Jason Walker

Episode 244: Risk, Opportunity, and Flexibility in Today's Credit Market: Jason Walker of Manulife CQS

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. This is part of our CIO Spotlight series, and we're joined by Jason Walker , who's the co-chief investment officer at Manulife CQS. Jason, man, thanks for taking the time. Thanks for being on. I can't wait to have this conversation with you. Welcome.

Jason: Thank you, Stewart. It's an absolute delight to be here. Thank you for inviting me along today.

Stewart: My pleasure. And just for everybody, CQS stands for Convertible and Quantitative Strategies. Is that right?

Jason: That's it. We kind of thought we'd try and come up with something that was quick off the tongue and snappy.

Stewart: There you go. But that's awesome. Let's start this one off the way we always do which is, where did you grow up? And what was your first job, not the fancy one?

Jason: Well, I think, probably, I get the luxury of giving you an answer that's probably a little bit different. As you can probably hear from my accent, I'm certainly not from America. I'm from Scotland originally. I lived in London a while, but I grew up in a little place that I'd be very impressed ... I'd love a poll of your listeners if any of you have ever heard of it. I've a little place just outside Glasgow in Scotland called Coatbridge, which is a pretty gritty end of town, to be honest. It's not had much to write home about since its past ... Its glories were probably, I guess, what, in the 19th century during the Industrial Revolution when it was kind of called the Iron Borough. And since then, it's kind ... It's not been so flush, but that's where I grew up and where everything started.

Stewart: I can relate to that. I grew up in Imperial, Missouri, what I've affectionately referred to as the beehive hairdo and mobile home park capital, but it's where I grew up. And it's a tough ... I mean, when you grow up in a tough town, you learn important lessons, and your word matters in a town like that. At least, it did in my hometown.

Jason: You learn something that, I think ... Well, we'll maybe touch on it later when we're talking about portfolio construction, but in a different context, you learn peripheral vision.

Stewart: It's so true. Right? Let's start us off this way. I don't get a chance to have a CIO on, and I think that that gives you ... Particularly at a place the size of Manulife CQS, it gives you a pretty interesting perspective, and you see a lot of data.

My first question is, what can you tell me about your view of current market conditions? And if you can work in risk and opportunity in your answer, please.

Jason: If I think about the immediate preceding period, if we think about the post-COVID period, for a while I've had the same broad outlook and broad lens in terms of how I've been positioning portfolios, and that's been thinking about ongoing uncertainty and volatility, and that's where I would start. But I think, before I go on and talk about what I see ahead of us, that same thematic exists, but we're having a nuanced version of it now. We're having new variables come into play. I'll talk about that with regards to what I see happening.

But I spent a lot of time in my role talking to ... Fortunately, fortunate enough to talk to a lot of investors and partners that we have, and it's clear to me that the path forward certainly is still not clear, and there's many much more qualified and wanted individuals out there that have strong conviction views on things, have had strong conviction of views on rates and geopolitics and all sorts, and have been proven wrong on a repeated basis.

The way I'm laying things out here is thinking about, what are going to be the drivers going forward of that potential uncertainty and volatility? And in credit, it's important to protect to the downside. How can we protect to the downside? And I'm not laying out it just being negative here. I think it's a great opportunity. When you think about it in that type of context of protecting to the downside, it's also about constructing flexibility into your positioning to take advantage of dislocation of volatility and uncertainty when others maybe don't.

Kind of coming onto some specifics there with regards to what we're trying to achieve and what may drive things, I talked about maybe new variables coming through. To mention a few of those, but also highlight some of the catalysts which I think are ... We're seeing more divergence in markets. We see it every day. Increased divergence. For a long period post-COVID, the tide was lifting and raising and lowering all boats in unison. There was a correlation one environment for a period, and now we see a lot more differentiation, very clear in terms of the direction of rates. We had the BOJ, obviously, raise rates today, overnight, and when will the US go? But maybe not as quickly as the UK or Europe. We have differential inequities, which is very, very obvious and much talked about and so on.

