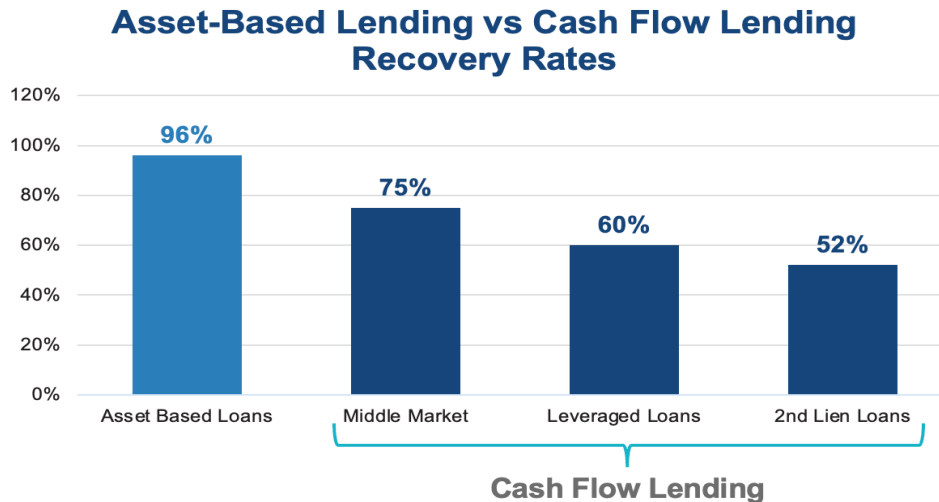




In Times of Crisis, Recovery Rates Matter a Lot

In our last QuickTake, “Not All Private Credit Is Created Equal,” we compared Asset-Based Lending and Cash Flow Lending. The purpose of the piece was to bring attention to the different underwriting features of these two lending styles and how they may perform in a difficult credit market.

One exhibit in that piece caught the attention of many: the differences in recovery rates across the spectrum of credit—as shown below. What we didn’t do in that paper was unpack what these different recovery rates mean in terms of differences in returns for investors.



ABL Source: Fitch Ratings, Inc., Ultimate Recovery Rate Study, October 1, 2019. Other Recovery Rates per LCD LossStats. Represents Average Discounted Recovery from 1987-2019.

In this brief QuickTake, we quantify how different recovery rates affect total returns during a heightened default rate environment. The key finding is that in times of crisis, recovery rates have a major impact on overall return.

Analysis

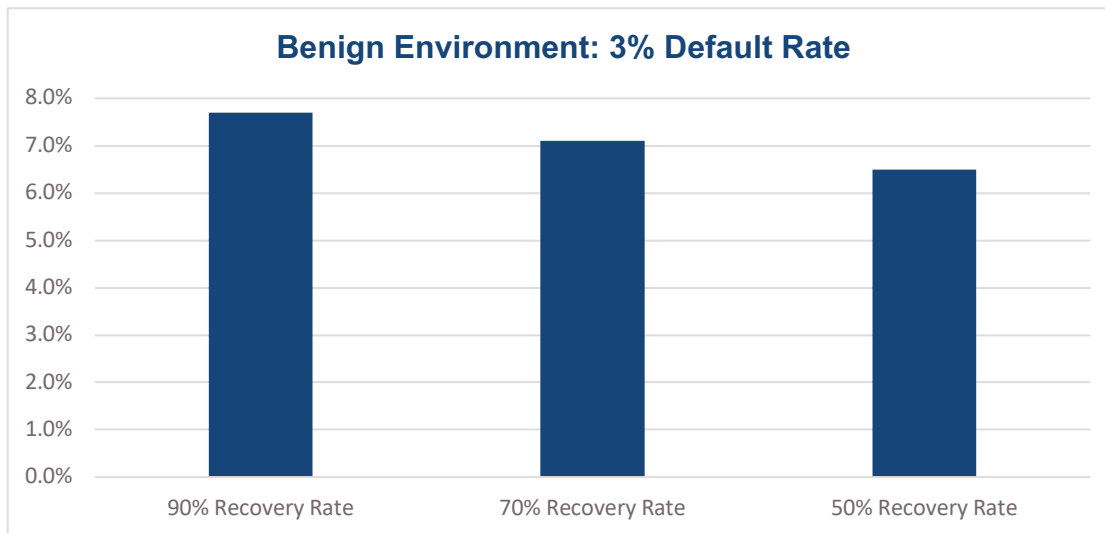
To analyze the impact of recovery rates on returns, we built a stylized model whose key inputs are the default rate and the recovery rate of a portfolio of loans. We do not seek to forecast either of these variables—we are simply “doing the math” to illustrate the potential impact in different environments.

Our model portfolio is composed of an equally weighted portfolio of 100 loans, each with three-year maturity and an 8% coupon. We analyze two scenarios: a benign environment in which default rates are 3%, and a crisis environment in which default rates are 13%. We then examine the impact of three different recovery rates across the portfolio: 90%, 70%, and 50%.¹

In the benign scenario with 3% default rates, recoveries don't have much of an impact on total return. A decline in the recovery rate from 90% to 50% leads to a modest 1.2% decline in annualized returns. When so few loans go into default, the magnitude of the recovery rate becomes an afterthought.

