Bob O'Leary

Episode 220: A Conversation on Credit with Oaktree Co-CEO Bob O'Leary

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name's Stewart Foley. I'll be your host. We are thrilled to bring you today's podcast guest. There are folks who run strategies in the space that are very noteworthy, and today's guest is one of those. We're joined by Bob O'Leary, who's the portfolio manager of the Oaktree Opportunities Funds and co-CEO of Oaktree Capital Management. Bob, thanks for coming on. Thanks for taking the time. We're really, really thrilled to have you on.

Bob: Thanks for having me, Stewart. Appreciate it.

Stewart: We are set for... I think few firms provide the level of overview and vision and foresight that Oaktree does on a regular basis, and I'm thrilled to have you on to talk about several topics today. But before we get going too far, I want to start off the way we always do, which is where did you grow up; what was your first job, not the fancy one. And, how in the world did you make it to this seat that you're in today at Oaktree?

Bob: All good questions. So I grew up in Portland, Oregon. I'll give you my first and my second jobs, both of which were non-fancy. The first job was at age 10 years old. I spent summers picking strawberries in a local farm and I graduated from that to working in my uncle's hay field during summers. That occupied me for the better part of my childhood years.

Stewart: I'm not sure that's a promotion. Every time anybody mentions hay, it is always what's referred to as 'character building', at least where I grew up.

Bob: You have to have a very strong immune system, or a lack of a hay allergy.

Stewart: Yeah, so true. And how did you find yourself in...? You've been with the firm since 2002, which is an incredible span of time with one firm. How did you even know that private company investing existed as you were looking for places to go in your career?

Bob: So I started my career in management consulting, and it was very good training, but the key component of it that was missing for me was at the end of the day, you don't get to make the decision. You can consult, you can advise, you can try to persuade, but you're not the decision-maker. And when I looked around, one of the fields that is very much about the decision-making is investing, and that's what attracted me to it. So I spent a couple of years at private equity, and then pretty quickly thereafter decided to try to make the foray into investment management, and was very fortunate to find my current boss, Bruce Karsh, who I've spent my entire career working for here at Oaktree.

Stewart: That's phenomenal. One of the things that Oaktree has become well known for is this sea change narrative. Can you talk a little bit about the crux of the sea change narrative and how it has impacted credit investing for you?

Bob: So all this comes from a memo that Howard Marks wrote back in the end of 2022 after we started to see a decided shift in the interest rate regime, and Howard's principal observation was that for the prior four decades you'd seen almost unparalleled financial asset performance, but that it was impossible to understand that performance without taking into account the role of interest rates, which had almost monotonically declined over that entire four decade period. And that of course was a huge accelerant to the stock market, the credit markets, all manner of financial assets. And that was really the main observation. There was a second order question around what had caused that decline in interest rates, and what those factors we're doing or are doing now. This is all garnered through a lot of observation, but I think you can say that there were at least three things that were involved.

Number one, demographics played a huge role. You had dependency ratios working in the right direction. Number two, you had integration of the global economy, and very specifically had integration of China, which was a huge factor. And the final thing was, quite simply, you had a very stable geopolitical environment. And so all of those factors, and probably more that I haven't mentioned, contributed to that forty-year decline in rates.

I think the further observation that Howard makes is that it's not only not likely, it's impossible to repeat that performance, and it's more likely that some of that starts to reverse. And when you look at several of those underlying factors, demographics are no longer a tailwind, they're probably a headwind for the foreseeable future. You've got trade barriers going up, you've got deintegration of the global economy, you have duplication of the supply chain, which of course is inflationary. And then I don't think anybody would disagree that geopolitical stability has decreased, and maybe decreased markedly.

So not only do you have higher rates, but you have more volatile rates. And I think everybody has attributed the move in rates that occurred two years ago to a temporary situation where we're trying to combat inflation that was caused by the stimulus following the pandemic. I think it remains to be seen whether this is a longer-term situation, whether we can see multi-year volatility and heightened levels of interest rates.

Stewart: So when we talk about private credit, there's been a significant expansion in that market, and I'm sure you're going to touch on that, but it's my understanding that Oak Tree thinks that this is an attractive time for credit investors. Can you talk about why that is and what is unique about this environment that we're in right now?

Bob: So I think the first thing you mentioned, private credit, and one of the big structural changes we've seen since the financial crisis is regulation on the banking sector and the resulting disintermediation of the banks by private credit. That's not reversing. I don't think you're going to get anybody arguing for a lighter touch regulatory regime on the banks. Maybe the banks would, but certainly in the main, those regulations are here to stay, and it just makes it more difficult for the banks to do some of the things that they historically did. In their place, private credit has stepped in and has become at least a trillion and a half of assets over that space of time, and probably bigger since I got that statistic. But it is here to stay, for sure. The interesting thing for me, and this starts to get to the second part of your question about what has become interesting about private credit, all that private credit grew up in an environment where base rates were low by any sort of measure, and in some cases at absolute zero.

