JOE EPPERS & TOM MAJEWSKI

CLO Perspectives Explored: Insights from Industry Expert Thomas Majewski of Eagle Point Credit

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com Podcast. My name's Stewart Foley, I'll be your host. Welcome back. It's so nice to have you. Thanks for joining us. We have got a phenomenal podcast today. This is the second in our Due Dilly series where we bring an insurance CIO on to do a deep dive on an asset class. Today, we're joined by Joe Eppers, the Executive Vice President and Chief Investment Officer of Selective Insurance Group, and a good friend and also co-chair of our symposium. Joe, thanks for being on. Thanks for taking the time.

Joe: Oh, thank you, Stewart. It's really, really great to be here. I'm excited to do the podcast and to talk to Tom from Eagle Point.

Stewart: Yeah, I'm thrilled. Tom Majewski, founder, managing partner of Eagle Point Credit Management. Tom, thanks for being on. This is going to be good. I'm thrilled to have you. Thank you.

Tom: Great. Thanks, Stewart. Thanks, Joe. I'm looking forward to the discussion.

Stewart: So this podcast idea originally came from John Patton because I've got a good background in insurance asset management, but I'm not a subject matter expert on the various asset classes that insurers are investing in. I haven't run money live for a number of years. So, the idea of a Due Dilly podcast came up where our audience could be privy to a conversation between a very seasoned CIO and a very senior person who's expert in the asset class. You, Tom, are absolutely that for CLOs. I want to talk a little bit about your firm in a second, but I want the audience to understand how we got here and what's going to happen. So, Joe came to me and said, "Hey, why don't you do a podcast with Tom at Eagle Point?" I replied with, "And it would be great if you would be the person."

Joe goes, "Oh no, no, no, no, no, I'm not doing that. That's for somebody else to do." I said, "Okay." So I thought, "Well, we'll figure it out." Then Joe came back and said, "You know what? I will do it." So I was so thrilled that Joe is going to do this. So, if you could each give just a little background on your firms and then I'm going to turn it over to Joe and let Joe talk to Tom about the asset class. So, Tom, with that, would you just give a quick overview on Eagle Point and then we'll turn it over to Joe to let him talk about Selective?

Tom: Sure. That's great. Thank you again for having me. Again, my name is Tom Majewski. I'm the founder and manager partner of Eagle Point Credit Management. Eagle Point is a specialist investment manager. We manage just a little less than $9 billion of investments, principally focused on, I call, esoteric or less mainstream fixed income securities. I founded the firm back in 2012, and today, we have about 70 to 75 employees on our team. Our main areas of focus includes CLO debt and equity. CLOs are securitizations of large corporate loans to large American companies. We're also a leading provider of non-bank financing to private credit funds, something we call portfolio debt securities.

Then we have a growing business in other alternative credit and regulatory capital transactions for banks. What we do, we look for investments that have a long track record backed by empirical data of having very low instances of loss. Then we look at how we can get access to those in many ways more efficiently or with some additional edge compared to other investors in the marketplace. Today, of the capital we manage, it's for a diverse group of investors all around the world. Notably, the majority of our capital today comes from insurance companies and a lot of the strategies that we manage fit very, very well in the investment portfolio of a typical life or P&C insurance company.

Stewart: That's really helpful. Joe knows a thing or two about that genre. Joe, tell us a little bit about you and Selective.

Joe: Sure, Stewart, thank you. So, Selective, we're a mid-sized property and casualty insurance company. We're based in Branchville, New Jersey. Been around a long time since 1926. Most of our businesses focused on commercial lines, and as you said, I'm the chief investment officer. I'm responsible for overseeing the portfolio, which is about $8 billion in assets, and I've been here almost 9 years now.

Stewart: Very good. So, with that, the floor is yours, sir.

Joe: Great, thanks. Hi, Tom. Let's start with just your view of the world from the macro standpoint and drilling down on your view of credit today, especially in light of credit defaults are starting to perk up, downgrades are starting to increase. How are you viewing the credit landscape today and how does that impact your thoughts around CLOs?

Tom: Well, the syndicated loan market in the United States is a large and important market, just shy of a trillion and a half dollars of loans outstanding. These are senior secured loans that we're talking about, first lien loans to large American companies. Representative borrowers over the years have included Burger King or Samsonite Luggage or TransDigm or Altice, large companies we do business with in many cases every single day. The loans are first lien and they're floating rate. When we look over the long-term, over the last 31 years, loans have actually had positive total returns for 28 of the last 31 years. Right now, the loan index is up over 10 points, 10% this year. So, for a surprise in the next 50 days, it looks like we'll be 32 years with 29 years of positive total return.

