Ray Kennedy, Hotchkis & Wiley

Interview with *Graham and Doddsville*, an investment newsletter from the students of Columbia Business School

Ray Kennedy, CFA
Hotchkis & Wiley

Ray Kennedy serves as a portfolio manager on the High Yield bond portfolios at Hotchkis & Wiley. Prior to joining the firm, Mr. Kennedy was a Managing Director, portfolio manager and senior member of PIMCO's investment strategy group. At PIMCO, he headed the global high yield business along with managing and overseeing High Yield funds, bank loan trading and collateralized debt obligations. Mr. Kennedy was formerly associated with the Prudential Insurance Company of America as a private placement asset manager where he was responsible for investing and managing a portfolio of investment grade and high yield privately placed fixed income securities. Prior to that, he was a consultant for Andersen Consulting (now Accenture) in Los Angeles and London. Mr. Kennedy, a CFA charterholder, received his BS from Stanford University and MBA from the Anderson School of Management at the University of California, Los Angeles.

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Graham & Doddsville (G&D): Hi Ray, thank you for taking the time to chat with us today. Can you start by telling us about your background and how you got into investing?

Ray Kennedy (RK): I came from a pretty different direction than most people. I graduated from Stanford with a degree in industrial engineering in '83 and spent three years doing operations and actuarial programming for Andersen Consulting (now Accenture). My second assignment was in London working for the London Stock Exchange on a project called Big Bang, which was to design and automate the exchange's equity trading system. At that time, in 1986, there was only one automated trading system and that was the early stages of the Nasdaq, so this was kind of a big event. Naturally, I became heavily involved in how trading works, how you build a position and clear a position by the end of the day, and that was kind of my first insight about the financial markets.

I enjoyed that project and understanding how markets work, so I said, "This is really fun. Let's go and get an MBA." So, I went to UCLA and got my MBA. During this time the LBO market was very hot, and the money was with the insurance companies – the first investor of KKR was actually Prudential, where I worked for a summer. At Prudential, we were among the first to buy the entire tranche of an LBO, the debt, equity and even bank debt, so I was interacting with Drexel and KKR on a daily basis and investing heavily in very leveraged situations.

After UCLA I returned to Prudential full time in 1988 doing private placements in the mezzanine space. Then the LBO market blew up in the late 1980s; Drexel went under, and the insurance market for investing in the space changed materially. I spent the next four to five years doing debt and equity investing, but more on a private basis.

We did a private placement for a small firm in Newport Beach called PIMCO in 1994, when the firm was still very much under the radar and had around $40 billion in assets and $500 million in high yield. I joined PIMCO's high yield group in 1995 and took over the global high yield business in 2001. By the time I left in 2007, PIMCO was $800 billion in size, $60 billion of which was in high yield.

It was a rush being at the firm during that 12-year period because we were making markets and making new products left and right. We were one of the first to do CLOs and CDSs. We were doing synthetic products because we always had an incredible need to

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invest the dollars. I always described it to people as drinking out of fire hoses every morning: you'd sit at your desk until 4:00 or 5:00 and you'd realize you just had more hours to work, so most of us came in on weekends. But the firm was growing so that was the focus. By now there aren't many of my generation left at PIMCO. Most retired, some started their own businesses, and I retired for a few years before joining Hotchkis. The CEO of Hotchkis and I were freshman roommates, and a lot of my college friends from Stanford are at the firm. It's slower paced here, but we decide what level of growth, what businesses, and what product lines we want.

G&D: You spent a big part of your career at PIMCO, which is a trading-oriented, top-down focused firm, and now you are with Hotchkis, which is a traditional bottom-up type of fund. How does trading and macro fit into your investment philosophy today?

RK: In high yield, we view macro as the guardrails for investing. We wouldn't necessarily avoid situations because we had a negative macro view on a sector, we would just need to be more secured or more senior on the capital structure.

When I was at PIMCO, high yield was largely founded by value equity managers. The guy I worked with, Ben Trosky, was a value equity manager from Merrill, so the roots of the High Yield group was driven by fundamentals. It evolved over time as the asset class became more commoditized, which is why trading has become such an important part of high yield and bonds, but we did marry the two a bit at PIMCO. We were always given the leeway to focus on research first, but as a firm, Bill's strategy was to trade around the curve and interest rates.