And you could argue that there hasn't really been a cycle to test that asset class. And it will be very interesting over the next... If the first part of the discussion here, which is the view on where interest rates are going, is at all correct, that they're going to be higher and more volatile, that's going to test private credit, and we're going to figure out who was made to last in that particular sector. But from the way we look at it, you're starting at a huge advantage relative to the last 15 years. Base rates are up at least 500 basis points and probably will stay that way for a while. At some point there will be cuts, but you're again starting from a very significant advantage, and over time, the increase in the cost of capital for the overall economy, the debt cost of capital, is going to cause some tail events to kick in. You're going to have defaults, you're going to have people needing rescue financing. But we think, relative to the last 15 years, it's become substantially more interesting to be a credit investor in this environment.

Stewart: There's a couple of things there. One is, it seems to me that insurance companies are particularly well-suited to be a source of that financing because, and this is just one person's opinion, but if you think about the banks lending long-dated loans with overnight deposits, and then basically the FDIC backstop and that gigantic mismatch, which an insurance company would never in a million years do, and there's a very nice alignment and some folks who are naturally predisposed to wanting those particular liability cash flow streams coming from private credit across the yield curve depending upon what lines of business they write, and there's not the opportunity for a run on the bank.

So when I look at that, and it's no surprise to me that insurance companies have moved in this direction, and to your point, there's absolutely, from everything that we've seen in the results of the survey of our registered attendees for our upcoming symposium, private credit and private structure ranked number one and number two. So it seems like that segment of the market is alive and well and going to continue to be. But you mentioned interest rates, and what I'm wondering is the rapid increase in short rates you mentioned, may cause some tail events that might not be related to the business itself. It might be related just to the increase in interest rates. So as we sit today, how does where interest rates go from here impact your response to my last question?

Bob: So I don't think anybody prior to '22 thought that a 500 basis point increase in base rates over what was essentially a year's time, or even less than that, was in the cards. And you had 15 years of debt build up. We look at four or five different segments of the market. There's private credit, of course, but there's high yield debt, leverage loan debt, and triple B. And that went from about $3.25 trillion before the financial crisis to over $13 trillion more recently. Most of that debt was issued in a zero rate environment and that massive increase, I think, shocked all those capital structures. It particularly shocked the floating rate portion of that, for obvious reasons, and then it shocked other parts of the economy. To your point, it shocked the banking system where you had this massive asset liability duration mismatch, and has caused embedded loss in a lot of those balance sheets. To the extent that the bank wasn't seized, it's caused embedded losses that over time need to get socialized or somehow dealt with.

But you're now at a point where you're starting to have to deal with the cleanup. In the first order, you have balance sheets that were set up, especially over the last five years, that cannot sustain these rates for any meaningful amount of time. So they're going to run short on liquidity and they will need a solution for that liquidity. The silver lining for them, if you will, is in their documents. The documents allow for massive and unprecedented levels of liability management that will buy them time, but ultimately they're going to need hard dollars, and they can get those through LME liability management exercises, and they can get them through priming deals. So there are ways to manage it, but in essence, really, all you're doing is adding more debt to the balance sheet and at some point even that becomes unsustainable.

The second big catalyst... So the rate move was the big catalyst to shock these capital structures. The second big catalyst is, of course, you have a maturity wall, and those maturities... Liquidity doesn't cause defaults; maturities do. And you've got a lot of the market, a lot of these markets that I just mentioned, high yield, leverage loans, private credit, triple B debt, you have a large wall of debt that needs to be refinanced between here and 2028, especially in high yield and leverage loans. Most of the companies will get through that fine. A good portion of them will not. And those that do not, have a choice: you can restructure and hand the keys to the creditor, or you can try to find a lifeline that takes advantage of the documents and things like that.

And it used to be that, I think, private equity firms look down on some of those techniques, but I don't think they do anymore. I think it's widely expected that they'll pursue their fiduciary obligations to the fullest extent, they'll pursue all manner of relief to try to save the equity. And that means there's a lot of room for the private credit operators to step in and provide some of those solutions.

Stewart: Can you talk a little bit about the main areas that Oaktree is excited about in the current investment environment?

