



[00:00] Kevin Minas: In this episode of The Art of Boring, I sit down with Brian Carney, Lead Portfolio Manager of the Mawer Global Credit Strategy. We explore the current state of credit markets, in particular, key risk indicators that we look for to position for potential market drawdowns, and the evolving landscape of private credit. We discuss our portfolio positioning, highlight an investment case study on Saturn Oil and Gas, and examine how technology, especially AI, is enhancing our investment process.

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[00:51] Kevin Minas: Hi, Brian. Thanks for joining today.

Brian Carney: Hello, Kevin. Good to see you again.

Kevin Minas: Let's start with the big picture. What's the current state of the credit markets? How would you characterize spreads and default rates? How are those evolving? And what does this ultimately mean for investors right now?

[1:07] Brian Carney: The world is in perpetual disarray. I thought you'd have it fixed by now, but I guess you've been doing something else. We've got conflicts. We've got natural disasters. We've got tariff wars, trade wars. In spite of all of that, financial markets, except for a little blip in early April, have seen smooth sailing.

So we've got equity markets reaching new highs, and credit spreads are tighter in every currency from the highest quality issuers down to the lowest quality issuers. Spreads are tight. You asked about defaults. So the average long-term high yield default rate is about 3%, according to our friends at JP Morgan. So far this year, we're at 2.7%, below the long-term average. So we've got tight spreads, low defaults. The market tilt definitely favors borrowers over lenders. So how do we square all that chaotic world with resilient credit and financial markets? There are two words I would use: convergence and complacency. Convergence because there are large pools of capital chasing after lower quality borrowers. So we've got the high yield bond market, syndicated loan market, bank lending market, and private credit, the fastest growing portion of the credit market. Companies who in a different era likely would have defaulted now have more options. So there's more capital around that needs to be put to work. And certain lenders in certain markets are willing to allow things that might not have flown in previous markets. So higher leverage, payment-in-kind structures, all of these things which alleviate stress on the borrower. If you're a company and you're filing for bankruptcy in this environment, you've really done something quite special. That's convergence. On the complacency side, I've got a long list of things I could give you. Just to limit it to three or four.



We've got the markets which are really ignoring what we think are some pretty serious signs. We've got politicians probably beating the Fed in the United States trying to manipulate rates lower. We've got inflation, or at least inflation concerns, brought about by tariff policy and this potential manipulation of the Fed, trying to coerce the Fed into lowering rates too much, too soon. And then I think we've got this overriding question about the credit quality of the U.S. government. We've got unpredictable policy, we've got growing deficits, expanding debt brought on by growing deficits. And then the last one I'll raise—there's a longer list—hidden leverage.

There's lots of leverage that is not discernible to the naked eye. So we've got leverage in private credit funds, leverage in strategic risk transfers in the insurance industry. So there's lots going on. And I think, again, in a different era, any one of those things would be causing real concern. But right now, everything seems fine. Market participants seem willing to overlook all of these potential warning signs. So what should investors do? We would say this is not an environment where you want to reach for yield, either by going down the credit quality spectrum or extending out the yield curve into longer-dated credit. We just don't believe investors are compensated for taking those types of risks.

So this is a credit market to protect capital, earn a reasonable return, and then look forward to whenever the next market dislocation comes to take advantage of it.

[4:32] Kevin Minas: So you've painted a picture that, at least from a pricing point of view, in terms of spreads, things are pretty benign. There are these risks in the market, whether they be structural or not. But things can stay benign for quite a long time, and then you get a pretty violent shift. We've seen that before in credit markets. So if you were to sketch for us, what are the key indicators you're looking at? Things are benign now, but that shift, when it occurs, what would you be looking for to give you some early warning signals that that shift might be happening? And then, of course, you can change positioning ahead of big shifts.

[5:04] Brian Carney: When the shift happens, a number of these things tend to happen all at the same time or very close to the same time. So one of the first things you'll see, if you look back to the financial crisis in 2008, COVID in 2020, you'll see hedge fund or leveraged player liquidation by prime brokers. Those things don't happen in isolation. So then you start to look at the entire interconnectedness between banks and their broker-dealer subsidiaries. All of these entities provide short-term funding to each other, and you'll start to see headlines where that short-term funding starts to either be reduced or evaporate very quickly. Then you get rumors of commercial banks in trouble, counterparty credit reductions. All of those things happen in the early days of a crisis. Those tend to precipitate widening of credit spreads, widening of bid-offer spreads, reduction in trading by broker-dealers, flight to quality in government bond markets. And then you'll see, oftentimes, the higher quality issuers—and those who are able—will draw down on bank lines just to shore up their own liquidity, unsure what's happening in the broader market, so they'll draw down on bank lines.

