NAVIGATING GLOBAL MARKETS: OPPORTUNITIES, RISKS, AND STRATEGIES

Announcer 00:00

Please welcome the panel on "Navigating Global Markets, Opportunities, Risks, and Strategies," moderated by Global Finance Correspondent at Bloomberg, Sonali Basak.

Sonali Basak 00:35

Thank you all for joining today, and thank you all for being here. They say you're supposed to love all your children equally, but I've got to say, alternatives has always been my favorite space to cover. So I'm looking forward to this conversation on navigating markets, especially in the world of private markets. Now, I was thinking a decent place to start off is, Michael, your business invests in many other businesses, and I've seen you do it for many years now, and you have made a lot of changes in your strategy over time. What's in vogue? What are the types of managers you're looking for?

Michael Rees 01:08

Well, what really—good afternoon everyone, pleasure to be on the panel. The really—the thing in vogue today is looking for the firms that are creating the next version of asset management firm. If you think about what we're dealing with today in terms of the overall macroeconomic environment, what it means to raise capital, what you need to have as an organization, you need to start by thinking about what the next gen of your business is going to look like, and we'll talk more about it today, but it has to have a much more global remit. It has to have the type of capabilities to approach the wealth channel, the insurance channel, geographies that really weren't in play just 12 or 18 months ago. So as we think about our firms, we've always thought about the type of firms that do great investing, but at this point in where we think we are in the industry development, it's about who's thinking about the whole business and trying to create the alternative firm of the future.

Sonali Basak 02:13

When you think about the alternative firm of the future, it'll be interesting to see how you see it from an LPS perspective. Andrew, what are the types of managers you're looking for when you're putting money to work?

Andrew Junkin 02:25

I think we spend a lot of time focused on managers that we can build lasting relationships with, so someone that is probably introducing new ideas, certainly, but can share intellectual capital with us and not just invest our assets. There are lots of people that are willing to invest our assets, fewer people that are willing to sit down and share intellectual capital with us.

Sonali Basak 02:51

That's interesting. Josh, your firm is about to turn 35 you've operated in credit markets for a long time. When you're thinking about the next frontier, how do you feel that you have to morph Canyon to meet these new opportunities?

Joshua Friedman 03:03

You know, we weren't terribly strategic when we started our business. We started out as a hedge fund. It was that era in 1990 when, if you built it, they will come. As long as you were a good investor, you could invest the way you wanted to invest, and you didn't really want the LPS telling you how to invest. And if you had smart, accomplished investors in the room capital would follow. That's completely changed today. You have an entire community of advisors who are advising institutions on exactly where to put capital. You have the retail world, which is a completely different world. You have international investors who didn't really exist in on the institutional side you so the investor base has changed and the markets have changed, and what it's necessitated with us is to think—and by the way, most firms who started that way in our era really aren't around anymore. So the question is, how do we transform our platform to be a modern platform and not necessarily aspire to be like a blue owl or like an Aries or an Apollo or whatever. But how can we continue to provide high value added and that's meant we'd have had to take sort of the club sandwich, if you will. That was the hedge fund, and say, some people just want the lettuce, some people just want the turkey, some people just want the bread, and have much more productized types of products. And then also think carefully about the right scale of each one of those, so they can still be true alpha generators and not just scale opportunities. So that's required us to develop new products. It's also required us to lower our cost of capital somewhat, because not all products have the types of you have to have a high cost of capital if you're going to put high fee money to work. And a lot of our products today are lower fee types of products, and they need to have more depth and more and more higher volume, if you will. So we've, we've had to think about all those types of issues as we've recrafted our firm, and I think Michael hit right on it very well when he was talking about insurance is an example of one type of capital you have to think about. It's quite different from the type of capital that we traditionally would deploy. So that leads me to Megan, I wanted you to set the whole stage for the type of environment we're walking through right now, and what it means for private credit managers, credit managers that are trying to navigate what could be a slowing economy, maybe even a recession.

Megan Neuburger 05:28

So I—my role at Fitch is I lead the group of analysts that rate nonfinancial corporates in US and Canada. So our remit is really pretty broad. So within that group, we're looking at everything from triple A rated corporates all the way down to the lowest portion of the rating scale. And the two most obvious ways we interact with issuers that finance themselves in the private credit markets are through our portfolio of ratings on companies that finance themselves in the direct lending markets. And we have also seen, I would say, a growing trend and growing prevalence of some of our investment grade rated companies looking to the private markets as a partnership for some solutions around financing of particularly capital projects, around the AI cycle and all this intense investment that you've been seeing there. So we've really been seeing this kind of evolution, I'd say, since the global financial crisis, where, from the perspective of the corporate issuers, there's really been this development of this alternative market and place for issuers to go, particularly in times of stress. It has proven to be a bit of a release, a bit of an escape valve for issuers, particularly who have find them finance themselves in the direct lending market, to be able to tap into that capital in times when we have dislocation in the public credit markets, which, as we all know, can happen fairly frequently, and can sometimes happen for reasons that are completely disconnected from the underlying fundamental outlook of the issuers that we're rating. So I would say that, overall, the way we've seen the private credit markets move and develop over the last decade or so has been quite constructive for the for the issuers that we rate in terms of diversifying and increasing the potential pools of capital that they can tap into. You know, throughout the course of Milken, there has been a lot of conversation about what kinds of companies will thrive in this environment—small companies or big companies, domestic companies or international ones. And by and large, a lot of people are more concerned about the smaller companies. And Blue Owl was built off of a series of mergers and acquisitions. You take stakes in other companies—it creates the question of scale, both in terms of how large you need a manager to be and how large you need the opportunities to be for them to invest in. Is it "go big or go home" these days?

