

# David Ross

## Episode 214: Specialty Finance: Low-Correlation Opportunities Lie in Niche Segments



GUEST Q & A

**Stewart:** Welcome to another edition of the InsuranceAUM.com podcast. My name's Stewart Foley, I'll be your host. We've got a great podcast for you today. The topic is private credit, which has been talked about a lot on this show, but today's topic is specifically around asset-backed specialty finance, which I love this. I love this sub-asset class of this specialty component of private credit. And we're joined today by David Ross, who's managing director and head of private credit at Northleaf Capital. David, thanks for joining us and thanks for taking the time today.

**David:** Hey, Stewart. Thanks for having me. I'm a huge fan.

**Stewart:** Thank you. And you've shown me you have a good microphone, so we're excited about that, and you sound good, and we're happy to have you.

**David:** Hopefully it can keep people entertained. That's the thing.

**Stewart:** Listen, that's what we say all the time. It's like, this is about, we have a little fun and learn a little something along the way here, so that's kind of our job. And so, before we get going too far down the path of the topic at hand, I want to ask you, the way we start them all, which is, where is the town that you grew up in? What was your first job, not the fancy one? And what makes insurance asset management so cool?

**David:** Wow. Starting off with rapid fire. So taking them in turn; hometown, Toronto, Canada. I grew up just off the lake, and since then I've spent a lot of time outside Canada, but that's still where my folks are. First job definitely was not a fancy one. I stacked lumber in a lumber yard. My great-grandfather had moved over from Hungary and set up an import-export business of lumber. So I was stacking, measuring wood on holidays and during the summer, and I can tell you definitely not a fancy one, but really proud of the family business, certainly having worked there for a long time as a kid.

**Stewart:** 'Character building' as they say, David. Character building.

**David:** Well, yes. So they say. It certainly gives you a lot of splinters and makes your skin in your hands a bit tougher. I'm laughing, I'm just thinking, as the debt guy, being asked about what makes insurance so cool, it just sounds a bit odd. I've definitely never been equated to that or been asked the question before. My job is... It's a bit like a Rubik's Cube. Every new investment is spinning the Rubik's Cube, trying to find the right balance of risk-return. I'm looking at companies, financials. I'm trying to figure out the structure and the right risk-return on the spread. And what I love about insurance, it is similarly what I'll call satisfyingly complex. If I've got a Rubik's Cube that's 6-sided, I'm then talking to the insurance guy who's got an 8-sided Rubik's cube. The complexity you see aligns with each other, and all of us are looking to solve a similar problem. How do we find good investments that fit within inside the Rubik's that we've got that's structured for us? So maybe that's the thing that aligns us as opposed to maybe makes us cool.

**Stewart:** I think we've actually made a fairly decent name for ourselves of making insurance asset management cool, so this is going to be cool by the end of this, I promise you.

**David:** There you go.

**Stewart:** But I think your point's well taken, which is if you ask a typical insurance CIO, they're going to tell you that their Rubik's Cube is more like 20-sided, which is why I always say on many, many podcasts, insurance investors are the smartest money in the world, because they've got so many externalities to solve for, in addition to getting competitive risk adjusted rates of return on their investment portfolio. But I want to talk a little bit about Northleaf just before we go too far. You're relatively new to our platform. And so give us a little bit of a flavor for the depth and breadth of Northleaf Capital today.

**David:** Sure. I want to just give you the quick elevator speech. We're a mid-market focused player, three private markets that we specialize in, private credit, private equity, and infrastructure. We've been investing since the early 2000s, so good long track record. Historically we were part of TD, so sort of the merchant bank if you will, investing on behalf of the balance sheet. Spun out in 2009, so Northleaf became a thing in 2009. For us, managing \$25 billion for hundreds of institutional clients across pension plans, insurance companies, sovereign, both public and private pension plans, but headquartered in Toronto, so my hometown, but really global. That's the key thing for us, which is we design global strategies across North America, Western Europe, and Australia, within those three asset classes. And I, obviously, run the private credit side of that business.

**Stewart:** And so let's talk about that just a little bit. So on the private credit platform specifically, where are you focused there?

**David:** Sure. Two areas of specialization. So my team is focused on corporate direct lending. So we've got people in Chicago and London specialized on that side of the business, and then asset-based specialty finance where we've got a dedicated team in New York, really 40-plus people across those offices as well as Toronto, where we've got our Portfolio Strategy & Analytics team, IR, operations. Ultimately for us, we've been pretty pleased with being able to serve over 100 institutional clients. We now manage close to \$6 billion across both of those corporate direct lending and asset-based specialty finance.

