

INVESTMENT STRATEGIES

Specialty Finance: An Expanding World of Opportunity

25/06/2024 Kristofer Kraus

Join Portfolio Manager Kris Kraus as he walks through the rapidly growing specialty finance market and the compelling investment opportunities it offers within private credit.

Read Transcript

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Text on screen: KRIS KRAUS, Portfolio Manager

So, as we think about specialty finance, we're thinking about the world of private lending that sits outside the corporate market. We've seen for many years now the development of the private corporate direct lending market. And as we think about specialty finance, there's this very, very large world that sits outside of that that we've been active in the form that that risk has taken has changed. Some of the risks that we work on underwriting and managing on behalf of clients may have been originally developed years ago in a securitization market, but now in the private markets, we

may have better access to information.

People are looking to use alternatives to securitization as they seek to diversify their funding models, and so that's brought, significant amount of risk as we think about opportunity sets, into these markets for us. So, think about the world of residential credits, the entire consumer complex, from unsecured consumer lending, student loans, auto finance, solar loans, residential solar loans, which are very popular obviously in the world that we're in today, home improvement loans. Another area that's seen significant growth.

But then you also have this whole world of non-consumer-related activities, which includes aviation Finance. That's an enormous market as you think about the growth there globally. There's a lot going on obviously, in the world of data infrastructure and chip finance. Everyone's reading about AI and the enormous amount of investment required there. There's a very large world of equipment finance too. So there are many of these parts of the market which actually we touch in our day-to-day lives in an effort to demystify them.

When you think about post-GFC, we all knew that the world was going to be different. We knew that how banks, which had been let's call it the primary source of risk for investment funds such as ourselves and others, that their business model was going to change. The amount of capital that would be required to support trading books as well as risks that you would hold elsewhere within the institution, that that was going to change.

And we've seen that evolution with Basel, and now in the United States, we're talking about the Basel III Endgame, which has a sort of apocalyptic name to it. But it's something that, depending upon where that ultimately lands, institutions are going to have to further grapple with that and we're now in 2024. I think what's been arguably equally as acute or if not even more impactful for institutions has been on the accounting side, the advent of CECL, which is Current Expected Credit Loss, which has led to a material change in how institutions provision for losses in certain parts of their business.

But also to you're seeing partnerships develop with banks. No one, certainly not PIMCO's calling for the death knell of banking. Definitely not. There's a lot of highly profitable banks that do really good work for shareholders and customers, but you're seeing this growing need to develop partnerships with institutions such as ourselves, where we can be an offtake for that type of risk, which helps them mitigate some of that provisioning volatility, helps them mitigate some of the capital volatility. And I think that's something that's going to develop in an even more significant way as we go forward in the world that we're in today.

So that's, again, going back to this, is this sort of a near-term event that could wane over time? I think you're just seeing some fundamental changes in how the economy operates, who are the providers of credit, to those in demand of credit, and I don't think we're going to look back. And there's this room to grow. And as we think about specialty finance alongside direct lending, borrow whatever metaphor you want, direct lending, whether that's in the 6th innings, 7th innings, people can debate, I think for specialty finance, and for asset-based lending more broadly, we're much more at the beginning of the game, and there's just, I think, a lot of tailwinds to support this development.

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Kristofer Kraus

Portfolio Manager