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Interest rates, property prices and the role of credit in today's portfolio

Transcript of Charlie Viola's chat with Josh Manning

Josh: Hello and welcome to this podcast. My name is Josh Manning and I'm Portfolio Manager at Manning Asset Management. We're here today to talk about all things, interest rates, property prices and implications for portfolios, and the role of fixed income and credit in today's investment environment. I'm joined today [00:00:30] by Charlie Viola. Welcome, Charlie.

Charlie: Hey, Josh. How are you, mate?

Josh: Very well. Thank you. Yourself?

Charlie: Yeah. All right, all right.

Josh: Excellent.

Charlie: Certainly, all very topical in what we have, perhaps the most volatile markets that we've seen for a really long period of time, isn't it? So-

Josh: Absolutely.

Charlie: ... we have investors almost conditioned to markets doing nothing but going up for 10 years. So certainly, some interesting conversations that are going on at the moment.

Josh: Yeah. Well, I'm really interested in setting the scene today. What are some of those [00:01:00] conversations? What are some of the headwinds that portfolios are facing, the conversations you are having with your clients?

Charlie: Yeah, it's a really difficult environment right now, I must confess. We certainly, and in our business, we manage probably 3.4, 3.5 bill of assets in our management. And I look after just a bit over two of that myself for my client base. We've got a lot of cash. We're sitting on our hands with a lot of cash at this point in time. We're probably in that environment where growth is down, inflation [00:01:30] is up, the impact on interest rates on everything across the stack is really profound. You've got this environment where, with the inflation somewhat rampant, it's having a real impact on consumption. Consumption has an impact on earnings. Earning has an impact on forward multiples. And that has an impact obviously on investor confidence and on prices, so you've got this piece where equity markets are really muted. It feels like [00:02:00] there's now more risk even in commercial property markets because those cap rates compressed really significantly and they probably haven't blown out, so the risks are probably a little higher. It's a really difficult environment to try and find return anywhere at this point in time.

Josh: And wen you think about it, we're quite early in that process [inaudible 00:02:21]. We have had 225 basis points of RBA cash rate increases, but only really 75 basis points of that has actually gone into [00:02:30] a lot of borrowers' mortgages. So, there's been a lot done, but we haven't really seen the impact of that. And I'm sure that makes it even more challenging to paint the picture of what's ahead.

Charlie: Yeah. It certainly doesn't feel like we're the end of this story. Quite how high interest rates go is questionable and love to get your view on it. But certainly, from our perspective, it's really hard to know what central banks and central bankers feel like is the right rate to put their foot

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on the throat [00:03:00] of inflation. When you've got cost of services, I think it's running at like 6% and cost of goods 5 or whatever it is. At this point in time, it certainly doesn't feel like we are getting a handle on it just yet. Probably, I tend to be the most optimistic guy in the market-

Josh: [inaudible 00:03:20] Charlie.

Charlie: ... [inaudible 00:03:21] I allow that for the granthams of the world and what have you. There's an old saying in our world which is, if you sit at the pub long enough, you'll get drunk [00:03:30] soon enough. So, those guys were always going to be right sooner or later in terms of when the cycle turned. But one thing that we try and impress upon all investors is we still need to make investments. We still need to get money out and invested. And we need to have the confidence that over time, quality will actually tell out. So, we still want to be buying good quality assets through the cycle, making [00:04:00] sure that we're generating revenue for clients. We just want to make sure that we've always got powder dry because if it does get worse and we certainly don't feel like we're at the end of this story, we want to make sure that we're able to deploy into the weakness.

Josh: Yeah, absolutely. No, it's a really good insight. And you asked me views on interest rates and where that at, and we would definitely agree. I mean, the central banks need to keep moving until they can get inflation down. They can't fix some of [00:04:30] these supply-sided issues which is really driving inflation, so they need to stay down consumers and keep raising those cash rates to try and, as you say, put the foot in the throat of inflation. So, it still does feel like early days for us. I think those lags in the system about the interest rates take time to feed into mortgage repayments. We've also got consumers or household balance sheets, having a lot of excess savings. And then also, another factor is that a lot of mortgage holders have actually [00:05:00] fixed their mortgage. So, it's taking a long time for this increasing cash rate to actually feed through to the underlying consumer. And we really haven't seen data that I see at least that really having any impact. So, I think-

Charlie: On consumption? You meant-

Josh: On consumption.

