

NORTH CAROLINA  
DEPARTMENT OF STATE TREASURER



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INVESTMENT MANAGEMENT DIVISION

# Opportunistic Fixed Income Review

November 20, 2019

All Data as of September 30, 2019 Unless Otherwise Stated



## Role in the Portfolio

### Attractive Absolute Returns

- Long-term returns that are competitive with long-term public equities, after consideration of lower downside risk, due to opportunistic investments, longer duration private investments, restructurings, leverage, hedging, and trading skill

### Competitive Relative Returns

- Achieve or exceed the return on the performance benchmark over a long period of time, within reasonable risk parameters

### Diversification

- Enhance the diversification of the total fund relative to public equity and investment grade fixed income

### Capital Preservation

- Protect capital through credit-oriented investments and trading strategies that are designed to minimize downside risk

### Deflation Protection

- The structure of certain fixed income assets may provide protection against the detrimental effects of deflation

### Portfolio Launched June 2009

- The asset class (N.C.G.S. § 147-69.2(b)(6c)) was approved for investment by the NC General Assembly in June 2009.



# Portfolio Components

## Components

Traditional Corporate Credit

Distressed Credit

Hedge Funds

Special Situations

## Strategies / Types of Investments

High Yield Bonds

Bank Loans

High Yield Bonds

Post-Reorg Equity

Structured Credit

Long/Short Credit

Relative Value

Convertible Arbitrage

Distressed Credit

Derivatives

Event-Driven

Structured Credit

Mezzanine Debt

Whole Loans

Direct Lending

Real Estate Loans

Dislocation

\* Portfolio Components, Targets, and Maximums come from the Investment Policy Statement for North Carolina Retirement Systems, July 1, 2014



# Opportunistic Fixed Income

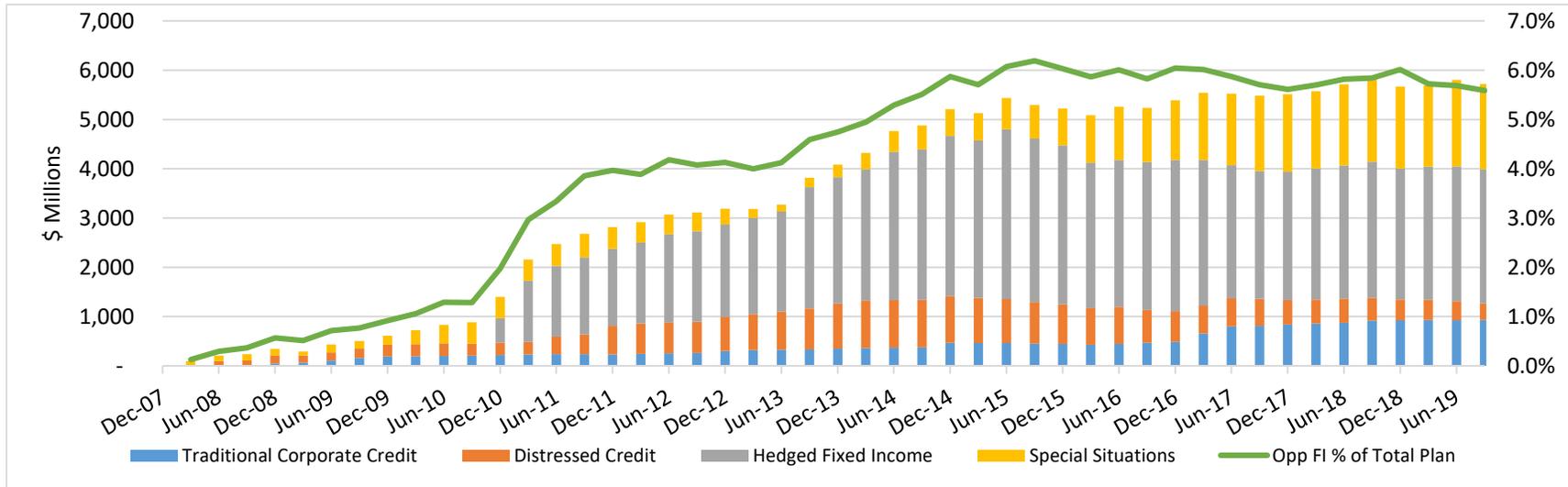
- Currently under-weight vs. target by 1.4%
- Additional capacity for more than \$1.5B

	Market Value (\$MM)	%	Target	Range		Relative %	Relative \$ (MM)
				Minimum	Maximum		
<b>Growth</b>	<b>\$47,049</b>	<b>46.00%</b>	<b>58.0%</b>	<b>37.0%</b>	<b>71.0%</b>	<b>-12.00%</b>	<b>(\$12,279)</b>
Public Equity	32,654	31.92%	42.0%	37.0%	47.0%	-10.08%	(\$10,307)
Private Equity	5,460	5.34%	6.0%	0.0%	8.8%	-0.66%	(\$678)
Non Core Real Estate	3,226	3.15%	3.0%	0.0%	8.0%	0.15%	158
<b>Opportunistic Fixed Income</b>	<b>5,709</b>	<b>5.58%</b>	<b>7.0%</b>	<b>0.0%</b>	<b>7.50%</b>	<b>-1.42%</b>	<b>(\$1,452)</b>
<b>Rates &amp; Liquidity</b>	<b>41,271</b>	<b>40.35%</b>	<b>29.0%</b>	<b>24.0%</b>	<b>42.0%</b>	<b>11.35%</b>	<b>11,607</b>
IG Fixed Income & Cash	30,915	30.22%	28.0%	24.0%	32.0%	2.22%	2,274
Pension Cash	10,356	10.12%	1.0%	0.0%	10.0%	9.12%	9,333
<b>Inflation Sensitive &amp; Diversifiers</b>	<b>11,894</b>	<b>11.63%</b>	<b>11.0%</b>	<b>4.0%</b>	<b>16.0%</b>	<b>0.63%</b>	<b>642</b>
Inflation Sensitive	6,106	5.97%	6.0%	2.0%	7.5%	-0.03%	(\$31)
Core Real Estate	5,788	5.66%	5.0%	2.0%	10.0%	0.66%	673
<b>Multi-Strategy</b>	<b>2,076</b>	<b>2.03%</b>	<b>2.0%</b>	<b>0.0%</b>	<b>4.0%</b>	<b>0.03%</b>	<b>30</b>
<b>Grand Total</b>	<b>\$102,290</b>	<b>100.00%</b>					

