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Aberdeen's Kence on A.I.'s Impact in the High-Yield Market

"Where You Really Find the Yield and the Juice": Matt Kence on Why A.I.-Direct Data Center Bonds Are Driving High-Yield Opportunity

Matt Kence
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Chuck Jaffe, in this episode of The NAVigator podcast, interviewed Matt Kence, Portfolio Manager at Aberdeen Investments, where he manages the Aberdeen Credit Income Strategies Fund (ticker ACP). Kence explains why high-yield fundamentals remain robust even as rates rise, and how fixed-rate high-yield bonds have diverged from leveraged loans and private credit. He also details how A.I. is reshaping the market — from buoying GDP growth and hyperscaler issuance to a fast-growing segment of data center bonds — why Aberdeen favors A.I.-direct credits over tight-spread power generators, and how ACP expects to sustain its reset 12.5% distribution rate through higher reinvestment yields, cheaper borrowing costs, and a global research platform.

TOPICS DISCUSSED

- Why high-yield fundamentals remain solid even as rates rise: moderate leverage, strong interest coverage, below-average defaults, and low distressed-debt levels
- How fixed-rate high-yield bonds have diverged from floating-rate leveraged loans and private credit, and why A.I.-exposed software is only mid-single digits in high yield versus 20% or more in private credit
- Where the risks are hiding: wide CCC spreads, software concerns, and packaging companies squeezed by rising raw-material costs
- How A.I. is propping up GDP growth, pushing rates higher through hyperscaler issuance, and creating a data center bond segment that's now 2 to 2.5% of the high-yield market
- Why Aberdeen favors A.I.-direct data center bonds over tight-spread power generators, and the credit work behind them: contracts, tenants, NIMBY hurdles, and securing power
- How ACP plans to sustain its reset 12.5% distribution rate: new-issue bonds yielding high-8% to 10%, a cheaper revolver, locked-in fixed-rate preferreds, and a global research platform

The discussion is educational in nature and intended to help investors and advisors better understand the tools, trade-offs, and data points involved in evaluating income-focused strategies.

THE CONVERSATION

CHUCK JAFFE

Matt Kence, portfolio manager for the Aberdeen Credit Income Strategies Fund, is here. We're talking high-yield investing, now, on The Navigator.

This is 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, an industry organization that represents the entirety of the closed-end fund business, from investors and users up to fund managers, sponsors, and creators. If you're looking for excellence beyond indexing, The Navigator will point you in the right direction. And today, we're pointed in the direction of the high-yield bond market with Matt Kence, portfolio manager for the Aberdeen Credit Income Strategies Fund. Its ticker symbol is ACP, and Aberdeen is online at AberdeenInvestments.com. But we're going to make sure there's a direct link in today's show notes so you can learn more about the Aberdeen Credit Income Strategies Fund. And if you want to learn more about closed-end funds, interval funds, and business development companies generally, go to AICAlliance.org. That's the website for the Active Investment Company Alliance. Matt Kence, great to have you back on The Navigator.

MATT KENCE

Hey Chuck, it's great to be back. Always enjoy talking with you.

CHUCK JAFFE

Let's start with where the high-yield market is right now, because anytime interest rates are rising, you're going to wind up with folks in high yield who might be more interested, but might be more stressed. So where are we right now in this market cycle, and how strong have high-yield bonds and high-yield credits been as we've watched this cycle unfold?

MATT KENCE

It's definitely a good question, and it's been an interesting market. The overall leveraged finance market in particular has been subject to a lot of headlines, and you mentioned higher rates as one of them. First of all, I think it's good to set the backdrop: fundamentals within high yield in particular are actually quite good. Leverage is moderate. Interest coverage is strong — not as good as it has been, but still relatively robust. Defaults have been well below long-term averages. And something we tend to watch is the distressed debt level, which tends to be a good leading indicator of future defaults, and that's been really low as well.

So higher rates, as you mentioned, definitely matter overall, but I'd say quite a bit less within high yield than in other portions of the fixed income market. You do have to watch the pocket of the market that's more levered — I'd say CCCs and below — because they'll potentially have to be able to service higher debt levels. But what really tends to matter for high yield in particular is growth. As long as growth is strong, returns typically hold up quite well, even in a rising-rate environment.

CHUCK JAFFE

When you and I have talked in the past, and when I've talked to other high-yield managers, I get a strong impression that I shouldn't lump high yield together. You've got high-yield bonds, which is what people think about, but then you've got private credit, leveraged credit, things along those lines. And as somebody who looks at all of those markets, it does appear that if you get away from the big, broad label of high yield and go to the level of "what kind of credit am I getting," there are some dichotomies — high-yield bonds performing one way, leveraged credit performing another. What are we looking at there?

