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Lead Left Interview – Mark Gold (Part Two)

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This week we conclude our conversation with Mark Gold, chief executive officer/chief investment officer, Hillmark Capital Management LLC and its affiliate NewMark Capital LC. Hillmark is a NY-based investment management firm focusing on broadly syndicated loans through CLO vehicles. Second of two parts – View part one

The Lead Left: *Mark, we're seeing a rush by managers to issue ahead of risk retention rules. Is this temporary?*

Mark Gold: Yes, we believe this burst of activity is in response to risk retention.   We also believe this demand has driven up liability prices.

TLL: *And banks are certainly not encouraged to be holders of leveraged loans.*

MG: And yet the loan asset class can be a decent investment. CLOs will continue to be important as REITs are an important source of capital for the real estate market, and BDCs are important as an investor in the middle market loan sector. The historical performance of CLO's and the income that they produce should make them an attractive investment for the retail market.

TLL: *How do you get more retail investors to put cash into CLOs?*

MG: Some BDCs are buying CLO equity, so that's one path into the asset class for public investors. But it's a matter of tweaking structures to allow retail investors into CLOs, in the context of the 1940 Act.

TLL: *Could you explain that?*

MG: The '40' Act governs a number of aspects of investment funds, including the amount of leverage that they can have. REITS have a special exemption from the Act on leverage. BDCs as well, which are currently limited to 1:1 leverage. But CLOs are leveraged as much as 10:1 and have no exemption. Which means they need to be off-shore or structured more as operating companies in order to be listed domestically.

TLL: *Can mutual funds buy in the secondary market?*

MG: Yes, but they are not allowed to originate, only invest in CLO equity. Several funds like Oxford Lane and Tetragon which are off-shore vehicles can invest in CLO equity.

TLL: *What happens if the 5% risk retention for managers goes through as proposed?*

MG: It's a game changer. There is a big difference between a manager retaining 5% of the equity, versus 5% of the total structure. Let's say the CLO is $500 million. That's the difference between 5% of $50, or $2.5 million, and 5% of $500, or $25 million. And the way risk retention is currently proposed in the U.S. you can't get any meaningful distributions on your equity retained.

TLL: *How so?*

MG: The regulators don't want managers taking money from the bottom of the capital stack ahead of the other investors. It's the ultimate investors they're worried about.

TLL: *Will there be a CLO 3.0 structure?*

MG: Risk retention will cause the cost of capital to go up. This higher cost of doing business will eliminate the smaller players, but returns will also probably go up, so players who are left behind will benefit as well.

TLL: *At $300 billion of capacity, CLOs represent 56% of the market. If they go away, what replaces them?*

MG: We don't believe it goes away.

TLL: *What kind of structural changes will the next generation of CLOs need to have to adapt?*

MG: We believe creativity will be going into figuring out how to survive in a more regulated environment. We believe the next generation of CLO's will be more like operating companies with little wiggle room.

TLL: *It wouldn't be the first time that CLO managers had to think outside the box.*

MG: In the early days, the rating agencies only gave you ninety days to ramp up the CLO and satisfy all the metrics before issuing you a final rating. That was always challenging, but we did it.

TLL: *Any other examples?*

MG: Moody's used to rate a model portfolio with specific names. If you couldn't find that name you had to replace it with an equivalent identified name and show how it met all the required metrics. The parameters are much more general today.

TLL: *OK, last question, Mark. What's been your biggest surprise so far this year?*

MG: I guess that we're back to 2006-2007 in terms of leverage, use of procedures and other bad habits. I also believe there is a lot of smart money in place that has embraced this business for the long run.

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