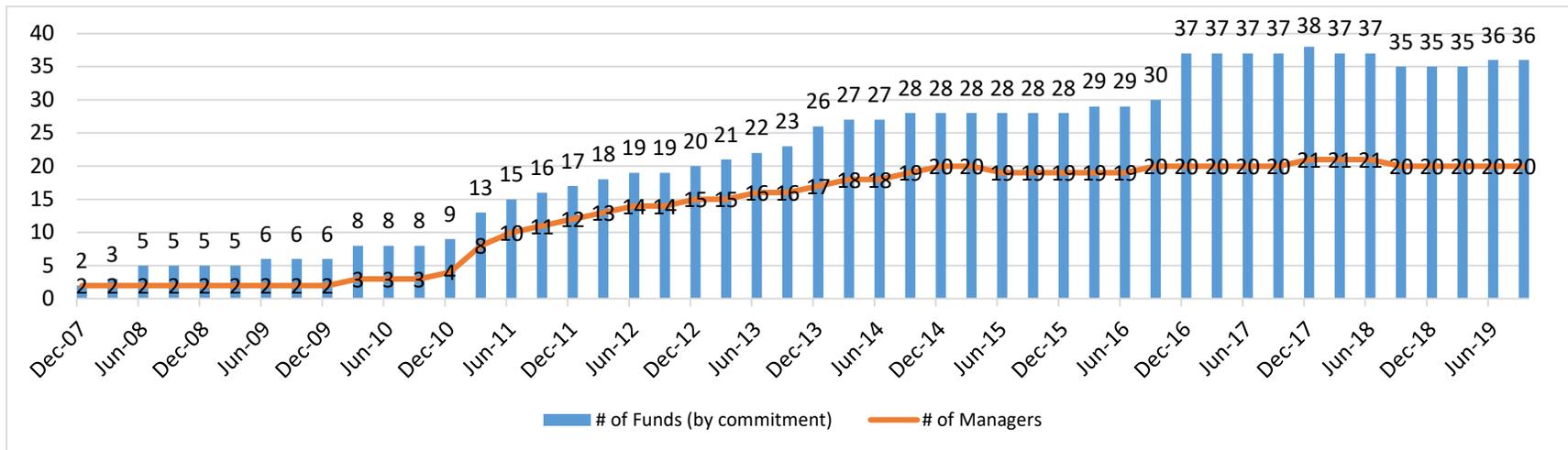
Unaudited financials as of 9/30/19

# Portfolio History

## Portfolio Market Value Timeline by Component



## Growth of Manager Relationships and Number of Funds

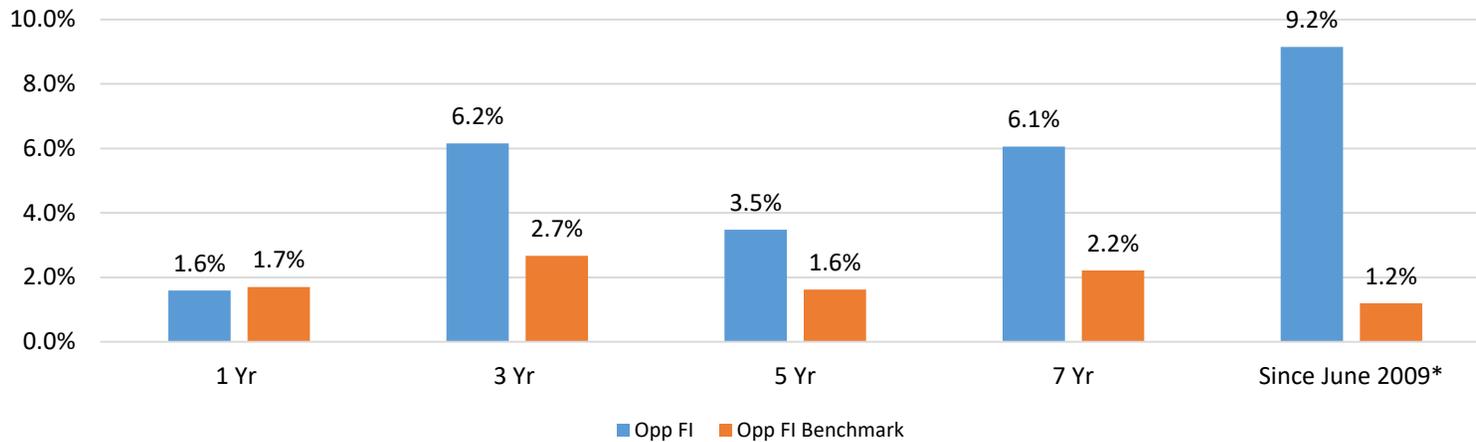


Note: Fund count excludes liquidated investments.

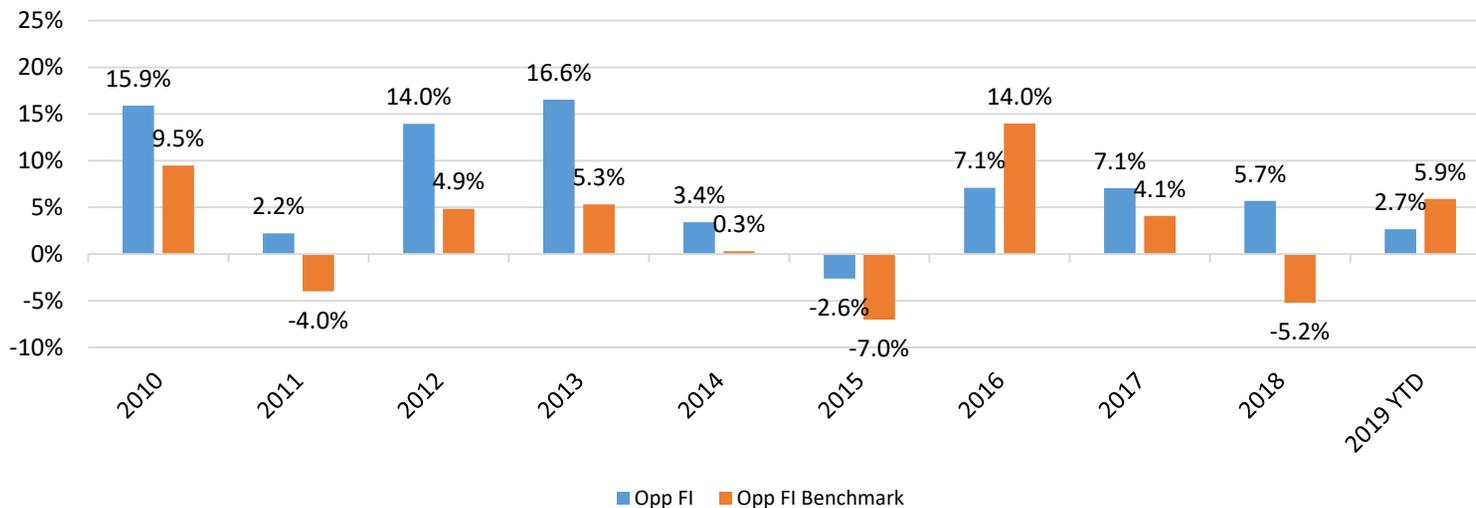


# Portfolio Performance

## Annualized Performance



## Calendar Year Performance

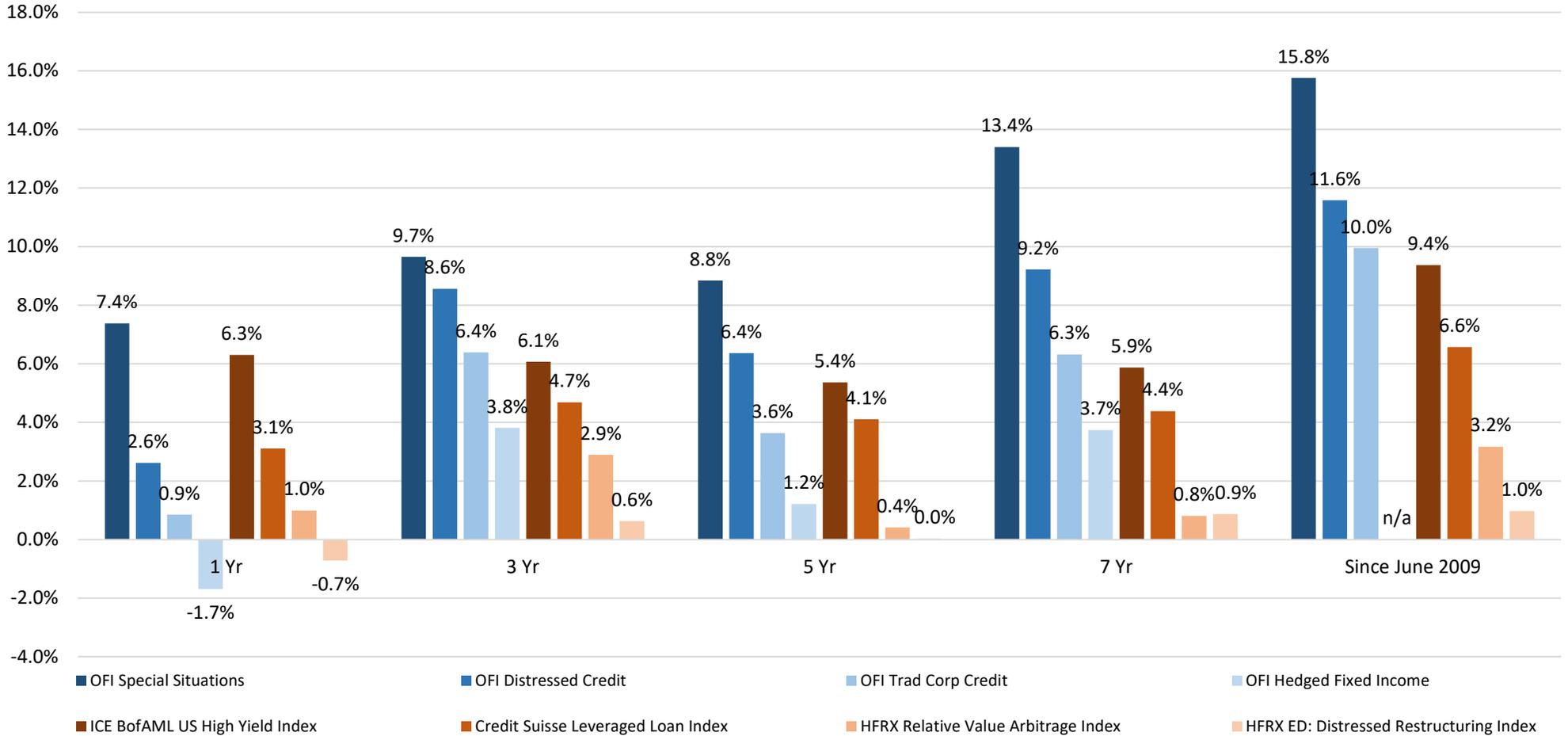


Note: See slide 20 for details on the composition of the Opportunistic Fixed Income Benchmark.