MATT KENCE

It's a good question, and there definitely is — particularly over, say, the past 18 months or so, there have been some significantly different drivers across all three markets, if you include leveraged loans, private credit, and high yield. The one thing we already touched on is the rising-rate environment. High-yield bonds are fixed rate, so for companies that issue those bonds, that portion of their debt stack has a fixed interest rate. As rates rise, they're not as impacted as a company that has all private credit or all leveraged loans, because those companies immediately feel the impact of higher rates. That's why you've seen a divergence in default rates across private credit and leveraged loans versus high yield. High yield has been relatively benign, whereas you've seen some increase in the others — that's obviously been in the headlines around private credit in particular.

The other thing you see a lot of headlines around within leveraged credit is the whole A.I. impact, particularly on software firms, and that's something we watch really closely. There are some opportunities there. We think you really have to do the work and understand the credits fundamentally — realize how impactful A.I. could be. But overall, it's a very small portion of the high-yield market — in the mid-single-digit range — whereas some reports put it at 20% or higher within private credit, for example. So those are a couple of areas that really distinguish the markets. And again, if you look at default rates, you can see there's been quite a divergence between them.

CHUCK JAFFE

We talked broadly about the types of credit, but are there segments or sectors within the credit market that concern you more than others?

MATT KENCE

It's a good question. You really see it in valuations, too. Overall, the market is relatively tight, particularly BBs. But if you look at CCCs and below, they're actually quite wide right now, and that again is due, I think, to some software concerns — but again, that's relatively small. You also have the potential impact of higher rates, as we mentioned, but overall that's a shrinking part of the market.

The area I think has been very topical, in addition to software, is companies exposed to rising raw material costs, such as packaging. We've found some opportunities within that space, but we think you have to be very selective. You have to understand the prospects for a company to eventually pass those costs on to consumers if commodity prices remain high, or the opportunities for cost savings that could offset it. So for us, it's potentially a risk, but if you do the credit work, it can be an opportunity as well. The packaging space, for example, is one we think potentially offers some opportunity here.

CHUCK JAFFE

You talked about the software concerns that have hurt part of the high-yield market. There's all of this A.I. financing going on — all of the capital expenditures everybody's talking about, the expansion of credit, et cetera. How much is that impacting the high-yield market? And if it's not impacting it yet, do you see it impacting it as those capital expenditures go from the drawing board to reality?

MATT KENCE

It's a good question, and the answer is multifaceted. It's a really unique dynamic, I think, what's going on in the world right now with A.I.. A.I. has had tremendous benefits: over 50% of GDP growth recently has been driven by A.I. investment, and that could be understating it because of all the secondary impacts — the businesses popping up around it. Even the guy pouring the cement for the data centers, for example, probably isn't captured in that number. So in terms of buoying the economy, I think it's incredibly important right now, because there are obviously pockets of the economy that are particularly weak, such as housing. So it's acted as an offset. That's one dynamic.

Then you have the dynamic around rates. Some people are attributing higher rates to the crowding-out effect of the issuance coming from the hyperscalers, particularly on the long end of the curve. That obviously has a secondary impact on the high-yield market in terms of driving rates higher. For a high-yield fund like the one we manage, that can be both a positive and a negative: higher rates can hurt what you already own, but when you're reinvesting, you're able to reinvest at a higher level, which can be positive.

And then there's the issuance directly within the high-yield market, which has actually been quite robust this year. That segment of the market has gone from basically zero to around 2 to 2.5% of the overall market, and it tends to be quite yieldy as well. Again, there's risk to it, but we actually see some opportunities. If you really do the credit work and understand this issuance, you can capture some really nice yields. Ultimately, if the company is able to execute, your underlying credit risk becomes the tenant, and in many cases that's a hyperscaler with very high credit ratings. So effectively, you could argue that's the type of risk you're taking on — if and only if the company is able to execute and get the data center up and running.

So that's where you do the credit work. You understand the contract. You understand the counterparty. And importantly, particularly recently, due to the NIMBY effect around data centers, you understand what the hurdles are locally. And most importantly now is power: has the company secured the power? As time goes on, that's become more and more critical. There are a lot of instruments coming to the market within data centers, and it's our job to weed through that and find the diamonds in the rough.

CHUCK JAFFE

And in weeding through that, you can be A.I. direct, or you can be A.I. adjacent. One of the areas high-yield investors might have liked in the past is energy companies that are trying to generate more power. Do you prefer to be A.I. direct now? As you're vetting opportunities, are you finding more with the A.I. companies directly, or more with things like the power companies? Because one guy's got to secure the power, the other guy's got to generate the power — but, oh, by the way, the power generation needs are maybe a little safer than the "how is AI going to play out" needs.