Michael Rees 07:59

Well, there's a certainly an aspect of what we look for that is "go big or go home." Our primary focus is on buying stakes in the top 250 firms in the industry, and that's because they have the scale and the wherewithal to be able to create this firm of the future and navigate the type of business environment we're seeing here. But you know, we also have to keep a farm team—a bench—of firms that we're keeping an eye on is as they continue to progress. Because we're positive that the top 250 firms now won't be the same 250 in three years, in five years. So, in the GP stakes world, we tend to skew towards the larger end and for our overall business, which is 60 percent direct lending at Blue Owl, we also have a scale bias, certainly as things get more choppy. And quite frankly, we don't see them getting choppy yet, but, you know, we're always mindful that they could. Our bias, though, is typically towards service oriented companies, nonmanufacturing, that are quite large and usually have a high degree of recurring revenue. So the whole company at Blue Owl has been positioned towards large safety and yield-oriented products for our investors, because of this very large and skewed equality bias.

Sonali Basak 09:22

Andrew, how do you think about the way managers show up? There's been a lot of conversation in the last couple of years about how LPs have been consolidating. They want to go to fewer and fewer managers. How do you feel about this dynamic?

Andrew Junkin 09:35

I guess that's not something that we've necessarily experienced at Virginia. I think we're looking for the right number of managers. We certainly don't want to create a very expensive private capital index fund. So that's kind of the "don't go there" line for us. I do, you know—back to my comment about looking for strategic partners—people that can bring multiple unique, interesting products, where we can create a relationship that covers multiple asset classes. Those are particularly interesting for us as well, but we do also have some small specialist managers. So I guess when you're dealing with $118 billion you kind of end up with some of a little bit of everything.

Sonali Basak 10:28

Now, Josh, I feel like you have an interesting view of what's going on into the world right now too. To the extent that you mentioned, maybe things are not getting bad yet. Where are they getting bad already?

Joshua Friedman 10:38

Well, you have to—when you think as an investor, you have to combine both what's going on in the underlying economy and what's going on in the underlying markets that you're serving. If you look at private credit, the part of private credit that has just massively hyperscaled—and certainly Michael, his firm and others have been at the heart of that—has changed. What used to be 675, over LIBOR and five times EBITDA is now 425, and it's seven and a half times, and there are no covenants anymore. So we know that doesn't end well. We've seen that. And then how do you keep the same returns to investors? Well, what some people do because there's just too darn much capital chasing large unit tranches as well. Let's just leverage what we have a little more to get there. That means you're really not seeing your debt at the end of the day. You're really junior debt, and you're very leveraged, and you're getting inadequately compensated for that, in my view. So you have to look at what's going on in the capital markets and when you see that, you say, okay, maybe I won't look there. But what have they have they left alone? That's a little maybe more interesting. And maybe there are things that are more bespoke or a little more, a little smaller or a little more complicated, with our higher value added, but not as scalable. And are you willing to run a firm that's not quite as scalable? Then you have to combine that with the economy, of course, overall, and where we are in that cycle is— difficult to know right now, because we don't really know what the ending chapter is going to be on some of the major issues that people are contemplating, including tariffs. I would say that my own view is there's a high probability that most of the tariff noise will ultimately be worked out in a way that's reasonable, and maybe a way that's a little more favorable and maybe a little fairer, even for the US, but, along the way, have you shaken consumer confidence to the point where that affects underlying fundamentals? Have you shaken corporate confidence where they don't necessarily want to make the capital expenditures the point where that affects the economy? Have you shaken counterparties confidence to the point where they're seeking changes in the supply chain, etc. So I think right now, you know, markets have a way of forgetting things that are bad, and so maybe everybody bounces back. And by the way, maybe the markets are down just because they were 10 percent too high the equity market. So maybe they're not telling us exactly. They were just looking for a catalyst for that because they were pretty frothy. So I think it's hard to know where we are. It certainly feels like transitioning from high level of government stimulus to less government stimulus to a world there are going to be more hot spots and more confrontations is one where you have to be a little cautious. And I would add to that caution that there's also the overhang of international issues that can be significantly disruptive to capital markets and significantly disruptive to individual companies that we invest in. We don't know how Taiwan is going to play out. We don't know how the Middle East and Iran is going to play out, but you can certainly imagine a higher probability today, maybe than in the past, of pretty sharp exogenous jolts to the economy as well. So I think generally, the fact that markets are being a little more cautious, and certainly we're being more cautious, I think, is probably appropriate.

Sonali Basak 13:51

How do you look across your portfolio companies right now, Michael, and tariff proof them?

Michael Rees 13:57

Well, the good news is I don't have to tariff proof them and I can't, their job is to tariff proof themselves. But,look, I think what people sometimes tend to forget about owning either public alternative firms like ours or the GP stakes that we own, is that our economics are really not derived all that much from the underlying portfolio. A lot of what we're earning is the, you know, continuation of the management fee income and the long-term performance of portfolios. There could and will always be ups and downs that will drive, you know, differences in cash flow from carried interest. But, you know, a Blue Owl generates all of its income from fees, and really very little from the underlying performance of our funds. And similarly, when we buy into a large firm, they're going to have, you know, $100 billion or more, sometimes of fee-paying AUM and. They're going to have 567, vintages of products, all sort of operating at the same time. And they'll be diversified across many, many different underlying asset types. We have domestic energy, we have private credit, we have infrastructure and buyout and growth. So, you know, there will be impacts from tariffs. Of course, we tend to look at the starting point. And if you go back four months to January 19, we were really in a—quite an accommodating position. There was—if you asked everybody on the street to get out your scorecard of where we sit, you would say, you know, inflation is more or less come down or coming down to the right level. Growth is strong. We have what we hoped was a positive tailwind from the president on the regulatory side. So at least at that moment, things were really, really good. Yes, valuations to Josh's point were high, but they were in a place where M&A activity, IPO activity, could really take off. So now, though it's been one heck of a four month window since that point. A lot of a lot of headlines and not a lot of actual action. But generally, you know, the managers that we are partnered with are very diversified across a lot of aspects, we have very little underlying manufacturing portfolio companies, and to that extent, very few that do a tremendous amount of cross-border trade. So generally, the private markets, and certainly where we operate in are much more immune to some of this tariff noise than you would see from large multinational manufacturing, auto companies, Caterpillar, etc. So we tend to feel like we're a second derivative from the tariff issues that are happening in Washington and across the globe.