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One of the strategies the firm employed was to buy off-the-run securities and price them to be on the run to get instant alpha, because that's how inefficient the market was at that time. The other part was also born out of necessity in dealing with the sheer volume of cash movement throughout the day. You never trade in high yield to pick up a few basis points. A bid-offer spread is anywhere from 15 to 50 basis points. On a good day, you may get an eighth. On a really good day, you may get a sixteenth. Contrast that with treasuries, where your trading positions are 1/64th bid-offer spread, and it's sometimes even 1/28th.

At Hotchkis, however, we view trading as a cost. Low interest rate environments often lead to portfolios being called as companies refinance at aggressive rates. This year alone we probably lost, on average, a third of our names this way. We then have to play the new issue market as our source of ideas. So, coming back to Hotchkis has brought me back to my roots of fundamental research.

"You can always buy a good bond in a bad company or a bad management team, or you can buy a bad bond in a good company."

G&D: You mentioned that PIMCO thought about macro as the guardrails of investing. Is that a framework that you still use in your day-to-day at Hotchkis?

RK: In high yield we say that you can always buy a good bond in a bad company or a bad management team, or you can buy a bad bond in a good company. Getting the credit right is your number one source of return,

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industry sector is the second, and duration the third. You can get burned on duration, though, as we have in the last 18 months because we were positioned more for a standard economic growth cycle that sees upward pressure and rates.
So that's our framework: get the credit right, get the sector partially right, at least be aware of what you're buying into, and the last thing is duration. Embedded in all that is making sure your structure is correct. But like I said, you can buy a good idea in a bad sector and still make money.

G&D: Could you elaborate on the process of getting the credit right? What's your framework around that?

RK: I'll share a few different approaches for perspective. At Prudential, we took a structured approach, and that's where my grounding was. We had a statistical framework similar to Moody's, where we bias credit ratios based on size because there are axioms like, "Smaller companies have a higher probability of default and lower recover rates because they have less financial flexibility." Smaller companies can't grab capital the way large companies can, and they have less ability to dispose of something. That's why it's hard to kill GE. If GE were a small company, it'd probably be dead by now. But GE, as a large company, can pull different levers to keep bailing themselves out and buying time.

"At Hotchkis we take the approach of looking at the business, because history has taught me that a bad business model will likely be your killer."

We also had a matrix we used to determine the implied risk of a specific rating and whether you're being priced rich or cheap relative to that. So, the statistical approach is one way to do it. It works up to a point and works better for investment grade issues.
At Hotchkis we take the approach of looking at the business, because history has taught me that a bad business model will likely be your killer. The first thing I do when evaluating an issue is to look at the balance sheet. If I can understand how things move around the balance sheet, I understand the income and I understand the cash flows. If I see receivables go up but no earnings, I know this is not a cash business.
The best example is film accounting. If you look at the numbers, you would invest in film and TV syndication all day long because they generate enormous earnings, but in reality they are just building huge assets on the balance sheet and spending a ton of cash. For example, Netflix is a horrible credit idea. It's not going to default, but it generates basically no cash because it's constantly building a stream of shows and movies that are earned over time.

Then the second thing is what we call a business test, which is "do they have a reason to exist"? Generally speaking, high yield companies are likely to run into problems. You're dealing in a space where on average 30% of the companies are in secular decline. They wouldn't be junk if they weren't. We used to come across paper companies all the time in high yield. Most of them have filed bankruptcy by now because there's just no reason for small paper plants to exist. Eventually the business hits the wall and your recovery is literally zero. So you don't get A+ businesses, and you don't get A+ management teams, but you do try to find little gems and little ideas out there.

The third thing is looking at the history of management and the incentives of management, because nine times out of ten, most of the problems we run into in credit are bad management decisions or bad

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management teams. In high yield, there's a cohort of management teams that just moves around because, again, you're not getting class A management teams in this space. So, we really do focus on incentives of management, their knowledge base and their tenacity to work through problems, because you're dealing with leveraged situations.

If you've noticed, I haven't mentioned anything about credit stats. I haven't mentioned anything about pricing, because I'll overpay for a good credit all day long, and there are yields at which I just won't buy a bad credit. In credit, there isn't always a price at which you can buy something because buying Chesapeake bonds at 30 cents on the dollar seemed great; well, now they're worth 5 cents. The fact of the matter is you have to think about the asymmetric return profile of bonds and credit in general, which is if things go well, maybe on a good day, you'll get a 120 or 130. If things go bad, you're at zero, and statistically, your historical recovery rate in credit is about 30, 35 cents on the dollar.

