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Exploiting 'inefficiencies' to find yield: Inside a unique bond fund

John Coumarianos / 21 June 2021

George Jikovski translated his training on Jeffrey Gundlach's team to success on his own structured credit fund.

Investors are desperate for yield. Enter George Jikovski, a structured credit securities expert who honed his skills at TCW on Jeffrey Gundlach's portfolio management team. Jikovski now manages the River Canyon Total Return Bond fund (RCTIX), where he invests in the entire structured credit universe, which can be less efficient than other parts of the bond market.

Jikovski has managed the fund since its December 30, 2014 inception. From then through April, the fund has posted a 6.4% annualized return. He can play some defense too. The fund posted a maximum drawdown of 7.6% versus 9.9% for his average Multisector peer, though the Bloomberg Barclays US Aggregate's was lower than both at 3.6%.

What follows is a lightly edited Q&A between Citywire and Jikovski.

How big is the structured credit or asset-backed market, and what are the main types of assets involved?

The structured credit market, as we define it, is $13tn-plus. Major asset classes are:

- Agency MBS: $8.4tn
- Agency CMOs: $1.4tn
- CLOs/CDO: $1.0tn
- Agency CMBS: $786bn
- Private label CMBS: $608bn
- Private label RMBS: $585bn
- ABS (CC, Auto, Equip, etc.): $173bn
- Student Loan: $126bn

Ratings tranching varies by asset class and collateral type. Asset classes such as RMBS, CMBS and CLOs have a significant portion of their capital structure rated AAA (~60-90%), whereas others such as Aircraft ABS generally have the most senior part of the capital structure rated single-A.

Spreads are historically tight for plain corporate (both IG and HY) bonds right now. How would you describe spreads in the structured market in comparison?

The general theme of broadly tight spreads is consistent; however, there are pockets of the market where spreads haven't compressed quite as much. Sectors like Aircraft ABS and some CMBS, particularly Single Asset Single Borrower (SASB) deals in the office, hotel or retail sectors serve as prime examples. In addition, credit curves in some sectors have remained significantly steeper relative to some others like RMBS, and there continues to be a steady stream of new asset types into the securitization markets that offer compelling opportunities from time to time.

Despite tight spreads and low yields broadly, the heterogeneity among assets is orders of magnitude larger than within other traditional fixed income sectors. This makes security selection important, and makes it possible to build a higher-yielding, less-correlated portfolio than what might be achievable in more traditional fixed income sectors.

Tell us how you stress test a security. Feel free to give a specific example.

Stress testing isn't uniform; it depends on sectors and subsectors where a security resides. That said, we stress test each security for a variety of value drivers that are applicable to the underlying assets. The goal of the exercise is to determine a reasonable base case that establishes a margin of safety and identify conditions that may impair the security or that are optimal for higher returns.

Our stress testing across different asset classes amounts to several hundred scenarios per security (typically 500-700). For example, RMBS credit analysis involves stresses for variability in home prices, defaults, refinancing activity, modifications, forbearance, etc., with various timing iterations across each scenario. In Aircraft ABS, we stress test for a different set of variables such as reduction in lease payments, aircraft values, expiring leases, maintenance cash flows, etc.

How would you rate the credit quality of the fund's portfolio versus those of basic IG and HY corporate bond indices?

Around 57% of holdings are rated investment grade as of March 31, 2021. The vast majority of the non-rated items in the portfolio are mostly senior tranche, legacy RMBS as well as new vintage CMBS SASB senior securities.

Do the credit agencies do a good job in placing ratings on the tranches in this part of the market? If not, is that part of the inefficiency a manager can exploit?

Generally, credit agencies do a reasonable job of placing ratings in most large structured credit sectors. But there are substantial pockets of the market that go unrated, which does indeed produce some inefficiencies, since the majority of market participants are ratings-based buyers. CMBS SASB deals are a good example of this dynamic. Often times, these are not broadly syndicated deals that rely on ratings and therefore see a smaller audience and can offer attractive value on a select basis. Other instances include sectors like new business securitizations and sectors in their nascent phase of securitization or unrated portions of the capitalization. Lastly, ratings cannot fully capture in real time how actively managed deals, such as CLOs, are likely to perform over time as the underlying asset mix changes.