Sonali Basak 16:56

Megan, how do you parse through all of the impacts across your coverage universe when you have to take that fine tooth comb and look at how companies are doing and what's on watch right now, given the uncertainty, where do you get the most concerned?

Megan Neuburger 17:10

Yeah, it's a great question, and we—you know, it as a rating agency, we really do our work bottoms up issuer by issuer. But we are starting from kind of a house macro view, right, in terms of where our economists think we're going to be going, in terms of the rate cycle, in terms of inflation. I think right now, with respect to, you know, particularly thinking about like the middle market portfolio, the direct lending portfolio, perhaps what's more concerning than tariff exposure is the fact that, you know, right now it seems that the Fed is leaning more towards inflation containment rather than recession prevention. So if we see a delay in that rate easing cycle, those are the kinds of things that can really create stress for the issuers in our portfolio that have capital structures that are highly exposed to floating rate debt. I will say, though, as we've moved through the rate hiking cycle, you know that we experienced starting in 2022, we haven't really seen defaults in that lower rated part of the portfolio materialize to the extent that we expected. And that's particularly true on the direct lending side, because you do have this sort of unique relationship there between the sponsor, the lender, and the issuer, and where we have companies that are facing a higher cost of capital. But they have a fundamentally intact business model that is not facing, you know, risk of technological obsolescence or some other, you know, really doom and gloom scenario. There is this sort of virtuous situation of everyone kind of working together to get that business through to the other side. Now, I think a good question for 2025 as we move into, you know, potentially a slower rate easing cycle, some tariff pressures that create knock on effects, economic effects, is how long we continue to see that, you know, continue and, you know, I think that's a really good question for everyone on the stage. But I think, you know, just thinking about tariff impacts, as Michael said, looking particularly at direct lenders, it's just a less exposed group of companies, from a business model perspective, a lot of domestic focus companies, not a lot of supply chain exposure.

Sonali Basak 19:23

Andrew, do you worry at all about the private markets and the ability to withstand any potential pain in the economy? There's been a lot of talk about the volatility of returns in public markets versus the lack thereof in private markets, but does that mean that there isn't pain there?

Andrew Junkin 19:39

I—yeah, I worry about everything, I think. So, yeah, that's probably somewhere on the list. I don't think it's particularly high. And I think some of it goes to what Megan just talked about in terms of this relationship between the sponsor and the lender and it's a—you know, it's a more agreeable relationship than perhaps public debt, where you're going to end up with lender on lender violence, trying to capture what's left. I do worry that an economic slowdown is of course, going to affect the underlying companies in private markets, but probably not significantly worse than in public markets. So then there's the last part of your question, which I think is, you know, is the accounting lag masking true volatility? And of course, it is. And so we try to look through that when we're doing our risk modeling. I happen to see our risk manager right there. That's where he spends a lot of his time trying to really get his arms around that. Can we do anything about it? Is another important question, and the answer really is no, right? So what we can—the levers that we can pull are really public market levers. What we've committed and invested, what's in the ground at the moment, really is kind of up to the managers that we've hired on the private market side.

Sonali Basak 21:08

It's interesting. There's one thing that a lot of private managers have seemed to be doing the last couple of years—Josh, I know you're very familiar with this—it's called "amend and extend," right? It's that idea of taking on more debt to get through another bridge period, then maybe another bridge period, and then maybe another bridge period. And I think this time around, as we talk to a lot of investors, they're starting to get concerned about how far the can is being kicked down the road. Josh, do you see this dynamic playing—how do you see this dynamic ending? Frankly, because we've seen many periods now of just continual borrowing.