So, buying bonds at 60 cents on the dollar on average is a great trade because you're starting from a fairer position at 30 points down, maybe 60 points up. At the end of the day, one of the things we do when we're looking at this is a Porter analysis: Where are they on the cost curve? Do they have some sort of technology that makes them unique? Do they have customers that make them unique? Because these are the things that will keep the company going. And again, we're buying credit, so swinging for the fence at 50 cents on the dollar means my potential return is 2x, whereas buying an equity at $3, your upside is infinite. It's a very different return profile. So, trying to find those companies that have survivability is probably one of the most important things you can do.

"One of the great things about today's environment, which is unfortunately tied to a pandemic, is that it flushes out the weak companies. Clearly, we've had a lot of the apparel companies going or gone under, but one thing that still has value is brand."

G&D: Are there any specific sectors or industries you view as difficult businesses to be in over the next five to ten years?

RK: Yeah, so we can talk about current ones and then emerging ones. The current ones are things telecom related, wireline. Just about all of them have filed bankruptcy now; Frontier Communications, Windstream Communications, Consolidated Communications – they've all restructured their balance sheet. There are also parts of the paper industry that still exist. For example, a printing company, LSC Communications, filed for bankruptcy. People don't buy books as much anymore, and textbooks especially.

Obviously, you know the story on retail. Big mall retail has been in decline for a while due to different shopping behaviors. You can blame some on Amazon, but at the end of the day, they just don't have a reason to exist anymore, and COVID has pushed them to the edge. One of the great things about today's environment, which is unfortunately tied to a pandemic, is that it flushes out the weak companies. Clearly, we've had a lot of the apparel companies going or gone under, but one thing that still has value is brand. Take Boardriders, which is the parent company of Quiksilver, they make t-shirts that are screen printed and charge $30 for something they

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make for $3. So, that's the value of the brand.

An emerging one we all talk about is autos. If you compare the auto world today against 20 years from now, it's going to be fundamentally different. California announced today that no combustion engine cars can be sold in California in 15 years. Sounds great on paper, but it's going to be very difficult to implement. So, you have to ask yourself who is able to adapt to that.

The last one I would add is energy. The high yield market overinvested in the energy sector and effectively sparked the Shale Revolution. When you look around at the energy sector today, the amount of carnage is stunning. Chesapeake was a junk issuer, and so is Aubrey McClendon, the pioneer in horizontal wells and fracking, who literally founded the modern-day shale revolution. 20 companies filed bankruptcy recently, and we're working on three of them.

Between climate change and the shift to renewables, we've seen a significant shift in gas demand around the US that indicates we may have too many pipelines. California is now up to 35% renewables in the form of solar, wind, and geothermal. As a result, all the gas pipelines that were pointed toward California are seeing excess capacity. So, long-winded answer, but those are the ones that I'd put out there.

G&D: For the industries you mentioned, would you stay away from them completely, or could there be potential opportunities? Or do you think that with the secularly challenged industries, it's better to just stay away completely?

RK: It depends. For example, when you look at telecom, wireline is easy to say no to. I'm sure none of you have a wireline. The only people I know with wirelines are my parents. So that's easy to stay away from. That being said, we do have one investment in a company called Unity, which owns fiber to the home that they lease to Windstream.

In the energy space, we own a company called Nine Energy, which specializes in making disposable plugs that are used in horizontal drilling, though that one scares us a bit because if Biden wins, you have to assume that fracking on federal lands will be challenging.

There are certain apparels that we think are valuable as well, like Quiksilver, which we talked about before. With autos, we own Allison Transmission that specializes in making not only the standard transmissions used in combustion engines, but also the electronics.

So the answer is, again, it depends. You try to find the ones that can survive because otherwise I'm walking away from 30% of the market, and that's just not feasible when you're trying to run a high yield portfolio.

G&D: How do you think about these more recent bankruptcies in retail? Is there anything there that you believe is still worth looking into?

RK: It has evolved a lot because COVID has changed the parameters. First of all, established brands do seem to have more value. For example, Forever 21 is a retailer that has some of its own brands, but those are fickle brands. Limited Brands, on the other hand, has Bath & Body Works. That part of the business is in good shape. The Victoria's Secret brand also still has value, but they missed the changing tastes in some of their key product lines. You'd have to think that if they repositioned with the right products, they probably could revise that brand, because it's a good brand name that people like.