# Portfolio Performance

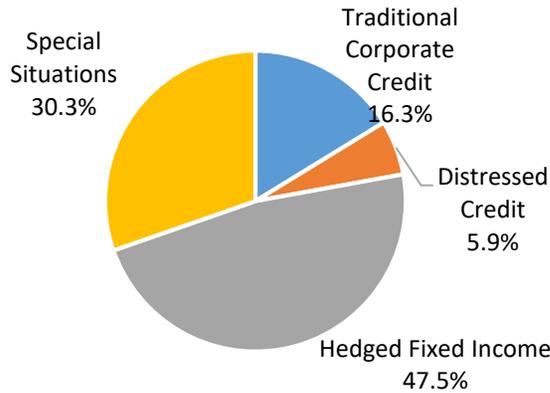
## Portfolio Component Annualized Performance vs. Market Benchmarks



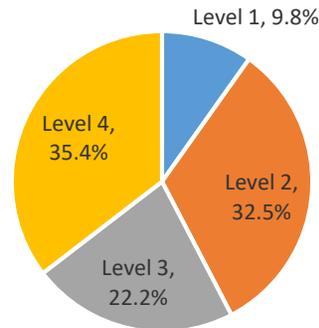
Note: See slide 20 for details on the composition of the Opportunistic Fixed Income Benchmark.

# Portfolio Characteristics

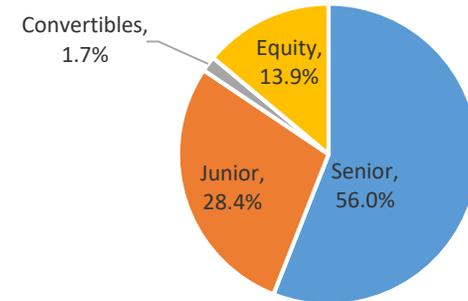
**Allocation by Strategy**



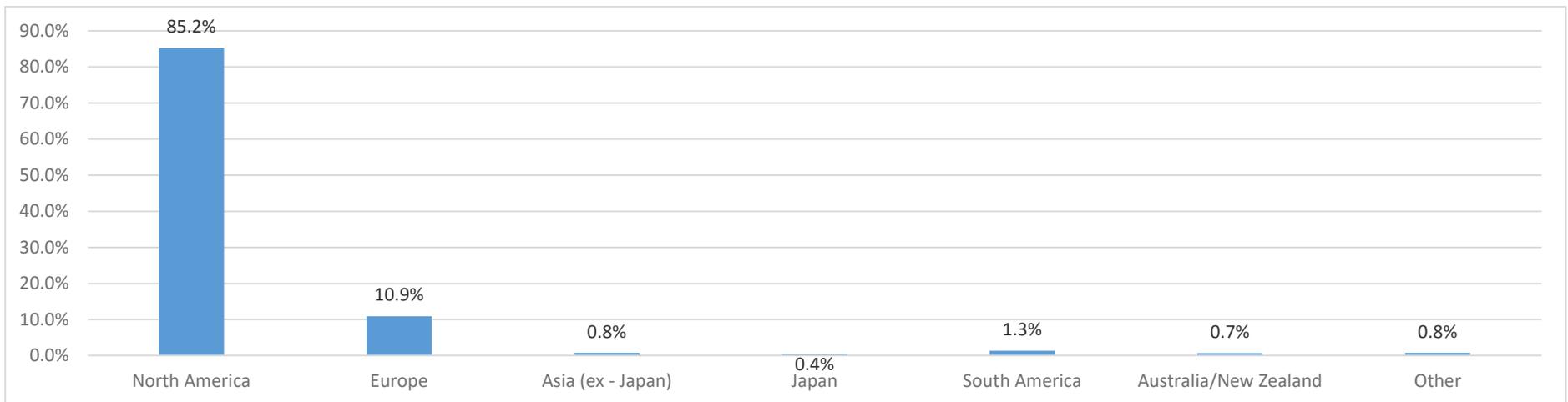
**Liquidity by Level\***



**Capital Structure**



**Allocation by Geography**



Note: Information is based on market value, as of June 30, 2019

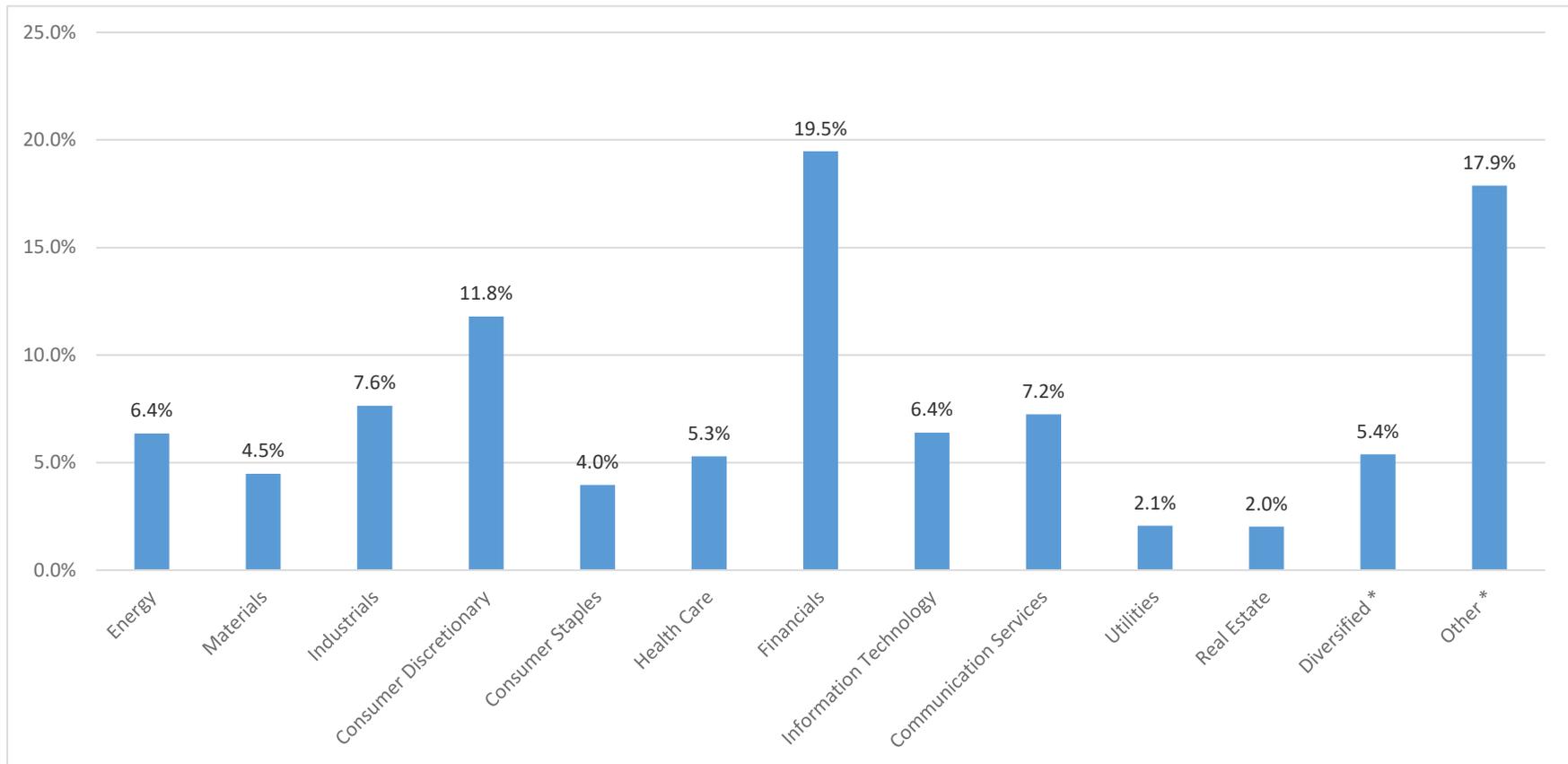
\*Level 1 Liquidity = T+3; Level 2 = T+3 to 12 Months; Level 3 = 12 to 24 Months; Level 4 = Greater than 24 Months