In benign default environments, recovery rates don't affect returns significantly.

ANNUALIZED RATES OF RETURN FOR DIFFERENT RECOVERY RATES

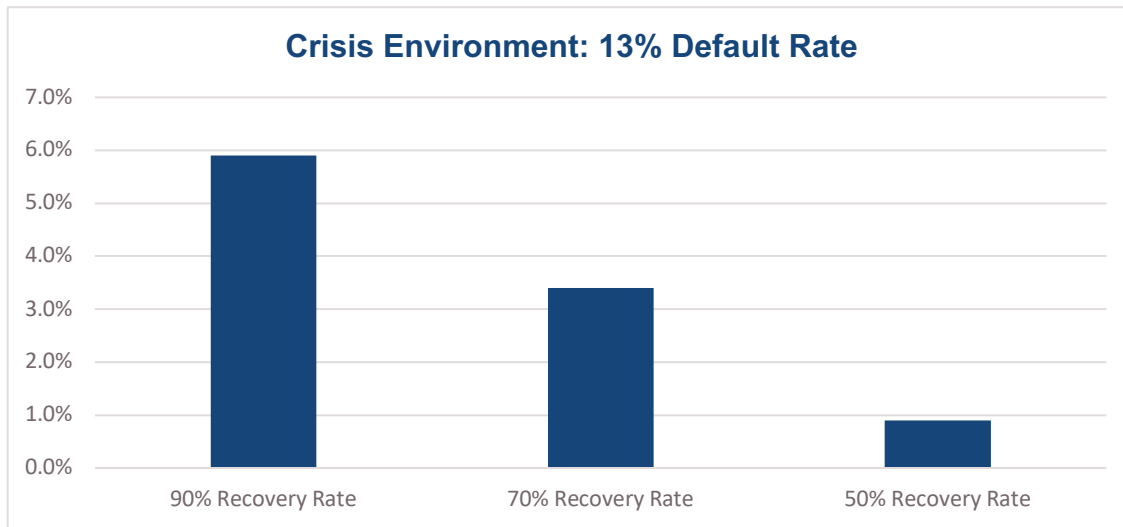


Contrast this with a scenario of 13% default rates. In this “crisis” scenario, a portfolio with a 90% recovery rate would return 5.9%. If the recovery rate dropped to 50%, the rate of return would drop to 0.9%—a significant decline.

¹ In addition to the assumptions on default and recovery rates, we also assume a 20% initial default discount. See the methodology section for more detail.

In high-default-rate environments, lower recovery rates are a significant detractor from returns.

ANNUALIZED RATES OF RETURN FOR DIFFERENT RECOVERY RATES



The fact that recovery rates matter more in crisis environments is not a blinding new insight. Our analysis above simply provides additional intuition as to the magnitude of the impact.

Conclusion

We have observed that many investors are hyper-focused on the risk of default in credit markets, but recovery rates are often viewed as a second-order concern. Our analysis suggests that this is perfectly reasonable when credit markets are not in distress.

However, during potential periods of credit distress, we believe fixed income investors would be well advised to pay as much attention to recovery rates as default rates, especially as the economic outlook continues to darken.

Methodology

We performed a Monte Carlo simulation, since there is some return dependence upon when loans are defaulting in the simulation period. Our model portfolio is composed of an equally weighted portfolio of 100 loans, with the following assumptions.

Portfolio Yield (PY)—The yield of each loan is 8%.

Maturity (M)—The maturity of each loan is three years.

Recovery Rate (RR)—The expected recovery on any loan that has defaulted.

Default Rate (DR)—The annual default rate of the portfolio. If the default rate is 12%, that means there is a 1% chance a given loan will default in a given month.

Number of Years of Analysis (NA)—The number of years over which the simulation is calculated. We assume the loans mature at the end of the analysis period.

Initial Default Discount (IDD)—When a loan defaults, we assume its value falls 20% past its eventual recovery rate, which is what typically occurs in the real world. For example, if the ultimate recovery is 80%, we assume the bond falls to 60% immediately upon default.

Years in Default (ND)—In this model we accrete a defaulted loan's price between the IDD and RR (between 60% and 80% in the above example). This mimics our observation of the real world, in which a defaulted loan value initially declines upon default and gradually creeps up to the eventual recovery rate over time.

Number of Scenarios (NS)—We ran our simulation over 250 independent scenarios. The outputs utilized in this analysis are the average returns over those scenarios.

Disclosures

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Investments in debt securities typically decrease when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower rated and non-rated securities present a great risk of loss to principal and interest than higher rated securities.

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The Fund is a "nondiversified" management investment company registered under the Investment Company Act of 1940. Since the Fund is non-diversified, it is subject to higher reduction of capital and volatility than a fund more proportionately allocated among a large number of securities.

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The Fund may use leverage its investments by "borrowing." The use of leverage increases both risk of loss and profit potential. The Fund is subject to large shareholder transaction risks which may cause the Fund to sell portfolio securities at times when it would not otherwise do to so satisfy large shareholder redemptions.

Shares of the Fund are not listed on any securities exchange and it is not anticipated that a secondary market for shares will develop. Shares are appropriate only for those investors who can tolerate a high degree of risk, do not require a liquid investment.

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