**Stewart:** So just to give you a little bit of color, we surveyed the people who are registered for our symposium coming up in June next month, so it's May 16th today, I like to timestamp these things because markets move and things change. And so the top two topics were private credit and private structure. And so can you talk a little bit about your experience working with insurance investors in private credit?

**David:** Yeah. We've had tons of experience on that front, and I would definitely echo the sentiment you started with up front, which is both an incredibly sophisticated client base, but also one that really you can relate to, and they are very well-versed in the private market. So first of all, I should say that we sold a piece of our business to an insurance company a couple of years ago, so we've got that heritage within our parent group and our governance structure. But from an investment standpoint, we've done SMAs with Canadian and US insurers. We've done and structured rated note structures. We've done co-investments alongside or talked to insurance companies about co-investments. And then obviously there's some that are direct investors in our strategy. So, certainly have a huge amount of respect for the partners that we've worked with and we've come across, and there's tons of ways for private markets in general, but particularly private credit and insurance companies, to continue to collaborate and to grow the collective exposure across both sides of our business.

**Stewart:** That's super helpful. And so I want to focus today's discussion on asset-backed specialty finance, which is starting to gain a lot of traction in the insurance space. I would say that it already has. So the private credit side, I think, has been talked about, but the structure side of things is really interesting. And so can you just, so we're all on the same page here, help us define what asset-backed specialty finance is, or what that entails, at Northleaf Capital?

**David:** Yeah. Let me just step back for a second. So this is a, when you think about it holistically, asset-based specialty finance is a \$5 trillion market. So that's two or three times the size of the traditional private equity-backed direct lending universe, so it's just an enormous part of the private credit investing landscape. And what I've seen over the past 20-plus years is it's become an increasing product for private lenders. So if you go back 20 or 30 years, certainly there's been enormous growth, but there's also been really a secular transition between the market being driven by banks, and what we've seen, as you've seen across multiple products since the global financial crisis, is banks have moved back into the more traditional businesses of consumer and commercial, and even more so moved away from some of the balance sheet parts of what they do. And that has opened up the ecosystem for private market players that really can design frankly more flexible and customized solutions in the asset-based specialty finance space.

Now as you drill down into that \$5 trillion, it covers really all parts of the economy, but the main spaces you'd say, a big part of that would be in the commercial ecosystem. The biggest piece is probably in consumer, when you think about credit card receivables, auto loans, all that kind of stuff that's serving the consumer, residential mortgages as an example. There's asset-backed stuff, so think about shipping, think about all of those assets that are hard, real assets. And then there's the space that we focus on, which is the more niche and esoteric asset classes, where the key characteristic is that they don't have a correlation to consumer or commercial.

So as we think about them, they've got high barriers to entry, which means you've got to have specialized skills to be able to do it. But the other key piece is, given they have low correlation, they provide an enormous value to an insurance balance sheet, not just in terms of return, but also in terms of providing something that doesn't correlate to what they're doing in other places on the balance sheet. So again, huge ecosystem, tons of different ways for insurance companies to participate, but where we are specialized is in that niche and low-correlated sub-vertical space.

**Stewart:** That's really interesting. And I think that whenever you're talking about differentiated sources of investment income, you'll find an audience in the insurance sector. Which is why I think that this podcast is particularly well-timed. Can you talk a little bit about the specific segments that Northleaf is focused on, and is there something that is driving investor demand for this asset class right now?

**David:** Yeah. So a couple parts to that question. The first thing I would say is that, for us, we do think that there's an enormous benefit of having a specialized team. So we only do four or five sub-verticals. Now, each of those sub-verticals will be \$50 to \$200 billion in size, so these are meaningful ecosystems in and of themselves. But to give you a few examples, music royalties, litigation finance, healthcare receivables, those are three of the areas that we're more focused on where there's a demonstrable opportunity for a credit investor to design solutions around highly diversified portfolios. I'm talking the stuff we finance are typically hundreds to hundreds of thousands of underlying loans or receivables.

And then the key thing for us is, when we do research on the sub-verticals in terms of where we want to focus, we're talking about a correlation factor near zero. When you talk to a lot of private market participants, they celebrate being 0.6, 0.7. The things that we're looking at, it's sort of a negative 0.1 to positive 0.1. So these truly are ecosystems where you get the benefit of diversified portfolios, real assets that you can lend against, but ultimately you're talking about low correlation underlying asset exposures.