# Portfolio Characteristics

## Allocation by GICS Sector

As of June 30, 2019



\*Holdings that cannot be classified into any one particular sector, as self-reported by the investment manager, may include CMBS, RMBS, ABS, or CLOs



## Credit Market Update

### Private Credit

- Senior, secured private loans continue to perform well
- Insulated from public market volatility, so far

### Structured Credit

- Market has been firm for CMBS, RMBS, and ABS
- CLO debt and equity performing well but with more dispersion between quality

### Bonds

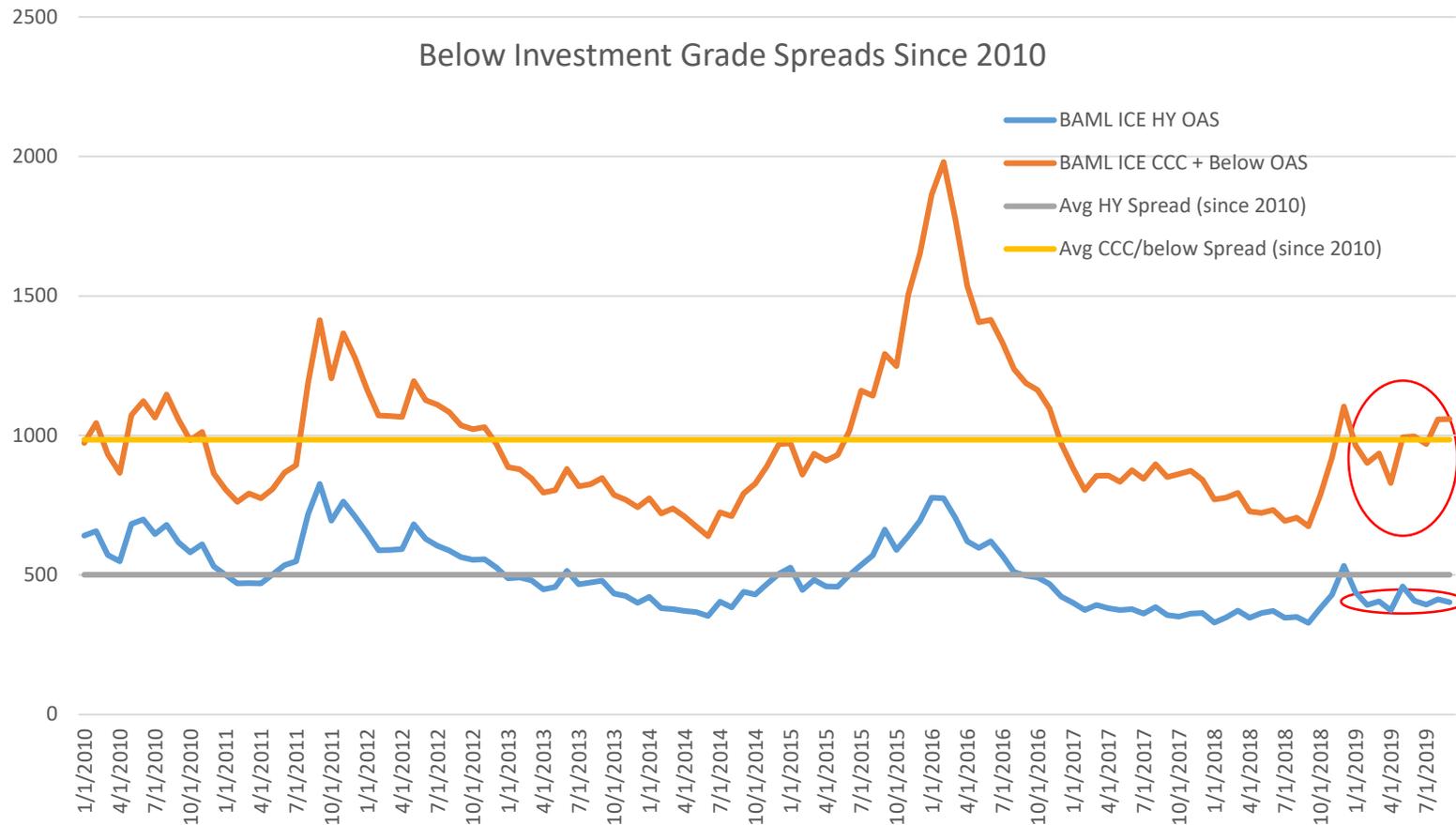
- Higher quality HY spreads continue to be historically tight
- Dispersion between CCC spreads and higher quality bonds

### Loans

- Outflows from mutual funds and ETFs have been offset by CLO new issuance
- Starting to see some cracks – creating opportunities

# High Yield Credit Spreads

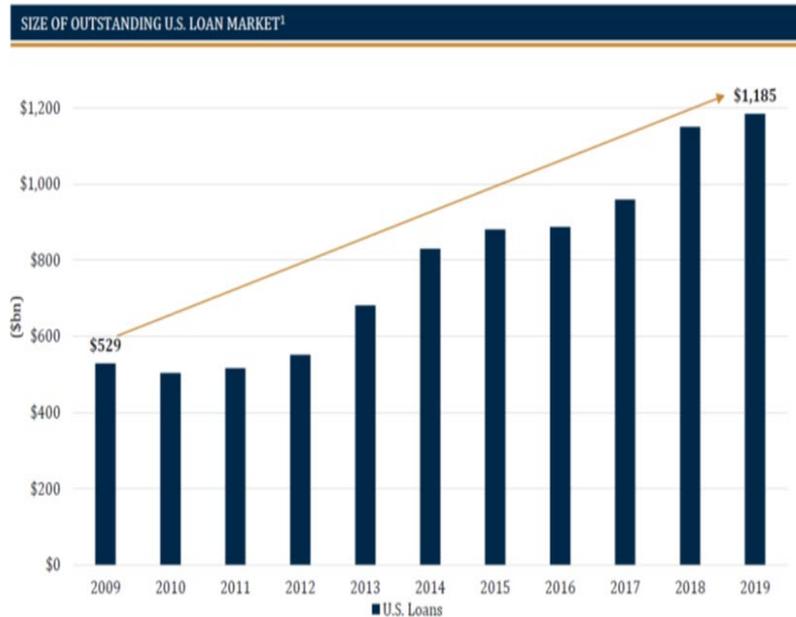
- Seeing dispersion between low (CCC) and higher quality bond spreads
- CCCs are slowly reaching the prior wides seen in Q4'18



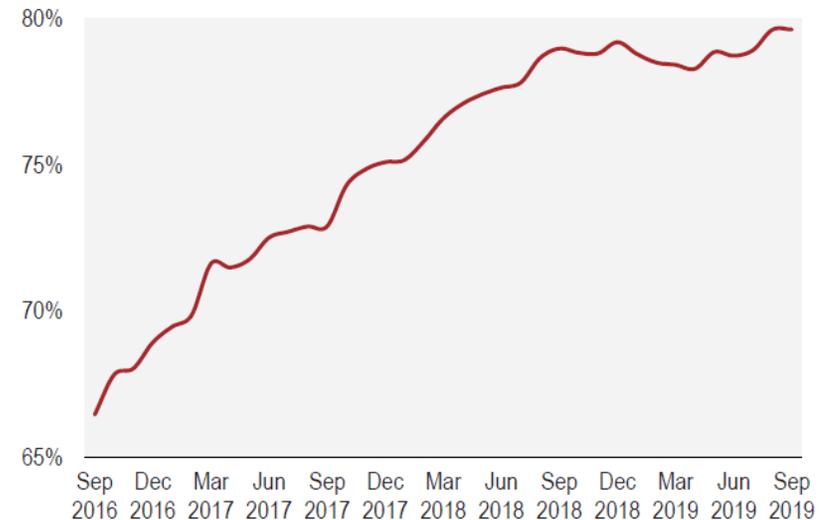


## In Focus - Loans

- Leveraged debt market (bonds and loans) has doubled in size since 2009
- Leveraged loan market is more than \$1T in size, comparable to the HY Market
- Almost 80% of Leveraged Loans are covenant lite



**Covenant-lite share of outstandings, U.S. leveraged loans**



Source: LCD, an offering of S&P Global Market Intelligence

As of 9/30/2019.

