

## Executive Summary

Concerns over the potential impact of the COVID-19 pandemic on a wide range of company and asset-oriented cash flows resulted in a sharp, technically driven sell-off across a wide range of credit assets in March of 2020. The forced outflows and lack of market buyers behind this sell-off has largely driven its depth and unprecedented speed, and caused a widespread, largely indiscriminate price dislocation across even the senior debt of relatively stable US companies.

We believe this dislocation provides a potentially compelling tactical opportunity for institutional investors—specifically, a series of “dislocation funds” in the alternative credit space have recently come to market and expect to activate over the near-term, targeting the purchase of a range of public fixed income securities at extremely low prices compared to their historical averages. The low prices at which these tactical buyers will potentially be able to acquire stable, senior debt over the next several months may enable them to realize equity-like returns with relatively low levels of corresponding risk, due to both the stability of underlying cash flows and assets securing many of these bonds, and the protection provided by capital structure seniority. However, investors pursuing this opportunity should also be aware of several key considerations, including the short time window that may be associated with this opportunity set, the low levels of investor liquidity associated with the drawdown structure of most dislocation funds, and the potential for ongoing price volatility as the pandemic negatively impacts the earnings of most companies and assets over the next several quarters.

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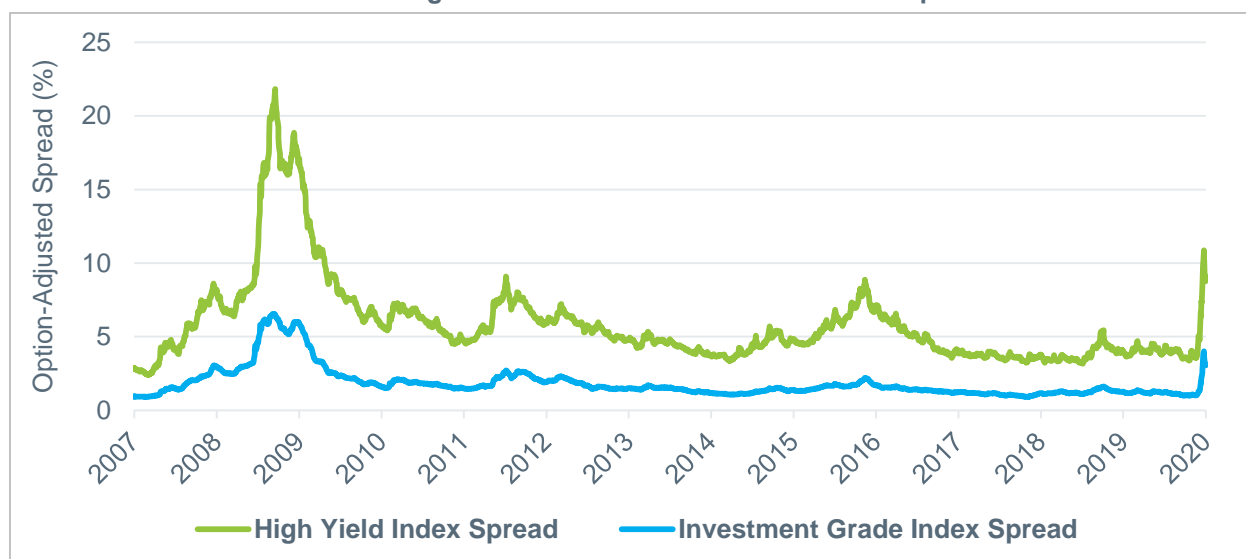
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## Market Environment

In March of 2020, a combination of investor liquidity needs and concerns over the potential income and cash flow impact of the COVID-19 pandemic on a series of public companies, assets, and related credit securities caused significant outflows from a wide range of investment vehicles, as well as the forced deleveraging of a series of highly levered investment products facing significant margin calls in a liquidity-constrained environment. The suddenness and scale of outflows and deleveraging, in combination with a lack of potential market buyers, has created an unprecedentedly sharp distortion across much of the US public credit market. In many cases, bond spreads doubled in less than one month, compared to a more typical doubling of spreads over periods of three to six months during the course of the 2008-2010 financial crisis. In [Exhibit 1](#), we show changes in high yield and investment grade bond spreads through April 1, 2020 as two examples of the scale and speed of the current credit market distortion.

Exhibit 1: High Yield and Investment Grade Index Spread



Source: Ice Data Indices, LLC. High Yield Index is represented by the ICE BofA US High Yield Index. Investment Grade Index represented by the ICE BofA US Corporate Index. Data as of 4/1/2020.