But some of the key drivers, I think, that might make it different this time around that we are thinking about is sentiment, liquidity, positioning, and untested markets. What I mean there ... Sentiment has long been a big driver but I think is intensifying even further. I had some interesting comments just a few weeks ago of now machine learning trading on the back of looking through human sentiments and speeches, et cetera. Super interesting. And in a period when you combine that with where we've had lower liquidity in certain segments of the market for a long period, you can get more extreme moves coming through. That's reflected in positioning.

And in terms of untested markets, what I mean there is think about the growth of private credit, for example. If we settle in a world of we're not going back to zero rates, if we settle in a world of not as high as we are just now but higher rates, there's going to be challenges coming through and opportunities coming through, and some of those markets have just not been tested.

I think a lot of interesting new variables coming into play this time around. A lot of market practitioners have not been in that type of environment. Experience really counts. The experience that hopefully I've garnered through my career, and we have certainly at CQS across the trough here, are going to be vital and be able to maneuver. And to lean into our previous experiences and calibrate how we position this time around, what we did in the GFC and in US mortgages really informs how we take the different market today, what we think about, how we position in US mortgages today, how we've traded. By the European commercial real estate situation 2010 through 2013 has been really instrumental in how we've really successfully navigated the US CRE debacle in the last couple of years, COVID, LDI, so on and so forth. There's a lot of moving parts.

Stewart: It's interesting. I think that the downside protection that you talked about is so key to insurance companies. Often, insurance companies are lenders. It's an asymmetric trade, right? Credit markets have been benign for a long time. You mentioned a higher-rate environment certainly is going to impact resets. How long can this persist? And how do you position the portfolio for markets as they start to become more challenging? And I wholeheartedly agree with you, by the way, as a guy that earned my head full and beard full of gray hair through a lot of market dislocations. I do think that experience is going to be key as we move forward here.

Jason: The way I'm thinking about positioning, as I said ... I think it's difficult to be specific on what might the catalyst of a move may be. I mean, for example, we get all the magnificent seven results this week. Election in November. Who knows what could be the tipping point? I think you have to firstly be very disciplined and consistent in your approach and positioning, especially when you're trading and managing credit markets which, as you said, there's only really downside. Best-case scenario is you get your investor's capital plus a return. That's really what you've got to focus on there.

With that in mind, what I have been thinking about has been volatility and downside buffer, but let's remember, and I'll come on and talk about, it's not just downside protection. It's about being prepared. It's about preparing, being a good Boy Scout, if that translates into the US, about having that flexibility ready for the next phase.

Tools that we've been using have been income, really embedding income into the portfolios, but that's great. There's been higher income in a lot of places. What sort of income? I talk about stable income, and what I mean by that is income that you actually receive because, if you don't receive it, it's not much use to you in terms of a volatility domino.

That leads you into credit quality. Credit quality being very, very core. We are bottom-up. We're pretty geeky, bottom-up fundamental credit analysts. That's kind of what we do. And so, everything is about sticking to your process and your approach and making sure that you're in the right sectors and the right deals in those sectors, the right geographies, et cetera, and so on and so forth. And then also, where possible, lowering beta in the portfolio as well on the long side. Higher beta on the short side if you can achieve that. That's from the bottom-up portfolio construction perspective.

On a top-down perspective, though, as well, I mentioned flexibility, and that is key. And what I mean by that is being able to lean into things and be a liquidity provider during those periods of dislocation. I mean, we successfully did that in LDI. We did it in COVID. We've done it in the last 18 months in US commercial real estate markets when there's been four sellers out there in the market. And again, income is very helpful from that perspective because you can actually afford to pay for hedges if you have a high income. You also focus on the liquidity side of your portfolio construction.

Stewart: That's super helpful. I've got a kind of a quick and maybe fun one for you. What has been your favorite trade and biggest opportunity in the last year or so?

Jason: I would say we've had quite a few. I'll kind of dance over ... I'll talk about our favorite trade right here right now and then two that are pretty close that we've been putting on for a while. We've been talking for a long time ... We've been in SRT markets. I think it's probably called many things, but it's probably the main acronym in the US markets. A significant risk transfer at bank regulatory capital trades. That's been a market we've been in since 2014, and I've been a long proponent of having that as a bedrock of portfolio construction because it's high income, great credit quality, low vol, all the things I said I was looking for.