Charlie: On spending?

Josh: I'm really trying to influence the household sector, which is 54% of GDP. It's a huge part of it. And until we start to see that household sector slow down, I think the RBA has got a very difficult job locally. [00:05:30] And if you look overseas at the Fed Reserve and I think they're spoken about it a lot, but it is interesting the pace of their rate hikes is a very consecutive rate hypes. And if anything, they're increasing in size, they're getting back to that neutral, but they're still thinking they need to do even more in getting the cash rate up. So, there's definitely some headwinds there that I think investors need to think about.

Charlie: Yeah. I must confess, we get concerned about what spending [00:06:00] numbers and consumption numbers will look like in three months time. That issue that you talk about, which we talk about, the fixed rate cliff, where you've got a whole bunch of investor or a whole bunch of people who have got fixed rate loans, those fixed rate loans come off and become principle and interest over a period of time. You've actually got to double whammy because you've got an increase in rates, but you've also now got people having to amortize their loans or pay their loan down over a period of time. So, where they [00:06:30] were maybe paying, and making up numbers, but where they were paying $1,500 a month, suddenly, they're going to have to pay $4,000 a month. So while the interest component has gone up, now the fact that they had a 30-year loan which is now truncated to 25 years or 20 years that they've still got to pay down, actually, we are concerned that that's going to impact spending over time.

If that starts to flow through in some of the data, we know how sentimental markets are, we're going to see reasonable levels [00:07:00] of selling and risk off behaviors from markets. So, we're sitting on our hands and waiting for a few of those things to occur before we deploy too heavily to equity markets. So, certainly interested to hear your view though. You're obviously a credit expert, so certainly interested to hear your view around how you see credit markets because there's two pieces to interest rates going up. One is as an investor when you're investing in credit [00:07:30] right now. It feels all right because you are getting risk-adjusted returns of two or three or 400 over

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and now, you're getting four or five or 600 over. But the other side of the equation, someone's paying for that, right?

Josh: Yeah, exactly.

Charlie: So, love to hear your view. If we're struggling to deploy into equities or to risk assets, why should we be deploying into credit markets given that there's got to be a risk that someone actually can't pay the coupon or [00:08:00] make the interest payment.

Josh: Yeah, that's a very good point And as a credit expert, the main thing we look at, the only thing we look at is risk. That's what our core competence is. And you're right, so the fund is based on a RBA cash rate plus, so as the RBA cash rate goes up, our returns on the fund go up because a lot of underlying notes or assets are floating rates. So as the rates go up, so does our returns. So, it's really good in that way. As you say, the other side of the coin is the outlook. And [00:08:30] can people continue to afford to make those repayments? And if they can't, what protections are there in the portfolio to get our capital back? In terms of the risk profile at the moment, I mean, it's remarkable speaking to a lot of mortgage lenders, consumer finance lenders. The key loss triggers you look at is what's your level of arrears, how many people are not making payments, how many borrowers in their books are [00:09:00] actually in some workout scenario where they're foreclosed on their loan or signs of distress, I guess, more simply.

And those statistics are very, very low. We had a really low level of arrears and so forth through the COVID period, and that was given largely attributable to a lot of the stimulus that the government put into the system. So they have gone back up but from a historical perspective, they're not elevated. I guess the challenge here is [00:09:30] as we see that transmission mechanism from RBA cash rates feeding to mortgage rates, will we see arrears continue to go up? And for us, the number one thing is the labor market. There's been periods of hiking interest rates, issues such as that. As long as the labor market is strong, we don't see housing or wider problems in the credit markets because while people [00:10:00] have the ability to pay their mortgage, pay their loans, other obligations, they typically will. It's when they don't have that capacity to pay and that is largely attributable to unemployment. So for us, our number one focus is just understanding that labor market because we feel like it all sort of starts from there.

Charlie: So, your credit fund is an asset-backed fund. Is there any sector, given the current environment, [00:10:30] given that the possible headwind in terms of consumption and people's ability to afford to go out and spend, in your view, are there any sectors that you will now shy away from lending to? Are there any types of businesses that you just put a red line through it straight away as the opportunity comes across the desk?