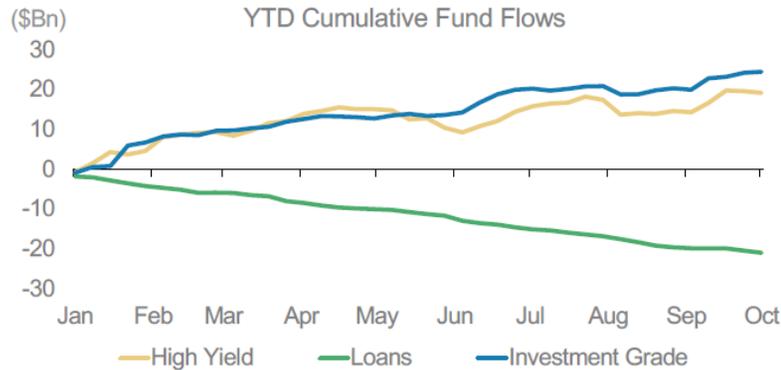
<sup>1</sup> LCD, an offering of S&P Global Market Intelligence.



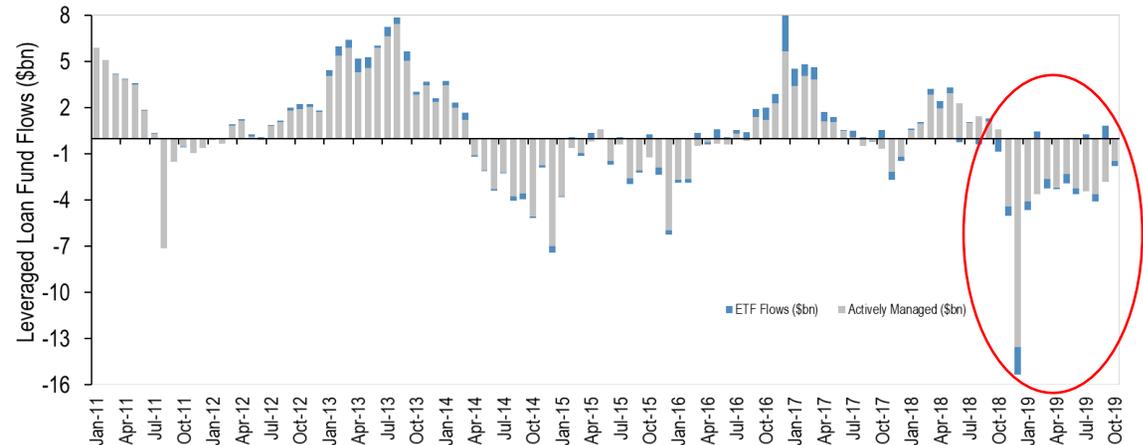
## In Focus - Loans

- While IG and high yield flows have been steady YTD, loans have seen significant outflows from ETFs and mutual funds.

**Exhibit 5:** Loans fund flows persistently negative this year, with \$22bn of outflows YTD



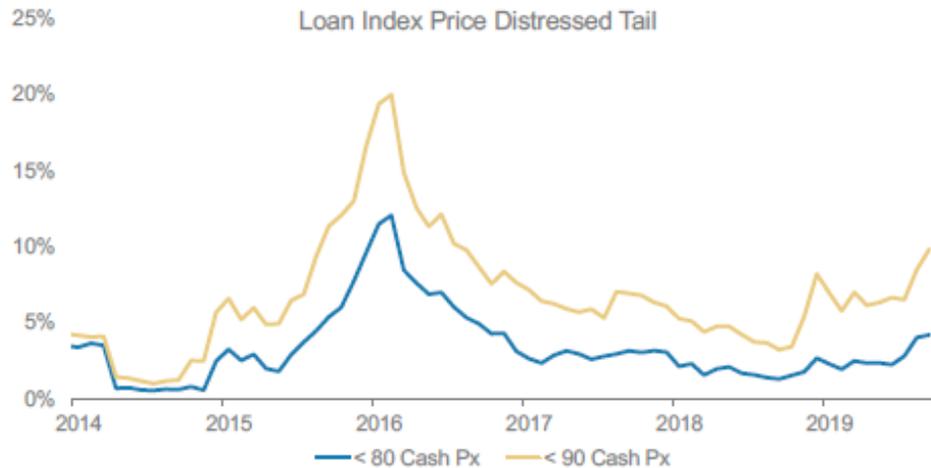
Source: Morgan Stanley Research, EPFR Global  
Note: Includes Mutual Funds and ETFs



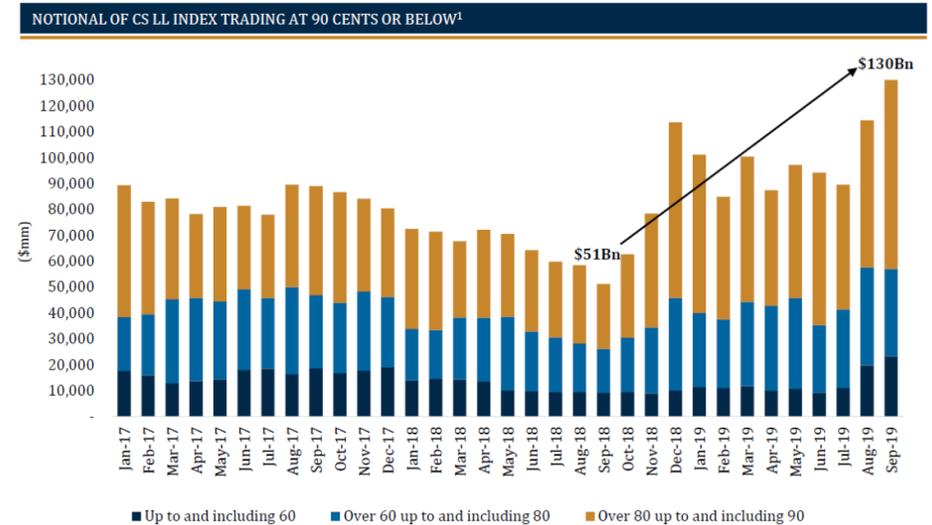
Source: JP Morgan

## In Focus - Loans

- Flows/technical dynamics have created some dislocation in the loan market
- The percentage of bonds trading below 80 and 90 cents on the dollar is now higher than we saw in Q4'18, which creates an attractive buying opportunity
- \$130B in notional value in loans trading below 90



Source: Morgan Stanley Research, S&P LCD



As of 9/30/2019.  
<sup>1</sup> Credit Suisse Leveraged Loan Index.