But let's talk about retail more broadly. We bought the first lien bonds for J. C. Penney. You're probably

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thinking, "Are you kidding? Who goes to a J. C. Penney?" Well, if you go out in the Midwest, people shop at J. C. Penney. With Sears and Kmart out of business, they were the last survivor, and the company seemed to have had a chance of making it. In addition, they owned a lot of their properties and just the dirt alone would be incredibly valuable.

It all seemed good on paper and seemed like the investment was working. The bonds were in the 80s, and we were almost rooting for them to go bankrupt because we could just take the leases and the underlying land, and flip it to another person. COVID changed the situation dramatically because now there is no one to replicate the space. Those first lien bonds are now in the 30s, maybe moving toward the teens. It now looks like the company might be split into two: the operations will be acquired by mall operators who want to resuscitate the corpse for rent, and the properties will be turned into dark store liquidation.

So, a creative solution to dealing with a dead retailer. On the other hand, we have Neiman Marcus, which has a good brand and good clientele, but the company was starved of capital because it was too over-levered. But if you go into their stores, especially in a world where there's a lot of global travel, they're packed, and people will pay an enormous amount for their products. As a result, they seem to have a reason to come back, and they probably will with a less levered balance sheet, especially if they can pull off the online.
The sad one to watch is Nordstrom. Nordstrom has done a great job of executing both its physical and online presence in an Amazon world, but COVID changed the dynamics for them and they're now a junk issuer. I think they can avoid a restructuring, but they need the market to come back to make it happen. The landscape has evolved in terms of how we look at retail due to COVID. Right now, the going consensus is to take the business, split it into two, keep the operations alive when they have a reason to continue to exist, and sell off the dead stuff.

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G&D: You have said before that the path it takes to get to a destination matters. Could you elaborate on that in terms of why it is important and how you incorporate that into fundamental investing?

RK: The tension between credit and equity is about path. Equity investors often make assumptions like, "Oh, they can get liquidity. Oh, the banks will roll. Oh, there's no shift in quarterly cash flows that will potentially starve a company." In credit we think about whether they will trip a covenant or be up against their bank capacity, which means the trade could pull their lines.

So, the path for credit investors can be incredibly important. Take energy for example – we can make very probably correct assumptions about the value of the resource, but if you can't get there, it doesn't matter what the value is. We had a company that was involved in building a plant, but they just kept running out of cash. With unlimited cash access, they obviously would have finished the plant and never would have had to file bankruptcy, but they ran out of cash, and that is what brings companies to bankruptcy at the end of the day.

But again, remember that in credit, at best I can get 2x my investment, maybe 3x.

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But in equity, you can get unlimited. So, equity investors are more likely to make a bunch of these bets, a few of them flop, but the third can be a home run. Credit, you can't do that. If you have three bad trades, you're pretty much done.

G&D: With path being something that matters, how do you navigate the market in the next 6 to 12 months?

RK:
It's a great question because we're thinking that ourselves. Base case is that things start going back to normal in first half of 2021. But the base case was also that we'd be back to normal by mid-July of this year. The way we've decided to think about this is to still stay somewhat conservative and senior in capital structures. If you think COVID is going away in the next three months, you should buy unsecured airline paper, Carnival Cruise unsecured bonds, and the worst part of the capital structure in the travel and leisure space. I'm not ready to do that. We'd rather buy a piece of paper secured by airplanes, by routes, by cruise ships, because there're just too many things that can come along and make things difficult.

The one thing that's made it extremely difficult is the Fed. If the Fed hadn't stepped in the way they did, neither the high yield nor equity market would not be at the levels we're at today. A company's ability to get cash determines its ability to survive, which means their equity would survive. Let's face it, if Carnival Cruise couldn't have gotten the billions that they did, the equity would be in Chapter 11. Take that across the entire travel and leisure sector and the equity market would be at a much lower level than it is today.

"But again, remember that in credit, at best I can get 2x my investment, maybe 3x. But in equity, you can get unlimited. So, equity investors are more likely to make a bunch of these bets, a few of them flop, but the third can be a home run. Credit, you can't do that. If you have three bad trades, you're pretty much done."

A lot of companies have not recovered to pre-COVID levels, but the Fed has put a floor on credit. They did it both directly through buying bonds that were downgraded after March and indirectly through purchases of ETFs. So, I guess we have to take our hands off the wheel a bit and just ride along, and that's frustrating because you want to do things fundamentally based, but you can't because you have this third party that can fundamentally change things. Let's say you want to short high yield at current levels. That's a dangerous trade when you've got someone with a big balance sheet and the willingness to buy through the end of the year.

