Nuveen's Caraher: High-Rates-For-Longer Puts Emphasis On Credit Selection

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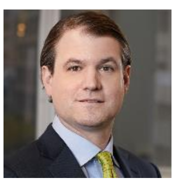
Chuck Jaffe, in this episode of The NAVigator podcast interviewed Scott Caraher, head of senior loans at Nuveen, manager of the Nuveen Floating Rate Income fund. Read the Q&A below as Scott says that the higher-than-expected increase in rates that has driven up borrowing costs has made credit selection 'more important today than it has ever been.' He notes that lower-rated companies can't sustain high levels of interest payments for long levels of time. As a result, Caraher says he is underweight the lower-quality part of the market, wary of a pick-up in default rates; the flip side of the situation is an opportunity to overweight better-quality companies which are generating superior returns now and which will be more stable and solid whenever the Fed starts cutting rates in the future.



Scott Caraher

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

CHUCK JAFFE: We're talking about the outlook for senior loans in today's higher-for-longer interest rate environment with Scott Caraher, head of senior loans at Nuveen, this is 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's going to point you in the right direction. And today we are looking at developments in senior loans with Scott Caraher, head of senior loans at Nuveen, where he manages the Nuveen Floating Rate Income Fund, ticker JFR, that's a closed-end fund with about two billion dollars in assets, but he also manages its open-end mutual fund sister, also called Nuveen Floating Rate Income, which is ticker NFRIX. You can learn about the firm and the funds at Nuveen.com. And to learn more about closed-end funds, interval funds, and business-development companies generally, check out AICAlliance.org, the website for the Active Investment Company Alliance. Scott Caraher, welcome to The NAVigator.

SCOTT CARAHER: Thank you for having me, Chuck. I'm really happy to be here.

CHUCK JAFFE: These are very, very interesting times generally speaking for any sort of loan or fixed-income credit product, but senior loans, particularly interesting right now. So explain a little bit about the opportunity that you see, and why senior loans are a different credit in this environment and something that people who maybe don't have it want to add.

SCOTT CARAHER: It's a great question, it's incredibly relevant to where we are and where we've been over the last two years, and maybe I'll just cut to the chase and give you the punchline first and dive in a little bit on the question as to the market. But if you think about the loan asset class right now, and really over the last two years, this is an asset class that is currently offering approximately 9% current distribution yields in our open-end fund, and approximately 12% in JFR our closed-end fund, which is the largest closed-end fund in the market. And when you think about those yields against a backdrop of other fixed-income asset classes, what's really important to understand is these loans are zero duration, they're not impacted by all of the volatility that we've seen in duration asset classes. And so the fact that these are zero duration and are not impacted by all of the volatility that we've seen in the treasury and the interest rate increases that the Fed threw very aggressively over the last 18 months, that has had no impact on their price. And so if you think about their performance, the loan index versus the Barclays US Agg, because it is zero duration and because of the yield that it offers, it has outperformed that agg by over 20% over the last two years, which is really just phenomenal. My belief is, and I feel strongly about this, is that the retail investor does not have enough loan floating-rate exposure in their portfolios. And so quickly, when you think about what loans are and what you are investing in if you buy a loan fund, and this is where I think maybe one of the reasons why retail investors are under invested in this asset class is that they might not fully understand. So just to break it down very quickly what you're getting when you buy one of our funds, whether it's JFR or the open-end fund NFRIX, you're really buying a slice of corporate America. You might think of the loan market, or I think some do, is not understanding the companies, or maybe they're small, middle market names you've never heard of, but that's just categorically not true. When you own one of these loan portfolios you're getting a slice of corporate America, you're vetting names that you see and you feel and you touch every single day; Uber, Burger King, Caesars Resorts, ADT, Clear Channel Outdoor. If you're driving down the expressway and you look up and you see a billboard, there's a good chance it's going to be Clear Channel Outdoor, so these are large, in many cases public, leading companies in their industry. Which again, we think is incredibly important to understand because it allows you, I think, to get a little bit more comfort around what's in the portfolio that you're buying.

CHUCK JAFFE: Well, the other thing that should make people comfortable with senior loans, though they aren't always because they don't think they understand them, is that floating-rate loans, there's a very active market. So I think a lot of times people think that they're going into something like this and they're getting illiquid credits, but they're not.

SCOTT CARAHER: That's a really great point, and I think again, a misunderstanding of what you're owning. We are buying and selling loans in our portfolio every single day, this is a $1.4 trillion market that trades actively, and so what we here at Nuveen do, we've been doing this for 20 years, is every single day looking for opportunities, but also managing risk. And when we see things that we're concerned about, whether it's an industry or a sub-industry or a company, going back two years that we were concerned that inflation was going to hit earnings, we're able to actively managing that risk by selling that loan. Three billion dollars approximately every single day trade in the market, and so we have a team of approximately 40 people that is looking across the loan and the high-yield market and really managing risk on a daily basis. And so unlike other asset classes where you cannot get liquidity, and in many cases you can't get price transparency within the portfolio, every single day when you look at the net asset value, whether it be a closed-end fund or an open-end fund, you know that the asset value is a good reflection of where you can buy and sell loans, and so that liquidity provides a number of really important benefits both to us as investors in the asset class but also the holders of, whether it be a closed-end fund or an open-end fund.

CHUCK JAFFE: You mentioned risk in there, so let's talk a little bit about risks that we're seeing based on current events because we've gotten to where rates are higher. So I'm going to ask both sides of the coin, when rates are higher, how much do you worry about default risk? We haven't seen junk bonds get junky, I don't think we would necessarily see a lot of senior loan defaults, but is default risk an issue with rates this high? And then the flip side of that coin, what happens when the Fed starts cutting?