Joshua Friedman 21:41

There's a lot more interesting restructurings now that the stock market's come in a bit. Of course, it's coming back. Sponsors want to hang on to these things, if they have optionality in their equity, and therefore they want to extend it, and they want to take a chance, and if they think they don't have optionality, they're more eager to get rid of it. And the—I think that—you know, let me give you an example. You can—there's a ton of real estate that was financed in this country in the last 10 years in a in a lower rate environment. And a lot of that wasn't financed for 30 years or 20 years or 10 years. And some of it's just great product might be fully occupied multifamily in Florida or in Arizona or in Texas, or places that have net inflow of people and a real lag in terms of new product. And by the way, a lot of new product was developed because rates were low. So there was a bit of a crush of supply that's about to vaporize. You're not going to see anything. The backlogs are nothing now, because the cost of materials is higher and the cost of debt is higher. Well, those are good products, but unfortunately, a lot of those buildings don't have a balance sheet that's built to last. And if it's one of the masters of the universe who was on the real estate panel the other day, they'll just put in more equity, and they'll eventually get bailed out by inflation because they have a real asset that is increasingly scarce as more population comes in and there's a lag in new product. But if you're not that, and you're a merchant builder, or you have a fund and you spent it all, what do you do? You don't really want to go to say everybody, well, I bought this thing at a four cap, and now caps are five or six. So that's an opportunity for people like us and others to play a version of that amend and extend game, where you make a loan, and it's a pay in kind second lien loan, and you know, we'll find out in three years if they get lucky enough to pay off our 14 percent or whether we own the building, and we own it at a seven cap instead of a four cap. That's a game that's going to take—we've seeing a little bit of that, we're going to see more of that, because a lot of those financings were not long enough. In the corporate sector, I think we saw a lot of things quoted way down when the market got walloped recently, spreads were ridiculously tight before they widened. We didn't necessarily see quite as much trading as we saw quotes. But I also think that a little bit in response to Andrew's comment, I think the creditors are getting tired of this creditor on creditor violence stuff. I find it personally offensive, to be honest with you, it doesn't sort of pass to me the ethical test of what I like to spend my day doing. If I have to defend myself enough credit we will, but we certainly don't like to be the person initiating some, you know, horrible asymmetric thing that benefits us and hurts everybody else who owns the same security. I just don't think is right. I think it violates what we used to call—they used to say every contract has an implicit covenant of good faith and fair dealing, that's what they taught us in law school. That's apparently not the case any longer. So I think people are sick of that, and you're going to see a little less of it. You're seeing larger and larger restricted groups, and people just they're really taking action against that. So—will you get more restructurings? Less restructurings? There's a lot of unstable balance sheets out there. There always are. It looked like we were in a period where everything was. Have a very bland ending, but with rates ticking back up and maybe things being a little weaker and the market showing a little more volatility, we're definitely seeing an uptick in restructuring supply.

Sonali Basak 25:13

It's interesting. The flip side to this is this idea of opportunistic investing, and we are seeing one fund after another being raised in that space. How much are you seeing that, Michael, and how interested are you in those types of opportunities?

Michael Rees 25:28

Not very interested and we try to stay away from that. You know the kind of, you know one time or temporal opportunity that would, you know, that you're referring to, Sonali. But, you know, when you think about what the—you know, what the largest managers in the industry are doing is they're trying to deliver the type of return over cycles that their investors want. I mean, I do think from time to time there are interesting opportunities, but there tend to be small and fleeting. And you know that this is a very creative industry and most good opportunities are armed away quite quickly. So you know what we try to do at Blue owl across 275 billion in assets is find downside protected cash flow strategies that are going to allow people to sleep at night, not just for a quarter, but for a decade. And so, you know, we tend to be, perhaps way too calm, way calmer than we should be at times like this. But you know, we've intentionally built these businesses across all of our underlying asset classes to not follow the shiny object and to build something that truly is giving cash flow back and mitigating risk on a continuous basis so that we don't have to really run to the next new thing.

Sonali Basak 26:55

Megan, when you think about this dynamic that Josh was talking about between creditors, how do you see that playing out, especially if we see a slowing economy?

Megan Neuburger 27:04

Yeah, well, I think, you know, we do hear sort of conversations on lender and lender violence in the private credit space, but from our observation, it's really a very different dynamic than what we see in the public markets. You know, what you see in private distress situations is generally the lender, sponsor, and issuer working together, coming forward with some type of quid pro quo transaction where both the lender and the sponsor give a little bit of concession in order to try to make that company get to the other side and survive and preserve value. Whereas, you know, transactions that are financed in in BSL market, it's just a very different environment. You have a relatively large, relatively intractable group of lenders. And I think it, you know, in those cases, you do have opportunity for the issuer and the sponsor to, you know, pit people against each other and come up with these very complicated LMT transactions, which, you know, typically result in very complex and layered capital structures, because you're adding layers of debt to that capital structure. And it is very value destructive in bankruptcy, right? Because you're going through this now very complicated, complex workout situation, when those credits finally get in to a full bankruptcy, you know, in court restructuring. And we have found looking at, you know, we've looked at research, you know, on, you know, public issuers that have defaulted, that have executed an LMT, and those that haven't. And we do see that it has pulled recovery rates down. We're now down to, if you look at recovery across, you know, bankruptcy situations in the public markets, you're looking at about average 40 percent recovery, you know, sort of across all bankruptcies. And if you look at just the LMT group it, you know, it's lower. So.

Sonali Basak 29:01

Now it's interesting when people talk about private credit, they so often talk about it as that nearly $2 trillion direct lending market, but then the estimates have gotten much larger in recent years. You have Apollo pinning it at about 40 trillion now, and what they're including is not that traditional direct lending. They're including all sorts of other types of private credit, asset classes, asset based finance, music royalties, even. What do you think of that? Andrew, I mean, when you think about the future of how you want to allocate to this industry—what do you prefer?

Andrew Junkin 29:38

It's a great question. I think what we prefer is...places—all things being equal, places where capital is more efficient. And so if it's more efficient for borrowers to do that in private markets, and that results in higher returns for us, that's kind of a win-win, I think, for everybody. I think we're seeing some of that on the investment grade private credit side, which is, I think, an area that is probably going to grow pretty substantially just in the way that private equity has taken away a lot of what would otherwise be publicly traded companies. You know, I think there's a number of different strategies that sort of lean into complexity and we're actually okay with that, because I think a lot of people are scared by complexity. They're scared by whatever it may be leverage or fees, or things like that. I'm not saying, "Hey, we love to pay high fees." Don't let anybody take that the wrong way. But if we're not having to compete against, you know, CalPERS or somebody for an allocation, we'd rather not. And so if it's complex enough to scare other people away from the opportunity, we probably actually really like it.

Sonali Basak 30:59

It sounds a little like to do?