So, in essence, you can't short the market, given that dynamic, and the Fed knows that. But you don't necessarily want to be aggressive either because it's a buyer that you don't know much about and acts a bit irrationally. No one in this current environment is comfortable investing, especially on the credit side. We hate it, but we have to play along.

There were two axioms that we stood by at PIMCO. One, don't fight the Fed. Paul McCulley used to say, "If that's where the Fed's going, you've got to be there." The second one is that technicals become fundamentals. This ability to raise cash in a very difficult environment is fundamentally saving these companies. Using Carnival Cruise as an example again, I had no idea how expensive

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it is to dock a cruise ship. You don't just tie it up, turn off the engine and say, "I'm coming back in six months." You have to constantly flush it. You have to have crew of 50, 60 people go out at the port every day, turn around, come back in, or else one side can basically get ballast issues. But a technical bid by the Fed caused the new issuing market to be supportive, which caused the companies to get cash, which caused them to fundamentally survive.

G&D: With the Fed stepping up in the risk spectrum and doing things they have never done before, what does that mean for the market and what are the longer-term implications?

RK: Well, once you do it, people will always know there's a chance you will do it again in the future. So, every bond that I think is going to get downgraded, even though I might not fundamentally like it, I will look at buying and potentially even buy some because I know this player is out there. So, it's fundamentally changed the risk of the asset class. And as a result, the asset class will probably never get to the cheapness that it should again.

For example, I think we had a thousand basis point spread over treasuries, and historically, hitting 1,600 or 1,800 was a very possible scenario. Our base case before the Fed stepped in was that that should happen and provide a great buying opportunity for high yield. Once the Fed came around, however, those spreads collapsed and now we're at 500 off. As investors now, every time you see a sell-off that's event-driven, whether it's the 2008 banking crisis or this pandemic, you're going to buy the asset class even though fundamentally the spread should widen.

"The Fed's ETF program also doesn't seem well-thought-out to me. Instead of buying a slice of everything to show no favoritism, they are buying winners and losers, which is something that disturbs a lot of us."

The Fed's ETF program also doesn't seem well-thought-out to me. Instead of buying a slice of everything to show no favoritism, they are buying winners and losers, which is something that disturbs a lot of us. Second, ETFs only represent portions of the market. In the case of high yield, you have a whole cohort of issuers less than $600 million in size, but the ETFs only buy $600 million in size and larger, so the bonds of those smaller companies were not supported because they weren't ETF eligible. This caused some strange behavior and I'm sure the Fed will just say, "That's just collateral damage in the process. We will be out of the market soon and you guys can act like a normal rationing risk market then", but it will never be the same.

G&D: Does that mean that the Fed can push up security prices forever, and prices will just never go down? What are the implications from a moral hazards standpoint?

RK: That's the implication. Thank God they didn't buy equities, but we think that's probably next. That's been the game plan in Europe, and Japan bought equities to manage through their difficult period. I think you have to assume that's coming for the US. It'll be a safer market for investors, but if you have a Treasury crisis, it's going to be a disaster for the markets, but no one sees that happening under the new, modern monetary theory.

I had a call with some UCLA professors about the moral hazards subject, and I think this is in the hands of the academics to make the case to the Fed that this isn't good. Companies that maybe shouldn't be getting

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money are getting money. Investors that shouldn't be in risk asset classes are in risk asset classes because they think you will always be there to bail them out. From my vantage point, yes, we saw bid-offer spreads widen out from a normal 25, 50 basis points to 50 to 100 basis points, we saw volumes being challenged at times, but what's interesting is that when lockdown happened in March, there was a rally that was beginning to occur at the end of March, before the Fed announced their program in early April. So, the market was already starting a correcting path. One of the things I like to say is that we never have a liquidity problem in high yield, what we have is a pricing problem: at the right price, there's always a buyer. We are an established asset class that's been through a number of cycles now, and the market would have corrected on its own. Maybe Carnival would have had to pay more for the pricing on their bonds or given up more equity, but instead they, in a way, got a free gift indirectly from the Fed. So, I do think the Fed made a mistake, but I'm not sure how we will realize that mistake occurred because we could be in this place for the next five years.

G&D: What was your day-to-day like in early March and what was your strategy in navigating this very unprecedented situation?

