THE IMPACT OF INFLATION

A Publication by HCM Academy | June 2021

HILDENE
CAPITAL MANAGEMENT

Firm Overview

January 2008	$12.4 billion	Asset-Based & Structured Credit
Inception	AUM	Expertise

- **Co-CIOs:** Brett Jefferson; Dushyant Mehra
- **Headquarters:** Stamford, CT

Executive Summary

As a vast majority of fixed income portfolios are comprised of fixed rate instruments, an inflationary, rising rate environment is largely construed to be a negative for the sector. However, under such a regime, floating rate securities materially outperform their fixed rate counterparts.

Hildene investments are mainly comprised of floating rate securities and are positioned to benefit from a rising rate environment:

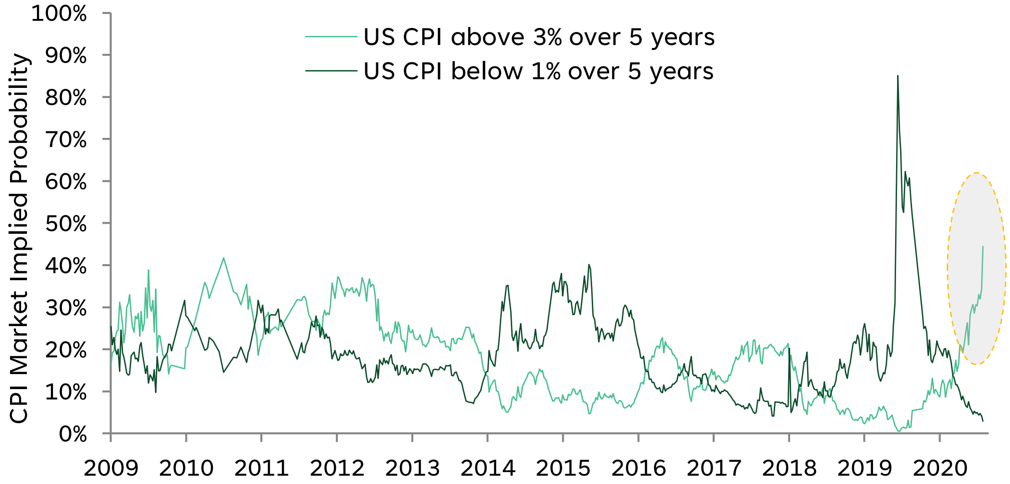
- **Carry:** Coupons on floating rate securities are typically linked to short-term interest rates that adjust higher as rates rise, boosting their carry profile and providing them a significant advantage over fixed rate bonds.
- **Spread Duration:** As rates adjust higher, demand for fixed income assets rotates out of fixed rate into floating rate instruments, leading to relative spread-tightening and outperformance in floating rate investments, like leveraged loans and CLO mezzanine debt.
    - Additionally, Bank TruPS and REIT TruPS CDO securities, characterized by longer cashflows, further outperform other floating rate instruments. Through their longer "spread duration", TruPS CDO securities typically generate 2-3x returns for every unit of spread tightening when compared with competing floating rate sectors (i.e. leveraged loans and CLO mezzanine debt).
- **Price Convexity:** As prices rise above par on higher dollar price securities, callability concerns can limit further upside. As a majority of securities in Hildene portfolios trade at substantial discounts to par, they are likely to remain unhindered by this dynamic.
    - These securities are also long several options that can come into play in an inflationary, rising rate environment, such as upside from prepayments.

Overview

Over the last decade, inflation has been like the Yeti – often feared but seldom spotted. However, unprecedented fiscal stimulus in the wake of the COVID crisis, in combination with easy monetary policy, is stoking inflation fears.

While some of the observed inflation has been dismissed as 'transitory' in nature, the market fears that the Federal Reserve will delay raising rates, which can lead to inflation gaining a stronger foothold.

Market-implied probability of U.S. Inflation overshooting is at its highest in more than a decade:



Source(s): Federal Reserve Bank of Minneapolis; Goldman Sachs Global Investment Research