Josh: Yeah, that's a really good question. So if I can start with how I think about credit, there's different types of credit. There's [00:11:00] fixed rate and floating rates. So fixed rate, it's X percent per annum irrespective to cash rate. Floating is floating over some sort of cash rate. There's secured where it's secured against the house, a building or a piece of equipment or a car or something like that or there's unsecured, some people call it secured but secured by a business, but the business has no real intrinsic value if it's not going well. So, we call that unsecured. Some people say it's secured by the business. The business isn't worth anything if it's not [00:11:30] performing, so I call it unsecured. And then there's single obligor or single borrower credit or diversified credit. So, we are in the diversified credit, so I'll leave that to the last single obligor, A is lending to B, an investor is putting money in a government bond, a diversified portfolios, where you've got hundreds and thousands of underlying loans and that's where we sort of specialize in.

So from a high [00:12:00] level, things that come across the desks that are unsecured, we just don't even look at it. We think that security is absolutely critical for recovering our capital if [inaudible 00:12:11] file. We look at diversified because the problem with single asset is you can't really get diversification across industries, loan types, underlying types of companies. So, that's challenging for us and it's quite lumpy, that type of exposure, [00:12:30] so we've never been a huge sort of advocate for that. And we're looking largely for floating rate securities where our rate of return goes up and typically where the underlying assets also have an interest rate profile that goes up with them so the more interest that's collected off the book gets fed to us, there's not this sort of mismatch in funding there. So, that's kind of how we think about it. So floating rate, secured, diversified [00:13:00] credit where lots of underlying loans, and then we look across mortgages,

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business loans, consumer loans. Mortgages and business loans I think is a good place to be right now.

Charlie: So to be clear, when you do a business loan, you're still looking for something real to secure the loan against?

Josh: That's right. Yeah, it's typically equipment finance. Somebody wants a ute or a piece of equipment or a trailer or something like that, and they've got some money [00:13:30] and they want to basically pay that asset down over a three to five year period. So there's a hard asset with a serial number that can be located and recovered in the event of a problem, which is the final backstop, but really, it's around the quality of the business itself. So, we think that space is a good place to be. We think mortgages at a conservative LVR without that construction development risk is a good place to be. Consumer I think is a more challenging [00:14:00] place just given the RBA's intent to really crimp the level of growth or really impact that to get the inflation rate down. We feel like we're fighting the Fed but fighting the RBA in some regards there, so that's quite a small part of the book.

Charlie: Yeah, right. So I reckon, if you talk to most investors, they'll put their portfolio into [00:14:30] two main buckets, right? They'll put them into growth assets and defensive assets. And hopefully over the time, what you get out of your growth assets is you get a bit of capital growth, you get earnings growth, so the income on your CBA shares last year was $3.90 and this year, it's $4.10, and you continue to see that over a period of time. And then, you have your defensive assets, which are bonds and cash and fixed interest investments, et cetera. We've probably [00:15:00] see, I should say, over the last six months or so, where those defensive assets, especially bond portfolios, have been absolutely torched. We saw this huge sell off in bond markets towards the end of last year in that October-November period. As a credit expert, and I realized that you don't do a lot of the bonds and corporate bonds and what have you, maybe give us the **layman's** explanations as to why those kind of bond markets got sold off [00:15:30] so heavily.

Josh: Yeah, sure, sure. So, there's really two factors there. The first is a lot of those bonds were fixed rate, so they're paying 2-3% and then as the RBA cash rate goes up, investors' expectations around the rate of return expected from that counterparty goes up and therefore, a lower yielding bond is worth less than a newer bond with a higher interest rate. So naturally, there's a repricing effect there. The other thing was the investor's [00:16:00] appetite for a unit of risk. It's a bit theoretical but for each unit of risk, an investor expects a higher level of return to compensate for it, and that's called a credit spread. It's the spread between a credit risk and a higher credit risk. The additional return. Those credit spreads blew out, got wider, which in layman's term basically means the lower the credit quality, the higher the expected return in the investor demands, and therefore those bonds fell in [00:16:30] value to deliver that higher rate of return. So, it was the double impact of those. And there's some evidence that risk margins come in, but it's still quite wired, it's still a lot in the market there. And then on the RBA cash rate, that's obviously also going up. So I guess we are not seeing a snapback in those prices. We really think almost there's a new equilibrium that's been established in a way. I don't know if you have a similar-

Charlie: Yeah. No, I mean [00:17:00] I must say, we feel very fortunate that we virtually had no long dated or long duration kind of-

Josh: By design obviously, Charlie.