Joshua Friedman 31:01

Yeah, I mean, I just wanted to add to the point about asset backed, because I think it's one of the most interesting areas today. Part of it is there's huge appetite for the rated parts of asset backed in the insurance world and elsewhere, but also because the traditional providers of certain services and certain types of credit simply can't provide it because the capital constraints today. So for example, if you have someone who has a first lien on his house and has a two and a half percent, 10 year fixed rate mortgage, and it might be 50 percent loan to value, a guy might be a prime borrower. That person is very unlikely to move, because the next mortgage is going to be 6 or 7 percent so okay, I'm stuck in my house. I need to spend money and fix the floors and add on to it and put the so they get a home equity loan. These could be 750 FICO score people, but they're still stuck getting a home equity loan. And the people who would normally—who are in touch with that buyer, the person who's provided the first mortgage is a bank that can't hold the darn thing anyway, because they can't hold any more real estate loans. So there are people who package these things, you buy them, you re-securitize them, and what's nice about them is you have very significant statistical base of what is likely to happen if the economy is horrendous, if the economy is in between, if it's whatever. And we're so far away from a 2008, you know, excess housing stock, kind of environment, pretty good quality product. And the thing about asset backed is, when you're in the public sector, you're talking about public bonds, Megan, and how sometimes versus private the transactions cost of resolving things can be enormous, right? Enormous. Everybody's fighting, and you have different committees, and the lawyers you thought lawyer for expenses were going down. Forget it. The cost of prosecuting a bankruptcy is insane. But the nice thing in the asset-backed area, there's a natural waterfall. You stop, you get less payments. Well, this gets cut off. This guy gets paid down. Now it gets restored, and the savings is really, really material. So I think these the market structure itself, who's allowed to make a loan, who has regulations, whose balance sheet is backed up, I think it provides a lot of really interesting and unusual risk, reward opportunities, and they're always shifting. These are not things where you can sit forever and say, I love this business for the next 10 years, because what's attractive today may not be attractive tomorrow. The large cap unit tranche business was awesome when it started. It was 675, over and it was a low multiple of EBITDA and it had covenants. That's not really the case today. The securitized business is way better today because the people who used to provide that service simply can't doit, and so—I think it's hard. I mean, we all like to do what Michael wants to do, which is invest in things so you can sleep at night for the next three decades and know that you're going to get your feast dreams. But I wish that were life.

Michael Rees 33:58

Yeah. I mean, we do have half of our business. It is direct lending. And you're right, we're not getting 675 over anymore. But, you know, we look at our, you know, our loan book, typically, our loans are 40 percent debt to total value. They're in companies that have over 100 million of EBITDA and there—and these companies are run by some of the best sponsors in the world that have a tremendous amount of equity at risk. So, you know, that's not a terrible place to be and you know, we're now operating on a balance sheet. If you take an average BDD or private credit fund. You know, let's call it one to one leverage. I—no one in their right mind should sit on a panel like this and criticize the most famous bank CEO of our day, but he always goes on Sonali's show or on TV and talks about how, you know, the private credit world is going to blow up. You know, the banking world runs it. You know, many, many more times levered than we do. You know, there—the mark to market requirements, and a lot of their books can be quite rapid. You know, we have permanent capital, direct lending funds, BDCs, that are levered about one to one in the types of companies I describe. I don't see a catastrophe. We're charging about 9 or 10 percent a year. Okay, if we have a you know what would be historic in recent times, you know, default rate of 5 to 8 percent and we only recover half of that—we're still going to be up for the year. So I, you know, I'm the religious zealot out there, you know, talking in my own book, I get it on private credit, but just because we're not getting 675, over, I don't really lose a ton of sleep at night for the type of businesses that we and others run. But I do have a question about, you know, Blue Owl did recently buy an asset-backed firm as well. And does this mean this is the future? The future is going somewhere else than the tried and true definition that we have been using for private credit. Is it kind of a recognition in some way that this business may not be the one where the most growth is? Well, I mean, yes, it's a creation of another asset class that is being stolen from the same CEO I criticized a few seconds ago. So man, if he comes running in the door, I'm going to be in trouble. But you know, when you look at it, banks are not performing these services anymore. There are new pools of capital that are being grown in size and scale. You don't get even, you know, 450 over in in the asset backed world. But you know, our asset backed business is lending to, you know, really secure, in most cases, short term, amortizing asset backed borrowers and we are able to generate something that is, is creating a nice spread above the liquid, comparable. And so, you know, when we go to Mark Rowan, and we go to the sort of insurance businesses across the private capital markets. Now, you know, we're delivering a really good service. And, yeah, that was, that was some sort of highly leveraged, securitized ABS CLO a few years ago, we're doing it at much lower leverage, but we're still delivering a premium product to our providers, and we think again, it's a good place to take. You know, we, the industry, has taken a lot of brains from the banking and investment banking world over the last decade and a half, private markets, that is, and we've hopefully, for the most part, in a conservative way, developed a new version of products that will tend to be safer than the nine times levered balance sheets, and we can deliver a premium product to both, you know, our end clients and our borrowers.

Sonali Basak 38:14

Megan, you know, it's an interesting point that you had brought up. You were talking about how much leverage is actually on the investments that you're making. Where are you seeing, Megan, the most amount of leverage? Where are you seeing the pile up?

