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Why Portfolio Construction Matters (Last of a Series)

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“Broadly syndicated loans are liquid, so have high volatility that exaggerates credit deterioration,” one market observer told us recently. “The middle market,” he continued, “is illiquid, so has low volatility which can mask credit deterioration.”

How do PMs in these strategies manage through market volatility and maintain credit quality?

Large cap loan buyers act like deep-sea trawlers, catching fish, dragging big nets along the bottom of the ocean. Direct lenders use line-and-tackle, going after big game fish, but also trout and salmon in smaller waters.

While an increasing share of large loans are being structured as unitranches held by the biggest direct lenders, the majority are still underwritten by banks, then distributed to CLO shops and retail funds. Those buyers often arrange their portfolio management by sector, using PMs with long experience in specific industries.

Middle market teams tend to be generalists. Experienced direct lending PMs focus on underwriting the particulars of each borrower. Industry trends are important, but not paramount in that analysis.

Because broadly syndicated loans are larger, they receive public ratings from the agencies. And by virtue of that rating and their size, with term loans typically over $500 million, they can be actively traded. That liquidity gives PMs a key portfolio managing tool.

If negative sector trends begin to develop or unfavorable company-specific news emerges, BSL PMs can reduce or completely sell out of a position at a reasonable price to par, assuming a normal market. If the loan price dips below its perceived real value, the manager can buy back in.

Accounting rules for large cap CLOs allows PMs to “build par” in their portfolios by purchasing loans at a moderate discount, then valuing them at par. That differential is then booked as an equity gain. That equity gain can be offset against losses in the portfolio which allows for flexibility in managing borrower exposure.

Industry specialization is a virtue and a challenge. Leading CLO managers cover a broad spectrum of sectors from aerospace to waste management for public credit issuance across the US economy. But that includes cyclical businesses such as chemicals, energy, and commodities. Covid defaults were limited to retail, restaurants, and travel, but impacted many issuers in those arenas.

For BSL managers, trading helps minimize losses, but close attention to sector trends is critical. Direct lenders can’t trade their way out of problems, so picking all-weather credits at the start and maintaining disciplined credit management thereafter is essential. Over time both managers establish track records that demonstrate just how good at portfolio construction they really are.