Now bringing a little more current, despite being up 10%, over 10% this year, there's certainly a lot of talk of what's going on in credit. Are there problems brewing? Are there things lurking that are going to get worse or could be a real perhaps problem for many lenders? The answer is, in my opinion, the headlines don't always reflect what's really going on. Defaults are up year over year, starting from a level last year of very, very low, nearly zero corporate defaults to today with rising interest rates, the default rate picking up. As of the last numbers I saw, it looks like the trailing 12-month default rate is about 1.3%. Notably not a single company in Credit Suisse leveraged loan index defaulted in the month of September.

So, despite the doom and gloom a lot of people have talked about, the performance hasn't been as bad as predicted. One of the great things about the loan asset class is the floating rate. So, over the past few years, if you owned an investment grade bond portfolio or a high yield bond portfolio, you're probably down due to rates. The ag is flat roughly this year and loans are up double digits because of the floating rate nature. The bad news is on the other side of that, companies have to pay that floating rate of interest. Frankly, there was a lot of concern from market participants and certainly media pundits that with interest costs going up between 2x and 3x for many levered borrowers that they'd simply not be able to service their debt. The truth is very different than that.

What's important to remember when you're thinking about lending to a company is very different than lending to a building or an office building with fixed rents or slightly increasing rents. Companies are living, breathing things. Even if your debt service is going up, there's a lot of different ways you can handle it. Going into the rising rates, the average company had debt service coverage probably north of four times, meaning their EBITDA versus their loan payments were 4x greater. So, there was certainly some cushion, but that 4x is an average and obviously there'll be components of that average that are below with base rates or LIBOR or SOFR now going from below 1% to over 5% of rates that these companies have had to pay have gone up.

That said, if you're starting from 4x coverage on average, you've got a good margin of safety. Further, companies, unlike a building which could be very static or real estate which could be very static, there's a lot of different things you can do. If you needed to, you could slow pay your payables. You could sell the overseas division or some non-core operation or something like that. The reality is not a single CFO of a company is going to say, "Well, we're $1 short this month. Let's hand over the keys to the lender." That's just not what's happening in the world. While most of the major investment banks predicted 3% to 6% defaults this year, based on our current pace, it seems like the low end of that guy is still going to be two times the actual default rate.

Now that doesn't mean everything is roses. One of the other statements you hear a lot about in the loan market is most loans today are covenant light. That on the surface has a very bad sound. It has two impacts in my experience or two ways it impacts the market. It actually makes defaults fewer in that there's no real concept of technical default anymore. As long as you pay your interest, you're fine. The flip side, it gives companies more runway and more leash. Sometimes if you give folks who are in trouble a little runway, they find their way out to the other side. A great example of that would be WeightWatchers. That was a loan a few years ago that was in a lot of trouble that ultimately paid off at par.

Other examples, however, have not ended so well where frankly the recoveries have been worse than they were in the past, more akin to the unsecured bond recovery rate than the first lien rate. Indeed today, we're seeing while defaults are actually still far below the long-term average, sadly, recoveries are a little below the long-term average as well for loans. So, that's what's been going on lately. As we look forward, one of the things that we still take a lot of comfort in is with all of the inflationary activity going on in the United States for sure, many companies still have pricing power. A recent research report from JP Morgan Credit Department said that the EBITDA margins or the profit margins at many below investment grade companies is better than they can remember in a very long time.

They didn't put a year on it, but knowing these folks have some gray hair themselves, I'll take that as a pretty good measure. Another interesting fact, Citibank recently put out research that actually showed in the loan market upgrades are exceeding downgrades, which is a surprise to many. However, I might group that in the richer getting richer and the poorer getting poorer. There's companies getting upgraded that are doing well, and then maybe some B3 companies getting downgraded to triple Cs.

We'll talk about triple Cs perhaps in a couple of minutes, but there is a net positive upgrade rate right now. However, that doesn't mean there aren't downgrades. Overall though, the state of the loan market and this is a broad measure of corporate America for below investment grade companies, frankly, is far better perhaps than the headlines would suggest.

Joe: So Thomas, it sounds like you're pretty optimistic on credit despite some of the negative headlines that we all read every day. What are you worried about, if anything, when it comes to credit or how are you guys thinking about some of these headwinds of higher interest rates, lower debt service coverage ratios, reduced bank lending from the banks, and how that may impact how you guys think about where you take a risk in CLOs?

