



IMAP Independent Thought Podcast

Episode 48: Disruption in Defensive Assets

Our host **Emily Barlow of (Evidentia Group)** is joined by Dr. Christian Baylis Ph.D (Fortlake Asset Management) to discuss:

- How post-GFC regulations shifted risky lending from banks into private credit markets
- Private credit ratings lacking transparency, raising investment grade classification concerns
- Redemption queues in semi-liquid private credit structures
- Covenant-light lending surging from ~10% to nearly 90% of leveraged finance
- Australia's inflation rates

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Emily Barlow - (Evidentia): 00:17

Hello and welcome back to IMAP Independent Thought Series podcast. I'm Emily Barlow, Senior Asset Consultant from Evidentia Private, and today I'm joined by Dr. Christian Bayliss Ph.D founder and CIO of Fortlake Asset Management <https://fortlake.com.au/>

Emily Barlow - (Evidentia): 00:31

Today we're talking fixed income and specifically how Christian and the team are navigating a market environment that has changed profoundly over the past few decades.

From structural shifts in how capital is deployed to rising concerns in private markets and whether fixed income is indeed continuing to do its defensive job. Christian, welcome.

Dr. Christian Bayliss (Fortlake Asset Management): 00:52

Thanks, Emily. I really appreciate you having me today.

Emily Barlow - (Evidentia): 00:56

Before we jump into the themes influencing the defensive parts of portfolios, for context and for those advisors who may be less familiar with Fortlake, could you give us an overview of how it is you describe your investment philosophy and process?

Dr. Christian Bayliss (Fortlake Asset Management): 01:10

Yes, so we classify ourselves as an alternative fixed income specialist, meaning that there are parts of what we do where we generate return streams from alternative parts of the market.

And my definition of alternative is a return stream that is different to anything else that you would typically have in your portfolio, such as equity risk, credit risk, these types of things.

So we're trying to give people a different type of correlation across the board, then when other things are ultimately going bad, we're going good, and vice versa. So that's really what the point of the strategy is.

I guess the philosophy from our side of things is we like to see ourselves as working in an environment with imperfect information. We've decided to try and build a strategy with airbags in it, which is I guess a method of basically trying to cushion the portfolio when things ultimately go wrong.

We see ourselves as being pretty bad predictors of the future and want to make sure that we are genuine with ourselves in understanding that there's imperfect information out there. We're in a world where it's highly competitive and you want to basically eliminate this predictive element coming through the portfolios and basically build a strategy that seeks to reduce error, rather than seeks to try to be right on any given day and in into the future.

So that's really the philosophy behind the firm. I always say in fixed income "you want to be right and wrong at the same time", meaning what you find in our markets is that you can be right on an economic call, but the way the market moves can be totally against the positioning that you have.

And so these are all the things that we try to drill down on and incorporate into our strategy, but it comes from a philosophical perspective that that we ultimately don't think that we can predict the future. We've got to build a strategy around that. And really what we've tried to build it for is something that basically encapsulates that way of thinking.

Emily Barlow - (Evidentia): 03:10

That's great context. Thank you. And with that, let's take a step back and zoom out a little bit. Financial markets have undergone a significant structural shift. I mean, all

the way back probably since the GFC. So I'd like your perspective on how fundamental that change has been. And does the old fixed income playbook still apply, or do investors need to be thinking differently?

Dr. Christian Bayliss (Fortlake Asset Management): 03:34

Yes well I think if you take a step back from back to 2008 and beyond, really what happened is there's obviously been a huge change from where you had the banking channel as the conduit for risk taking, meaning that most of the risk was absorbed through the banking channel. And basically banks were effectively like a shock absorber in the economy.

Now, what you've got post-2008 and post-the-GFC with the Basel banking regulations (and obviously the additional regulations across the board), banks have now been heavily incentivised, plus basically been instructed to take risky activity off their balance sheet and park that somewhere else.

What used to be called the shadow banking system is basically code for private credit at the moment. And a lot of what I call "the fish that John West rejects" have gone from the banks off into the private credit space.

It's not to say that that's all bad quality lending or bad quality risk. It's more that there's a more appropriate place for it to be and to keep that away from deposit holder funds. So arguably the system is better today, and those loans and that riskier activity is in a better structure. And so I think it's a huge systemic improvement on where we used to be versus where we are.

But we've also had some incredible microstructure improvements across the markets. An area that we focus on is defaults and harvesting defaults and using defaults as a source of alpha. If you think back to 2008, one of the big issues was that there wasn't effectively a properly functioning default system, and distress was not easily sorted through. In fact, when you had a corporate default or a bank failure or something like that, it was the lawyers that basically got paid all the money, and creditors ultimately didn't get much.

