Credit & Rates Strategy

Dislocations, trends and relative value

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Q&A

Look for Value in Distressed Mortgages, Lower-Rated CLOs, Ellington's Vranos Says

Michael Vranos, founder and CEO, Ellington Management Group

- Distressed mortgages and lower-rated tranches of seasoned CLOs look attractive.
- There's a liquidity disconnect between passive investments and semi-liquid assets, said Old Greenwich, Connecticut-based Vranos. Ellington has more than $6 billion AUM, with as much as three-quarters devoted to credit strategies.

Interviewed by Emma Orr on June 14 and 22. Comments have been edited and condensed for clarity.

Q: Where are the opportunities right now?

A: On distressed mortgages, both commercial and residential, we see a lot of opportunity. We're very active buyers of non-performing small-balance commercial loans. The property could be retail, multi-use, multi-family.

On the residential mortgage side, a lot of these are the fallouts from 2008, NPLs that are eight, nine, 10 years old, or re-performing loans that have been re-capped and are performing now but might be spotty in terms of performance. It's a very meticulous, labor-intensive type of business because you're buying hundreds if not thousands of small loans and working them out.

Q: How do you assess the current environment for credit?

A: There's nothing about this macro environment that seems really compelling, certainly not on the corporate side where we think lending standards have loosened significantly. We do see pockets of opportunity on the loan side, up the capital structure, on less-followed names or names where the structure's experienced a ratings downgrade.

We're more constructive when it comes to consumer debt because consumers who are paying mortgages or credit card debt or loans are much more right-footed, if you will, since the crisis. We're at an all-time high in home equity, over $10 trillion I believe. We like the balance sheet of the consumer.

Q: Which CLOs do you like?

A: Lower-rated tranches, but in seasoned deals at or near the end of the reinvestment period. These collateral pools have shorter maturing loans and de-risk quickly as the pools amortize. They're far less exposed to a credit cycle two years forward than new issues. We priced a CLO for financing the loans in our credit hedge funds and had a successful deal done recently.

Q: When you look at the current credit market and where it's headed, what's your biggest concern?

A: Asset pricing in the liquid credit market remains driven by central bank activity. Although the Fed is starting to tighten, the Bank of Japan and European Central Bank are still pumping liquidity into the system. Many credit markets appear much more liquid than they will be when and if this liquidity gets pulled. Reduction in dealer balance sheet makes them much more vulnerable than the market realizes.

Q: You see a liquidity disconnect in the market, in terms of relative value?

A: Underlying assets that are managed by large money managers or passive investment flows via ETFs are extremely tight. However, you have a significant reduction in capital at banks so assets that can't benefit from these passive flows don't have the bank capital pursuing them the way they used to. As such, many of those assets look very cheap, including some in the corporate sector like first-lien loans in mid-cap companies where the structure's experienced a ratings downgrade.

Q: The downgrade doesn't bother you?

A: The entire capital structure could be downgraded as the rating agencies anticipate a restructuring or debt exchange, but this doesn't concern us as we typically own the most senior debt. Similarly, a company could restructure or go through a bankruptcy and exit with asenior secured exit term loan that's assigned low ratings until it has posted several quarters of good performance post-restructuring. We like these situations.

Q: What don't you like right now?

A: Generally, we've been avoiding retail and health care because those sectors, especially retail, have serious headwinds. In distressed overall, there's a lot of cash chasing very few opportunities, so generally we've been avoiding the large-cap distressed and high-yield situations. They're just not trading at compelling prices or yields.

Q: When will we see the next distressed cycle?

A: Everyone's waiting for the big disaster, but I think mini-cycles are the key word. We're looking at retail, health care, potentially auto.

Q: On a scale of 1 to 10, with 1 being risk-off and staying in cash, and 10 the other extreme, where should credit investors be right now?

A: Spreads are near post-crisis tights. We'd put this at a "2." However, largely due to reduction in bank balance sheets, we're finding investments in certain structured credit markets quite compelling, offering double-digit returns. There's a big disconnect between the value proposition in index and ETF credit markets and semi-liquid corners of the credit markets.

At a Glance

Music: Iron Maiden concerts

Activities: Weight training with my son, playing in a competitive soccer league

Fun fact: An anagram of my name is "chairman solve"