Tom: Sure. So, we are, I think, more constructive than many on credit. We'll talk a little bit about how that works within a CLO shortly and some of the defenses we have in place if our opinion is wrong. The things we're worried about principally right now include idiosyncratic risks where it's company specific risks. One company that defaulted not too long ago is a company called Envision Healthcare. It was a fully levered LBO backed by a blue chip sponsor, and they had two different business units, each of which got adversely impacted by two different changes in regulation. They had COVID. They had delayed billing or the surprise billing rules and a number of things went wrong. That's a company that defaulted. It wasn't to do with interest rates going from 1% to 5%.

It might make a good headline that it did, or maybe it was too levered, but the reality is they face some unfortunate business outcomes. That's going to happen no matter what goes on in the world. There's always changes in regulations, changes in customer sentiment. So, within the loan market, the main thing I'm focused on is idiosyncratic risks where not every business is a good business and every year there's always a few that go the wrong way. We also look on a macro basis beyond the emotional and social factors, just the economic uncertainty of two raging conflicts 5,000 to 6,000 miles away from where we're sitting today. We hope for the best and short resolutions in all of those.

To the extent that does not happen, perhaps there's greater economic uncertainty and more challenges in the economy that we could be seeing here in the United States probably bode poorly. The flip side, something that's really helped us lately, and I'm sure many of the listeners today will appreciate the new prevalence of private credit funds. These used to be called middle market loan funds, but now they have a moniker, private credit funds. Indeed, many cases they're doing loans to even larger and larger companies. One of the things that's been a real blessing for the syndicated loan market is frankly, private credit funds are refinancing quite a few triple Cs rated loans in our market.

Some recent names would include MISys, which is a software company for a company financials, PetMed, and then even a company called Triple C Industries. How they came up with that name, clearly not someone from a credit market.

But each of those three loans, which were triple Cs rated, were paid off at par and refinanced into the private credit markets on the private credit funds. Obviously, we wish those companies well and we were very happy to get our triple triple Cs dollars back at a hundred where we can go reinvest them within our CLOs.

So, certainly not all roses. There's some things going on in the world, there's always idiosyncratic factors. The flip side, there's some other new idiosyncratic factors, the large, large private credit funds, frankly, that are solving some of the problems that might otherwise have manifested in the syndicated loan market.

Joe: Do you think that's a good thing or a bad thing with the growth in the private credit market, how that's impacting the broadly syndicated market?

Tom: Well, it's certainly a good thing in the case of those three loans. So, we're very happy with that. By and large, I think it's a very good thing. While a recent Fed governor talked about $500 billion of new private credit funds coming out, that sounds like a big number and that is a lot of money. The flip side of that, private credit funds, be it traditional GP, LP structures, or business development companies, things that are traded on the stock exchange or public non-traded BDCs, have something very good going for them. They're steady hands and they don't typically use repo financing. They don't have to worry about investor redemptions.

Those are long-term private equity style funds or permanent capital funds, A. B, while many of the loans, many of the sponsors of those funds will talk about their own proprietary origination. The reality is the vast majority of loans in that market are club deals where a number of large sponsors might participate in them. However, that's typically between 3 and 5 large sponsors, unlike a syndicated loan which might have 50 or 100 different lenders. So, to the extent something has to happen, it's much easier to work with a small group than a big group. Then finally, those loans don't trade often. While one or two banks are starting to make quotes and be willing to trade some of the larger private credit loans, perhaps to the chagrin of the private credit fund managers, by and large, everyone's starting from the same reference point.

One of the things I've observed over the years in the syndicated loan market where the loans trade much more easily or readily, billions of dollars trade every day. If someone bought a loan at par, it gets in trouble. It's now trading at 50. Someone else might buy it in the secondary market at 50. For the investor who bought it at 50, getting 75 cents on the dollar as a recovery, that's a great outcome. They just made 50% on their money. The investor who bought it at par just took a 25% loss. In private credit land, in addition to folks having a steady hand, they typically all have the same starting point.

While they might disagree on the way to work out a company if they need to, at least they're all trying to get to the results of 75 is the same impact for all of them versus a win for some and a loss for others. So, while it's a big number, one of the things we really like about private credit is that it's a very steady hand in the market. Then on a more close to home level, we could give them a list of 5 more triple C names, we'd gladly let them refinance.

Joe: So you covered the ingredients, the loan market in terms of what's in a CLO, I think very constructive on that. Maybe you can translate that into then how you're seeing relative value across the CLO stack from the AAAs all the way down to BB's in equity, which is I know where Eagle Point spends most of their time. So, maybe you can talk a little bit about the CLO market.

