



## XA's Perry Says Leverage In Rising-Rate World Is A Double-Edged Sword

Friday, February 24, 2023

Chuck Jaffe, in this episode of The NAVigator podcast interviewed Steven Perry, vice president at XA Investments, where he oversees product management on the XAI Octagon Floating Rate and Alternative Income Trust. Read the Q&A below as Steven discusses the benefits and risks associated with leverage in closed-end funds during a rising-rate environment, noting that for the closed-end fund market at the end of 2022, the levered market yield on net asset value was about 7.8 percent, compared to 6.4 percent on unlevered yield. Perry says it is important to watch how managers respond to what the Federal Reserve is doing, noting that managers who don't 'get



creative with how the leverage is going to be structured might miss out on opportunities.'

Steven Perry

The podcast can be found on AICA's website by clicking here: <https://aicalliance.org/alliance-content/pod-cast/>

**CHUCK JAFFE:** Steven Perry, vice president at XA Investments is here, we're talking about leverage now on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. And today we're looking in the

direction of Steven Perry, vice president at XA Investments, where he oversees product management on the XFLT, that's the XAI Octagon Floating Rate and Alternative Income Trust. If you want to learn more about Steven, the firm, and the fund go to [XAInvestments.com](http://XAInvestments.com). And if you want to learn more generally about business-development companies, interval funds, and closed-end funds, go to [AICAlliance.org](http://AICAlliance.org), the website for the Active Investment Company Alliance. Steven Perry, welcome to The NAVigator.

**STEVEN PERRY:** Chuck, good to be here, thanks for having me today.

**CHUCK JAFFE:** We're about to have a discussion on leverage, and the fact is it can go in a lot of different directions because leverage can go in a lot of different directions. There are different types of leverage and economic conditions and things like interest rates affect how much people want to use that leverage and how they use it. So give us a basic primer on the leverage picture and how it's all being affected by what's going on now in the headlines for the market.

**STEVEN PERRY:** Great question, I'll handle that in two parts. First part, what is leverage, what are the types of leverage? So leverage is in addition to the common equity of the fund, the common shares, and what happens is the manager will go out to the marketplace, will go to a bank, be it a credit facility in the form of debt or borrowings, or another common type is issuing preferred shares. Both of those come with different sets of rules and both are used very, very commonly in the non-listed space and the listed closed-end fund space. A third type of leverage that a lot of people talk about is portfolio leverage, but I probably won't hit on that as much here. Second part of that question, the environment that we're in right now as everyone is well aware, is a rising-rate environment. The Fed raised rates by 425 basis points in 2022, followed by another raise about three weeks ago, so that's a 450 point basis swing in the base rates of leverage if you have a floating-rate facility.

**CHUCK JAFFE:** For a lot of people, they hear leverage, they think risk. They think, I'm adding risk to the portfolio. Risk is about managing risks for the most part, so help folks understand what are the risks that they're facing when they're looking at the kinds of leverage you're talking about, and all those risks at all heightened by current market conditions?

**STEVEN PERRY:** There are risks in leverage. As leverage costs increase, the arbitrage and the benefit of leverage can decrease. It's important to understand the asset/liability mix of the asset class, of the leverage facility. Important to understand the duration, is it fixed, is it

floating? It is important to understand that leverage can sometimes also amplify losses, and there are also regulatory requirements on the amounts of leverage. And if a manager trips that requirement, sometimes they can be a forced seller at a time where asset levels and prices may be depressed, and that can crystalize losses for investors. So it is important to be a proactive manager of leverage and understand those risks and understand the suitability of your end shareholder and what they're hoping to gain from the use of leverage.

**CHUCK JAFFE:** So let's talk about that, help us quantify the benefit of using leverage. Okay, so if I'm looking at investing in something, what's going to be the benefit and how much do I want to stretch? Because if you say, "Oh, wait, this is going to result in heightened returns," everybody wants to gravitate towards heightened returns. You just talked about some of the risks, but those risks, at least of late, have felt more theoretical than real because we haven't seen a lot of the real problems come up from overuse of leverage.

**STEVEN PERRY:** Agreed, agreed. I hate to use mental math here on a podcast but we'll simplify it. So let's say you have a portfolio of \$100 million, and let's say, this may sound high to a lot of folks but let's say that portfolio yields 10%. If you add leverage onto that portfolio, and we'll go up to the regulatory maximum for debt borrowings of 33.3%, preferred leverage you can add up to 50%. If you add 33.5% or 1.5x leverage factor, you can generate more yield on that portfolio. And if we use a cost of leverage of 5%, reminder 10% yield, 5% cost of leverage, we're adding \$50 million of leverage on a \$100 million portfolio, you can generate up to 5% more portfolio yield. Now that's before expenses, you have to take out the cost of leverage, you have to take out the management fees and the other expenses, but it's going to generate significantly more yield in some cases. Obviously depending on the cost, depending on the yield profile of the assets, but it is often used to enhance that yield for investors. If I'm looking at the closed-end fund market as of 12/31/2022, the levered market yield on net asset value was about 7.8% across the entire marketplace. If you're looking at un-levered yield on NAV, that yield's going to be 6.4%. So managers using leverage to enhance yield and income for investors.

**CHUCK JAFFE:** Do investors want to diversify the kinds of leverage they're taking the same way they want to diversify asset classes? If I'm building a portfolio, do I want to make sure I'm including different kinds of leverage?