RK: The situation never seems to change whenever you have weak markets. The first thing, you never have enough cash. Your clients always take cash out, so your job is to manage through the cash flows. We run a product that can't take cash positioning and redeploy, nor do we have the ability to call on cash and say, "Hey, market's cheap, come in." So really, you're just in triage mode.

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Once we got control of that, the second thing we did was a liquidity analysis on the entire portfolio. So, we just broke it into a risk category and said, "Okay, based on history, who's likely to get hurt the most in this world, and who's likely to get hurt the least?"

We took every company and evaluated their credit lines, how much they're likely to bleed per quarter, who's going to run out of cash first. Anything that looked mispriced, you'd try to sell it. For example, we had some aircraft leasing company bonds, and for some reason, at the very beginning they were still bidding like they were investment grade. No one's flying, which means there's going to be a ton of bankrupt airlines, which means aircraft lessors are going to be challenged. So we let those go.

Then there were buys that were strange. Charter bonds were off 15, 20 points when people were at home watching cable. If anything, there's going to be more demand due to stay home orders. We went on the offense there.

There were things that completely caught us off guard too. We were overweight in building materials and home builders, and I was scared for them at first because we thought no one would buy homes virtually. I was obviously wrong. People buy homes virtually all the time now, and with the additional time on their hands, they're preparing and upgrading their homes. So that one caught me off guard.

The cruise lines were probably the most interesting because they clearly have to dock the ships for 6 to 12 months,

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and some think that people are never going on cruise ships again. But we've been through this before with 9/11, when everyone swore they'd never go to hotels in Las Vegas or go on airplanes again. As we know, they all did again eventually, and that same thing is going to happen for cruise ships. So, you can buy cruise ships. Am I going to go buy unsecured? No, but I could go buy secured, and so that's kind of what we did and saw the bid-offer spread widen out and narrow back in.

So, we started with cash management, then got our arms around the portfolio, because none of us anticipated a scenario like this during the initial investment decisions. Then the next thing is look for defensive play. You go on defense for some and offense for others. We went defensive on the aircraft lessors and offensive on charters. We were also trying to pitch and bring in new money in the midst of all this. And then, of course, you're trying to do all this remotely.

G&D: What do you think COVID's impact on both the economy and on the world will be?

RK: I'm still trying to figure that out myself. I am actually in Utah right now, and I flew commercial for the first time since it all started. The plane was clean and there were a lot of people there. The fundamental questions we're asking ourselves is, "Will we ever get back to normal travel mode?" I'm in the camp that says we will get back to normalcy, that people will look back and say we overreacted. We will be smarter about it – like how we adopted TSA after 9/11, we'll adopt a different travel pattern post-pandemic. But I'm not sure salespeople will ever be traveling at the pace they used to. So, that's a wild card.

"I think that, with the exception of travel, we will probably get back to a normal world. Interest rates are going to be low for a very long time. The Fed has said that. People are starting to really embrace the modern monetary theory, and it's scary that you can flood our world with money and there's no consequences for it."

I also think people will get back in the offices. JPMorgan's already said this doesn't work for them. I'm on the board for a privately held REIT, and they said their productivity simply stopped. I feel the same. We need to get our people back into the office to interact and make decisions together, and I'm tired of talking to people on the phone when they're walking their dogs.

So, I think that, with the exception of travel, we will probably get back to a normal world. Interest rates are going to be low for a very long time. The Fed has said that. People are starting to really embrace the modern monetary theory, and it's scary to old people like myself that you can flood our world with money and there's no consequences for it. But for the foreseeable future, I just don't see that changing. Credit still has a role in a portfolio, even more so for older and high net worth people because they need income. The losers in these type of worlds are always the people on pensions, because they need high deposit rates and high interest rates to survive.

G&D: Shifting gears a bit, do you have any specific investment ideas that you are excited about today?

RK: Well, given that I see travel returning to normalcy eventually, the travel space is still the opportunity, whether it's a Carnival Cruise or Delta secured

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bonds. I think the other one that's interesting is the idea that this is the end of energy, so maybe we're supposed to be looking for exits. That's one I struggle with because we're long energy, and it's a fundamental shift in our thinking. But we're all starting to really question whether energy is going to fundamentally change.

One bond that we like a lot is PG&E bonds, post-bankruptcy. We think their bonds are really cheap given that PG&E, as a utility, is a buyer of power generation, so the business is more about the distribution of the lines. Their current situation is due to a specific risk situation, rather than being tied to macro risks.