Tom: Sure, maybe I'll talk about the very top and then we'll work our way down to the bottom parts. Certainly, the CLO triple A market, CLO triple As, in my opinion, are a truly remarkable investment in the 25+ years of the market. According to every rating agency data and my certain experience, every one of those bonds has paid off at par. Now, people might've said that about other triple A rated securities in the past. On a rough basis, these securities have typically 35% par subordination and a ton of other structural protections. So, that even if half the loans went bad in a CLO 50% default rate, certainly not something we're predicting. I'm assuming that happened over 2 or 3 years. The structure of a CLO would still protect the CLO triple A holders and indeed they'd be paid in full.

Frankly, many of the largest holders of CLO triple As own the loans in addition through separate accounts are directly on their balance sheet. So, they're exposed to those same assets in a few different ways. Today, with base rates where they are, CLO triple As offer a 7% return opportunity. That's roughly akin to most people's long-term S&P 500 capital markets assumptions. Stocks obviously can go up and down. There's risks and uncertainties in stocks. At some point, the balance, while I don't think folks should stop investing in equities as well, but if you really believe that 7% S&P 500 long-term assumption, we might have an alternative that's lower risk for folks. So, we think it's a very attractive opportunity.

Joe: I think you make a great point on how attractive the triple As are and how resilient they've been through multiple credit cycles here. Insurance companies have historically not been very big investors in CLOs and triple As in particular. Now it's been growing. The last several years, it's been growing by double digits, but it's still, call it, less than 5% of invested assets across the investment landscape for insurance companies. For such an attractive asset class, why is that? Why do you think insurance companies have been hesitant to invest in something as safe and simple as the triple A?

Tom: Well, where we're seeing, and I don't live this every single day, but maybe I'm sitting very close to it, right next to the dugout shall we say, where we do see insurance companies most active frankly is in the single A category, which is still something that brings typically an NAIC 1 capital charge for a US insurance company. So, the incremental return investors can pick up there without any additional capital charge under current regimes. Maybe we'll talk about maybe some of the upcoming changes being considered, but at the sweet spot frankly, for an insurance company in my opinion, is either single A or double B seem to be the two most prevalent spots.

The challenge there, the size of the market, if we think broadly the US CLO market is about a trillion dollars, but generically, the triple A or the single A tranche might be 10% of the capital structure, give or take. It's a $100 billion market in total. Many insurance companies have rules. I can't be more than 20% of a tranche or 20% of a deal or very prudent measures just to make sure there's comfort in numbers investing with others. All of a sudden, for many of the largest insurance companies, it just becomes too small of a market relative to the size of capital they need to deploy. More mid-size insurers, frankly, that presents opportunity in my opinion, where it can be a little more nimble and a multi-billion dollar allocation could move the needle.

But if you're running a $500 billion general account at one of the largest mutuals, it's nice, but it's truly not going to move the needle relative to the resources you need to deploy towards it. So, while CLOs are a large and important market, unfortunately, some of these tranches get a little too small for insurers. Moving down to the double B area, one of the things we've been working with a number of insurance clients on, so CLOs, just like the underlying loans are floating rate assets. We've worked with both life and P&C companies over the years where we've proposed CLO double B as a high yield replacement strategy. Certainly, over the last several years, that's worked brilliantly. Even when rates were flat, it worked very, very well.

In a world where LIBOR or SOFR was between 0% and 1%, we were typically able to get us LIBOR plus 600 to 700 type return. This is back when high yield, which is probably poorly named, was yielding 4% to 5%. So, even if rates didn't move up, you were able to pick up 200 basis points of return holding the CLO of double B securities versus double B high yield, and then you had the benefit of floating rates. So, roll forward 2022 and 2023, the number of high quality or double B rated high yield bonds, which I believe will pay off at par that are trading in the 70s today is still very, very real. That's a very real impact. CLO double Bs floated upward and were not actually benefited from the increase in rates.

So, for a number of our clients who invested with us in the mid-2015, 2018 area, they benefited from higher current income while they were low rate environment. Then as rates rose, their weighted average yield or their book yield on their portfolio kept going up while other investors holding fixed rate frankly were losing. The reason you might pivot or overlay the next step and then we'll talk about why you might pivot, but the next step in all of this, frankly, is the credit losses. Very, very few in CLO double Bs, the long-term default rate on CLO double Bs measured over 20 or 25 years is below 10 basis points per annum, and the loss given default is about 50 cents on the dollar.