While we believe that sharp declines in price are justified in the case of some securities, the recent dislocation across US credit has been largely indiscriminate. In many cases, the prices of senior debt, securities issued by stable companies, and structured credit instruments secured by robust underlying cash flows or assets have dropped nearly as sharply as the prices of junior debt, securities issued by unstable borrowers, or instruments unsecured by collateral. Similarly, the prices of more stable securities have, in many cases, dropped more sharply than would be expected even in the event of a material, multi-year negative impact on company earnings or, in extreme cases, the bankruptcy of their issuers. In many cases, high quality securities with negligible associated risk of delinquency or default, even when the likely effects of an ongoing pandemic are accounted for, are currently trading at discounts that indicate the potential for a realization of equity-like returns in a relatively short period of time.

Although many dislocations can be identified in the current market landscape of global asset prices, we believe the opportunity to potentially earn equity-like returns through investment in the senior debt of stable, “blue chip” borrowers or in structured credit securities backed by stable cash flows or high quality assets represent some of the best risk-adjusted relative value currently available to diversified institutional investors. From the perspective of historical valuation, we similarly believe that this environment likely represents some of the most compelling broad-based opportunities that have been available in US credit markets for many years. As such, RVK is recommending to clients with the willingness and ability to make opportunistic credit investments to carefully consider establishing or expanding their exposure to these types of securities through a dedicated credit dislocation strategy while the current dislocation persists.

While we expect the opportunity set to continually evolve, at this time, we believe it is likely that the near-term investments of most credit dislocation focused funds will target the senior, publicly traded loans and bonds of stable, cash-flow heavy companies, a large number of which are currently trading at extremely dislocated prices as a result of the recent technical sell-off. Specifically, a large number of senior debt instruments that typically trade above par (or \$100 for each one hundred dollars of their nominal or face value), are currently trading in a range of \$65 to \$85, representing the potential for investors to realize equity-like annualized returns at the time that the principal of these securities is repaid, or at the time US public credit prices normalize. For ease of reference, an example of the current price, yield, and expected return of four sample investment opportunities targeted by a top tier dislocation fund tracked by RVK is shown in [Exhibit 2](#). Each of these investment opportunities were trading at or above par prior to the dislocation, with corresponding spreads of only

1.5% - 2.5%. As can be seen from the figures in [Exhibit 2](#), the prices have dropped by around 20% as spreads have widened to the 5-8% range. Additionally, the unlevered return potential of these opportunities is in the 10-14% range today as a result of the recent dislocation in public credit prices, where the return potential prior to the dislocation was in the 3-5% range.

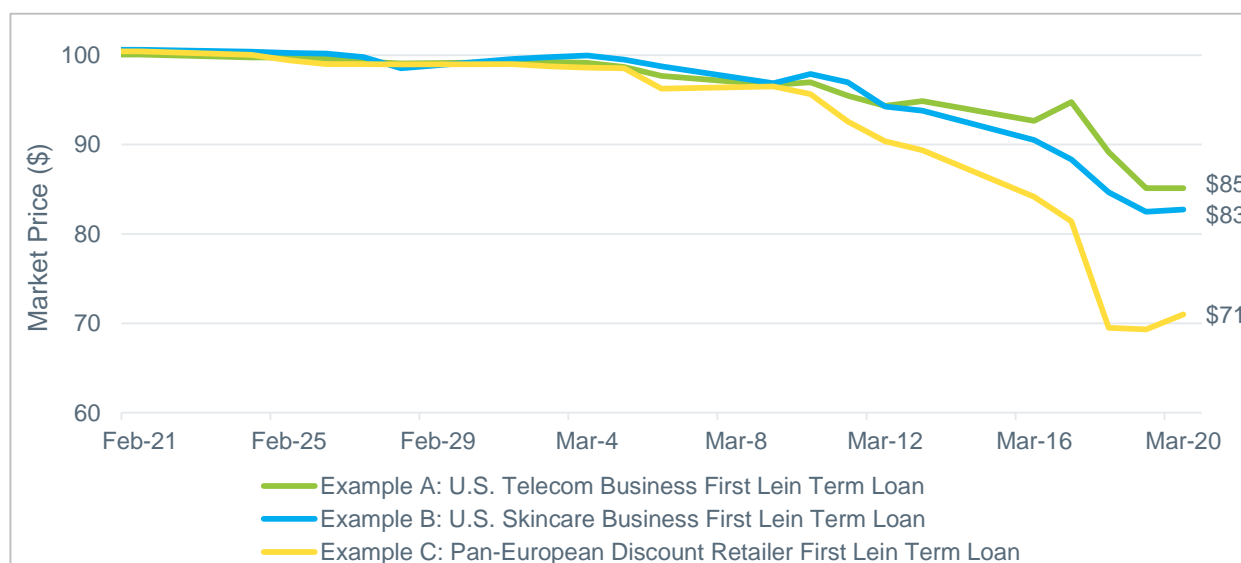
**Exhibit 2 – Current Dislocation Opportunity Set Examples**