MATT KENCE

It's a good question. With a higher-yielding fund like ours, we'd love to buy more of the power generation companies, but the reality is those spreads are really, really tight, for the reasons you alluded to. They're getting tremendous pricing power in many cases, so those credits have really improved. We do own, and have owned, some of those in the past; they've just become a little less compelling. Where you really find the yield and the juice — close to double-digit-type returns — is A.I. direct. But you have to understand both markets, because right now power generation is so critical. Understanding those credits and that market remains incredibly important, and that allows you to make better decisions on the actual data center bonds you buy — the more A.I. direct, as you termed it.

CHUCK JAFFE

> You and I spoke, I don't know, about five years ago at this point. And it's funny — what were we discussing? Higher inflation and concerns that interest rates might be rising. Well, guess what? We've got higher inflation and concerns that interest rates might be rising. Back then, one of the things you said was an important factor for you as an investor was that we were seeing a record supply of high-yield bond issuance. Are we still seeing that record level? Obviously it would be a higher record level now, but are we still seeing enough issuance that it's basically overcoming some of those factors?

MATT KENCE

> It's interesting. We had seen really, really high issuance, and fortunately, back then rates were much, much lower. That goes back to one of the comments I made earlier about interest coverage — effectively, how much cash flow a company is able to generate versus its interest burden. What these companies did over the past several years was they were very, very active in refinancing debt, and they did it at what now look like incredibly low rates. That's been really beneficial to companies and the market overall, keeping that interest burden at bay.
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> Currently, issuance this year started out quite strongly, but over the summer it slowed down quite a bit, and the market's been able to absorb it quite well. Data center issuance has been a meaningful part of that, and it's continued to give us some opportunities for supply. But overall, from a technical standpoint, the dynamic remains very constructive, I would say, for the time being. We tend to get a slowdown in the summer, and in September you tend to see a pickup in issuance, which is consistent with what we're seeing this year. So that's something we'll continue to watch. I wouldn't be surprised to see some technical pressure on the market as it begins to digest this issuance. Fund managers such as ourselves were anticipating it, so cash levels were increasing going into the end of the summer. We do think over time this will be digested, even if you see a bit of a hiccup in valuations in the short term.

CHUCK JAFFE

> And last question: how does all this impact your fund, ACP? You've got a 12-and-a-half-percent distribution rate. Can you maintain that? Because that's something investors are certainly going to want to see.

MATT KENCE

> It's a good question. We did just adjust the distribution down to that 12-and-a-half-percent range, and we feel really good about that. First of all, interest rates mean we can reinvest the portfolio at higher rates, which gives us more confidence in being able to do that. The new issue market we just talked about, in particular, is providing us opportunities — we're seeing a lot of bonds coming to

market in the high-8% to 10% range. Add some leverage, and that gets you quite easily to the 12-plus percent we're looking for.

And since I just mentioned leverage: it's critical to have affordable borrowing costs. We've been fortunate — we've been able to reduce the interest rate on our revolver, which definitely helps the impact of leverage. We were also very proactive last year and locked in some fixed-rate financing in terms of preferreds. So our borrowing costs for the fund aren't increasing, while the reinvestment yields we're able to capture have been going up.

The last thing I'd point to, which I think is really important: we're a fundamental shop, so we think it's important to really dig into these credits, and we're able to leverage a global research platform. We have full-scale teams in the U.S., full-scale teams in Europe, and people literally across the company. So we're able to capture opportunities in the U.S. high-yield market, the European high-yield market, and across emerging markets as well, and take the best ideas across those markets. So despite pockets of the market being relatively tight, as we discussed, we're still finding a good amount of opportunities. Overall, we feel pretty confident about our ability to continue to generate the return we need.

And I would say, too, we think it's really important within a portfolio to have a meaningful amount of strong income-generating assets. As I'm sure you're aware, the equity market and other pockets of the market have been incredibly strong. Will price appreciation continue at that level? That remains to be seen. But what's nice about income-generating assets is that you don't need asset prices to keep going up for you to continue to generate nice returns. For that reason, we think funds such as ACP really do earn a place in investors' portfolios.

CHUCK JAFFE

And we appreciate you talking about it, because we know there are going to be plenty of investors who are interested in ACP and in high yield generally. Thanks for joining me on The Navigator, Matt.

MATT KENCE

Thanks, Chuck. Again, it's always nice to talk with you.

CHUCK JAFFE

The Navigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. Yes, I'm Chuck Jaffe — you can check out my show by going to MoneyLifeShow.com or searching for it on your favorite podcast app. If you're searching for more information on closed-end funds, interval funds, and business development companies, go to AICAlliance.org, the website for the Active Investment Company Alliance. Thanks to my guest, Matt Kence — he's portfolio manager for the Aberdeen Credit Income Strategies Fund, ticker ACP. The firm's online at AberdeenInvestments.com, and there's a link directly to information on the fund in the show notes for this podcast. The Navigator podcast has something new for you every Friday, so make sure you join us again next week for more closed-end fund fun. And until then, happy investing, everybody.

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