So, when you compare that to high yield, which defaults on average between 3% and 4% a year, you're able to get an asset that has a higher current yield benefited from floating rates in a rising rate environment and has an extremely rare instance of loss. The drawbacks, to be candid and it's important investors understand this, CLO double B prices move around more than high yield bond prices do. Certainly, in times of COVID, you'll see greater price volatility. That's a reality of the market, frankly, just due to the small size. Then if you are sitting here saying today, and I don't think this is your view necessarily, Joe, but if you thought we were going to have rates tightening by 200 points over the next year, you'd actually have some real appreciation on your high yield bond portfolio versus you'd have a decline in your book yield on your CLO double Bs.

If that's happening, if the fed's cutting rates that aggressively, that's probably into a credit cycle and being in high yield without the benefit of any subordination versus being in CLO double Bs where you have a thick equity class beneath you. You might still be better off in the CLO world, even in a tightening rate environment.

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Joe: So on that point, insurance companies that you've talked to that are considering this hybrid approach of replacing their high yield or bank loans with double B CLOs, what are some of the other trade-offs? I know obviously, the returns have been good, the default rate is better. Talk a little bit about liquidity. You talked about price volatility obviously being more. There's more price volatility owning double B CLOs as an example, but talk about liquidity in that market and then also just the convexity profile. Because depending on spreads, you may own these tranches longer than maybe you think or shorter than you think depending on the direction of spread. So, talk a little bit about the calculus one needs to think through in replacing high yield and bank loans with a CLO mandate.

Tom: Sure. So, to talk about liquidity, CLO double B trades hundreds of millions of dollars every single week. If you're looking for liquidity because of you, maybe you have some claims to pay or there's some other event going on at the firm and it's a normal random Thursday, you'll have no problem at all accessing liquidity. We've traded billions of dollars of CLO paper over the years and one of the things I do very carefully and we manage public funds that invest in CLOs in addition to money managing accounts for insurance companies, we have a very strong compliance process around our exit price analysis. While we all use third-party pricing services for our securities, can you sell the securities at the mark? By and large, the answer is yes.

Certainly, if the market's moving up, your sale might be up a little, or if the market's moving down month over month, it might be down a little, but it's an asset where if you need liquidity because we're repositioning the portfolio or we need to move money to an overseas division or whatever it may be measured in the tens of millions or even low hundreds of millions of dollars, the ability to access liquidity is actually really quite easy in the CLO market. If it's the day after COVID hits and everything shut down, liquidity is going to be challenged on that day, but not any different than the high-yield bond market frankly, even things that were liquid were treasuries and SPY in my opinion on those days. Then you hit on a second point of the uncertain duration in these investments.

While the returns are tremendous and several hundred basis points higher than high yield bonds, one of the things that you tackle with a CLO is the timing of repayment is uncertain. While your likelihood of repayment historically is extremely high, we don't really know exactly when. Now, along the way, you're not taking any rate risk because your rate resets every three months. So, from a rate perspective, you're indifferent. However, CLOs typically are set up with a 12-year legal final maturity, but a two-year non-call period. So, one of the things that holder of CLO debt is doing is writing a little bit of a spread option.

If the world turns to roses and companies have figured out how to pay all their bills and no one's worried about defaults anymore, spreads on CLOs are nearly certain to tighten and the equity investors in CLOs might say, "Oh, it's a great time to refinance our CLO debt if we can refinance at a tighter spread." So you might be happy with your 700 over double B. Well, bad news, you get a notice in 20 days, you have an option to roll into a 600 over double B or just get your money back at par. So, you do have some higher reinvestment risk that goes along with the security.

Although what I'll say is that dynamic has certainly crept into the high-yield bond market. In the good old days, if it was a 5 or 7-year high yield bond, it was non-call life or non-call 6.5, giving the company a half a year window to refinance their debt. Frankly, quite a few 7 or 8-year high-yield bonds today are non-call 3. So, that same risk, which is both spread-based and rate-based, it has certainly crept its way into the high-yield market perhaps more than investors appreciate.

Joe: Great. Well, I do want to spend a minute or two on your firm in the investment process and how you select CLOs. Before I go there, I don't think any conversation would be complete without talking about the elephant in the room for insurance companies and that is the NAIC. As you know, the NAIC has been looking at CLOs for the last year or two and considering changes to the risk-based capital treatment. Do you have any view on that and how do you see that shaking out?