And if they're able, they'll do issues in the bond market that they might not otherwise have done, again, to shore up liquidity. And then if you add three or four of these things happening all at once, then I would say you're close to or possibly in a full-blown crisis, and then you might expect the central banks to start reacting and making policy announcements about shoring up liquidity for financial intermediaries, potentially buying securities in the marketplace. And when that happens, you know that actually you might be closer to the end of the crisis than the beginning of the crisis.



If you go back to the financial crisis, all of those things transpired over 12 to 18 months. If you look at the COVID crisis, all of those things happened over a period of a couple of weeks. Those crises seem to be getting shorter and maybe much more dramatic, and the willingness of central banks to intervene—they seem to be willing to act much more quickly to stabilize markets and try to restore confidence.

But I think your point is a very good one, which is the markets can remain euphoric or irrational, depending on your perspective, and credit spreads can remain tight for long periods of time. But that inevitable dislocation, because we know there's always another dislocation coming, it either incinerates capital for people who are overextended, or it creates an opportunity for capital appreciation for those who are prudently positioned going into those types of crises.

[7:46] Kevin Minas: That's a small sample size. Central banks do seem a bit more willing to intervene. Do you think that's something that's likely to persist? I know this is getting into the realm of trying to anticipate what central banks would do, but is there anything structural that might be causing that perspective of being more likely to jump in? Is it the nature of how they are intervening now versus in the past? Did they learn lessons from '08? Are there any lessons you would draw from the two data points that we have more recently?

[8:11] Brian Carney: I'm not sure there are any lessons, but I think what you saw in COVID was particularly the Fed taking their intervention to a new level, which was a willingness—historically, when they stabilized markets, they provided funding to intermediaries, and they would buy government securities. During COVID, they actually came out and said, "We're willing to buy corporate credit, including high yield." Now they ended up doing virtually none of that, but just that statement in and of itself gave the markets some confidence and helped to stabilize markets. Maybe they'll behave differently in the next crisis, but I think they've set a precedent. Every time they do something, they set a precedent, and then I think it's hard to walk back from that precedent because the market now expects them to do something similar. And clearly what we're seeing in the U.S. is a real blurring between politics and what was supposed to be an independent central bank. When you've got that political pressure, if there's a crisis, I think it would be very hard for the central bank, particularly the Fed, to not behave similarly to how they've done in the most recent crisis.

[9:19] Kevin Minas: So there might be new tools that they adjust for the current crisis, but at least everything that's used in the past is fair game. It's on the table.

[9:26] Brian Carney: I think that's right.

[9:27] Kevin Minas: Somewhat related, credit covenants. They often come into focus, particularly during periods of stress, but even at the individual issuer level, they're obviously highly relevant even if you're not in a stressed environment. Can you explain for us what credit covenants are generally? Why they matter? And then of course, if you could put covenants generally into the context of today's market environment.

[9:45] Brian Carney: As a bondholder, we're lenders. So as a lender, you have a contract with the issuer or the borrower. Covenants are those clauses in whether it's a bond agreement, a trust indenture, loan agreement that impose certain obligations on the borrower. And those could be things like providing periodic financial disclosure. So that's something we call an affirmative covenant. Or it could restrict the activities of a borrower, maybe limiting how much additional debt they can borrow. So that would be a negative covenant. And covenants are meant to



help lenders manage the risk of lending to an issuer and to ensure borrowers maintain some level of financial discipline. And oftentimes, borrowers will try to put financial limits, financial covenants into the documentation.

So, if a company is leveraged above a certain debt to EBITDA, they can't borrow anymore. Or they might actually have to maintain something like debt to EBITDA below a certain level for the life of the obligation. And then there are things called events of default. So when does a lender have the right to step in? If a borrower or an issuer doesn't meet its covenant obligations, at what point do I as a lender have the right to step in and seize assets, try and realize value? There are a bunch of different ways that you can structure lending agreements. There's a big disparity between how lending agreements look. So part of our job is to determine if company A and company B have a bond that's yielding the same thing and they both seem attractive, then you have to look at the ultimate contract underneath and decide, are the covenants the same or does one have a stronger covenant package, something that benefits a lender even more? Suffice to say, over the last decade or so, the pendulum has swung decidedly in the borrower's favor.