Megan Neuburger 38:26

Yeah, I would say, you know, I completely agree with Michael's comments around the relative strength of the balance sheet of some of the companies we see finance and the direct lending market. You know, typically your highest leverage credits. And I think this historically has been the case and continues to be. So will be your LBOs that with a relatively aggressive sponsor that are financed in the public markets. And I think, you know, there's two, there's two aspects of that, relative to looking at a company that has financed itself in a direct lending environment, that public market LBO typically is, you know, very highly levered. Typically has a smaller equity check behind it than, you know, we would see on the direct lending side. But the other really interesting thing about it is that there's typically some type of momentum with the public LBO credit, meaning there's a story that's kind of on the come where we're going to do a bunch of strategic M&A and that's how we're going to grow into the balance sheet, or we have this aggressive schedule of cost synergies that we're going to be able to realize. And sometimes it works out great. You're in a benign operating environment, and everything you know sort of falls into place, but oftentimes it doesn't. So I think what we see is more momentum around ratings for those types of issuers than we see in the than we see in the direct lend portfolio, where really the biggest headwinds to credit there are, as we said, you typically invest in in larger direct lend companies, but we do have many in the book that are that are typically much smaller than something blue owl looks at. And you have that lack of scale, lack of diversification, which has proven over cycles to be very protective. To credit. So that's really it's more of a business profile issue than a financial profile issue as the rating constraint.

Sonali Basak 40:08

Andrew, what are the questions that you're asking your managers right now?

Andrew Junkin 40:14

Well, we made it 12 minutes without talking about tariffs. So that's probably the longest 12 minutes anybody's gone at this conference. We've had those conversations. Nobody knows anything right? I think the rest of it is kind of business as usual. So until we get some clarity on that and can figure out how to sort of rethink through the economics of the results of that. I'm not sure where we're changing the way that we're investing. So it's, you know, in private markets, what are your edge? Edges in in sourcing or creating value? How are you going to exit? I mean, that's, we're spending a lot of time on that one right now, because there haven't been very many accidents—

Sonali Basak 41:01

Right, are you disappointed? [AJ: Say it agai—] Are you disappointed?

Andrew Junkin 41:06

No—sort of—on a one off basis, our liquidity from our private equity portfolio was at an all time high last year. So and we've had four years of positive cash flow from our private equity portfolio. So full credit to the team that's been able to generate that. At some point., though, you know, the 2021 deals that are all aging and probably have too much leverage and probably got paid too high a price—we're gonna have to figure out how to get distributions on that. And I know there's a lot of creative ways to do that. You know, it'd be better if those companies would just kind of grow into the multiples and maybe be sold in a normal process. But I came into this year—I think this is probably the third year in a row, or this is the year for private equity transaction volume is going to be through the roof. It's going to be great. And, you know, my view is probably private equity transactions are pretty much dead for the rest of the year.

Sonali Basak 42:07

Now we're having this conversation. I very intentionally didn't bring up tariffs, by the way. [Well done]. We're navigating a volatile market, tariffs or no tariffs, at the moment. And one thing that I'm watching in particular is the 10 year yield. And right now, today, we are at almost 4.4 percent it's been drifting higher the last couple of days, despite the general calm we've seen struck from the administration and just shot right into the markets. You still see that yield higher. Josh, what's the implication of this? Because this is not only tariffs. We're going to come up against the backdrop of a fiscal situation in the United States that will change dependent on the course of taxes as well, and how the tax bill ends up looking so rates higher or lower from here, and what are the implications?

Joshua Friedman 42:55

You know, it's funny. Earlier in the year, I had been for two years saying that rates were going to stay higher for longer, and everybody was saying there's going to be six cuts and four cuts and three cuts. And I'm like, why would the Fed rush to cut rates when the market is ripping unemployment is zero and there's all this pent up spending. Save it for when you need it. We make it getting closer to a point when they actually need it. Now that doesn't necessarily affect the long end of the curve. It might affect the short end of the curve. Because one of the reasons why I think the long end of the curve is reacting the way it is people are saying, I'm not, you know, and my argument earlier in the year, like in January, when everybody was finally coming around to hire for longer, I did a piece where I on Bloomberg, where I was saying, I think that rates are more likely to come down. One of the reasons, I said is because all of you guys think they're going up. So usually the other side is something at least worth considering. Second of all, you had deregulation, you had Doge, you had a lot of things that were deflationary. AI is deflationary. Inflation prints were starting to come down, et cetera. I guess now, the way I look at it is, one of the reasons I think rates have gone up is because we've got one monster amount of federal debt, and we have not figured out how to cut that, and the supply of treasuries is a big number. When you sideline some of the buyers because they're kind of pissed off at you, that's not a help. We had a horrible three year auction that we all know about a little while ago. And on top of it, Doge doesn't appear, at least yet, to be coming anywhere close to the types of numbers that were represented. And I had one of the senior officials who I won't name, who it is, I asked, you know, well, how much is it going to be in Doge? And I said, well, at least $50 billion and it was all I could do not to do like the Austin Powers $50 billion like this is nothing like $2 trillion or $1 trillion. It's not —it's a speck, especially given how much the budget has gone up. So I think it would not surprise me at all to see the Fed start to take some action, but I don't know how easy it is for them to affect the tenure; it's a lot easier to affect short rates, a lot easier. Longer rates are driven by inflation expectations, by how much debt is going to be printed, and all that kind of these other factors that are more difficult, I think, for the for the Fed to deal with and the Treasury, especially when you have ongoing deficits of the size that we have.

Sonali Basak 45:29

Andrew, how is that dynamic likely to affect our portfolio? Because there are a lot of debt instruments that are tied to that longer term interest rate, not that shorter term, one that the Fed has more control over.

Andrew Junkin 45:41

Yeah, I think one of the places that I have some concerns about a much higher tenure would be in real estate, where it seems like, you know, we just kind of stopped the radical repricing that's gone on there. But if everything's sort of priced off of four and a half percent tenure, and it goes to five and a half, which I don't think is out of the realm of is out of the realm of possibility. There's another leg down in real estate, and it's probably not pleasant. I think everything has to get repriced to some degree off of that. I, you know, we didn't see it with the Fed hikes, which I thought was sure to cause, you know, normal finance theory say, well, the risk free rate is higher, therefore everything must be priced. It just didn't. The market continued to rip. But I think if it's the 10 year, you end up starting to crowd out some other investment ideas. I mean, you know, our goal is 675, but really it's kind of 375 real. If I start getting opportunities to buy tips at kind of three or three and a half, I'm gonna have to start taking that pretty seriously.