Around 24% of the portfolio is in CMBS, according to the most recent fact sheet. What kinds of property types are you finding attractive?

We think the CMBS market offers select opportunities that are quite compelling. The private label CMBS in the fund is primarily senior risk in deals issued post-Covid across a variety of property types including office, hotel, retail and industrial. We view this exposure as shorter duration, floating rate, high yielding ballast in the portfolio that is very well covered from an asset value perspective and comes with additional structural protections that typically were not included pre-Covid. However, the assets are senior in the capitalization, floating rate, shorter duration and should be well isolated from reasonably severe macro shocks.

Tell us a little about your background and career. How did you get involved in this market?

I began my structured products career 18 years ago (2003) in the mortgage-backed group at Trust Company of the West (TCW). Previously, I had been an M&A investment banking analyst at Bear, Stearns & Co. and a restructuring analyst at Houlihan Lokey. While at TCW, I focused on high-grade MBS including derivatives / CMOs and CDOs. My tenure at TCW served as valuable experience and a great stepping stone coming into 2007, when I joined Canyon and was able to take advantage of the wide scale opportunities on both the long and the short side of the RMBS market in addition to expanding my coverage area to include the entire structured credit market.

DISCLOSURES

The information in this publication represents the opinions of the portfolio manager and is not intended to be a forecast of future events, a guarantee of future results or investment advice. Due to various risks and uncertainties, actual events or results may differ materially from those reflected or contemplated in any such forward-looking statement

Historical ratings, as reflected in this article, are not indicative of future fund performance or ratings. Quality ratings reflect the credit quality of the underlying securities in the fund's portfolio and not that of the fund itself. Quality ratings are subject to change. Moody's assigns a rating of Aaa as the highest to C as the lowest credit quality rating. S&P assigns a rating of AAA as the highest to D as the lowest credit quality rating.

The fund's asset allocation percentages as discussed in this article are reflective of various points in time in 2020.

Definitions:

The Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage pass-through securities, and asset-backed securities.

Agency MBS – Agency Mortgage Backed Security

Agency CMO – Agency Collateralized Mortgage Obligation

RMBS – Residential Mortgage Backed Securities

CMBS – Commercial Mortgage Backed Securities

CLO – Collateral Loan Obligation

ABS – Asset Backed Securities

CDO – Collateralized Debt Obligation

SASB – Single Asset, Single Borrower

IG – Investment Grade

HY – High Yield (below Investment Grade)

Duration – A measure of the sensitivity of the price of a bond or bond portfolio to a change in interest rates.

Spread – The difference in the yield between two different bonds or different classes of bonds.

Floating Rate – An interest rate that moves up and down with the market interest rates.

RCTIX

Investment Objective: Seeks to maximize total return via income and capital appreciation.

Fees: Gross Expense Ratio – 1.09%, Net Expense Ratio – 0.68% (contractually waived through 1/28/22).

For RCTIX standard performance, please see the link: https://www.rivercanyonfunds.com/total-return-bond/

Performance data quoted represents past performance; past performance does not guarantee future results.

The investment return and principal value of an investment in the fund will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 800-245-0371.

It is important to note that the fund is not guaranteed by the U.S. Government. Fixed income investments involve interest rate risk, issuer credit risk and risk of default, and price volatility risk. Funds investing in bonds can lose their value as interest rates rise, and investors participating in such funds can suffer a partial or total loss of their principal. The fund invests in asset backed and mortgaged backed securities which may be more volatile than other fixed income securities and influenced by the housing markets or markets from which the collateral is drawn. For a more complete list of fund risks, please see the Prospectus.

The River Canyon Total Return Bond Fund is offered only by prospectus. The prospectus contains important information, including investment objectives, risks, advisory fees and expenses. Please read the Prospectus carefully before investing or sending money. For a current Prospectus please call 800-245-0371.

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