**Stewart:** And let's just digress for a quick second and talk about... Unpack that idea of the correlation. So just for people who maybe aren't as steeped in the tea, what we're talking about here is the correlation of private credit with the broader fixed income markets. And when you're referencing a 0.6 or a 0.7, that really is sort of a beta equivalent or correlation factor with the larger public fixed income market. And then when you're talking about this area having a negative 0.1 to a positive 0.1, which has virtually no correlation, which has optimal diversification properties. Is that fair? I'm dusting off my finance prof hat here for just a second.

**David:** No, that's totally fair. So you're absolutely right, let me pull back for one second. So when we look at sub-verticals, we test them against both market and macro factors. So from a macro factor, we're looking about correlation to GDP, maybe correlation to employment or unemployment rates. And then from a market factor, we're looking against correlation to public equity, public fixed income, any type of public market correlation. So we're really looking to design strategies that are insulated or low correlated to both market and macro factors. That's the first thing.

The second thing is how you do that, and it starts with the essence in terms of the types of assets we're focused on. So I'll give you an example. Actually I'll give you two. Commercial legal finance is one great example, where we're lending against generally hundreds of individual corporate litigation cases. That litigation case is totally uncorrelated to anything else in the market other than the specific or idiosyncratic fact and circumstances of that particular case.

Another good example would be music royalties. You think about streaming in music. This is a factor in all of our lives, whether it's Apple, Spotify, music is just an increasing present in all of our lives. It has a single correlation to interest rates, but other than that, individual consumers and consumption of music is not correlated to what's going on in the equity markets or what's going on with GDP. So that gives you a sense of, firstly, we're looking for things that are low correlation to multiple factors, and then the second thing is we're looking deeply within the sub-verticals to ensure that there's no correlation within each of them. And so hopefully that gives you a sense of how we select the sub-verticals and how we define low correlation.

**Stewart:** That's super helpful, and I want to point out that not only does Apple and Spotify carry music, they also carry this podcast, so let's shout out to those folks, all the podcast platforms out there that we are very grateful to.

So, other guests on our show have talked about banks pulling back in direct middle market lending and creating opportunities, and I've always been of the opinion that banks fund long-dated loans with overnight deposits, and then have the FDIC stand behind them to backstop in case somebody comes and wants their money out. I love the way that insurance companies' balance sheets match up with private credit, because there's this nice match of the kind of liabilities and the things that they're trying to fund match nicely with this, and so you don't have that run on the bank risk. How active are banks in the segments that you're talking about, litigation, finance, or music royalties? What roles do the banks play there, and are they active in this space?

**David:** Yeah. I would say the themes are pretty similar to what I'm sure other people on these podcasts have talked about in terms of corporate direct lending, which is banks historically were more active. They have generally receded since the global financial crisis. Certainly when you think about the activities over the course of the past couple years, certainly in 2022 and 2023, there's been further retrenchment. So, yeah, of course there's competition in the space. There's really no part of the market that doesn't have a degree of competition. But what we're focused on is sub-verticals where there's a real specialization required. This is not consumer credit cards or auto loans or mortgages where all the banks have experiences, there's tons of market activity, public and private. What we're focused on is really ecosystems where there were never many banks involved, some regional banks used to play it through specialized teams, but even those banks have receded back into really their traditional commercial and consumer lending. So we do see it as a particularly attractive opportunity today.

But I do hasten to say that I've been investing and looking at this space now since really almost 20 years, and it has continued to be an attractive space. What's happened is it's opened up, and there's been a continual growth, and with the transition of the banks, a vacuum that's been able to be filled, to the benefit of private lenders like ourselves that have moved in. And you're absolutely right that we've got different assets with different duration, and we spend a lot of time with insurance companies, working with them to ensure that it's not just that Rubik's Cube of regulatory and risk-return, but it's also the duration piece that we're making sure that matches up and provides for a good asset liability match for the balance sheet.

**Stewart:** Yeah. And I'm sure that's music to their ears. So you mentioned music royalties earlier. Can you talk about why this is attractive investment for an insurer, just to get a single data point out there?