Charlie: Yeah, by design. Absolutely. So, we had virtually no long duration bond portfolios in our client portfolios and that stood us in good stead. And certainly from a portfolio construction point of view, we've always been a big one for real diversity. We like any business, any business with the level of assets out of management that we've got have got a reasonably vast [00:17:30] exposure to equities just because over the years, they've done the best and they've gone up. The reality is if you did nothing but invest in Australian equities since 2010, you've seen your portfolio do nothing but go up and generate more revenue. So by nature, our portfolios are reasonably bloated from an equities point of view, but we're big ones for diversity, we're big ones for generating revenue in different ways. So, we were really fortunate through this last 6 to 12 months where we had a lot of non-correlated assets or we had a lot of real assets [00:18:00] in the portfolio.

We had a lot of infrastructure, we had a lot of industrial property style assets in the portfolio. So, we were still eking out positive returns when markets were being sold off around arrears. And we take

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the view from an investment management point of view that we want to be generating returns in different ways. We want cash flowing into the bank account from different types of assets all of the time. And we don't want to be taking all of [00:18:30] the same risks with all of our clients' money all of the time kind of thing. And I think it was probably easy to forget credit style investments while risk assets are going through the roof and cap rates are compressing, and therefore industrial property values are blowing the doors off. So, I think it's at this point in the cycle now where we almost look back and go actually, where does credit fit [00:19:00] in our client portfolios, which corner of the portfolio is it for?

And the real value we get out of a funder like yours or any of the asset back credit funds that we might look at or use is we're almost getting that inflation protection within the portfolio. We're getting a rising rate of return as rates go up. We've got cash flowing into the bank account all the time. We are big ones in our world for backing the jockey. We need [00:19:30] to know that you are picking the right loans. We need to know that you are putting the credit out to the right people. And then we can comfortably sit there and have cash flow into the bank account for clients because ultimately, investment management is actually really simple. By good quality assets, don't blow up your clients capital and have cash flow into the bank account so they can buy bread and milk and rice and race cars or whatever it is that they spend their money on a day-to-day basis.

So for us, we [00:20:00] do have lots of cash and we are a little skittish about making new investments, but we are allocating because my view [inaudible 00:20:10] is cash is really just sitting there waiting to be invested. I don't really see it as an asset class. It's there to buy bread and milk or it's there to be invested. So, we do want to allocate. We want to continue to allocate across the stack. Certainly for equity markets, we want to wait for that kind of deep weakness before we deploy because [00:20:30] it'll make us feel better about ourselves once markets actually do recover. History will tell us that, but credit is certainly now something that we're looking far more closely at, we're deploying far more into, and really across the spectrum of those credit style assets.

Josh: Do you think that there's a third bucket now, Charlie? You got your growth assets, your equities, volatile, et cetera. [00:21:00] You've got your very defensive asset, cash, term deposits [inaudible 00:21:04] high investment grade, fixed income. Is there a third bucket that's in the middle, which has high return, still has a capital preservations of the fixed income and so forth but just adds a little bit more return profile without going right up to that equity risk? And I was asking that in the context of industrial property and those asset class as you've mentioned, [00:21:30] that straddle [inaudible 00:21:32] and add diversification.

Charlie: Can I answer that question in two ways? Firstly, I never see risk in... Sorry. The way I look at risk is not the risk of volatility, it's the risk of impairment. So, people will often talk about equities. Equities are really good example because they're easy, they're easy ones to describe. Most people know what CBA and BHP and Westpac and Woolworth's and Transurban and whatever [inaudible 00:21:56], right? People will put those in the bucket of [00:22:00] being growth assets or aggressive or what have you, and they'll see them as high risk just purely because they change in value every moment of every day kind of thing. So we in our world never look at those assets from a risk point of view in terms of the risk of volatility. We know they're going to change in price. We look at them in terms of the risk of impairment.