Tom: Certainly, we're very much aware of it and we've helped provide data when requested both from our clients and from different parts of the regulatory regime. The short answer is across the capital structure, CLO tranches have outperformed comparably rated corporate securities from a default perspective. So, what that says is the ratings are right or perhaps even conservative. The flip side is if you owned a pool of loans straight up or if you owned every tranche in a CLO, you'd get a different capital charge answer.

Joe: That's a sticking point.

Tom: Therein lies the issue. The reality is what's missing and this is a highly nuanced position, but it's true. When someone owns CLO equity or proper accounting for CLO equity, you wouldn't report all of your cashflow as income. You treat a portion of it as a return of capital. So, while the math of the weighted average tranches comes out to a lower capital charge, what investors if they're accounting, if they did do that, and I think very few have actually bought every tranche of a CLO, by virtue of treating some of the income on the equity tranche as a return of capital, they're basically using some income as a capital subordination. That said, it seems like there'll be some degree of increased capital charge for equity.

At the flip side, it seems like there'll be lower capital charges at the top of the stack reflecting that just as far superior credit expense. By and large, the messages we're hearing from insurance companies are certainly at single A and up, it's indifferent to maybe even better to start buying. Then at the double B level, while there's probably a little bit of a higher capital charge with the pickup and yield you're able to get, I mean, if you own high yield bonds, you're down. You own CLO double Bs, you're up. It doesn't matter what the capital charge is, you're probably supposed to buy the thing that's up.

So, we see it certainly will have a little bit of an impact. The top of the stack, I'm not particularly focused on. It might cause a little bit lower interest from insurers at the bottom of the stack, certainly, at the double B level, but even there, the high return in my opinion will likely offset the impact of the higher capital charge.

Joe: Okay. Let's pivot to Eagle Point and your investment process. How do you guys make decisions? How do you determine relative value? Maybe if you could weave in an example of a recent purchase or sale that exemplifies how you guys think about this.

Tom: Sure, gladly, and this is the most fun part of our job, frankly. So, CLOs, not unlike companies, are living, breathing things. They have a 5-year reinvestment period typically where any loan that pays off, the proceeds are reinvested. Collateral managers, which are like servicers, but with a bit more discretion to just make a mortgage analogy and also sell loans and reinvest, take those proceeds and move them into other loans. We think of a CLO really as a fixed life bank with no retained earnings and we'll talk about that, but there's triple As who are the depositors, thankfully all in CD format. So, there's never been a run on the CLO. There has been a run on the bank. We're all aware.

The mezzanine lenders and then the equity holders, the owners, and then two legged management who go home every night, these are the collateral managers, just like the heads of banks go home every night. Then regulators in the form of rating agencies and trustees. It sounds a lot like a bank. The only thing different here is all the earnings get paid out every single quarter, which has a nice feel, certainly for the equity investors. There's about 120 active collateral managers in the United States. We view ourselves much more as a private equity investor in a fixed income market in that the securities we buy and sell trade on the mortgage key on Bloomberg, but we don't really think in basis points or duration.

We obviously do the math and we appreciate all these things, but we're looking much more at the people and the structure and the motivations around the transactions. Even if we're buying debt in a transaction, who the equity holder is, is very important. Not unlike if you're buying debt in an LBO, is it an aggressive sponsor or a conservative sponsor? You want to know those things. Is the management team focused or did the manager just get a new yacht and is also sailing off over the years? So we're very, very focused on the management teams behind these CLOs. I'll share with you one example of a transaction. A couple of interesting things happened all at once.

One CLO manager, a longstanding firm, public company, tens of billions of dollars under management had a robust CLO program. The lead portfolio manager who joined the program a few years after they started quit to go somewhere else. The market said, "Oh, my goodness. This is terrible. They don't know how to run a CLO without this person there." The reality, they've been running CLOs for 5 years before this person got there and had a deep credit bench. The bonds started selling off very quickly, but we knew the team while the person who left was a solid player and continued to do well at his new firm, we started buying up those bonds. This was in early, mid-2016 if memory serves. A little bit dated, but it hits on a couple of things.

So, this is a buying opportunity just because the market's overreacting to this one person. However, a few weeks later, some other news in an unrelated part of this company came up, which had a potential trigger. We knew their deals had an esoteric provision that said, "If the collateral manager is removed for any reason, the reinvestment period in those CLOs ends." In this case, we were actually buying equity when that person left because it was being given away by one or two investors who maybe put too much reliance on that one person. We had bought up a bunch of equity, but then we saw some news that said, "Oh, my goodness. There's a possibility these people will have to resign as collateral manager."

