



Jon Dorfman and Don Leitch

## It pays to be quick off the mark with credit strategies

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INVESTOR STRATEGY NEWS

Credit managers have come into their own since the global financial crisis. First it was the search for yield as interest rates headed towards zero around the world. Now it is more about diversification, protection – particularly against another correction in equity markets – and opportunities to produce alpha.

One prominent credit manager based in New York, which has recently increased its presence in Australia and New Zealand, has introduced a “contingency” strategy for clients to allow it to take advantage more quickly of opportunities as they arise, such as during the 10 per cent equity sell-off in most markets in March and early April this year.

Napier Park Global Capital, a US\$14 billion (A\$19.2 billion) manager which was formed in 2013 from a spinout of the credit business of Citi in the US, was able to buy some securities in April, for instance, at 40-45c in the dollar which subsequently recovered to around the 90c mark, helped by the quick access to cash from the contingency strategy.

The strategy was introduced, well before COVID-19 struck, in 2018 when the firm was getting concerned about the credit cycle. According to Jon Dorfman, co-founder of the firm alongside long-time colleague Jim O'Brien, up until then as much as 90-95 per cent of performance was dependent on the direction of GDP. “We’ve immunised against that,” he said in an interview from New York last week (September 16), together with another long-time colleague and partner Don Leitch, who co-heads global marketing and client service.

The three have been working together in the asset class for more than 25 years, first at Morgan Stanley, when in their 20s, and then Citi. Jon and Don, while at Morgan Stanley in New York, were both sent to then-swinging Tokyo when they were 25. Jon and Jim work so closely that they have shared an office for much of the last 25 years (and still do) while co-heading credit trading at Morgan Stanley and leading the Napier Park business.

The contingency represents a contractual commitment by a client to provide further funding when required, in much the same way as private equity managers operate. However, unlike many private equity managers, Napier Park doesn't charge any fees on that money until it is called on for investment. This allows clients to stay fully invested at all times, which is particularly important when cash rates are so low or even negative.

While Leitch has visited Australia and travelled throughout Asia on many occasions, the firm has recently appointed a Sydney-based third-party representative, Principle Advisory Services. Napier Park has several small clients in Australia and Leitch says has had some meaningful conversations with regional asset consultants. The \$14 billion is split between three main strategies: traditional credit, of about \$5.5 billion which is mostly invested on a multi-strategy basis; CLO business, with the firm managing about \$6.5 billion in CLOs on behalf of other investors in the US; and, private investment, including leasing and real estate and consumer lending, about \$2.2 billion.

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When they transitioned the business from Citi it had a predominantly wholesale and retail client base. The new owners, who were part-owned by Citi for a year or so, have changed this to be now about 90 per cent institutional and more international in their focus. About \$1.5 billion is overseen for clients from a substantial London office. There are more than 100 staff in the two locations.

Dorfman says that compared with equities since March, Europe had recovered in a similar fashion but the US credit market, both for investment grade and high-yield securities, has underperformed the equities market, which, until this month at least, has been driven by the big tech stocks. With interest rates at, or near, negative and other initiatives from the Fed and the US Administration, there is "an enormous stimulus", Dorfman says. "The Fed is intentionally putting money in people's pockets by assisting with mortgages... But, in the end with negative interest rates credit as an asset class will perform well.

The Fed announced in March that, for the first time, it would invest directly into investment grade and high-yield securities, but its purchases have averaged only about \$500,000 a day. "They have only spent about 3 per cent of their budget," Dorfman says. "The \$500,000 a day is miniscule in a market worth around \$2 trillion. This market is being driven completely by non-government participants."

In terms of investment risks, he says there are a lot of potential issues on the horizon, including:

- The US election is an obvious risk. With the Government stimulus they failed to pass the 'Care Package' and need to be spending more, even if it is more targeted, which it probably will be
- The historic level of financing by companies over the past six months, which is money that will have to be paid back. If there is not a rise in growth, there could be a rise in defaults
- Valuations are too high and will revert at some stage, and
- Worldwide technology is a "real risk", Dorfman believes. During the 1998 Asian currency crisis a collapse in interest rates created a similar situation to what is happening now, with a huge upgrade in growth assets, especially tech companies.

The main business risk for Napier Park is for there to be a breakdown in liquidity, but Dorfman points out that the firm is highly diversified and the portfolios are actively managed. With private lending, for instance, you can manage the risk profile by adjusting duration. "We studiously avoid binary outcomes," he says. "We want there to be different scenarios."

One area which has taken off during the work-from-home trend is what's known as either the "fix and flip" or "renovation rehab" market in residential property.

Leitch says: "The property market is flipping upside down since COVID. Millennials (age 24-49) are now demanding more suburban properties, with yards, rather than apartments. The average house in the US is 40 years old and there is a substantial business in renovations. The loans are by and large of about a 12-month duration and we get an 8 per cent return from the developers. We want to buy short duration, high yielding assets with good collateral..."

"When you look at the credit market over the past 10-15 years the best times to be had by investors are when there is some form of dislocation. We spend a lot of time talking with clients about this and why contingent vehicles make a lot of sense. You need to be prepared to act when the opportunities present themselves."

Ken Licence, the managing director of Principle Advisory who oversees the on-the-ground marketing for Australasia, says opportunities for credit investors tend to be "very episodic". "When they occur, it can be challenging for some investors. That's why you need the ability to invest early in a downturn before the recovery has been priced into the market." Licence says that there is a lot of interest in credit being shown by Australian and New Zealand institutional investors.

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