What we've is the advent of clearinghouses. The main clearinghouse in the credit world, at least, is called ICE who have bought a company called Creditex.

CreditX has effectively become a default auction system, which basically processes every capital market default. And now we have a market clearing mechanism for defaults where lawyers don't get the lion's share of what's left over, and we've got a fully functioning system. And so these are just some of the improvements that have happened from a microstructure perspective, from a systemic perspective. But it's not to say that the system is perfect now; it's just to say that probably the risks have moved from one place to another.

But the million-dollar question is the system better equipped to deal with some type of future crisis? My argument would be certainly we've got a more robust framework, but we just never know. You've always got blind spots, and that's why I always like to say we have to accept that we're in a world of imperfect information, and "you never

know till you know”, and you do have to drive looking in the rear vision mirror, unfortunately.

Emily Barlow - (Evidentia): 06:35

There's a few things that you've touched on there that I'd love to delve into with a little bit more detail. The first one being private credit. So the narrative has very much been a compelling one: illiquidity premium, the floating rate, low volatility.

But I know from your fund commentary there has been some flight concerns. So I'd love to understand what the risks are that you're seeing that the market perhaps isn't adequately pricing or disclosing. And perhaps from your perspective, are you starting to see stress show up in other parts of the market, perhaps before it's being acknowledged in those private markets?

Dr. Christian Bayliss (Fortlake Asset Management): 07:15

Yes I think on private credit, I'll start with a few areas. Obviously, private equity, in my view, has led into effectively a private credit boom, i.e., you've got sponsors out there who have obviously raised debt. Some of them have raised debt into company, meaning you've got a private equity company, and a private credit company in the same company doing back-to-back loans and these sorts of things. And ultimately a lot of that is due to the inability for sponsors to sell private equity transactions in the secondary market or through secondaries or list on the stock exchange.

So private credit has grown as a result of the clogging in the pipes of private equity. A lot of the growth has been because of that. You've also had insurers, which have become huge adopters of private credit. They use a thing called **private ratings**.

There's a lot of question marks around private ratings. It's not to say that they're that they're not as robust as the public ratings, but there is a little bit of scepticism, I think, in the broader market about how robust those private ratings are because they're not publicly seen. They're typically only given to the buyers of the credit. And it does appear, or at least, or it would be the market narrative that there is a little bit of shopping around with these private ratings, meaning if you don't get the rating you want, you go to another rating agency and get the rating that you want that allows you to be classified as investment grade.

What that means for an insurer is that if you're classified as investment grade, you can have a bigger allocation of capital, and that's obviously very beneficial for the for the private credit issue. It's also beneficial for the insurer. So these conflicts that are in the system, and I think are ultimately at the heart of the issue of how will private credit perform under some type of macroeconomic distress, i.e., another an organically led recession or something like that.

So the other thing that I think has popped up in the private credit world is obviously the technology sector which is a very large weighting. Typically, I think 30% is the number that's thrown around as what private credit has across the board in terms of the exposure. Obviously, you've got different managers with different types of exposure levels. And then the other thing that's put out there, which is in the market, is that since 2010 to 2020, private markets have grown at a factor of six times.

So the growth in that private market arena has been very, very substantial. And again, with lots of growth, I think it just naturally brings about a degree of cynicism. It's not to say that things are being done badly, but people just tend to have, I guess, the scars of the past. When we see significant growth and a booming type of growth outlook, people tend to think that underwriting standards may have been dropped, i.e., because you've had a huge influx of money. The way to deploy that capital is drop your underwriting standards.

And then I think what we're also experiencing or what we have experienced was during the pandemic and onwards was a significant amount of capital that was transferred from the public balance sheet to the private to the private sector in order to prop up ailing businesses so employment wouldn't fall in a in a big hole. That basically meant that we had one of the lowest default periods in 2021.

In fact, in the capital markets, we only had one default, which was Europcar. And I always make the joke, you basically had to be talented in 2021 to default because you had negative real rates of circa negative 5%. You had fiscal transfers from public to private. it was almost impossible to default in 2021!

Dr. Christian Bayliss (Fortlake Asset Management): 10.53

As we fast forward to where we are today, the fiscal position of most sovereigns is weaker, interest rates have obviously stepped up a lot, real rates have stepped up a lot. And a lot of these business models that probably would have fallen by the wayside, who were propped up by alternative forms of capital, have basically been able to stagger to their feet and sort of mosey along now for a few years. And so my view is that if they didn't make hay when sun shines while those while those zero interest rates were in place and fiscal transfers were happening and you're still struggling, what you'll probably find that those defaults have not been eradicated, instead that they've probably just been pushed down the road.

