk often about the difference between being a lender and an equity holder. If we're managing our downside risk properly and assessing the downside risk properly, it would make sense that we're taking more significantly sized positions than our equity colleagues might.

[00:19:21] Kevin Minas: If you can just highlight a few credits that you're particularly excited about or have the material weights and just some trades that you guys have put on over the last few quarters.

[00:19:29] Brian Carney: As spreads continue to tighten in the last quarter in the global credit strategy generally, we have been reducing holdings in what I would call BBB industrials. The lower tier of investment grade—so the lower tier of good quality companies, industrials—they're trading pretty tight. Not that we think there's anything wrong with some of these companies, but we've been eliminating and reducing those holdings. As I mentioned, we've eliminated all the high yield holdings in the portfolio. We don't think you're being compensated for holding high yield. Again, the specific companies we thought were fine, but we think at some point we'll probably have an opportunity to buy them at cheaper levels, and the proceeds from those sales, we've invested generally in much higher-quality holdings, so AA and A-type corporates. Specifically, the largest holdings in the strategy are in short-dated bonds issued by major North American banks—think Bank of America, J.P. Morgan, Royal Bank. We spent a lot of time talking about these institutions with our equity colleagues, but keeping in mind, we might have more significant weights than they do because our primary concern is return of principal and interest, not share price appreciation, and we're sitting much higher in the capital structure than our equity colleagues. I will also say for those who haven't seen it, our equity colleagues did an amazing podcast just a few days ago, covering a range of banks around the globe. Suffice to say, this institution, Mawer, knows a lot about a lot of banks. If you haven't seen that episode, I would encourage you to go out and have a look.

Then the last thing: short-dated Ford Credit Canada paper. We've owned this almost since the inception of the strategy. Ford Credit Canada guaranteed by Ford Credit U.S., which in turn has a support agreement from Ford Motor. We like Ford. They've got lots of liquidity. They've got over $25 billion in cash. We'd like to support agreement between the credit companies and the parent, and spreads in Canada are about 180 basis points, which, relative to what I talked about at the beginning, the average high-quality spread is less than 100. We're getting 180 basis points for short-dated Ford paper. We think that's one of the most attractive corporate bonds out there.

Maybe the last thing I would say is, I think the further we get away from the last crisis—and hard to believe we're coming to the end of 2024—the greater the tendency for markets to become complacent, that temptation to reach for yield down the credit spectrum or out the curve. We are very comfortable with the positioning of the strategy, and we're really excited about the prospects for the strategy and the credit markets in the coming months, years, and decades. I can't wait to get back on this podcast in six months or whenever you'll have me back and talk about all the good stuff we're doing.

[00:22:19] Kevin Minas: Awesome. Looking forward to it, Brian. Thank you very much, and appreciate the updates. We'll talk to you soon.

[00:22:25] Brian Carney: Great. Thanks, Kevin.

[00:22:27] Kevin Minas: Hey, everyone. Kevin here again. To subscribe to the Art of Boring podcast, go to mawer.com. That's M A W E R dot com forward slash podcast, or wherever you download your podcasts. If you enjoyed this episode, leave a review on iTunes, which will help more people discover the “be boring, make money” philosophy. Thanks for listening.

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