Investment Opportunity	Date	Current Price	Current Spread	Expected Gross Return
Seasoned Legacy Non-Agency RMBS	As of 3/27/2020	~\$80-\$83	6-8%	15%-18%
A-Rated CLO Debt	As of 3/31/2020	~\$84	5-5.5%	12-16%
Senior Single Borrower CMBS	As of 3/27/2020	~\$82	5%+	10-14%
Basket of High-Quality Senior Bank Loans	As of 3/31/2020	~\$86	6%-8%	10-14%

Source: PIMCO.

A further illustration of the current opportunity set can be found in [Exhibit 3](#). The examples below are all first lien term loans for high quality businesses that carry a credit rating in the single B to double B range. All three loans were trading at par as late as February 24th, but were in the \$70-\$85 range less than a month later. Another top tier dislocation fund tracked by RVK has targeted these investment opportunities and believes that a gross return of 12-20% is possible should the market stabilize and loan prices return to par in the next 12-18 months.

**Exhibit 3 – Current Dislocation Opportunity Set Illustration**



Source: KKR. Data as of 3/20/2020.

However, given the speed and comprehensiveness of recently announced policy initiatives by the Federal Reserve, which have involved not only the lowering of interest rates but also an aggressive renewal of the Federal Reserve’s quantitative easing practices with a stated focus on the price stabilization of both corporate bonds and mortgage backed securities, it

is unknown how long the current credit dislocation and its associated investment opportunities will last. As of April 3, a large number of alternative credit managers focused on this opportunity set have stated their belief that the majority of price dislocations have the potential to resolve within only a few months under some circumstances, though, as always, a more extended period of price distortion is also possible. As such, we believe that motivated clients with a strong desire to take advantage of the current credit market mispricing will likely need to move quickly before the price distortions correct.

## Portfolio Context and Considerations

Given the technical skill, market visibility, and sophisticated risk controls needed to correctly invest a dislocation-focused fund, RVK recommends that clients approach this opportunity set only through large, experienced, top tier managers that command a high degree of fixed income expertise and benefit from significant scale, extensive resources and high quality operational processes and procedures. Even given investment in a qualified, top-tier product, all investors should be conscious of the fact that most dislocation-focused funds are structured as closed in funds. As such, the liquidity of these investment options is likely to be extremely limited, with investor capital “locked up” for several years before distributions are made. Other key risks that potential investors should be aware of include the potential for continued, significant price volatility across even the senior secured debt instruments of stable companies until visibility on the earnings impact of the current pandemic improves and the trading and liquidity dynamics of the US credit market normalize, as well as the expected use of limited leverage by some credit dislocation strategies.

Within a portfolio context, we believe the equity-like expected return and debt-like risk inherent in most credit dislocation investments will contribute to improving the long term risk-adjusted relative performance of a typical, diversified institutional portfolio, both through elevating expected returns and through some degree of risk mitigation, which is made possible by the yield-heavy nature of this type of investment, the relatively low expected default and delinquency rates that characterize high grade companies in stable industries even during volatile periods, and the low basis at which securities will be purchased.

At the request of our clients, RVK intends to continue tracking potential opportunities related to both credit market volatility and ongoing changes in the US monetary policy landscape as a high priority, and will proactively reach out to interested clients as additional opportunities become available. Please do not hesitate to contact us at any time with questions related to this evolving opportunity set.

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<sup>1</sup> Between July and October 2018, Greenwich Associates conducted interviews with 1,128 senior professionals at 924 of the largest tax-exempt funds in the US—including corporate and union funds, public funds, endowments and foundations, insurance general accounts, and healthcare organizations—with either pension or investment pool assets greater than \$150 million. Study participants were asked to provide quantitative and qualitative evaluations of their asset managers and investment consultants, including qualitative assessments of those firms soliciting their business and detailed information on important market trends. RVK is one of three firms recognized in the large investment consultant category. The ratings may not be representative of any one client's experience with RVK; rather, they are representative of those clients that chose to participate in the survey. The results are not indicative of RVK's future performance. For more information, and to read the Greenwich article, please refer to the following URL: <https://www.rvkinc.com/about/about.php>.