"The losers in this COVID world are not the high yield companies but the middle market companies who are struggling to get capital from regional banks, who don't have the risk tolerance to provide capital. As a result, specialty credit will continue to grow.

Regional gamers are still interesting. I would probably stay away from the Las Vegas, because that's going to be a much slower recovery as Vegas is predicated on jamming everybody in a building and feeding you drinks, which is something that will take some time to get back to in a post-pandemic world, if ever. Regional gamers tend to be a bit smaller and more niche, and people gamble in good times and bad times, so that business will continue to exist. Those are the ones that stand out. As I mentioned, high yield tends to have a lot of secular challenges, so sometimes it's a game of avoiding the losers.

G&D: You mentioned you think travel will return to normal levels of activity, specifically for cruises. How do you contrast this thinking that people will return to traveling the way that they did before versus people would be a little more cautious about going into a casino?

RK: That's a good point. My gaming comment is a relative one versus an absolute one. If you're going to own a gaming company, many of which are in the 80 cents on the dollar range, you probably should own a regional versus a Las Vegas. The travel comment is that people just like to get out. Following 9/11, people learned that there are safe ways to travel and not be concerned about a catastrophic event occurring.

G&D: Got it. Finally, Ray, you come from a business background as well. Are there any tips and advice that you have for current students that are trying to go into investing, and specifically high yield investing?

RK: The need for credit will increase in this world because the banks have pulled back and will continue to pull back. The losers in this COVID world are not the high yield companies but the middle market companies who are struggling to get capital from regional banks, who don't have the risk tolerance to provide capital. As a result, specialty credit will continue to grow. Also, as equity markets get increasingly rich and concentrated in terms of performance, people will look at ways to invest, and one of the ways to do that is through high yield and specialty credit funds.

When we interview people for equity, we always ask, "Which equities do you buy? Which portfolios do you buy?" That's an unfair question to ask a high yield candidate because you can't really buy high yield bonds as a private investor. It's extremely difficult, especially in your 20s, unless you have a million

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dollars or more in assets, so you need to get under the wings of somebody else. Internships are key, even if it's through the platform of an insurance company.

"Summer's often a strange time for credit. It tends to be slower, so it's actually one of the worst times to learn the credit markets. You want to catch it in the fall because that tends to be where the volatility really picks up."

The other path that people should think about more is the world of distressed, which has gotten bigger and more involved. We work with a lot of folks from Evercore, Greenhill, Houlihan, AlixPartners, and I think those are great training grounds because you have to do a lot of models, you have to understand balance sheets, you see a lot of problems really fast. Once you do that, you can carry that over into investing. I think a lot of distressed funds tend to hire from those firms because they come with some incredible expertise.

It's a grind, but that's probably one of the best ways to get expertise if you can't get your foot in the door on the investment management side. It's hard for us to train because we don't have the depth nor the time, and summer's often a strange time for credit. It tends to be slower, so it's actually one of the worst times to learn the credit markets. You want to catch it in the fall because that tends to be where the volatility really picks up.

G&D: That's great. One final question, and this is one we like to ask to just see a different side of investors. What are some things you like to do outside of investing?

RK: I have ownership in a real estate brokerage business that's actually the fifth largest Berkshire franchise. It's fun and different because you're working in a world that is more crude and making real-time decisions that impact businesses. I'm also on a board for a private family REIT. They have about a billion in assets, but they do industrial properties and they're one of California's land grant families.

I was on the governing body for USA Water Polo for a number of years, and I do a little bit with the UCLA business school. I've done career days with them, and I'm part of a credit pitch contest that they do every year. Then it comes down to interest of sports. My kids are now out of sports, but I had some very accomplished college athletes, so it was fun to travel all over the nation and internationally with them. Other than that, I work out a lot, and I have a house in Utah where I do a lot of outside activities, hiking, skiing, things like that. And I'm an intermediate piano player and I've been taking lessons for about seven years.

G&D: Thank you Ray, we really appreciate you taking the time to speak with us today.

RK: Thank you all and good luck.

All investments contain risk and may lose value. Investing in high yield securities is subject to certain risks, including market, credit, liquidity, issuer, interest-rate, inflation, and derivatives risks. Lower-rated and non-rated securities involve greater risk than higher-rated securities. High yield bonds and other asset classes have different risk-return profiles and market cycles, which should be considered when investing.

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