So for us, we still see a lot of those large cap defensive equities as good quality, reasonably conservative [00:22:30] assets that aren't going to turn to dust tomorrow, are going to continue to generate revenue for us. Where the CBA's worth $90 or $105, we don't care that much. What we care about is that it's well-run, it's got a good balance sheet, it's heavily regulated, and it continues to generate revenue for us over a period of time. The old way of doing risk profiling and asset allocation we think is a little nonsensical. We just want to buy good quality assets for clients. [00:23:00] To your point though, we like real assets. We like that middle ground real asset that is asset-backed, that doesn't change in value all the time, that generates revenue for our clients, that pushes cash into the bank account, that protects value over a period of time, and that the real risk of impairment on either the underlying asset or the instrument is very, very low.

So for us, the [00:23:30] first screen that we do for everybody is what's the risk of impairment, what's the risk that this thing that we're buying is going to go from being worth a dollar and being able to generate income to turning to dust or simply no longer being able to generate income for us. And in truth, and this is perhaps a little contrary, and we're happy to give up liquidity as long as we

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know that it's not going to turn to dust and it'll continue to generate revenue for us because we can get liquidity [00:24:00] from everywhere. We can sell equities if we need to. We are generating cash all the time. So, I do think there is that kind of third bucket or something that you almost need to throw the buckets away and think about the asset classes and the assets in the context of what they actually do as individual assets, if that makes sense.

Josh: Yeah. No, that's very good point. Absolutely. So, you spoke a little bit about the spectrum of assets you look at in the credit sleeve of [00:24:30] your portfolios. Is it worth just maybe going into some of those and talking about them in a bit more detail and views on those?

Charlie: Yeah. So, we look at credit or fixed interest or debt, and you almost put them in a box a little bit. So, things that we haven't done a lot of and don't do a lot of is bonds, especially corporate bonds. We've just not been big fans of it. We've found not so much [00:25:00] access but pricing access and getting a real good understanding of pricing and what have you reasonably difficult. We've also probably found that piece that you talked about before about the gap between the risk free return, the return that you're getting out of those, which are still corporate-backed, you feel like you're coming up the stack from a risk point of view without really being rewarded for it. So, we probably haven't done a lot of bonds.

People will still put [00:25:30] hybrids, so listed hybrids into the fixed interest bucket, they're not really. They're equity. You're taking equity risk and getting fixed income returns. We've probably only used hybrids when we've seen dislocation or an opportunity in market. We probably haven't bought them just purely as an income-producing asset. So certainly during COVID, we went out and actually bought a whole stack of bank hybrids that had fallen well below their face value knowing that we were comfortable with the balance [00:26:00] sheets and what have you. So if we could go and buy $100-face value hybrids for 85 or $88 knowing that we're going to get bank bill swap rate plus two and a half or three and a half or whatever they were and then we were going to meet that arbitrage back from $88 to 100, we felt that that was a good return for investors in that environment. So, we did a bit of that.

So we used that almost just a way of generating a little bit of alpha for clients, but we haven't tended [00:26:30] to use them just to generate revenue. We've found generating that revenue from other assets as being more effective. We have done a fair bit of and we do like the asset-backed and property debt space. We've been a reasonably big investor in property debt style instruments over time with a number of groups that we like and trust, and we like the CIOs and we trust the investments that they're making and we trust [00:27:00] the projects that are being done. Like any business like ours where we're the custodians of a whole bunch of clients' life savings, we have some parameters in terms of what we're happy to invest in in terms of LVR, sponsor strength, time that the money is out, et cetera. But we've done a fair bit of that.

And probably, what we've probably found over the last five years or so, and [00:27:30] whether the environment's changing is questionable, and I'd love to get your view on that, is we've probably found the return on a bunch of that property debt stuff that the return has been asymmetric to the risk in that you've probably had house prices going up, you've had lots of people being able to borrow money to buy the properties at the other end, you've had developers feeling like the interest expense on the underlying asset is a very small margin of what their total margin is, [00:28:00] and therefore we've probably ridden the wave of that. We're certainly starting to do less of that as we feel like we're moving up the risk curve, but love to get your view on that because it has been a real source of client return over the last... And groups like Qualitas, Pallas, [inaudible 00:28:18], whoever, have done an exceptional job at managing their books, managing their risks, generating client return over the last number of years. But mate, you're the credit expert. Tell me, [00:28:30] has the risk changed?