Right here right now, that is just a super interesting place. I mean, I know your audience knows this really well and has been hearing more and more and more about this sector because it's coming to a cinema near you in the US. At the moment, it's been a market that really was born in the UK and Europe, but now with the Basel III endgame focus, et cetera, it's really front and center with the US banks, and the market's set to grow. That, I think, is an opportunity for us, but it can be a risk as well. And it's when you really have to, again, be disciplined in your investment profile, and investors have to pick the right manager. The experience manager. Back to that point.

I think that's a super interesting trade, and it works well, I think, for an asset liability mix perspective. It's that private credit flavor for insurance investors. We are putting on some really interesting trades in US commercial real estate and commercial mortgage bank securities. Born out of being positioned correctly, I think, post the regional bank situation and the realization. We'd been short office that we took off. Some office shorts just posted the regional bank crisis because it was fully priced. And at the same time, a lot of people woke up and said, "Oh gee. I've got all this office exposure. What am I going to do?" And they sold what they could, not what they should, basically. That's been a great opportunity because there's a lot of ... I don't think it's the right time to be buying stress-to-stress risk in US commercial real estate, but there's great opportunities turn 10%, 20% returns in really high-quality risk. Really interesting profiles.

And then finally in CLOs, this is an example of bottom-up fundamental credit picking identifying mispricing. European CLOs, compared to the US market ... Less liquid. A little bit less poured over. Great for us because we're sat here, and we really understand it and get in between the pages, really, a little bit. There's just been some great opportunities to lock in some structurally very, very attractive returns, and that's enabled us to put a lot of embedded value into portfolios that is going to naturally be realized through refinancing over the next 12 to 18 months.

Stewart: That's really helpful. Those three specific examples are super helpful. My next question I want to pose in a familiar way, which is, on a scale of 1 to 10, if your median-risk appetite is a 5, how would you characterize your risk appetite now based on my made-up scale?

Jason: I will answer that in a numeric basis. I would say, in a narrative, I am actually cautiously constructive despite saying I got concerns of all these tail risks and everything going on. And that's just because of the opportunity set in structured credit and in an area such as SRT, et cetera. And so, I would say, actually, a 7, 7.5, type scale right now. That's really to signify that I think the risk adjusted returns in structured credit, both public and private markets, really stands out versus other corporate credit markets and so on and so forth.

And the opportunity to be able to capture attractive loss-adjusted returns ... And that's something always to remember because in our markets we always talk about loss-adjusted returns vis-a-vis just buying high yield or something are really attractive. It gives you a pretty significant buffer in terms of what your return profile might look like.

Stewart: That's helpful. I've got a question for you that nobody in the US has an answer to. I'm hoping maybe, as someone sitting across the ocean, maybe you've got an answer for this one. Political risk has been front and center, in no uncertain terms, and we've had a variety of ... I mean, the political situation in the US is challenging to handicap, if you will, or assess, but how do you view the upcoming US election in terms of risk to your portfolios?

Jason: I would say I'm somewhat agnostic because we have purposely gone back to my view that I certainly don't have a crystal ball. What I want to do is be aware of all these potential issues but try and not be exposed to them, if possible. What I'm trying to achieve in terms of portfolio outcome, and then I'll answer that question specifically, is my litmus test is 2022, for example. Obviously, a really tough year, broadly, for markets. And in that period, we were fortunate enough to be small positive return, but the real rub is that we used that flexibility point to actually take advantage and embed more value and drive returns subsequently. That's kind of how I'm thinking about issues like the elections in November, what's happening in other areas.

We've not specifically taken any direct exposure to trades that might be directly impacted if Trump becomes president, for example. Cognizant of impact, most of what we do is floating rates. One could argue that, if a Trump victory, maybe rates stay a little bit higher than net-net. That could be on the margin. That could be on the margin of kind of a positive for us, but we're really just trying to not have too much beta to impact that.