**STEVEN PERRY:** I would flip that around and I would put that burden on the manager. I think the managers want to make sure the funds that they're managing, investments that they're managing, if possible and if it makes sense, have different types of leverage. If we take 2020 for an example, and we saw that massive drawdown in the markets, a lot of managers saw themselves going up against regulatory limits, they saw themselves tripping bank covenants, and if you don't have multiple switches of levers to pull you can find yourself in a tricky situation. If I look at some of the funds in some of the closed-end fund marketplace they'll have bank borrowings or debt, and then they'll also have preferred shares, but that doesn't mean they're then going to run their portfolios at 50% levered, they just have more flexibility. The bank borrowings are going to be floating rate for the most part, the preferred shares can be floating or fixed, but if they're fixed you suddenly have two options in a floating-rate environment where the cost of your bank borrowings may now exceed the costs of your fixed leverage. And if you have the ability to use that fixed leverage in a rising-rate environment and fix that cost for your investors, you're going to save expenses. So I think it's really, really important that managers explore the different types of leverage, how it can be used, and that will benefit the shareholder.

**CHUCK JAFFE:** Well, of course managers have been dealing with market conditions that have been changing fairly rapidly. So as we finish this up and we're talking about the impact of leverage, let's talk about the impact of the Federal Reserve, because the Fed dramatically changed the picture last year when it was raising interest rates. Depending on who you talk to, we've got a couple of interest rate hikes, maybe some smaller ones, maybe not so small, until rates peak and then plateau and then eventually start coming down. So how did it change things for leverage last year and how will it continue to change things until the rate hiking cycle is done?

**STEVEN PERRY:** The cost of issuing new leverage in the form of preferreds has gone up and up and up. There's also a risk-off attitude and focus by the lenders providing leverage to these fund sponsors that's maybe expanding the spread over the base rate. I also think there's another factor of what types of funds are being levered and how they're reacting to rate increases. At the end of 2022, because of what the Fed was doing, we saw a lot of municipal bond funds have to cut distributions due to the increased costs of leverage, and so the Fed and raising interest rates has had an impact on portfolios that are maybe more

focused on fixed-rate debt or fixed-rate income. Now if you're looking at a portfolio of floating-rate assets and you have floating rate leverage, maybe you're still benefiting, maybe the portfolio and the fund is still benefiting from that spread or that arbitrage opportunity of leverage. So I think it's important to look at what the Fed is doing in relation to the type of asset and in relation to the type of leverage.

**CHUCK JAFFE:** Sounds like it's not scaring you away from leverage but it has to make you a much more careful buyer of leverage.

**STEVEN PERRY:** Absolutely, and I think you have to look at what the manager's doing, you can look at the type of leverage. I think any manager that's not willing to get creative with how the leverage is going to be structured might lose out on opportunities. So if I'm thinking about the inflection point of leverage on our portfolio I'm thinking, okay, when is the floating-rate debt going to surpass the cost of the fixed-rate options we might have? When are we going to transition to that? What's the duration impact of that fixed-rate option? How long are we going to have to hold that? And I think it's really important to have those conversations on a weekly/monthly basis, you're managing the expectations coming out of the market, you're managing your fiduciary obligation to your shareholder. There's a lot that goes into it, but there's also a lot that you can do with leverage.

**CHUCK JAFFE:** Well, thanks for explaining so much of what we can do with leverage, it's been really interesting. Steven Perry, thanks so much for joining me on The NAVigator.

**STEVEN PERRY:** Chuck, thanks for having me, appreciate it.

**CHUCK JAFFE:** The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me, and you can check out my hour-long weekday show on your favorite podcast app or by going to MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies, and yes, the use of leverage in them, go to AICAlliance.org, the website for the Active Investment Company Alliance. On Facebook and LinkedIn @AICAlliance. Thanks to my guest, Steven Perry, vice president at XA Investments, overseeing product management on the XAI Octagon Floating Rate and Alternative Income Trust, learn more at XAIInvestments.com. The NAVigator podcast is new every Friday, ensure you don't miss an episode by following along wherever you go to get great podcasts, including Spotify. Wherever you find us, we hope you'll be there and have happy investing, till we do this again next week.

Recorded on February 23, 2023

To request a particular topic for The NAVigator podcast please send an email to:  
[TheNAVigator@AICalliance.org](mailto:TheNAVigator@AICalliance.org)

Click the link below to go to the home page of Active Investment Company Alliance to learn more:  
<https://AICalliance.org/>

**Disclosure:** *Views and opinions expressed are for informational and educational purposes only as of the date of production/writing/speaking and may change without notice at any time based on a multitude of factors. Speaker's/presenter's/author's opinions are their own and may not necessarily represent the opinions of AICA, its Board, or its staff. Materials may contain "forward-looking" information that is not purely historical in nature, such as projections, forecasts, market return estimates, proposed or expected portfolio composition, and other items. Listed closed-end funds and business development companies trade on exchanges at prices that may be above or below their NAVs. There is no guarantee that an investor will be able to sell shares at a price greater than or equal to the purchase price or that a closed-end fund's discount will narrow. Non-listed closed-end funds and business development companies do not offer investors daily liquidity but rather offer liquidity on a monthly, quarterly or semi-annual basis, often on a small percentage of shares. Closed-end funds often use leverage, which can increase the fund's volatility (i.e., risk). Actual distribution amounts may vary with fund performance and other conditions. Past performance is no guarantee of future results. This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity. Shares of closed-end funds are subject to investment risks, including the possible loss of principal invested. Closed-end funds frequently trade at a discount to their net asset value (NAV).*