**David:** Sure. So, let's start with the first bit, which is why they're a great example of low correlation in terms of an asset class. And that's really the fact that it's uninfluenced by market volatility or broader economic cycles. So the central concept is, music consumption is inelastic. Music royalties enable that very stable long-term cash flows. We're talking about assets that have decades, 70-plus years of life to them, where the way a music song works... So think about if you hear a song, and it's just released. That first year, it has what you think of as peak consumption. After that, you consider what we would call the decay curve. Listenership will decline, generally for 5 to 7 years, and at the end of that decay curve, you have an enormously stable listenership. Again, there's no doubt that there's the bump at the beginning, but then you've got that stability post decay curve.

So for us, the reason why it's attractive for insurance balance sheets is that we are lending against hundreds of thousands of these music royalties, generally 10 years plus. So I'll give you an example. We own the royalties for The Who, a great example of a band that is well-liked, been around for a ton of time, and very stable characteristics around the type of listenership around that particular band. Now, what we've seen is actually growth, given streaming has and continues to grow, it's probably expected to triple in size, so you've got a real tailwind driven by new technologies and streaming platforms, but ultimately the underlying royalty will be either stable or growing depending on the pickup in terms of streaming demand.

So from an investment standpoint, and if you think about monetizing that value, we can look at these catalogs, we can look at 10-plus years of historical data, and obviously we've got quants on our team that are just parsing through hundreds of thousands of lines of historical data on each individual lyric or each individual song, making sure that what we build up as an aggregate portfolio has the type of stable characteristics that an insurance company, or any investor for that matter, would look for.

So to characterize it, you're talking about diversified portfolios of hundreds of thousands of individual line items, generating very stable consistent returns, but with a tailwind given what we're seeing in streaming and the growth from different new media technology platforms. So again, we lend against that. So for insurance companies, you also have a great cushion for anything to go wrong, and you're generating a mid-teens type return for something that might be a 50% to 75% loan-to-value.

**Stewart:** It's really interesting, and I'll just throw this data point out. I looked the other day, and I just happened to be looking at Notorious B.I.G., and Notorious B.I.G. on Spotify still has 23 million monthly listeners. And that person passed in 1997. And you just go... I mean, it's just amazing, right? I mean, the other day I was having a bite to eat and Free Bird came on, and everybody in the place started singing it. It's incredible how persistent some of the demand for some of these songs is over time. It's just anecdotally... I mean, I just think it's interesting.

**David:** Yeah. And I think there's two or three... And you just triggered a couple thoughts, because the thing about music royalties that has changed in the last decade... You used to be a writer or a musician, you'd own this royalty. What would typically happen is, you'd die, it'd be placed in a trust, and your descendants would get that annual income off of that royalty. Now, what's happened with the privatization of these markets is there's been the ability to monetize. So you've seen Bob Dylan, you've seen an enormous number of living musicians, that have taken the opportunity to sell their music rights and really create a private wealth for their family.

But really the important thing that they've seen is they've put that royalty or that set of royalties for their entire life's work into the hands of a professional manager. Because that's the key thing, is that you want someone that's dealing with Apple, that's dealing with Spotify. And for us as a lender, there's an enormous opportunity to unlock value, because a lot of those songs won't have been associated with anything. And so if you're a big corporate looking to do a TV commercial, or you're a big studio that's looking to do either a TV series or a movie, all those things have music embedded in it. And so the monetization of those assets enables for the elevation of the royalty. And that's really the opportunity for the equity, if you think about the ownership play of these assets.

And then the other piece is, I like to call it the plumbing. The Music Modernization Act created a very stable and consistent regulatory-driven and legislated set of documents that ensures that it is very clear how that royalty gets divided up. And so there's been an enormous amount of transition in the last 10 years that has created this institutional asset class that people can now see and invest in. And I think there's an enormous opportunity on the lending side in that space.

**Stewart:** Listen, the good news is, when I decide to syndicate the InsuranceAUM podcast library, I know who to call.

**David:** You know who to come.

**Stewart:** That's right. You will be my first call. So, I got one last question for you. Can you talk a little bit about the commercial and consumer space where many of your peers play? How do you view it? And I'll tell you where this is coming from. I saw a headline yesterday that said that one in five credit card balances are delinquent. A flash headline. I think everybody agrees that that's an indication of consumer stress. And I don't know what to compare that number to, maybe that's the norm, I don't know. But can you talk a little bit about those markets and how you view them?