What we will do, going back to the high-income and flexibility point, is that, if markets continue to be the way they are and looking glass-half-full on a consistent basis here, we'll take advantage of that and look to put on cheap, out-of-the-money tail hedges, be that if we look at roundabout the election timing, buying out-of-the-money S&P puts or something of that nature.

Stewart: I want to go back to what kind of a spot that you were talking about earlier, which is SRT. I've heard it called synthetic risk transfer. Significant risk transfer. There's other names. We've actually done a couple podcasts on that topic. It's a very interesting opportunity. Can you help our audience understand what the bank regulatory capital changes are that have created this opportunity and why you think it's compelling?

Jason: Essentially, I mean, like I said, this has been a market that's been well-trodden in the UK and Europe, and the regulators have really kind of gotten bored. The laggard ... And this is really unusual, but the US is the laggard in terms of getting with a financial innovation or a new product. It's great that we're now there, and the US regulators are behind this. Well, and partly because ... The answer to your question is more and more higher and higher requirement of capital to be held by banks to avoid situations and catalyzed, I guess, by what we saw in the regional bank situation and so on and so forth.

The big change that's bringing it into focus now is the advent of the US banks coming along, but I guess the caution I would give is that, for me, the definition and why of SRT or bank regulatory capital trades and why it should be interesting to investors ... The litmus test is quite different from other structured credit markets or maybe some other areas of private credit that we see in so far as it isn't or shouldn't be a risk or economic arbitrage. It should not be. The litmus test should always be you're asking the bank ... Is the bank trying to get rid of risk that it just doesn't want anymore? If it is, then it's not an SRT. This is ... The clue's in the significant significant risk transfer, risk sharing trades, we often call them, that the bank should really be shoulder to shoulder and continue to have exposure to the same borrowers and same part of the market, et cetera. That's a real key test.

I think we'll see a slightly different flavor coming through from some of the US banks, which is going to be interesting. Different products. From Europe and the UK, it's been not exclusively but heavily corporate driven, large-cap corporates, small and medium-sized kind of enterprise deals, and so on and so forth.

But from the US perspective, I think it's going to get really, really interesting and right up our alley from an ABS-specialist perspective because I think we're going to see credit card deals, auto deals, student loan deals, subscription-line financing deals. It's a whole plethora of opportunity, which is great because the advantage of structured credit markets is or should be that you can pick and choose your flavors and your risk profile and structure it in a bespoke basis to get some risks. We've now been bought by an insurance company, a Canadian insurance company. It really is an interesting defensive product that should be very attractive.

Stewart: That's super helpful. And one of the things, and just kind of on the back end here ... Whenever I talk to people who have managed a lot of money for a long time, they often have some kind of rules that they live by that have stood the test of time over the course of their career. And so, I guess my last question would be, do you have any cardinal rules that you would want to share about investing in markets today?

Jason: That's a great question. I think that overarching discipline and being consistent ... The three rules I would really call out are always do that bottom-up work, always understand what you're investing in, which is why I've referenced a couple of times having these litmus tests for exactly what you're getting exposed to.

That leads into the second element, which is know the downside. You've got to be comfortable with what might happen, but also that informs you hugely in terms of protecting yourself, in terms of being able to quantify for your own portfolio to your investors of where risk may be, and to make sure it's within the correct parameters.

And then finally, as I've used the phrase a number of times when we were speaking today, flexibility. And what I mean by that in this context in terms of that overarching understanding is understanding the liquidity and the value of the positions you own. And I think that's going to be quite interesting. Looking all the way back to some of my comments at the beginning of our conversation today on untested markets, I think that's going to be super interesting when we go through the next cycle, and some of these markets that have not been frankly through a cycle kind of get tested. What happens when some of these companies have to refinance? Maybe a three-handle interest rate, for example. Where are we going to? What can you actually get out of risk? We've seen that clearly in commercial real estate where the value in the tin really isn't the value you can trade up.