So there are fewer and fewer covenants in our lending agreements, fewer financial tests. And it's part of this convergence I mentioned where there's a lot of capital chasing deals. So if you want to put money to work, you might have to be a little more flexible on covenants. We spend a lot of time on covenants. And when you're lending to high yield companies, you really want to know not just the yield that you're lending at and the term, you want to know what your legal remedies are as contained in the documentation. There's a lot to look at.

Capital structure seniority, where do you rank in the capital structure? How do companies calculate something as simple as EBITDA when you're doing these financial tests if they have them? Are we using EBITDA from the financial statements or are they manipulating it to make it look higher to give themselves more flexibility? And then something simple like disclosure—and Canadian disclosure as it relates to credit agreements and trust indentures. We've really lagged here versus the U.S. It's much harder to get those types of documents up here in Canada for reasons unbeknownst to me than it is in the U.S. So covenants are really important. When they're crafted well, they are guardrails that can help preserve value for lenders and limit the downside. But when they are too lenient, all those protections that lenders should have can very quickly disappear. We always ask, what could a borrower do that will leave us exposed? And then we have to decide, are we being compensated in the yield for taking that risk that we've given up a protection or two.

[13:12] Kevin Minas: We talk a lot about, as you said, yields, duration, the shape of the interest rate and credit curve, but we don't talk as much about credit governance. That definitely seems like both a source of potential return and potential risk if you haven't done your analysis properly. You've mentioned a few times the concept of convergence. There's a variety of different means of companies funding themselves, private credit being one of them. We've talked a few times on this podcast over the last few years about private credit, just some of the developments. Perhaps it's a good time. We haven't talked about it for a little while. If you could just give us an update on the private credit market, if there are any particular trends or things you're seeing there that are worth noting, and then of course how that market's comparing to public credit more generally.

[13:50] Brian Carney: Few corners of the financial market, both equity and fixed income, have received more attention and probably more capital in the last few years than private credit markets. And investors have been lured there by the promise of high returns and comforted by the notion of reduced volatility. And they've moved out of, in many cases, traditional fixed income into private credit. It's so popular. Private credit is attractive. So



much attention. And the fees are much higher than traditional fixed income. So that spawned a proliferation of credit managers. And they all claim a unique access to product and a black box ability to extract value. Just a refresher. Characteristics of private debt. Typically no credit ratings. Narrowly distributed. Often just one or two buyers privately placed so you don't get a prospectus. No external pricing source typically. And oftentimes it's a private company or a company that's being taken private by a sponsor. Most private credit strategies employ leverage. Oftentimes provided by banks. So we mentioned hidden leverage before. There's often hidden leverage in private credit strategies. And this leverage can amplify returns in strong markets. And unfortunately it can erode returns significantly in weak markets. So it's simply put, private credit is high yield with no liquidity. No transparency. No mark to market. Higher fees. And if leverage is employed, potentially more upside. But equally potentially...more downside. So add all those risks and you should be compensated more for being in private credit than high yield or quasi-public credit. So today's single B spreads in the quasi-public markets are about 300 basis points. In private credit, somewhere between 475 and 500. So the question investors need to ask themselves is, is that incremental 200 basis points fair compensation for assuming all of those other risks? That spread differential has compressed quite substantially over the last five years.

So I think that's an open-ended question. I would say I'm not sure investors are being compensated for those risks. The other thing that's happening in private credit is a big push by some of the major private credit firms to give access to high net worth and, much more broadly, retail investors. What I find striking is many of those investors, having talked to them over the years, when you brought up high yield, they would run the other way and say, "I would never buy high yield. That's too risky." These same investors are now being told private credit is absolutely where they should be and you should have access to it. The big push is on in the United States. It's happened to some degree here in Canada, but I think for retail investors, they need to ask themselves, if I'm not comfortable owning high yield and I'm losing sleep owning high yield, then going into private credit is not the solution. It's not going to help your sleep patterns. Spread compression in private credit markets makes it less attractive. Leverage is something investors need to take into account. For retail investors, they need to think about, along with their advisor, if they have one, their risk patterns, their risk framework, their risk tolerance, and is private credit appropriate in their portfolios. Because the risk characteristics and the liquidity and the transparency are much different than public credit markets.

[17:20] Kevin Minas: Do you think it's primarily a volatility story? It's kind of hard to generalize in the case of investors that you mentioned, maybe a little less interested in high yield but private credit which is ultimately just unrated high yield. They're more comfortable there. Is it the perception of it being less risky because of the suppressed volatility because you get relatively infrequent pricing on private credit or is there perhaps some other reason that high yield is seen as being less attractive even though it's ultimately a similar type of credit?

