THE DAILY CHECK-IN WITH GOLDMAN SACHS

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RECORDED: MARCH 11, 2021

Liz Bowyer: Hi, Lori.

Lori Pomerantz: Hi, Liz.

Liz Bowyer: You invest in bank loans and in high-yield bonds for Goldman Sachs Asset Management. Both of these asset classes have seen a significant amount of investor interest recently. What do you think is driving them?

Lori Pomerantz: So 2020 was a really strong year for high yield. We saw about $45 billion of assets coming into the asset class. And the reason for this is really the global reach for yield. So if you think about rates globally they've been low or negative. And with that, investors are trying to reach for the greatest yield, and so high yield is a place, particularly as spreads widened at the height of the pandemic.

So we saw investor flows into the asset class. And we also saw support from central banks, particularly the Fed. And with the support from the central banks as well as the money coming into the asset class, the capital markets were able to reopen. And with the reopening of the capital markets, companies, even if they were negatively impacted by COVID, were able to tap the capital markets, push their maturities forward, and add liquidity. And that really created a way for them to survive the pandemic. So we saw lower defaults.

Liz Bowyer: And what are you seeing so far in 2021?

Lori Pomerantz: This year so far we've seen a little bit of a different story. A bit of a pickup of volatility based on the potential for rising rates. And so we have seen a bit of outflows, around $8 billion so far this year. With that said, we mainly think investors will stay invested. This is probably just a bit of profit taking, and we anticipate another strong year for high yield.

Liz Bowyer: And what about bank loans?

Lori Pomerantz: So for bank loans it was quite a different story. Over the past few years that we've been living in this low-rate world, we actually saw a lot of outflows from the bank loan asset class. So we saw $85 billion of outflows between November 2018 and November 2020 because the floating rate component of bank loans. So lower rates means lower coupon on bank loans.

But this year with the pickup in treasury volatility and the anticipation of potentially a higher rate environment we've actually seen inflows into the asset class. And we've seen about $8 billion of inflows into the asset class so far this year. We anticipate that this will continue throughout 2021 and into the next year.

Liz Bowyer: And just given that the Fed has indicated that it's in no hurry to raise rates, what do you think is driving the inflows into this asset class?

Lori Pomerantz: Yeah, I think that that's exactly rate. The Fed isn't anticipating rising rates but the market seems to be thinking that there could be some increase in rates. Just stepping back beyond just thinking about rates, when it comes to the floating rate asset class like bank loans, there are other attractive features of bank loans. And I think that for that reason it's a good time to invest in bank loans because you have this potential for rising rates, but you also have very attractive yield in the asset class, particularly versus other fixed income, public fixed income asset classes. You also are higher up in the capital structure, so you have security. So bank loans are secured pieces of paper. They're secured by the collateral of the company or the real assets of the company, and essentially that is real value that's given to the loans.

So if we think about if a company were to file for bankruptcy, essentially bank loans would be in the top of the line of payments essentially having a value from the company if the company were to file for bankruptcy. Additionally, just thinking about the rates topic, there's essentially no duration in bank loans. And that's something that's attracting investors to the asset class as they think about the potential for rising rates. The fact that there's no duration and you have this floating rate component, the coupon would step up if rates were to increase.

Liz Bowyer: And where is the demand coming from? From what sort of investors?

Lori Pomerantz: Really, over the past couple of years, there's been growth in the CLO business, and that's collateralized loan obligations, which are securitizations of pools of loans. And CLOs are now about 65% of the demand for bank loans. And what's pretty notable about this is that CLOs are essentially buy-and-hold investors, which means that they give some stability to the prices of bank loans. And with stability in the prices of bank loans, it's essentially created lower volatility and better risk-adjusted returns. And as a result, we've seen very strong, sharp ratios over the past ten years of bank loans, higher than US treasuries, S&P 500, high yield, and investment grade.

Liz Bowyer: So let's turn back to high-yield debt. Just by nature, the companies that issue that type of debt are generally considered riskier because they tend to have more debt. How are investors thinking about that particular risk?

Lori Pomerantz: So you're right in that the rating agencies rate them high yield or assign them lower ratings to these companies because they have higher debt to IBIDA or a higher leverage. And as we think about 2020, leverage actually picked up pretty significantly in COVID because of the lack of revenues or even negative IBIDA that these companies were generating. So with that, leverage ticked up higher, but the capital markets were open and companies were able to tap the capital markets in order to put more liquidity on their balance sheets to push out their maturities in order to survive the pandemic.

It's really important for investors to look at each individual credit, to evaluate each idiosyncratic situation and determine if you're getting paid appropriately for the risk that you're taking this is really where active management comes into play because you can invest in companies that you believe will come out the other side and avoid those that you don't think will. And in turn, this is really what drives performance, the ability to security slack as well as to avoid or reduce the defaults in a portfolio.

Liz Bowyer: And what about the concern during the pandemic that many investment-grade companies would fall into that high-yield or junk bond territory? How's that played out?

Lori Pomerantz: Yeah, so if we rewind to 2019, we saw 50% of the investment-grade market go to triple B, and this is the lowest rated tier of the investment-grade market. And so investors were very concerned that if the risk was going to be some sort of a negative event that there could be a large downgrade cycle from investment grade into high yield. And this is what we call fallen angels.

So fast forward, COVID happens. We actually did see this large rating migration from investment grade to high yield. We saw about 200 billion of downgrades in 2020. And what the fear really was was that the high-yield market wouldn't be able to absorb this large amount of investment-grade paper coming into the market, but that's not what happened. The high-yield market was actually able to absorb it, and it actually provided for some really interesting opportunities as it diversified the market, it made the high-yield market higher quality, so about 50% of the market is now double B, so overall bringing the quality of the market higher. And it also provided some more dynamic papers to invest in.

Liz Bowyer: So what's an example of a place where you've seen this play out?

Lori Pomerantz: One sector where our team really played this trade was in the energy sector. So going into 2020, we were actually significantly underweight the energy sector because of the quality of the high-yield companies in the energy sector. We felt that they had overwhelming capital structures and wouldn't be able to survive the lower oil prices.

However, the investment-grade companies in the energy space that were falling into the high-yield asset class had much more sustainable business models, would be able to operate at lower oil prices, had dry powder if they needed to sell off to raise liquidity, and were able to tap the capital markets. So we found this portion of the energy market to be much more attractive, so went up in quality and were able to close some of that underweight overall in energy.

And what's interesting now is that there's potential for some of these energy companies to become rising stars or move back to investment grade. We think over the next 12-24 months there could be a significant trend instead of fallen angels going to rising stars.

Liz Bowyer: So finally, Lori, given the additional fiscal stimulus and an economy that's slowly reopening, what's your outlook for bank loans and high-yield bonds for the rest of 2021?

Lori Pomerantz: Yeah, so we think that 2021 is going to be a solid year for both high yield and bank loans. For high yield, we're forecasting about 4-5% returns in US high yield, about 3-4% in European high yield. And this is really going to be driven by CARRY [sp?], which is the coupon that you get. We think spreads are going to be relatively range bound at this level.

Bank loans are a bit of a different story. We see slightly higher, about 4.5-5.5% returns. This is going to be CARRY as well, but we also think that there is room for some price appreciation there. And what really drove the market in 2020 was the technicals, the flows coming into the space, the ability of the real backstop that the Fed provided to corporations, and the fact that the capital markets were open and able to help companies survive in that period. But what's really going to support our 2021 outlook is that we are anticipating pickup in performance in the back half of 2021 as vaccines get distributed and the pent-up consumer demand that's really in the market starts to come to fruition.

Liz Bowyer: Thanks, Lori.