**David:** Yeah. No, you're absolutely right. The commercial and consumer spaces are large, but they've also gone through a pretty volatile period, if you go back to 2020 and just say... They were impacted by COVID, certainly. There's no doubt that the inflation environment had an impact as well. And these things, to be honest, both positive and negative, I think we're now in a phase where people are starting to see some of the deterioration in those spaces. But again, they encompass very large and diverse asset classes with different risk-return profiles. And this is why I think investors need to think about them and the specific sub-verticals within them. And I think there is attractive investment opportunities.

We do see a little bit, I'd say 20% of what we do would be where we're able to find a sub-vertical within consumer or commercial where there isn't correlation, or less correlation. Take factoring as an example, that's on the commercial side, where the discounted purchases of short-duration invoice receivables creates a working capital management tool for small and medium-sized companies. So it's got a real, practical use for these companies to enable liquidity into the management of those businesses. But for us, that takes the combination of highly diversified portfolio with a high-quality set of counterparties, because typically these are investment grade counterparties that are looking to settle these receivables. And we can benefit with the collateral enhancements that we put in place as a lender.

So again, consumer and commercial are places that you're right, there is probably a little bit more volatility, and certainly the last three years, still lots of opportunity, but not a place that we tend to play, just because we want to stay disciplined and focused on sub-verticals where we can find low volatility, low correlation, and still maintain that high level of diversification within the underlying portfolio.

**Stewart:** I have gotten a phenomenal education on asset-backed specialty finance today, and I appreciate that. I've got a couple of fun ones for you out the door. They have some optionality, you can answer either or both. Most of our guests answer both, no pressure. The first one is, you and I have both been at this for a minute, and I'm wondering if there's a piece of advice that you would give a 25-year-old David Ross, or someone similar who's early in their career, or earlier in their career, that would be useful. And the second one is, who would you most like to have lunch with, alive or dead? You can have a table of up to four, including you, which means you can have three guests. Could be one, could be three. But I always think those are fun ones. So what do you think?

**David:** All right, I'll think of the answers, but you got to tell me what have been some of the best answers you've heard in the past. But for me, going back to 25... I mean, there's some things that I think have worked out well for me, and there's some things that I wish I'd known at that age. I would say, I do have a moniker that change is good. I think people need to have a diverse set of experiences, but you got to build up capital at the place that you are, because I think that goodwill goes a long way in terms of the opportunity set that you can generate. But don't be afraid to back yourself. I think change is good, and you've got to be able to get to a point in your career where you've got the confidence to embrace that change.

And the second thing I would say is, and I say this to every employee when they start, you have an obligation and your employer has an obligation to keep you on a steep learning curve. That's the only thing that makes life interesting, is continuing to engage in new things, challenge what you do, and challenge the ecosystem that you're in. So, stay on a steep learning curve.

In terms of the lunch or dinner, I'm a debt guy, so I love diversification, so I'm going to stay with living, because there's just too many options once you go back in history. I'll go with one. I think probably a cheesy one, which I'll say Warren Buffett, only because he's obviously just had probably among the... Well, obviously with Charlie Munger going, I think we're getting to the end of the days, I think he would be fascinating to hear just how things have changed, and just from an investor standpoint, he's got to be an icon for all of us.

I'll go with different industry, I would say, I think Bob Dylan, sticking with the movie theme, or music theme, but I would say him at 25 if I can, not him at 85. I think probably some interesting stories, and plus I would like as a 25-year-old if I could beat it to go out with him afterwards and see what life is like as a Bob Dylan 25-year-old.

And the third, I'll go a bit left-field, only because... I'll say Larry David, and just to mix it up, and just to bring a little bit of humor. And also, I mean, the guy's just a creative genius. So I guess the four of us, hopefully that brings enough diversification. I don't bring cool, Bob Dylan brings the cool, but I think Warren Buffett and Larry David each bring something pretty special to that meal.

**Stewart:** Listen, man, I think you bring the cool. I really do. I learned a lot today. I certainly appreciate it, and our audience did too, so thanks so much for being on, and thanks so much for the education. We certainly appreciate it.

**David:** Great. Thanks for having me, Stewart.

**Stewart:** We've been joined today by David Ross, who's the managing director and head of private credit at Northleaf Capital. We appreciate you listening to our podcast. Please rate us like us and review us on Apple Podcasts, Spotify, Google Play, Amazon, Stitcher, or wherever you listen to your favorite shows. My name's Stewart Foley, and this is the InsuranceAUM.com Podcast.