## Late Cycle Investment Considerations

1. Remain disciplined – continue to focus on higher quality, senior secured, larger issues that may be more defensive in the event of a credit market disruption
2. Take advantage of structural dislocations and mis-pricings while being opportunistic in restructurings
3. Continue to explore the creation of additional investment capacity and prepare for the next large scale investment opportunity
  - Working with existing and new managers to add capacity to capitalize on a structural credit dislocation or distressed cycle
  - Capital call features to drawdown capital using market triggers (i.e. spreads, default rates, and price levels)



# Forward Looking Opportunity Set

## More Attractive

- Dislocation Mandate
  - Opportunistically buy corporate credit when market triggers are breached
- On a select basis:
  - Loans – higher quality, trading off due to technical issues
    - Larger issuers
    - High Quality
    - Senior/Secured
    - Strong fundamentals
  - Middle market lending
  - Select restructurings
  - Energy debt

## Less Attractive

- US High Yield
- Large issuer distressed
- Regular way loans – “loan beta”
- Covenant-lite, broadly syndicated loans



## Appendix

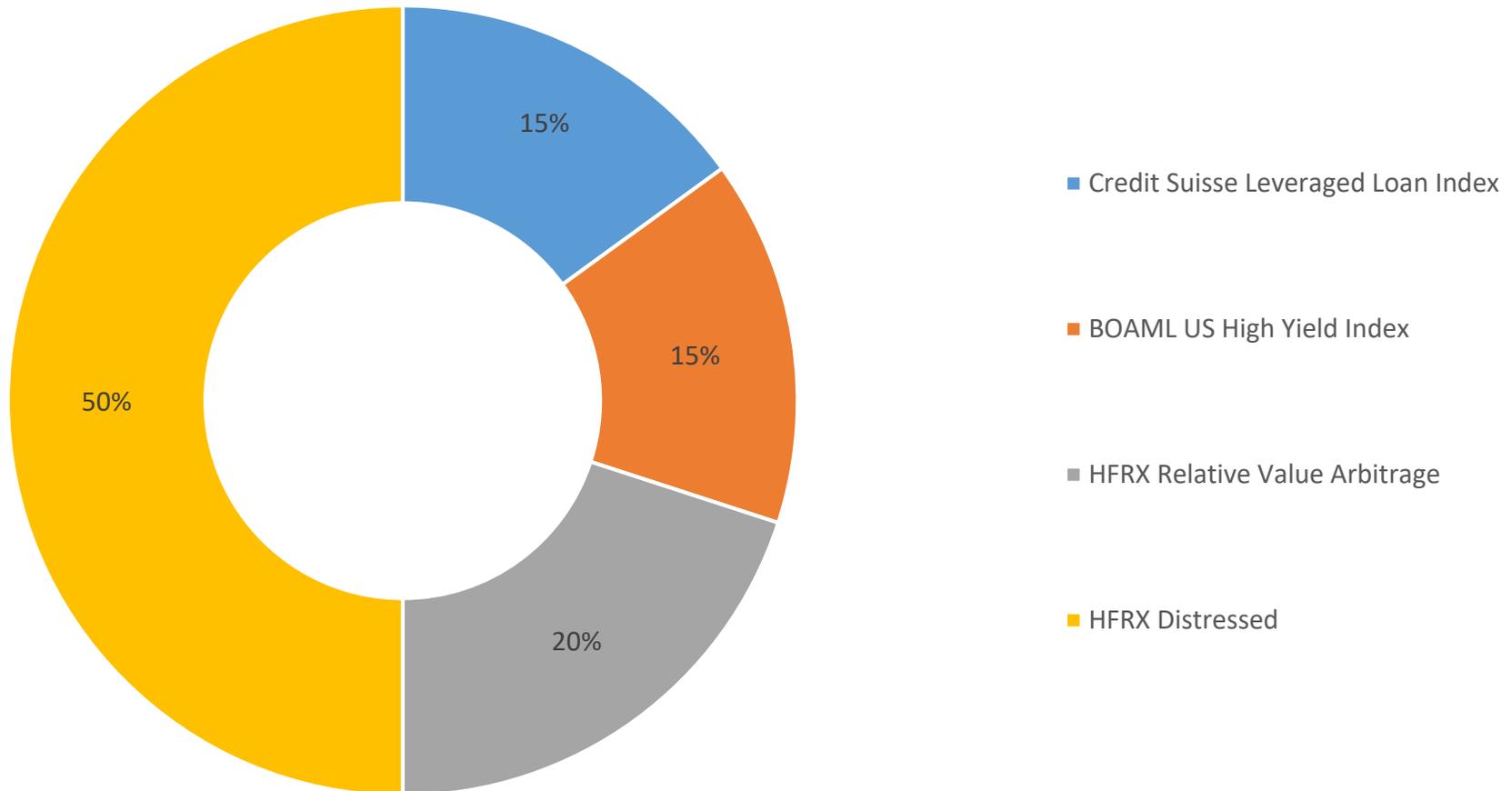


## Portfolio Components

Portfolio Component*	Target*	9/30/19	+/-	Maximum*
Traditional Corporate Credit	15%	16%	+1%	50%
Distressed Credit	25%	6%	-19%	50%
Hedged Fixed Income	45%	48%	+3%	75%
Special Situations	15%	30%	+15%	75%



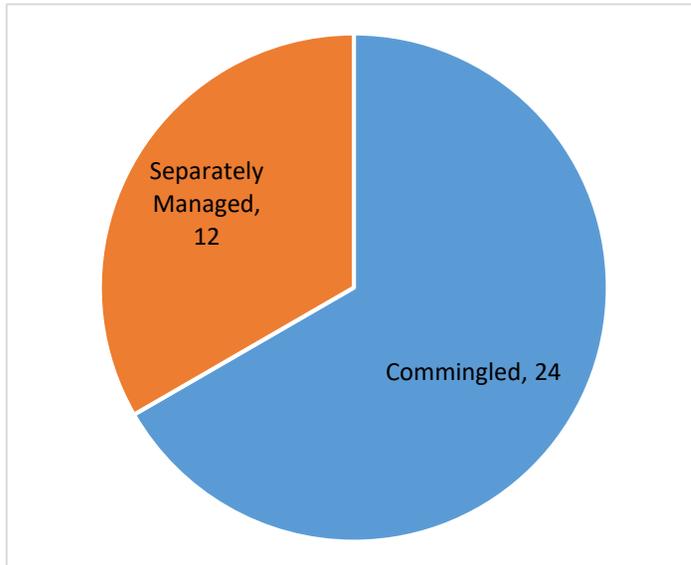
# Portfolio Benchmark



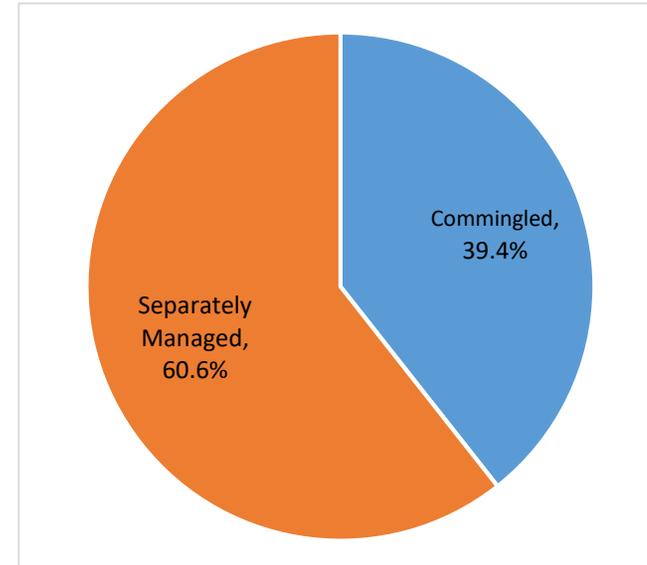
Note: The BOAML US High Yield Index is from BofA Merrill Lynch and is used with permission. See disclaimer on slide 27.