Just to give you some numbers behind that, defaults in the private credit sector are only running at about 2%. It's not a significant amount at this point in time. But the million dollar question is with the way that the private credit world has evolved, i.e., through semi-liquid structures to retail, and probably your listeners may know that basically the private credit world is now like this (I'll keep it very stylised and simple).

You've got the institutional landscape, and then you've got the retail landscape. BDCs in America, which is basically private credit lending at almost the SME level and can be in ETF format and what not, that is typically what we call retail investors, and they call those semi-liquid structures.

In that part of the market, I think that's only about 15 to 20% of the market, but that has been the part of the market which people have focused on in terms of getting a gauge for underwriting standards.

There's been a lot of media around that particular part of the market, particularly around technology loans and whatnot. And really what's started to evolve in that part of the market is that defaults aren't high.

But what you have found is there's been a continuous step up in the queuing for redemptions from quarter to quarter. And data is getting better at looking at all of the prop providers of these semi-liquid structures.

And what we have started to see is that just over the last two quarters, (even though equity markets are at all-time highs), the queuing for redemptions is still building across the board. And that flows through to an information or a data point for the institutional investors who typically would never sell these private loans. And then equity markets latch onto it, other people latch onto it, and it becomes almost like a macro distress indicator out there. But we do have to remember it is only 15 to 20% of the private credit pie.

So I guess what we are starting to see is that a few fundamental things have changed from say years gone by where people used to look at refinancing humps in the high yield market, i.e., people would say, oh, there's you know billions and billions that need to be refinanced in March and June of 2027 as an example.

Now, what people are doing in order to gauge credit distress, they're looking at these semi-liquid redemption queues and using that as a bit of a proxy for distress in the market. So these are all the things that are going on in this in this incredibly sophisticated part of the market, and it's a big behemoth.

Dr. Christian Bayliss (Fortlake Asset Management): 13.56

The one final point I will make is this, if we go back to 2008, we used to have the acronym which has been banned from the vernacular of financial markets now, which was CDOs. Now you've got CLOs. No one really talks about CDOs. CDOs had predominantly a lot of corporate or private credit in them, and also a little bit of mortgage-related debt in them and they had a few other little things, but predominantly you'd probably had mainly mortgage debt in them.

That was back in the day when banks were doing bad things from an underwriting perspective on mortgages. And just to give you another indication of what was happening in that time slot back then, covenant-light lending in the corporate sector was a very, very small proportion. In fact, I reckon it was around about only 10% of leveraged finance deals were covenant-light back then.

As we fast forward to today, the viewpoint is that about 80 to 90 percent of the leverage finance track transactions are all covenant-light now. So what's happened is banks have basically gone back into mortgage-related finance. Their underwriting quality is a lot better. They've got rid of basically the not so profitable corporate loans off their balance sheet into the private credit sphere.

We've also now got products called CLOs. CLOs are effectively like a CDO. The only difference being is a CLO is purely for corporates, i.e. that's the only thing it does. But with CLOs and with these types of structured products, they are designed to create additional leverage on leverage through the structure and it's typically through a tranching structure.

And so, you've got leverage in the background, (which is where the funds will take leverage to enhance the returns of the loans and things like that). But you've also got

structural leverage in the system, and it is building in that CLO area. And it's not to say that we're going to have a crisis tomorrow. These are just the warning signs, you know, that are early stage, but we need to keep an eye on them.

It's a bit like a sick patient coming into a hospital saying, I've got a bit of a fever, we don't get the alarm bells out too early. This could all be fine and the system could be well equipped to deal with this. But some of these things are just worth keeping an eye on as we go through time. So that's a very, very broad overview of the whole, the whole pie that I've tried to give you in a very short space of time. But that is the world that we're operating in.

Emily Barlow - (Evidentia): 16:50

Oh, yes that's been really interesting and great to get that broad picture. And if only we had a bit longer to delve into that in a bit more detail, but as we've got to stick to our 20 minutes, what I do want to touch on is inflation, given your PhD in econometrics, which did focus specifically on inflation modelling, if I'm right.

And I feel like we can't talk about fixed income without talking about inflation and interest rate rises. So, with that and this is going to be another really broad question for you, but has the job been largely done? Are we back on a track, (be it not consistent across the globe,) to getting that back under control?

Or is there still more work to be done? And are we likely to see more rate rises than perhaps the market's currently pricing in?

Dr. Christian Bayliss (Fortlake Asset Management): 17:41

I think if we go back to first principles, I think when you look at about it, why have we come into a higher inflation era? and I'll break it up into 10 years past and 10 years into the future?