Bob: So I think this dovetails nicely with the last question, which is for one, we are going to get defaults. Some of them are just unavoidable, and I think in opportunistic credit, defaults are generally correlated with higher activity levels and, frankly, better returns. The other thing that's out there that is quite interesting, and it's a feature of the credit markets that I haven't seen in size or with any level of frequency in my 22 years or so of doing this, which is you're starting to see the rise of a lot of rescue financings, where you can play the documents from the liquid credit side, in which case you're signing up to what is a relatively poor document, in most cases. And you're susceptible to anything the sponsor wants to do within the limits of those documents. But you can also play it from the other side, which is you can provide rescue financing or some sort of capital solution to the sponsor to take advantage of what's in those documents.

And more and more I think you're going to see a lot of people interested in those rescue financings. I think sponsors are going to be quite interested in them. I think it's a way for them to preserve equity value to at least have an option of bridging them to a better day. So I think there's going to be a big demand for that, and it's going to be often very sizable checks that are required in these companies, which themselves are very large. So that's exciting. I'd say another area, we touched on just a moment ago, was the banking sector. You have by some accounts $0.5 trillion of loss embedded in the US banking sector. A lot of that sits below the major money center banks and in some of the regional banks. They need a way to deal with that. And historically there's been a couple of different ways, but back during the financial crisis it was selling off pools of sub-performing or non-performing loans. That's how they got out from underneath this, and they sold to the alternative asset sector.

That's a typically very invasive process, and can be a little public and may contribute to concerns about the balance sheet quality. A more elegant solution is synthetic risk transfer, where they sell what is effectively the bottom 10% or 15% on a pool of assets to an alternative asset manager that agrees to ensure that bottom 10% or 15% for a period of time in exchange for premiums. And I think that's quite interesting as well. And I think more and more, separate and away from rescue financings or SRTs, there are entire sectors that are dislocated and are just being starved of financing that have maybe suffered adverse losses over the last 10 years, and banks or other intermediaries have retreated. That again leaves an opportunity for alternative players to step in and provide that capital, usually debt capital.

Stewart: Bob, that's really interesting and I want to pick up on the point you made about up to a $0.5 trillion of unrealized loss on bank balance sheets. And my understanding is that something on the order of 65% of commercial real estate resides in regional banks. I know that there are folks out there who are cautious on commercial real estate. Can you talk a little bit about Oaktree's view?

Bob: Sure, and you're right, a lot of that loss, or a lot of the exposures, reside on bank, and especially regional bank, balance sheets. And a lot of those probably have further to go in terms of the marks before they hit the right level. But commercial real estate is a massive sector. Most people equate commercial with office, but it also incorporates things like multifamily, it incorporates industrial, warehouse, life sciences, in some cases student housing. So I'll try to be specific as to which areas. The sector everybody wants to talk about is office, and for good reason. You had just a massive rerating of that sector that hasn't fully concluded. We all found different ways to work during the pandemic, and that's just meant lower demand for office. And I don't think anybody sees that... I certainly don't see it coming back, and I don't think anybody else does either.

That being said, there will be a moment, and I think it's probably in the next 15 months or so, where you see a lot of foreclosures start to happen in office, and you don't have a natural owner at risk. And it's when you run out of natural owners of an asset that the distressed community starts to get interested and things get more active. So those foreclosures, a lot of people say what you guys said last year, there were going to be foreclosures. Well, what happened is a lot of people anticipated that rates would come down this year, so they went to their lenders, got them to forebear, bought a rate cap, and decided, "Let's just kick the can until next year." So instead of $400 billion of real estate coming due last year, $600 billion coming due in 2024, you now have $1 trillion coming due this year, and it's less likely that that's going to be an extend and pretend type procedure.

It's like a lot of these will start to go to foreclosure, and you're not going to see situations where the junior capital steps up to pay down senior capital, because in a lot of cases the junior capital is tapped out and doesn't have. So a lot of these will foreclose all the way through senior mortgage. And when that happens, then a lot of those senior mortgage instruments are leveraged for inside leverage vehicles, that the leverage provider will not allow them to keep it in that vehicle. Will have to be bought out. At that point, I think you'll see a major risk transfer and often at surprisingly good prices, and you're starting to see some of it today. Again, it's a function of price. If you can look at what the leases on the office are, and you don't have to pay much of anything for the development option, that can be very attractive or can get to a level where it's attractive.

We're not going to pay for anything like conversion to residential or things like that, but there'll be times when you can get home on just the embedded cash flow and get a good rate of return. And we're not there yet, but we think we'll get there in the next 15 months or so. I'd say other classes of real estate, multifamily... Office is a demand problem. You don't have enough demand for the supply out there and there's not an easy way to rationalize the supply. Multifamily is a supply problem. There was a huge buildup in that sector. The fundamentals are still quite good. We don't have enough dwelling space and we need to build more of it, but at the moment a lot of the key markets are going to be overwhelmed by supply, and a lot of the assumptions about growth and rent growth are going to be proven to be misplaced. And when that starts to get factored in, you'll see some defaults and there'll be attractive things to do there. But it hasn't started in earnest. Probably won't start in earnest for a while yet.