Sonali Basak 46:51

Megan, and now I'm going to talk about tariffs—

Michael Rees 46:52

Josh has quick—

Sonali Basak 46:53

Yeah, please go ahead.

Michael Rees 46:55

Josh and Andrew—to all of you—if you notwithstanding all of the sort of enforced debt that exists now, if you wanted to just set like the perfect yield curve for looking forward, you know—where would you put it? Where would you put the 10 year and where would you put the short end? Of course, everybody, I think, would like to borrow short term for less than where we are today, but I kind of don't think we're far off of where I would want the yield curve to be.

Megan Neuburger 47:34

One thing that was interesting in the rate hiking cycle, particularly for investment grade credit. It was really positive for credit. You know, we saw a lot of companies rein in balance sheets that have become incredibly aggressive post the GFC. So I guess from the credit rating agency seat, if you're thinking about the quality of corporate credit over the longer term, this environment where rates are a little bit higher has been, has been quite constructive.

Joshua Friedman 48:02

I try to think about sustainability of the federal balance sheet. You know, what can really last? Are we past the point of no return? Is this time it's different, all that kind of, that kind of stuff. And to me, yeah, rates are part of it. Part of it's just we just can't spend this much. And, you know, Elon Musk did a panel the other day. He was talking about just how inefficient spending is, and how every individual, when they're working for the federal government, is a lot less efficient than they are if they were same individuals working in the private sector. And some of the things that are crazy. How much do they add up to? Are they enough to make a difference? Well, somehow or other, the budget was a lot lower in the not too distant past. We almost have to do zero based budgeting on things and get back to a system that is a bit more sustainable than what it is today. Steve Mnuchin, I think, was very good at trying to look at debt to GDP, and keeping those two numbers more or less in parallel, even though the GDP is mostly private and the debt is mostly public and understanding that sometimes there are exigencies that that occur that cause you to have to increase that to take some but then you got to figure out how to get back again. And that's the part that we didn't do. And so I—it concerns me. I'm not sure—what I'm not sure about when you ask about the yield curve is the time frame over which it concerns me. And the reason I say that is the alternatives aren't that attractive. Like you go to, you know, someplace, visit a sovereign wealth fund and say, "Well, we're thinking of putting more money in Europe." Okay, you have a collection of high tax-prone, high regulatory-prone. They're almost like internally tariffing themselves, because the way they structure themselves, countries that had a 1.86 percent growth rate to their stock market the last 20 years, versus 10 percent in the US, and they're all fighting each other. Okay, I understand, Germany is going to spend more money on defense, but do you really want to put a huge percentage of your assets there? Or maybe China. Do you really want to put a huge percentage of your assets there if you're a global asset allocator? We're all a little more domestic in our thinking, you know, so—but I don't think we're at a point where the alternatives are terribly viable. But I almost think that puts an extra burden on us to be responsible, to defend that position, and I don't really think we're doing that very well.

Sonali Basak 50:26

I think the other important question is, who does the yield curve look good for? Right? Because one question I have is, to the extent that you're worried about the fiscal situation of the United States, it's more expensive to finance the US debt load at 4.5 than it is at four or even 3.5 and at what point does that become a problem for all of you?

Michael Rees 50:48

No, without a doubt, sort of the continuing growth in US debt and the requirement for refinancing sort of gets problematic. And it's, you know, it's razor thin in terms of moves, but in terms of the economy and where we stand domestically. You know, being able to, you know, look at a 4.3 tenure is still below the average over the last 50 years. So, you know, I chuckle. We all—I'm guilty of saying higher for longer all the time, but it's sort of like not. That's probably not the right way to describe it. It's not as high as it usually is and—but higher than it has been recently for a little bit longer. That's a mouthful. That's why no one says it, but kind of where we are.

Sonali Basak 51:39

Okay. So I have a question from the audience now as well. Toss up for who would like to take it—isn't the main issue for private credit, specifically BDCs valuations. When externally, usually with strong influence from funds, the marks determine nav, which dictates stock performance and the fees generated by the manager, GP valuations typically lag one to two quarters, which can mask some pain for some time. Then you factor in potential nav lending at the fund level or internal capital markets, BDCs, max leverage at two to one. Could there be can kicking from the borrower all the way up to the GP? Would you like to take a [inaudible]

Michael Rees 52:19

...Aimed at me, since I've been so bullish on our portfolio. Look, I think, yes, that's a great question in the—and all comes down to valuation, because I—maybe too cleverly pitched by, you know, my portfolio attributes based on debt to value. Now, question is, what do you—where's—what's value, if we or the underlying GP, are making up value and saying, "Look, this company is worth 22 times, and look, we're only levered 40 percent of that." Well, that could be really bad if the valuation should be half. You know, we do believe in private credit, you got a long way to fall from 20 to 60 percent of 22 times is a long way to go before the private credit market gets hurt and boy your equity portfolio, whoever, whatever GP on the equity side you you gave your capital to just got wiped out well before we do so, you know that certainly would be bad for the GP stakes side of my brain, but for the private credit side, you know, it is all about valuations, and that's why we care so much about it. And that's probably a driver as to why activity is certainly muted compared to what we hoped for. But by—I guess—on the one hand, I say yes, it's heavily dependent on valuation. On the other hand, I say 60 percent is a long way to fall in most in most of these mechanisms.