[17:46] Brian Carney: The perception of reduced volatility is one of the big drivers. And then the other big driver is in many cases, not all cases, private credit typically are the senior secured loans within the capital structure. So they're at the top end of the capital structure. So it's reduced volatility, first priority in a bankruptcy. But the reality is, if you're making poor quality loans, it doesn't matter if you're the priority lender, you can still at the end of the day get pennies back on the dollar. You're seeing more and more circumstances where private credit funds are writing down the value of some of their holdings, whether it's because auditors are telling them to or they finally come to the realization that not all loans are worth par. I think the volatility argument is probably stronger with the institutional investor. And the first lien argument is probably stronger with the retail investor because they're being sold as relatively low risk assets.



[18:44] Kevin Minas: Shifting gears a little bit and turning more to the global credit strategy that you manage. What are the characteristics if you can provide an update there on how the portfolio looks today, how you're positioning, given all that we've talked about up until now and just your general views on the market backdrop in the context of the global credit strategy.

[19:02] Brian Carney: I just want to reemphasize that the portfolio characteristics that I'm about to give you are the sum total of a series of individual credit assessments. So we assess and manage risk at the issuer level. We're bottom up just as our equity colleagues are, not top down. So we're not trying to drive to a certain amount of high yield or a certain number of U.S. holdings. It is just what falls out of our individual credit determination. We live by the mantra of we don't want to diversify away return potential if we find something we think is really attractive. We don't want to bet the farm on any one security or holding either. Today we've got 33 issuers, unique issuers in the strategy. And that's right within our target of between 25 and 35. About 60% of those companies are domiciled in the U.S., a little less than 10% in Europe. Duration is relatively short, a little over one year. We've been gradually reducing our floating rate holdings.

The strategy had up to 30% not too long ago. We feel it's more and more likely that the Fed's going to cut overnight rates. Floating rate will become less attractive. So we're down to about 13%. It's generally a high-quality strategy. So over three-quarters of the portfolio is in A-rated securities and higher. We do have a little over 10% in high yield. Those are very unique situations and maybe we'll get a chance to talk about one of them. We have foreign currency holdings, but we hedge all of those holdings back using three-month currency forwards. And we've got a fair amount of liquidity in the portfolio. A little over 10% cash at the moment. We may keep it in cash. We may buy high-quality short-dated corporate paper. We're trying to be conservative. We're trying to be in a good position to take advantage of potential opportunities that come along so we're comfortable having a little bit of cash. And maybe my last comment is the portfolio is just a little bit shy of \$650 million at the moment. And this is extremely important when we think about relevance. So as the strategy grows, we become more and more relevant to both our trading counterparties and issuers, which is important. And then we can also absorb larger tickets into the strategy without influencing the strategy at all.

The second point is the strategy is very scalable. So as AUM grows, it doesn't require a shift in portfolio composition. So said another way, if \$100 million were to come into the strategy today, we would just go out and buy the same names that we currently hold. We don't have to dramatically change and find a bunch of new names to buy as money comes into the strategy. It's very scalable with the issuers that are in the portfolio at the moment. We'd say we're well-positioned to capitalize on widening credit spreads, if and when that happens, and rising bond yields, or both. And we've got an inventory list, another term that our equity colleagues use frequently across different market scenarios. Some of those are if high yield spreads widen dramatically, another one is if long U.S. treasury yields move up dramatically. So we've got inventory list names we'd like to move into or expect to move into under different market scenarios.

[22:25] Kevin Minas: That's critical. I guess coming back to the conversation earlier about timing and the market dislocations potentially being brief, having that inventory is always important, but particularly in credit, given the dislocations can be so quick and then you need to be ready to take advantage of the opportunity. Of course, you re-underwrite the investment before you put it on, but you kind of want to have that list ready to go, is what it sounds like. So why don't we zoom in on a specific portfolio holding, Saturn Oil and Gas? Why don't you walk us



through the thesis on that investment, key risks, opportunities, things of that nature.

[22:54] Brian Carney: Saturn is a Canadian exploration and production company. So the global strategy also looks at Canadian opportunities and we happen to find what we believe is a really good one. They are relatively small, about 40,000 barrels of oil equivalent a day production, Alberta-based oil and gas company. They operate in Saskatchewan and Alberta. They've got about an eight-year reserve life and they're relatively small and they've got a reasonably concentrated footprint. But we think that risk is mitigated by a number of things. So production skewed to light oil. So they've got higher netbacks than peers that would have larger natural gas or heavy oil exposure. Management's really focused on deleveraging the balance sheet. Currently about 1.4 times debt to EBITDA. They're looking to get it down to one times.

