

A photograph of a concrete staircase with a dark blue overlay containing the title text.

What Contributes to the NAV of a Credit Fund?

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Credit fund net asset values (NAV)s often experience periods of sharp increase and decline, just like other asset classes. However, because of the structure of credit assets, there are often other factors involved when credit fund NAVs decline. Should prospective investors be concerned?

When a fund invests in credit assets, which have a much more involved structuring and underwriting process, the determination of NAV is slightly more complex than a simple liquid bond or equity fund. To provide shareholders and other constituents a transparent view of a fund containing credit assets, a fund's Board of Directors would adopt a policy to ascertain their fair value.

Successful credit funds have valuation policies and procedures that are consistently applied, including the collection and analysis of valuation data and the preparation of written reports, produced at least quarterly. Moreover, many credit funds engage third party valuation experts to provide independent analysis, verification and other assistance to the Board in its determination of fair value.

The NAV movement of a credit fund is influenced by a multitude of factors, but they can primarily be boiled down into two separate categories: market risk, or more worrisome, asset-specific risk.

Market Risk

As discussed previously, a fund containing credit assets and governed by the '40 Act must value its entire portfolio at a minimum of once each quarter. Market risk speaks to the price a willing buyer would pay for an asset on a given day and is driven by forces external to the fund itself. But prices aren't everything. In fact, an asset can improve in credit performance but based on market factors, the current fair value might go down.

The fair value process is intended to provide shareholders with a transparent view of a fund's portfolio by valuing each investment at a price it could be sold for at that specific time, regardless of whether a fund intends to actually sell an investment or not, and regardless of how an asset itself is actually performing from a credit perspective.

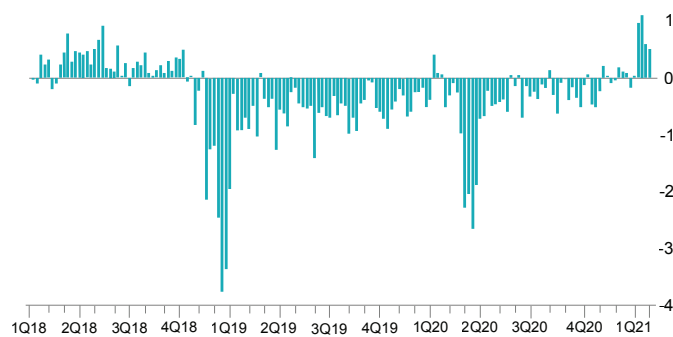
Asset-Specific Risk

More concerning is when the fair value of an asset goes down not for market-driven reasons, but for asset-specific reasons. If an asset's performance has deteriorated from what was originally expected, the fair value will go down in order to compensate a buyer with a higher yield to take additional risk. While companies can often turn their performance around, a deterioration in credit can sometimes be a more worrisome sign, as it could indicate poor underwriting or asset selection by an investment management team.

Successful funds have access to an experienced investment team with a strong track record of low portfolio delinquencies and net losses. Moreover, prudent management teams tend to diversify their portfolios among different asset classes within credit and in companies that vary in industry, geography and scale. This may limit the impact that a single underperforming investment may have on a fund's overall portfolio performance.

The fourth quarter of 2018 was one of the worst quarters on record for the senior loan market, even worse than the beginning of the pandemic in 2020. The chart below details fund outflows in each period. The prices of leveraged loans, driven by outflows and an increase in supply as issuers rushed to meet the strong demand for floating rate assets, tumbled sharply in Q4 2018. In the two months from October 16, 2018 to December 16, 2018, the S&P/LSTA Leveraged Loan Price Index fell from 98.6 to 95.5.¹ These market pressures, not necessarily a decrease in asset performance, pulled down the NAV of credit funds with them.

U.S. Bank Loan Fund Flows



Source: Chart: Financial Times. Data: EPFR Global

For an example of market-level swings influencing NAV, consider a bank selling a loan position that was previously marked at \$93 but maturing at a par value of \$100. The bank, fearful of a continued sell-off and with a desire to clear its balance sheet for year-end, needs to sell at a distressed price.

With only the most opportunistic buyers in the market, the bank would be forced to accept an artificially low price of \$88, thereby creating a new mark for the same position held by all other investors. Because many of the positions held by credit

funds are not traded in the public marketplace, price discovery can often only be found if a position is put out to bid.

When evaluating a credit fund, it is of paramount importance to read published disclosures to determine what is driving movements in NAV one way or the other. Funds with a higher concentration of illiquid assets may be less susceptible to market forces because they are not rated daily and are less subject to the whims and emotions of investors. Market pressures are usually temporary.

If an asset goes down for market-level reasons, everything else being equal, it will still mature at par. The real troubles arise if fund managers have not been diligent or selective enough in their investment processes, resulting in portfolio delinquencies, reduced asset performance, and ultimately net losses.

Footnote

1. S&P/LSTA Leveraged Loan Price Index Returns.

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