Stewart: I've learned a bunch today. I've got a couple of fun ones for you out the door. I did a little research on your background, and you graduated with honors in accountancy from Glasgow Caledonian University. I want to take you back to that time period when you got your undergraduate degree. If you could talk today to a 21-year-old Jason , what advice would you give them? And I think it would be transferable to, what advice would you give somebody who's early in their career?

Jason: That's great, and it's a real-life situation for me because my son is actually ... Well, he's actually 22, but he's just about to start work, but he might not listen to my advice, but I'll give it to you and give it to the listeners and see if there's anyone out there.

I got some great advice at that time, and I'm glad you mentioned accountancy because that really is the pivot point of some of the advice I got. There was ... A friend of my parents recommended to me at the time ... As I said, I grew up in an area that wasn't surrounded by asset management firms, let's say, so it was quite difficult to know where I wanted to go and what I was doing. And the advice that he gave me was to do accountancy because it was broad. It gave you this grounding. It allowed you to have a number of different building blocks which you could be nimble and flexible from.

And I did that, and whilst I also decided I didn't want to become an accountant, through that period, it was absolutely true, and it allowed you to see a number of different areas and facets of both accountancy and corporate finance and to really give yourself an optionality, if you like. I guess my advice would be is that to take a broad look and to not pigeonhole yourself and jump in and become too silent too quickly. Yes, at some point you might want to specialize, but it goes full circle because the way I like to run our business now is of course we have specialists in different areas, and guys and girls come up and specialize in different aspects, but it's really important to have that peripheral vision. It's really important to understand what's coming from left or right and to be able to relate it to different situations.

Stewart: That's good stuff. All right. Last one. Ready?

Jason: I'm ready. This is going to be a tough one, right?

Stewart: No, this is going to be a fun one. Table of four for lunch. You don't have to invite all four, but it's you and three guests. Who do you want to most have lunch with, alive or dead?

Jason: Alive or dead. I'm going to go firstly for a personal one. I'm going to go for my dad who passed away a number of years ago just because in terms of my mom and dad were super supportive and made some sacrifices, et cetera. And whilst they might not completely understand asset management, it would've been nice to explain and share the journey a little bit more than I got the chance to. That would be certainly something I'd like to do.

Secondly, we were talking about ... You were asking me about ... This is quite relevant, I think. You were asking me about political risk and so on and so forth. And I was speaking at a pension CIO conference recently. Super interesting crowd. And the keynote speaker ... I was doing a keynote. It was two days. I was in the keynote on the second day, and the keynote speaker on the first day was a chap I'd love to ... I didn't get a chance to meet, but I watched his presentation, and it kind of blew me away. He was a chap called ... I might pronounce his second name wrong. James Stavridis. He was a four-star US naval officer. He was the Supreme Allied Commander of NATO, and he'd done all this stuff, and he was super interesting. Phenomenal speaker. Great view on geopolitics. And I thought, blimey, I've got to get up and speak after this guy, but nevermind. He was super ... I would love to spend some time with him because he was entertaining but super knowledgeable about a whole range of different things.

And finally, markets-wise, one of the guys I think is very relatable, and I like hearing his views, and I've never met, and it would be cool to meet ... If he's listening, it'd be cool to have lunch. Would be Rick Rieder at BlackRock. I think he says a lot of sensible stuff. And from a markets perspective, for me, that would be super interesting to share some thoughts and shoot the breeze with him a little bit.

Stewart: That's really cool. That would be a great lunch table, for sure. That's awesome. I really appreciate you being on. I've learned a lot today. Learned a lot about markets and your views. And I just enjoyed getting to know you a little bit. Thanks so much for taking the time. I appreciate it.

Jason: Thank you so much, Stewart, and thank you for all your listeners. Our door is open. Anything you need, just shout. Stewart: Thank you so much. We've been joined today by Jason Walker, who's the co-chief investment officer at Manulife CQS. Thanks for listening. If you have ideas for a podcast, please shoot me a note at Stewart@insuranceaum.com. Please rate us, like us, and review us on Apple Podcasts, Spotify, Google Play, or wherever you listen to your favorite shows. We'll see you next time on the Insuranceaum.com Podcast.

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