# Portfolio Characteristics

**Account Type by Count**

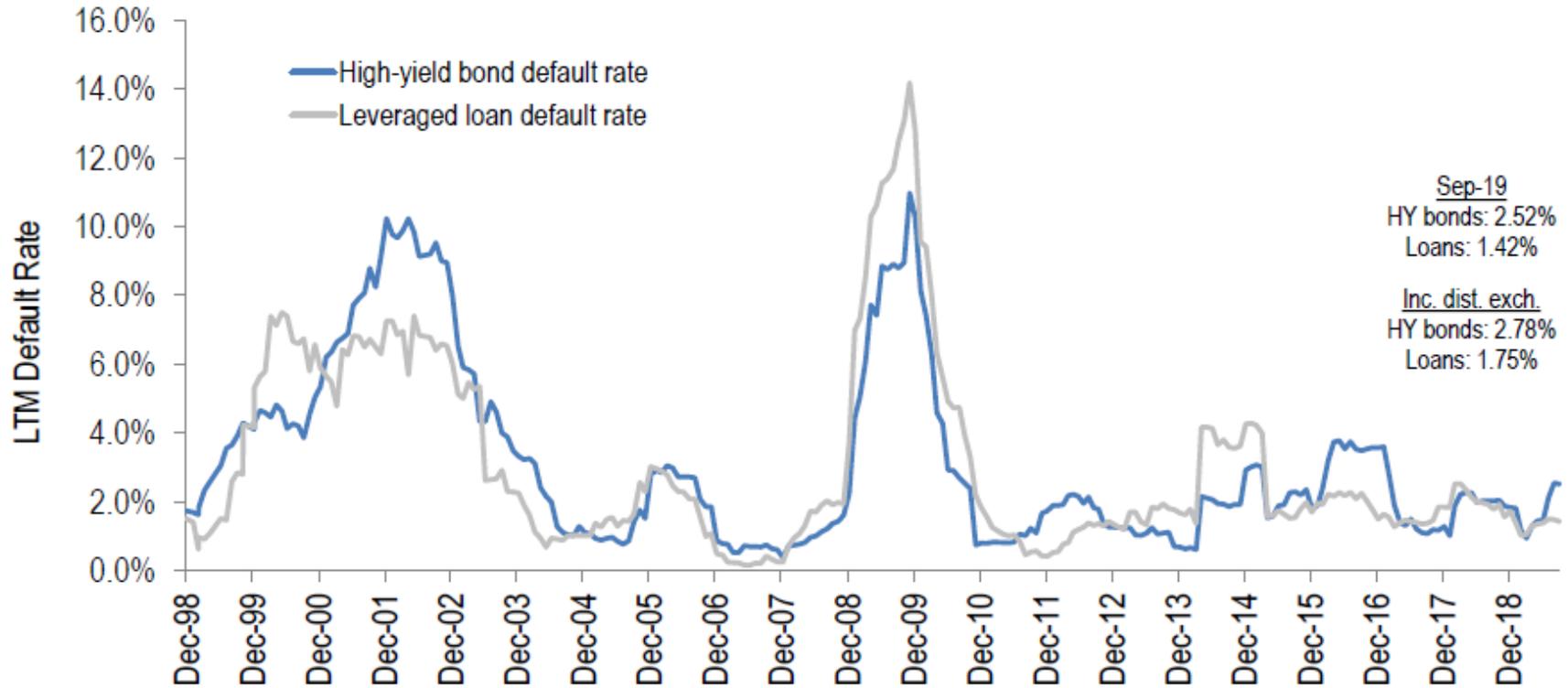


**Account Type by Market Value**





# High Yield Bond and Loan Default Rates

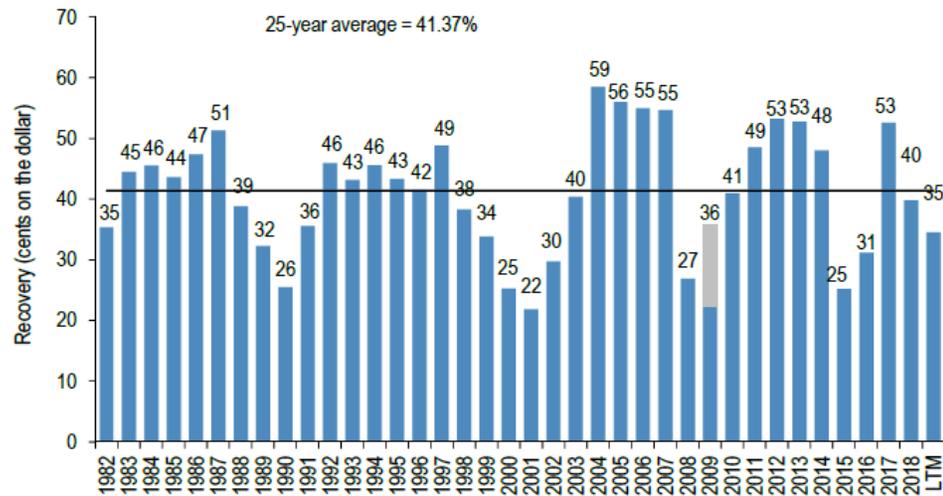


Source: J.P. Morgan.



# High Yield Bond and Loan Recovery Rates

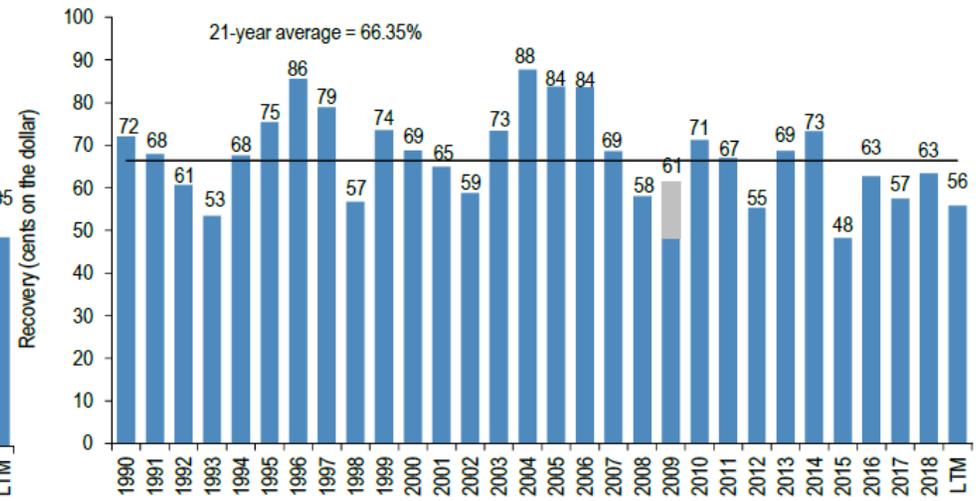
Bond issuer-weighted recovery rates



Note: Recoveries in 2009 were 22.4 based on prices 30-days post default and were 35.7 based on year-end prices.

Source: Moody's Investors Services; J.P. Morgan

First-lien leveraged loan issuer-weighted recovery rates

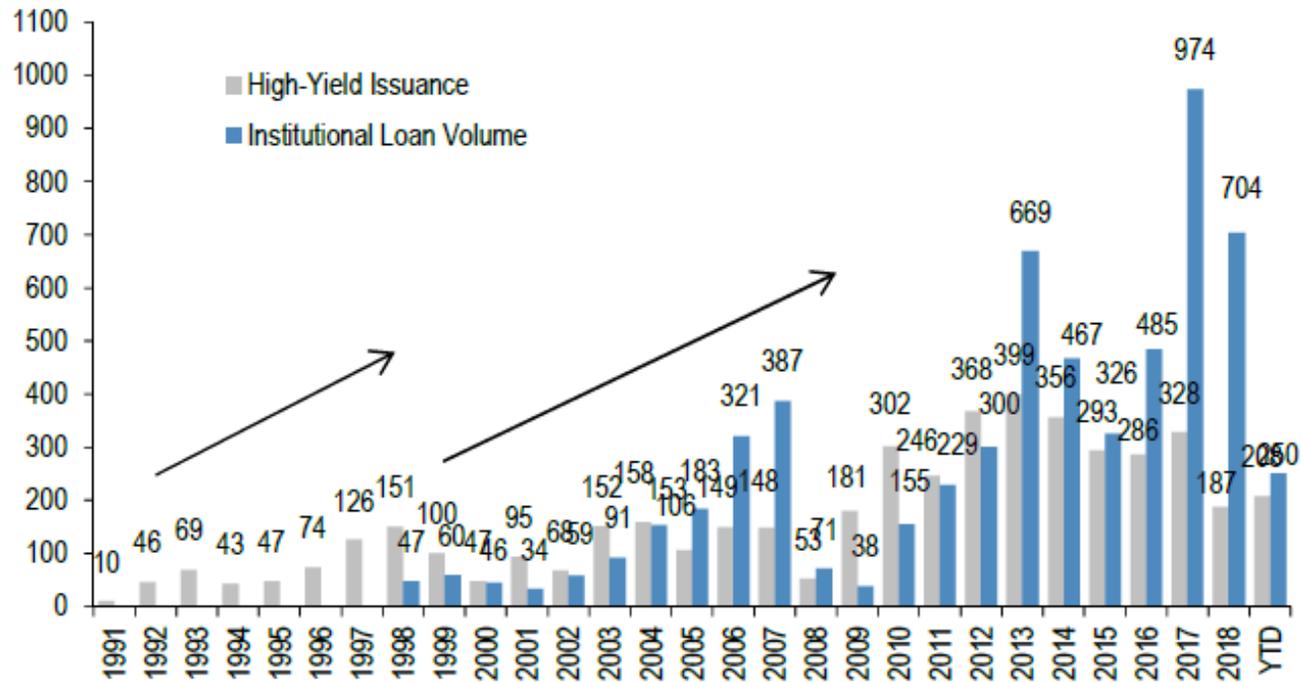


Note: Recoveries in 2009 were 48.3 based on prices 30-days post default and were 61.4 based on year-end prices.