Because I think if you look back at the last 10 years, it's basically been a disinflationary period, and now the argument would be that now we've got more of an inflationary period. And obviously, when you've got a disinflationary period, you've got lower interest rates, a lower term structure.

And as we look out beyond, we've obviously got a higher inflation period ahead of us, and I would say we're going to have much higher interest rates on average over the next 10 years than what we did in the last 10 years. So, how do we get here?

Just think of the simple, the simple economic example of where you had 10 bananas in an economy and you had \$10, and then you increase the money supply by basically 50 times, which is almost what's happened. Guess what happens to the people that hold those bananas? You've got basically this factored leverage, which is now chasing fewer bananas, and guess what? All the value of those bananas starts to go up. And that's exactly what's happened across the economy.

That's happened to goods and services, it's happened to assets, and basically, it's no coincidence that everyone feels like they're spending a lot more money these

days, but they're not really getting ahead. And that is because we have increased the money supply by so much.

So, what that means is that the next 10 years is really about reducing the money supply and slowing credit demand compared to the prior 10 years.

And what that's going to mean is that we're going to need higher real interest rates. Gone are the days where we have negative real rates, which was only, you know, literally a few years ago. And in the case of Australia, we have a negative real cash rate still. So, all of that heavy lifting that the RBA has done in order to temper inflation in a real sense hasn't really gone too far. And so, long story short, what we've got is we've got people that have accumulated massive amounts of wealth.

The people that owned those 10 bananas have done very well. But if you didn't own those 10 bananas, you've basically really felt the difference. You've basically said, look, I wasn't on that train, I didn't own those bananas, then all I'm getting is the negative consequences and none of the positive consequences of holding the bananas. And I think that is why you're getting so much friction in society. And a lot of it comes back to inflation.

That's a very broad overview of the way the world is and why we've got to where we've got to. But what it means for the future is it means we've got to be very cognisant of the way in which we deal with inflation shocks. Obviously, I'm talking at a point in time where we've had the US invade Iran, we've had a huge oil price shock. And in my view, what central banks may be underestimating this time round, which is similar to what they underestimated during COVID, it is not just about the length of the length of the shock, it is about the impact of the shock on the relevant supply chains.

The Strait of Hormuz is a very, very significant piece of, let's call it, supply chain infrastructure in the global economy because oil runs through it, as does fertilizer, as does other products. And what that means is that even though this crisis may all be over now at the time I'm speaking, what central banks need to be very careful of is that because of the type of nature of the shock and where it's happened, it could actually linger around for a lot longer. So what that means for inflation is that if inflation's sitting, say in Australia at the moment, sitting at 4.2%, probably going to be around 4.8% by the end of June, even if oil prices come down a long way, you are still going to have the lingering effects of higher inflation probably to the rest of the year.

So, the RBA needs to get back to 2.5%. Their current forecast is that's not going to happen until 2028. The thing we've got to be very careful of is does that outlook for inflation or that higher inflation world that I'm talking about, does that start to feed through into wage-setting behaviour? I.e., do people sit here and go, hey, my cost of living is going to be up by, you know, well over 4% for the next year or two, maybe? Do people then start to ask for pay rises? Does organised labour start to say, look, we need much bigger wage increases, which is what we've seen with the recent price negotiations.

And then how hard does that make the RBA's job in terms of getting inflation under control and getting it back down? And so, I always say there's three stages to inflation.

- You've got the part where people look to get compensated for past inflation.
- you've got the part where people look to get compensated for present inflation,

I would say we're at a stage now, where people are looking to get compensated for future inflation, and that's the stage of the inflation cycle that we're at. And that's why there's probably more heavy lifting to do across the economy. We just had the ECB raise rates.

In my view, probably the US is going to need to raise rates, whether or not they can because of the political interference in the system, who knows? But basically, the days of cutting rates and going back to zero are gone. And we are going to have what I would call higher lows in cash rates, globally speaking. And it's going to take a lot more heavy lifting and really putting the shoulder into the wheel to get rid of, I guess, a more stubborn inflationary environment because it's not going to go away easily because of my very first example of when you increase the money supply, like what we have done by such a huge margin, it just takes years and years to drain that out of the system. So that's my worldview on inflation.

Emily Barlow - (Evidentia): 23:22

Christian, thank you. We have run out of time. It's been a genuinely really rich conversation. I mean, clearly markets have changed structurally over the past few decades, and the risks that are building up across private credit and alternative capital are still continuing. So, thank you so much.

Dr. Christian Bayliss (Fortlake Asset Management): 23:41

Thanks so much, appreciate it.

Emily Barlow

And to our listeners, thank you for tuning in to the IMAP Independent Thought Series podcast. If you found this conversation useful and interesting, please feel free to share it. And we hope you'll join us again next time.

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