We knew that would end the reinvestment period. This was buried on page 197 in the offering document. It wasn't on the cover. We have one person at our team who has perhaps the worst job on Wall Street. His job is to read every CLO indenture, even if we're not involved in the transaction. He's also one of the most fun people at our company. But between him and all of us, we try and keep fancy ourselves to have an encyclopedic knowledge of these transactions. Once we heard this, "Oh, my goodness, this could be very bad," because the equity, we want that long reinvestment period. If this event were to happen in the reinvestment period, then that would significantly diminish the value of our equity.

So, what we quickly did, the market had stabilized and people realized this one person leaving wasn't the end of the world as it often isn't. The equity had moved back to pre-departure prices. So, we sold all that at a gain and then we started buying debt at discounts in the same CLO with the hopes that they were removed, because that would then start the CLO debt getting amortized if that happened. The traders on the other side of the street were the banks we were dealing with. What the heck are you doing? You guys just bought this a month ago. You made a couple points, that's great, but now you're buying the debt at discounts. That's very unusual. We didn't tell them all this until it all played out, and thankfully, that firm didn't have to resign.

So, it all worked out well and we made money on every leg of that trade. But here's the situation where knowing the teams on a deep basis where we knew there was a strong bench around this one individual who might've been the star, but who had a good supporting cast, very good supporting cast, and then knowing the documents intimately. After we did all these trades, we told one or two of our bigger trading counterparties, "This is what was going on." They're like, "Really? That's in the docs?" We're all institutional investors. I'm sure many people listening might not have read every page of a prospectus of an investment they're considering making. We know this is every page of a CLO is a heavily negotiated matter.

The definition of interest rate, the definition of principal balance can be negotiated. We're deep in the weeds on those things. That knowledge helped us make money in two different ways in this case, both on the team change and on the potential news. So, it all worked out for the best. We made money. The people who left to great firms continues to go on. But those are the kinds of things where this is very different than I'm buying Ford bonds and selling GM bonds today. It's a much more nuanced and deep knowledge type investment opportunity.

Joe: So Tom, that's really helpful. I think what I get from that is it's not just as important to understand the collateral, but also understanding and have a view on the manager and their behaviors and their performance history, but also importantly, the structure. I think probably a lot of folks don't really appreciate the importance of reading the docs and understanding what's in the docs in terms of the devil being in the details. You've been doing this a really long time. Can you just speak real quick to lessons learned, maybe an instance where you've lost money or missed something in terms of how that now informs you in terms of how you think about relative value and investing today?

Tom: One of the changes we've built into the CLO market and we put this in ages ago, something that happens in CLOs are called resets. This is an opportunity where basically, the majority of the equity can direct reopening the debt, pay off all the old CLO debt and issue new debt. This goes a little bit to the uncertainty of repayment timing that we talked about for the CLO debt investors. But over the years, in the old days, 10 years ago, to do that, it required 100% consent of the equity. Invariably, there was some investor in a faraway location or owned in a trust or something that you couldn't get a decision.

So, we've changed that to just be the majority of equity can make decisions. Similarly, this goes back to the '90s and early 2000s. It used to take 66% or 75% of the equity to even exercise a call of a CLO, and that's something that we've streamlined typically to be 51% of the equity at this point. Everyone's treated equally, but you don't need everyone to agree just the people with the most money in the game. So, that's something that's very important. Probably 3 things I'd share is that continuing to evolve the documents as we learn things. There were one or two CLOs we wanted to reset, but we couldn't because we couldn't find a 68th holder or something like that. The next thing is to focus on people and their motivations.

On one hand, when we invest with CLO collateral managers, many of them have distressed funds or other deep research teams to go the opportunistic investor. What we find is if they also have a distressed credit fund, when things get ugly, you want their attention on their CLOs. All the people go work on that 2 and 20 money with the hopes of getting a giant performance fee not focused on the long only locked up CLOs. So, looking at the motivations of people that they're focused, that they're going to be doubling down on their focus on CLOs is important. While we can't get favorable allocations that all the CLO managers are regulated money managers, obviously with compliance departments, we can get disproportionate portfolio mindshare. That's something that can't be regulated.

We want to make sure our CLOs are top of mind. If we're a PN, we might have 20 CLOs. The ones we're involved in, we want to have the most focus. Then finally, when we construct our portfolios, we have a view that's off market on this. I value the reinvestment period far more than the average CLO investor. This is the point in the first five years typically of A CLO where pay downs from loans, defaults, recoveries, sales can be used to buy new loans. To frame how powerful this can be, in April of 2020, a very dark day in the world, no one knew what was going to happen. 2% of the loan market paid off at par that month. The long-term average is about 35% per year. So, it was a slower month, and it was previously announced M&A.