Josh: Yeah.

Charlie: If investors are still piling their money into this stuff, is that the wrong thing to be doing?

Josh: In the main fund or as a business, we're not in construction finance. We're deliberately contrarian in that way, so I don't know if I'm unbiased in my viewpoint here just to caveat that. I do think you're exactly right. There has been a wave, banks are pulled back from that space, there's been a need for more flexible, [00:29:00] nimble capital to enter, to help meet the construction

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demand of eastern seaboard states. And when property prices march higher year after year, a developer might come in and pay $10 for a piece of land and then two years later, it's $12. If you're at 65% LVR at two years time, you're-

Charlie: 50, yeah.

Josh: ... 50 something. So, it's been a very good risk from a historical context, [00:29:30] but the historical context suggests that there is risk in that space. I guess for us, we're a bit different. We run a fund. We've got a track record. That track record will be around hopefully forever. So, we just simply can't afford to have any impairment, any issues. So when we look at that stuff we think yes, it makes sense, but [inaudible 00:29:58] I don't think I'm ever [00:30:00] going to have a problem in that space.

Charlie: How many positions are in your actual funds?

Josh: I think there's about seven and a half thousand loans in the book today, and that fluctuates around a lot. And our biggest exposure is about 1% of the book. So we look at it from that context of like, what happens if our biggest loan just walked off the face of the earth? The security also went with it and we keep that to a very small number, whereas a lot of that construction is quite lumpy. [00:30:30] And I guess it's the project risk element of it that we struggle with, which requires a series of things that happen to get your exit. And the other thing, we talked about property as this very homogeneous asset, where it's actually very heterogeneous. And some spaces are okay, some others aren't. It's a very complex area. And I think going with specialists is very important in that space, [00:31:00] but we shy away from it. Our client base is a lot of people who are mid-stage of their career to retirement and who really want that consistency of income, that sleep at night factor, and we just feel it's incongruent with that. So, I think there's a role for it, but I do think it's been a bit of a Goldilocks period through time and we're reaching a level maturity there.

Charlie: And to be clear, we won't do anything with construction in it now [00:31:30] at all, we just feel like, with cost of materials going up and the labor market, the cost of it. I do a little bit of industrial property development myself with a friend of mine and we were lamenting the other day where it was costing us. Only 4 to 8 months ago, we built some really simple concrete box industrial properties. Our cost to build was about $1,100 a square meter and now, it's 1,950 a square meter to build, which has just [00:32:00] completely shredded the margin in this next project that we are doing. We do this on the smallest possible scale compared to a bunch of these guys. The purpose of the example there is just to give the example of why we just won't do anything with construction debt attached to it.

We always, certainly, in our due diligence, want to see the underlying assets and the underlying sponsors [00:32:30] who've got the ability to continue to meet demands over time. But you're right, we've probably really benefited from the last few years in terms of that kind of asymmetric return versus the risk that was being taken. But it probably heightens that point that returns for investors are actually going to be somewhat muted and somewhat difficult to achieve anywhere over [00:33:00] the next little while. Do you know what I mean? And that's really a challenge. As investment managers and as people who look after other people's money, we need to continue to protect it, not blow it up, generate revenue and hopefully, still generate a level of return for them over a period.

Josh: Exactly right. And I think the playbook of what worked historically is changing just given the new equilibriums, the new geopolitical outlook. There's a whole lot of factors which I think today makes the investment environment very different to [00:33:30] what it was. And I think what's worked historically may not be the right place to be going forward. Well, I think that's almost time, Charlie. Do you have any final words of wisdom or insights to share with the audience?

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Charlie: No, no, but I think funders like yours, which we coursely refer to as the stay rich fund, not the get rich funds, are going to be good places for clients to continue to eke out those reasonable returns [00:34:00] from pockets of their portfolios in what will be I think a continued challenging period. And I think all eyes to the Fed and to central banks as to what's going to continue to happen with these interest rates because that should in reality, I think, be somewhat the lead indicator as to what's happening with spending and inflation and which, again, I think is the indicator as to where confidence goes over time.

Josh: Excellent. All right. Well, thank you for joining [00:34:30] us today.

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