SCOTT CARAHER: Clearly rates have moved to a level that I don't think anybody necessarily expected where they are today with SOFR being over 5%, which has driven borrowing costs across the market in the loan market to anywhere from approximately 8.5-12.5%. And so credit selection is more important today than it has ever been, and the reason for that is a number of companies that are lower rated in that kind of B3, which is one notch above CCC, and in the CCC cohort, they cannot sustain high levels of interest rate for long periods of time. It really wipes out free cash flow, their capital structures were built or constructed on the notion that rates were going to be lower. And so what we are focused on are companies that are not going to be able to sustain a higher-rate environment for longer, where companies are either free cash flow neutral or burning cash, and so really being underweight, the lower quality part of the market that is going to struggle. And if rates stay higher for longer, which we think they're going to, you are going to see a pickup in defaults in that part of the market. But on the flip side, if you look at high single B, BB loans, in this point in the economic cycle, those companies are having no issues whatsoever financing their debt or paying their debt, and so we do not expect any real pickup in defaults in that part of the market. And so being overweight better quality, and underweight lower quality, we think sets us up really, really well for the current environment. And then the second part of your question, which is what happens when rates start to come down? Well, obviously that will help the lower rated cohort of loans, but what we've seen historically is that when the Fed starts cutting rates, why do they do that? Generally that means that the economy is weakening, maybe we're either in a recession or we're seeing recessionary signals, and so historically what has happened is that better quality issuers have returned approximately 7.5% in the 12 months after the Fed started cutting rates, while CCC loans, lower quality loans have had a negative return of approximately 5%, which again goes to how we're positioned today. And so active portfolio management within the loan market, because we can trade loans every single day, is critically important. And it's one of the reasons why we believe that if you look at the performance of our funds on an absolute relative basis over long periods of time, we're very proud of the returns that we've seen because we can rotate the portfolio, we can insulate it in periods where we see rising risks, and then we can get more aggressive in times where we see some really interesting and unique opportunities to really layer in loans that are yielding anywhere from 10-20% that are going to generate alpha within the portfolio to the extent we're right on buying those loans at those yields.

CHUCK JAFFE: You've talked about the performance and importance of active management and all the rest, and of course we've talked about the fact that you have this fund in closed-end form and open-end form. The yield is different, et cetera, you've laid that out as well. But help somebody understand, you're looking at the space, there is crossover between the funds in terms of the things that you're looking to put in it, but what's the difference? Why would somebody want to choose one over the other, or do they want to choose both structures?

SCOTT CARAHER: It's a great question. I own both, I'm a big believer in both. You just need to understand the nuances between the two, and the overlap between what the funds own is very, very significant. The difference between a closed-end fund and an open-end fund really is more structural in nature, and what I mean by that is JFR does use a little bit of leverage, so about 30 cents on the dollar is borrowed, so that enhances the yield return of JFR, so you're always going to see the closed-end fund with a little bit of a higher distribution yield. JFR also can trade at a discount or premium to NAV just like every closed-end fund, so that does introduce a little bit more price volatility in the underlying stock, because when you buy or sell JFR, it's like buying a stock. NFRIX on the other hand, there's no leverage, you can come in and out of the fund every single day based on NAV, so you're really not taking price risk, you're only taking risk around whether the underlying loan portfolio moves up or down. And then the last thing I'd mention is because JFR is a closed-end fund, there's daily trading volume, and so your ability to get in and out of the fund is really a result of the average daily trading volume. Whereas NFRIX, the open-end fund, in most cases you can put larger dollars to work a little bit more efficiently, meaning if you wanted to put one to five million dollars to work in NFRIX, it's easier and more efficient to do. With JFR, if you wanted to put that kind of money to work, you would be needing the average daily trading volume to support the buy and sells. But they're both in my opinion, and I'm obviously bias, I own both, both offer incredibly attractive and unique characteristics. At this point in the rate environment, and the fact that we believe rates are going to be higher for longer, clipping a 12.5% yield in JFR and almost a 9% yield in NFRIX is just incredibly powerful from a yield perspective, again, if you believe rates are going to stay higher for longer. And then the last thing I'll say is even if the Fed were to start cutting rates next year, and the Fed, if you listen to every Fed governor they talk about wanting to keep rates higher for longer, think about where we're starting. SOFR today is in the mid-5% range, even if they took 200 basis points and decreased rates by 200 basis points, we're still starting at such a high level, that would be a distribution yield all else being equal on NFRIX in the 7-ish percent range and JFR in the 10% range. So on an absolute relative basis, really still incredibly attractive returns, even if you bake in some level of rate cuts from the Fed, call it eight to 24 months out.

CHUCK JAFFE: Scott, great stuff. Thank you so much for joining me on The NAVigator to talk about it.

SCOTT CARAHER: Thank you so much for having me, really appreciate it.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yeah, I am Chuck Jaffe, 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 closed-end funds, interval funds, and business-development companies visit AICAlliance.org, the website for the Active Investment Company Alliance, which is on Facebook and LinkedIn @AICAlliance. Thanks to my guest Scott Caraher, the head of senior loans at Nuveen, where he manages the Nuveen Floating Rate Income Fund, ticker JFR, and its open-ended sibling also called Nuveen Floating Rate Income, but trading under ticker symbol NFRIX. Learn about the firm and the funds at Nuveen.com and on Twitter @NuveenINV. The NAVigator podcast is new every Friday, but you can be sure not to miss an episode if you subscribe or follow along on at your favorite podcast app. And if you like this podcast, please leave a review and tell your friends, because that stuff really does help us. Until next week, happy investing everybody.

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