Eagle Point Income: More Income, Less Risk, And A Fund Institutional Investors Love

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[This article was first published last month for ***Inside the Income Factory*** members.]

Eagle Point Income (EIC) announced its quarterly earnings recently and included in the press release was the welcome news that the fund's distribution was increasing by 33%, effective in October, from 9 cents a month to 12 cents a month. This brought the fund's distribution yield up over 8%, although the market's favorable reaction to the news has moved the price up, and the yield is now down to 7.8%.

That's still a very attractive yield when you look closely at what this fund invests in, and how it compares from a risk/reward standpoint with other high-yield credit funds.

EIC focuses primarily on junior, BB-rated debt of collateralized loan obligations ("CLOs"). This positions it in the upper range of the non-investment grade credit spectrum and therefore higher than most of the credit ratings of many high-yield bond funds that tend to focus on the higher-yielding single-B and below credits. This table shows a range of high yield bond and loan funds that have distributions in the high 7% and low 8% range, where EIC fits comfortably.

Note that in every case, EIC's portfolio is tilted more to the upper range of the high-yield spectrum, that is the BB-rated credits. Default statistics over many decades show that BB-rated credits default at a substantially lower rate than credits rated single-B, CCC or lower.

Higher Yields, Lower Risk!

But the story gets even better. The BB-rated debt of CLOs, which ranks above the equity held by funds like EIC's sibling Eagle Point Credit (ECC) and its Greenwich neighbor Oxford Lane Capital (OXLC), is an asset class that has a phenomenal record compared to the more typical BB-rated debt of corporations (i.e. operating companies, not CLOs). If you review published default studies for CLO debt versus regular corporate debt there have been very few defaults of BB-rated CLO liabilities over the past few decades since CLOs were first introduced.

In fact, speculatively-rated debt (i.e. BB+ and below) shows a big difference in CLO debt's favor, between actual defaults for CLO debt and corporate debt with the same ratings, as this chart from Standard & Poor's shows clearly.

The default rate for BB-rated CLO debt is only a tiny fraction of the default rate for BB-rated corporates. Between 1996 and 2018, the cumulative default rate for BB-rated CLO debt was only 1.5%, which works out to about 0.07% per annum.

But the story gets even better. Despite its having a better credit record than similarly rated corporate debt, BB-rated CLO debt invariably pays a **higher coupon** rate than the more default-prone corporate BB-rated debt.

Yes, you read that right! The CLO BB-rated debt pays a higher coupon than similarly-rated corporate debt, even though the BB-rated corporate debt actually defaults at a higher rate than the CLO debt.

The only logical explanation for this is the "better the devil you know" rationale, which would suggest that many investors have been buying ordinary corporate debt for decades and are totally familiar with it. Institutional investors, especially, don't have to explain what it is to their investment committees or boards of directors.

Although CLOs in one form or another have been around for over three decades, many investors (or their investment committees and boards) may still find CLO debt (and equity too) to be somewhat more complex and therefore sort of "funky" compared to the asset classes they are used to. So they accept a lower interest rate on the debt they're familiar with, rather than move up the learning curve to understand (and profit from) the somewhat more complex CLO debt (and equity).

Investors who are willing to climb the learning curve get rewarded by a higher return for taking less risk than they would in a typical corporate debt issue with a similar credit rating. Economists would probably say that the limited number of investors willing to go to the extra trouble to understand CLOs and CLO debt moves the "intersection of the supply/demand curve" to a different point where it takes a higher interest rate to induce the smaller number of potential investors to participate.

Personally I'd rather take "complexity risk" than real credit risk any day of the week, which is why I like investing in CLOs and other high yielding asset classes that may be harder to understand, and therefore are not every investor's cup of tea. (New to CLOs? Check this out.)

Floating Interest Rates And A Booming Market

The CLO debt that EIC buys is all floating-rate debt, that adjusts its coupon rate upward as interest rates rise. This makes it an even better inflation hedge than typical high yield bond funds, whose bonds are generally fixed rate. High yield bonds, with terms likely to be closer to 5 years, are still a much better investment to own when inflation and interest rates rise than traditional investment grade bonds, whose coupons are much lower and terms are typically 10-20 years or more, leaving investors starved for yield and facing capital losses when inflation and interest rates move up.

Finally, the market for senior loans (the "raw material" of CLOs) and the CLOs themselves is booming, with issuance at record levels. This chart shows that, even during the first half of 2020 when retail investors retreated from loan funds, institutional investor demand for CLOs continued, and has now risen to record levels.

EIC's management referred to this, and specifically expressed a lot of confidence about the fund's future when they announced the recent 6 months earnings results along with the distribution increase:

> "We had another excellent quarter, generating net investment income and realized capital gains of $0.28 per share, comfortably above our distribution level during the quarter," said Thomas Majewski, Chairman and Chief Executive Officer. "We have been slowly increasing the portfolio's exposure to CLO equity as we see an attractive opportunity to further increase NII on a sustainable basis. Given our recent financial performance and our

> continued confidence in the Company's future outlook, we were pleased to further increase our monthly distributions by 33%, to $0.12 per share, beginning in October."

Here's how EIC has been covering its distribution over the past two years.

As explained in a **recent article,** net investment income ("NII") is the "gold standard" when it comes to coverage of a fund's distributions since it includes only the actual dividends and/or interest that a fund receives during the period and doesn't depend on earning additional profits via asset appreciation. As we can see, EIC has covered its distributions completely with NII in 2019 and for the first six months of 2021, and even came pretty close (85%) during the challenging year of 2020 when market losses pulled its overall GAAP earnings deeply into the red (along with most other funds).

While those 2020 losses came roaring back as gains in the first six months of 2021, my main point is that NII is the stream of cash that can support a fund's distributions "through thick and thin" regardless of whether the market value of its assets rises or falls within a particular period. (That's probably not surprising to most readers, since our entire **Income Factory® strategy** is based on creating a "river of cash" that will continue to grow our portfolio earnings - i.e. the "factory output" - through all sorts of market volatility.)

In EIC's case, management is telling us they are confident enough that they can "further increase NII on a sustainable basis" to raise future distributions by a generous 33%. One way they intend to do that is by increasing the percentage of CLO equity that EIC plans to hold in the future from the present level of about 20% to 35%, which is the current authorization limit.

This will change the risk/reward profile of EIC somewhat. Whereas two years ago it was about 90% CLO debt and only about 10% CLO equity, in future it will be more of a 2/3rd debt and 1/3rd equity split. The two-thirds allocation to CLO BB-rated debt means EIC will be firmly anchored in the solid CLO debt asset class we have just been discussing, but it will also have the additional upside that a position in CLO equity provides. This may enable the fund in future to be more of an 8%-9% yielder as opposed to its having been more of a 6% yielder in the past.

What Do Other Investors Think?

In my recent article ***From Slide Rules to Spreadsheets*** I described how helpful it can be to check out who else owns a fund's shares, especially institutional investors. While I wouldn't solely base my investment decision on it, I find it useful to know whether professionals who invest big institutions' money for a living have chosen to invest in a particular fund at a particular time. In the case of EIC, the insurance group Enstar owns 62% of EIC's common stock. Enstar itself is owned 90% by other major institutions, the list of which reads like a "Who's Who" of heavyweight investors. While none of that is conclusive, I think that retail investors in EIC, like us, are in good company.

As always, I appreciate your reading and look forward to your questions and comments.