Stewart: That is incredibly helpful and a great perspective for our listeners to hear. Thank you for that. So as you know, most of our listeners are insurance investment professionals and are running insurance investment portfolios. How do you think insurers should be thinking about the current opportunity set in today's credit markets?

Bob: And you said it earlier, this sets up very nicely for the insurance balance sheets. They're going to be a beneficiary of the disintermediation of banks, and you could argue that this should have been the likely home for a lot of the activity that banks had historically in the first place. So in many cases, insurance companies have long-dated liabilities that are wellpositioned. I would say think of credit holistically. There are a lot of different places to play in credit, but it's not just private credit and liquid credit. We think opportunistic credit is interesting as well. And I think what it really gets down to is how many elements of your balance sheet as a portfolio manager are procyclical versus countercyclical. And a lot of things are procyclical. I don't think anybody would disagree that private lending or direct lending is procyclical. It generally relies on a transaction, a private equity transaction, to generate the activity, and as a consequence, you have to have a performing equity market, a performing debt market to support that.

But I think there is also room, and we haven't experienced markets that were dislocated for a long time, but I think there is some chance we get that; a dislocation of some form over the next several years. And I think it's worth thinking about what on your balance sheet will perform well, or at least not as badly, if there is that dislocation. And there's a lot of thoughtful CIOs in the insurance industry out there thinking about exactly that, but I think opportunistic credit does deploy and return capital in a way that's asynchronous to a lot of the other parts of the credit spectrum, and I think is worth consideration.

Stewart: That's extremely helpful and I have so enjoyed having you on. It is not my typical day when I'm getting a chance to get these insights from somebody that's in your seat. And I just want to say thank you very much. I've got a couple of fun ones for you out the door, if you're willing.

Bob: Sure, absolutely.

Stewart: So we have some commonality. I was involved, I taught, at a small liberal arts college, and you went to Pomona College undergrad. And so the question goes like this: as you walked across the stage and got your diploma from Pomona, what advice would you give a 21-year-old Bob O'Leary today? As you look out at the opportunities with all of the unknowns around AI and everything else that's talked about, what's a piece of advice that you would give your 21-year-old self?

Bob: I'd say figure out what you want to do and get to it. As I said, I had a couple stints in management consulting and a stint at private equity, and ultimately I found my home in this industry, and I wish I'd just gotten to it straight out of college. I think the learning for me is that I probably meandered a little than I should have, but then again, maybe some of that meandering was essential to ending up in the seat that I did, and obviously been very thankful for that. But figure out what you want and get to it. There's no time like the present.

Stewart: I've become a professional meanderer, apparently. I can understand that. And the last one is this: you could have a lunch of you up to three guests, could be just one, but who would you most like to have lunch with, alive or dead?

Bob: So I'll give you one name. I have a list of 10, but I'll keep it to one in the interest of concision. So Henry Singleton who famously, or maybe not famously, or at least somebody that I think Warren Buffett has called out previously, ran Teledyne, and I think his principal years of operation were 1963 to 1990. And what he was at his core was an amazing capital allocator, and I think he was an investor. He ran a company, of course, and that was important, and he did it well. But the big notable points about his career, what he did in capital allocation, and if you invested a dollar with him at the beginning of his career in 1963 and left it there, you'd have about $180 by the time he fully retired. I think that works out to 20% or so per annum. So that is the type of capital allocation we should all be aspiring towards. So he's also a Chess Grandmaster. He also grew up on a ranch, which of course is near and dear to my heart, so I think he'd be a fascinating character to have lunch with.

Stewart: What a great answer. That's well done. Thanks for being on. I just really appreciate it. We had a great education, and thanks for some terrific advice, and I love the lunch answer. It's good stuff. So thanks for being on with us, Bob.

Bob: Thank you very much, Stewart. Appreciate it. Thanks everybody that was helpful in putting this together. Thanks, Greg.

Stewart: Thanks so much for joining us. We've been joined today by Bob O'Leary, who's the portfolio manager of the Oaktree Opportunities Funds, and co-CEO of Oaktree Capital Management. Thanks for joining us. If you have ideas for podcasts, please shoot me a note at Stewart@insuranceaum.com. Please rate us, like us, and review us on Apple podcast, Spotify, Amazon, Google Play, or wherever you listen to your favorite shows. My name's Stewart Foley, and this is the InsuranceAUM.com Podcast.