We talk about covenants. They've got a very unique covenant which you rarely see. So every quarter they buy back 2.5% of the bonds that are outstanding. 10% a year. So we like that. It's forced deleveraging on the company. And actually last quarter the company disclosed that in addition to their regular amortization, they bought back an additional \$15 to \$16 million of bonds in the open market. They've got \$50 million in cash, undrawn bank line. And what we think is a real crackerjack excellent management team. And we had a really good conversation with them last week, which just reinforced our favorable view. They're very disciplined and really think about how they're allocating capital. And they're not just out drilling wells for the sake of drilling wells. They're drilling wells when it makes sense to do so. And they've got a couple of supportive major shareholders. So we look at it and we say even though the company's a little bit smaller, the spread that bonds are trading at about 650 basis points, much wider than some of their peer group and this contractual quarterly pay down, we think makes for a really attractive investment opportunity. So it's a good example of even in a market where the vast majority of high yield bonds that we look at, we think are expensive. There are situations that are tilted in favor of lenders and not the borrower. And we think this is one of those cases.

[25:10] Kevin Minas: The process and process improvements are really at the heart of what we do. You've walked through a few elements of the process actually when we talked about credit covenants, the work that's done there. When we think about technology, AI in particular, it's hard not to talk about AI nowadays. Is tech more generally but AI particularly being integrated into the process? Have you found it useful? Have you found it not so useful yet? That maybe might be in the future. If you can just give us a little update there on any developments, technology related in the investment process.

[25:37] Brian Carney: As we think about it, we'll maximize portfolio return by optimizing the process through which we select issuers. And the key is, how do you figure out which issuers you want to do in-depth analysis on? We've got over 4,000 issuers in our investable universe. We can't do deep dives on all 4,000. So we need to take that 4,000 and create a manageable number where our team can go through and do intensive analysis and from that group then create a portfolio. This is where AI comes in, not in the selection of the portfolio, but in helping to maximize the number of issuer investigations we complete. We call that triage and then shortening the time period in which we complete that triage. So we're working very closely with our technology friends on investigating how do we use AI to refine and enhance our triage process? And then also on the covenant side, is there a way to use AI to help compare and contrast covenant packages amongst issuers?

So we're early days, but we're very excited about the prospects for how AI can enhance the process—not replace the process—but enhance the process. And maybe just on that, the importance of relationships. And when I talk



about relationships, relationships formed by our traders, so Morgan [Caissie, Fixed Income Trader] with our counterparties, by our research analysts, with issuers, and by all of us with our clients. This is at the end of the day a people business and AI, no matter how beneficial, cannot replace the importance of that human interaction that's so critical in the research process and in providing value to our clients.

[27:19] Kevin Minas: Awesome, appreciate that. We've covered a lot of ground today, but is there anything, any other closing comments?

[27:24] Brian Carney: As we see it, credit markets are converging and they're complacent. So what you're seeing is little differentiation between companies that have dramatically different financial and operating profiles. An increasing number of market participants, we believe, are reaching for yield. We don't believe current yields compensate investors for those differences in credit quality. And unfortunately, the potential for material negative impacts are high. As we think about the global credit strategy, we think it's in a unique position.

We've got universe bond on one bookend, private credit on the other bookend. We're in the middle operating without duration or credit quality constraints. Right now, we're in high quality, short duration securities, which we think is appropriate given how narrow risk premiums are and how uncertain we believe the yield environment is. There are periods where we believe investors should have exposure to high yield. We don't think this is one of those periods. We're very confident in our process. We think things like AI will help improve our process. And we believe consistently executing our process will provide substantial long-term value add for our clients.

[28:39] Kevin Minas: That's a good place to stop. I think Brian enjoyed the conversation. Definitely learned a lot. I found the credit covenant part of the conversation particularly insightful. I learned a lot there. Let's leave it there. Thanks again and looking forward to the next conversation.

[28:52] Brian Carney: Thank you very much, Kevin. I'd love to hear that you enjoyed the covenant part of it.

[28:56] Kevin Minas: Hey, everyone. Kevin here again. To subscribe to The Art of Boring podcast, go to mawer.com. That's M-A-W-E-R.com forward slash podcast or wherever you download your podcast. If you enjoyed this episode, be sure to leave a review on iTunes, which helps more people discover the be boring, make money philosophy. Thanks for listening.