Sonali Basak 53:52

Megan, what are your scenarios here? What is kind of the highest end, in terms of where you see rates going from here and the lowest end, depending on where we are on tariffs and where we are on taxation and the rest of Trump's agenda?

Megan Neuburger 54:07

Yeah, that's a great question. You know, generally speaking, sort of the view from the top of the house and the macro is that rates will drift lower very slowly, right? And I think from our perspective, though, in the seats that we sit in, we love to stress test the portfolio, you know, one of our favorite activities. So we'll routinely, you know, pick a sort of outlandish interest rate scenario and run just, you know, that test across our entire portfolio of, say, B plus and below rated credits, and we will match that up with credits that have the lowest headroom under their existing rating sensitivities. And then think you know critically about whether those are companies we want to have a conversation with them about what their plan would be if we're going to be in a consistently higher rate environment, and or do we want to hold a rating committee on that company? So those are the. Kinds of scenario analyzes that we're constantly doing. So, for us, it's less about picking a point a destination in terms of rates, and more about thinking about—what does the worst case scenario maybe look like, and then how would all of our issuers perform under it?

Sonali Basak 55:15

Dare I ask, what is your worst case scenario?

Megan Neuburger 55:17

I think at one point we had modeled around, like a 12 percent scenario for the greatest part of like our book of business, in the B+ and below rated category at the start of the rate hiking cycle. And that proved not to be all that conservative. So—we recently went back and did it with a little bit of a higher one, just to you know, stress test further, but it's constant exercise.

Sonali Basak 55:44

So with the remaining time left, we only have a few minutes left, want to ask each of you for your biggest risk and your biggest opportunity as you're going through the year.

Joshua Friedman 55:55

I think you have to be careful about exogenous risks that can affect the capital markets in a really big way and sort of change the mood of investors. Remember, we started from this point where Trump got into office and gave a great advertisement for why you should give all your money to the United States of America. We're going to be deregulated and lower taxes and all these wonderful things. And then we had the tariff narrative, which sort of interrupted that. But I think that—my guess is that we work our way through the tariff stuff. It'll take time, and we'll have a little bit of collateral damage from the reasons we talked about earlier, in terms of people's mood. But I think a significant change in a place like Taiwan, I think the market doesn't discount adequately. I think the same thing is probably true with respect to Iran. I think there are other hotspots as well. I think the nature of global dialog is such that these things always happen when you least expect them, and they really can rock the market. So I'd say that's kind of, in some respects, the biggest risk to capital markets. Generally, it'll affect all the capital markets, because these are the kind of things where everything gets correlated, because everyone's mood sinks.

Sonali Basak 57:04

Biggest risk, biggest opportunity.

Andrew Junkin 57:08

Biggest risk, I think, is that the economy is slowing way more than we think right now. I mean, we're definitely seeing that in sentiment numbers. We haven't started to see it in any of the hard data, but if it shows up, I think that puts the Fed in a very difficult spot, trying to decide whether to cut rates to help the economy or to deal with what is likely to be, you know, nontrivial amounts of inflation, thanks to tariffs. Biggest opportunity—well struck trade deals maybe? But I still don't—I'm not sure there's—I'm not losing sleep about a big rip up in the market, I guess, at the moment.

Joshua Friedman 57:52

I would just—I didn't answer the opportunity part—but to me, one of the biggest opportunities is that the regulatory framework around banks and the balance sheets of banks is so difficult and it's so impossible that, on the one hand, it creates this whole private credit opportunity, but they also don't always like all the business going to people that show up ahead of them in the league tables. So at least for people like us, what gets us really excited is places where, you know, major money center banks, will send us really easy real estate loans, where they'll get, you know, a crazy capital charge, you know, like 100 percent capital reserve requirement, and it's not a difficult loan, and then provide us back leverage at a super low yield, because that doesn't count as a as a real estate loan, and so then we're leveraging ourselves into a 15 percent yield. But they might not show that to some of the people who they think might otherwise compete them out of existence. So for the moment, at least, then the same thing is true in asset backed I think the regulatory environment, it's tough to be a bank, even if you have a really good balance sheet. The Web of regulations is enormous, and I think it presents big opportunities when you combine it with the cluttered up balance sheet that they have for making low yield, long duration loans in the past.

Sonali Basak 59:16

It sounds like you were talking about Michael's favorite banker over there for a moment. Megan—risk, opportunity.

Megan Neuburger 59:23

Well, I think from the perspective of corporate credit, the biggest risk we probably see right now is a prolonged stagflationary scenario, right? Like, the effect of tariffs is really the worst that we fear, and we start to see the consumer weaken, because the consumer going from strength to strength has really been what's supported corporate credit over the past four or five years. I guess on the opportunity side, you know, I think if we—if things turn out to be, you know, hopefully a better result in terms of what we see with the whole pack around tariffs, and perhaps we see something on tax reform. You know, there are companies who have balance sheets in relatively good shape. If we do see sort of a restart in the transaction environment and see some more strategic M&A, I think that could be interesting.

Sonali Basak 1:00:15

And the last word.

Michael Rees 1:00:16

Sonali, I'm only going to go with the risk because I'm—I go to bed every night sick to my stomach. I worry about one thing. It plagues me. I get up worrying about it, and that's if the Steelers are going to enter week one without a quarterback, and we have absolutely no clue what we're going to do—

Sonali Basak 1:00:33

I knew you were going to go there somehow.

Michael Rees 1:00:39

That'll be my answer.

Sonali Basak 1:00:40

I'll leave it at that. Thank you all so much for your time today. What an amazing topic at this point in time, in this economy, and thank you all so much for having us.

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