It was scheduled amortizations, whatever it may be. Just by opening the mail, you got 2% of your money back at par. Loans were trading at 80 cents on the dollar on that day. If you had a CLO in the reinvestment period, you could just take your $100 checks and you got a 20% off coupon to go buy new loans. If you owned a CLO that was set up to be static at times zero or that had run out of its reinvestment period, those 2% dollars, you went to repay your triple As at par. That's the last thing in the world you wanted to be doing on that day, obviously, except if you're on the triple A. But for even the junior debt investors, that's so beneficial. Everyone made mistakes going into COVID. No one picked every credit perfectly envisioning a worldwide shutdown.

But in the case of building more par, that helps the junior debt, that helps the equity weather those storms. When we look at our portfolios, one of the risk metrics I look at, frankly, the first one is, "What's my remaining reinvestment period in my portfolio?" We're a little different than the market on that, but I think it's served us well over time. That's something we've seen time and time again. If you're in distress, you want to be able to keep going and the CLOs allow you to do that.

Joe: Great, Tom. Well, this has been a really great conversation. I think we could probably go on and on, but I'll turn it back to Stewart and let him wrap things up.

Stewart: That was amazing. I learned so much about CLOs today, and thank you both for being on. I've got one fun one for you guys on the way out the door. I've always got folks who are earlier in their careers in mind when we do these podcasts, right? Because these are very educational and not everybody gets to sit down and spend an hour with the two of you. So, to each of you, what advice would you give someone who's early in their career about how to navigate this market, where to focus, and what would you tell yourself at 25? Tom, I'll start with you.

Tom: So the thing that attracted me to CLOs was all of this equity optionality in a fixed income market, in a fixed income security. Most other securitizations are static pools, autos, mortgages. The loans you get with at the beginning are what you get, and you hope for the best. Here, the loans change all the time and that intrigued me. What made the difference for me was focusing on something that caught my attention that seemed different than everything else. On one hand, maybe structured products 25 years ago were the oddballs. You didn't get into big M&A and all the... I went to state school and whatnot, didn't have the fanciest degree. Maybe that was my only choice, but it was something that really interested me and I knew it was different.

I thought there were things that could be done that people weren't doing yet. Maybe I was a little lucky on that, a little skill, a little luck, but I was right. What I've tried to do over the last 20+ years is help change the market. 20 years ago, there were very few majority investors. Today, it's rare not to have a majority investor in a CLO. I think that's something we've helped pioneer at Eagle Point that I've done in my prior lives at working at banks and other firms, but it's finding something that interests you and finding something that you think you might be able to do differently. Now, it's tough at 25 to change the world and it took me a long time to get this going, but if you find those little attractions, something that you've got an edge on you think, follow it and pursue it as best you can.

Stewart: That's great advice, Tom. Joe?

Joe: Yeah, I think what I would tell my younger self as I think back on my career is really just the importance of relationships. I mean, this is a great example. Tom and I have a good relationship. You and I still have a great relationship. I think when I was younger, I probably didn't appreciate the power of relationships and networking for that next job as an example or learning what you need to do in terms of moving your career forward and the importance of relationships both internally in the organization you work within, but also externally. If I think about the environment that I'm in now in terms of moving your career forward and the importance of relationships both internally in the organization you work within, but also externally. If I think about the environment that I'm in now in terms of being a CIO and working in the insurance asset management space for over 20 years now, the relationships I've built over the last several years are just relationships I'll take with me for forever.

I've learned so much from these relationships that I think over the course of time may have made me a better investor, had made me a better leader of people, and just a better person. So, I think when I was younger, I really wish I'd spent more time building out my network and my relationships.

Stewart: That's great advice too. I really appreciate both of you being on. It was a fantastic podcast, fantastic information, really rich content. So, Tom, Joe, thanks so much. We certainly appreciate you being on.

Tom: Great. Thanks for having us, Stewart. Thanks so much, Joe.

Joe: Thank you guys. Take care.

Stewart: Thanks so much. We've been joined today by Joe Eppers, Executive Vice President and Chief Investment Officer at the Selective Insurance Group, and Tom Majewski, founder and managing partner of Eagle Point Credit Management. Thanks for listening. If you have ideas for podcasts, please shoot me a note at podcast@insuranceaum.com. Please rate us, like us, and review us on Apple, Spotify, or wherever you listen to your favorite shows. My name's Stewart Foley, and this is the InsuranceAUM.com Podcast.