Sources: Moody's Investors Service; J.P. Morgan; Markit



# High Yield Bond and Loan Issuance

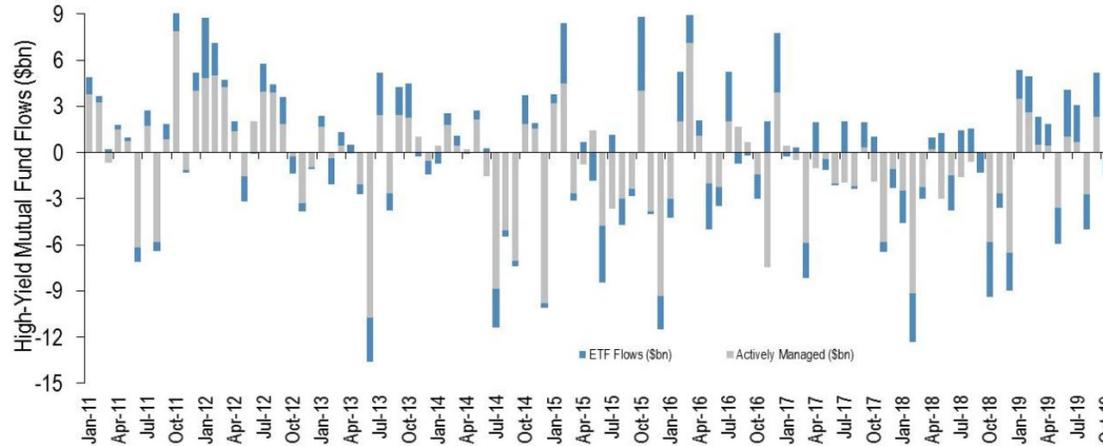


Source: J.P. Morgan; S&P LCD



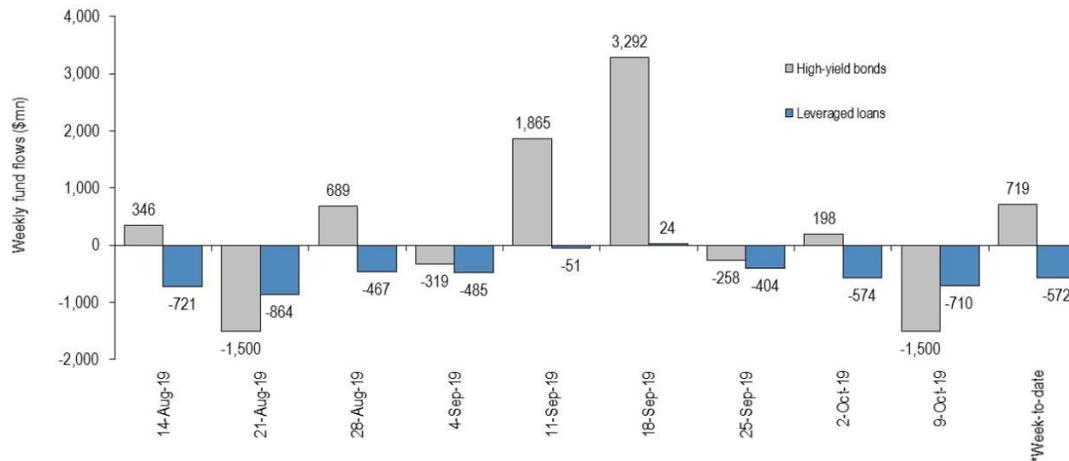
# High Yield Bond and Loan Fund Flows

## High Yield



Source: Lipper FMI

## Loans

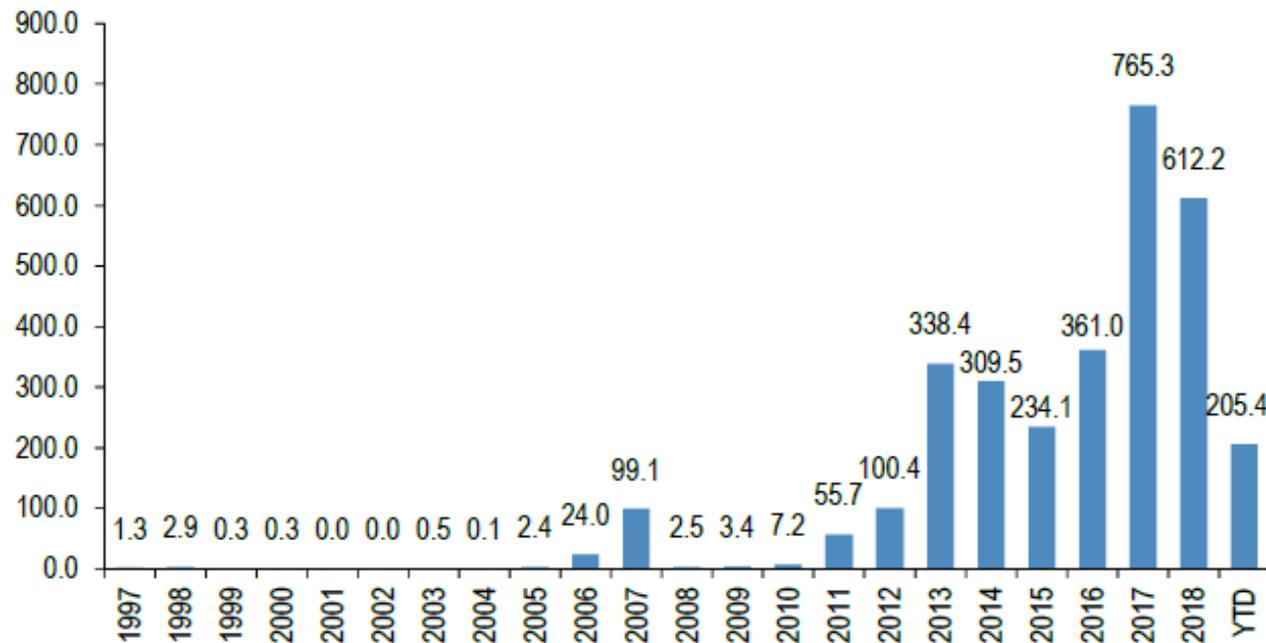


Sources: JPMorgan, Lipper FMI



# `Covenant-Lite Loan` New Issue Volume

Covenant-lite loan new-issue volume



Source: J.P. Morgan

Note: Includes only US dollar-denominated securities



## Notes:

All data presented are based on currently available information at time of publication and may be revised subsequently.

The Opportunistic Fixed Income Benchmark is comprised of 50% HFRX Distressed Securities Index; 20% HFRX Relative Value Index; 15% Credit Suisse Leveraged Loan Index; and 15% BOAML US High Yield Index. The BOAML US High Yield Index is from BofA Merrill Lynch and is used with permission. See disclaimer on slide 28.

The Opportunistic Fixed Income asset class (N.C.G.S. § 147-69.2(b)(6c)) was created by the General Assembly in June 2009. It included some investments that were previously authorized under other provisions of G.S. § 147-69.2.



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