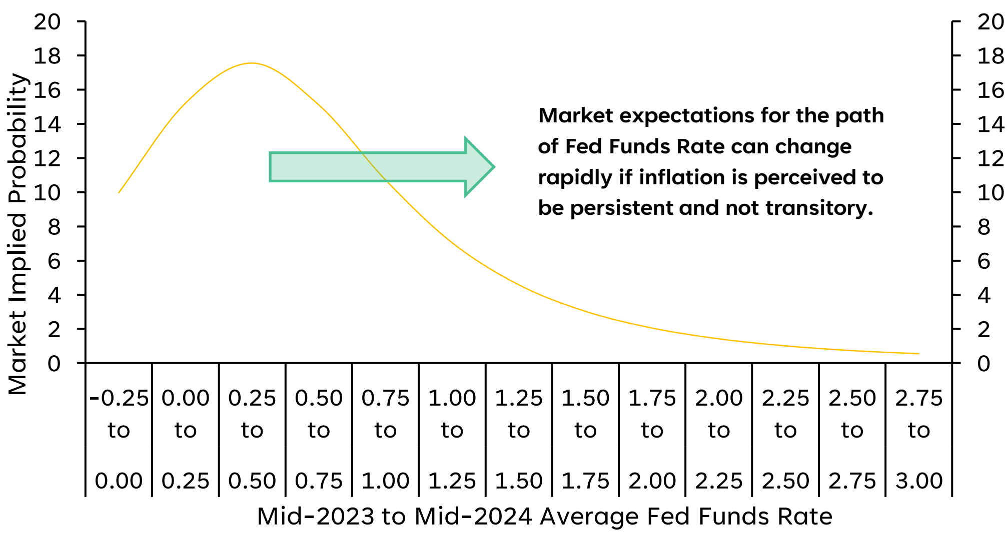
Inflation and Interest Rates

Thus far, the Fed's forward guidance and monetary purchases have combined with demand for duration and carry from real money investors to keep interest rates in check. On the flip side, the market is wary of the fact that the Fed's purchases of treasuries and Agency MBS will eventually come to an end – taking away a substantial source of demand.

Another source of concern is the Fed's new Average Inflation Targeting (AIT) mandate. Under AIT, the Fed will effectively allow the economy to run 'hotter' for longer before raising short-term interest rates. Arguably, as a result, a reasonable conclusion is rates may be raised faster than in previous cycles, when hiking begins to bring the system back in balance.

Such a Fed reaction function can cause a rapid change in interest rate expectations with far reaching impact on all asset classes.

Investor expectations can change on a dime



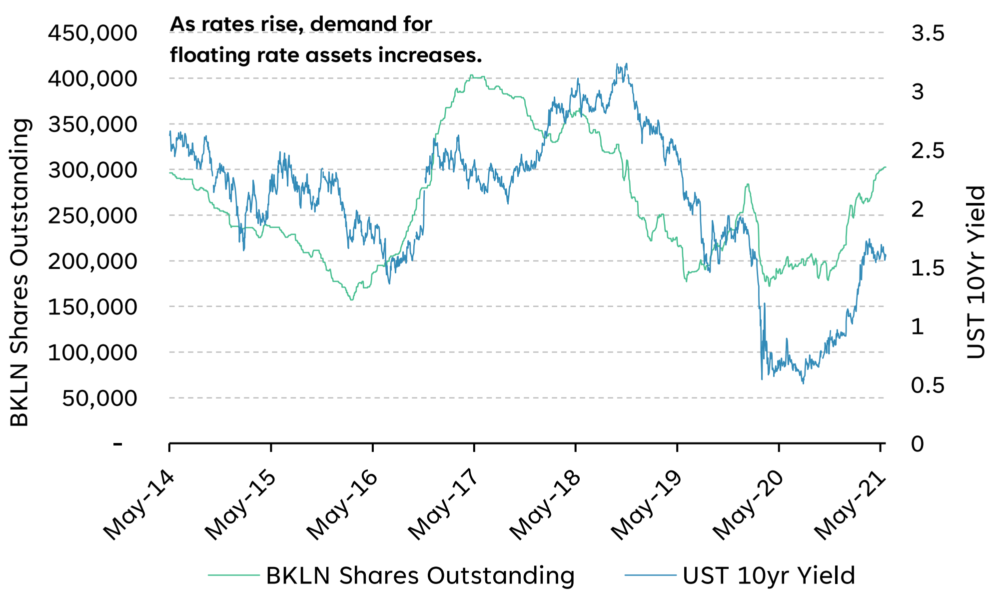
Source(s): Goldman Sachs Global Investment Research

Impact on Fixed Income Portfolios

The nature of inflation, along with its level and the speed at which it materializes, can lead to a range of outcomes. However, in general, market participants expect fixed income instruments and portfolios to behave as follows under a moderate inflation regime:

- **Fixed Rate**: These securities are characterized by longer interest rate durations. Inflation, and the ensuing rise in rates, reduce the values of these portfolios as prices move inversely to interest rates.
- **Floating Rate**: In contrast to fixed rate instruments, floating rate securities are better-insulated against inflation and rising rates.
    - Coupons adjust one-for-one with interest rates, negating any duration-related impact
    - Fixed income mandates shift allocations from fixed rate portfolios to floating rate portfolios, leading to shrinking risk premiums

BKLN (Floating Rate Leveraged Loan ETF) shares outstanding vs. 10-year U.S. Treasury yields



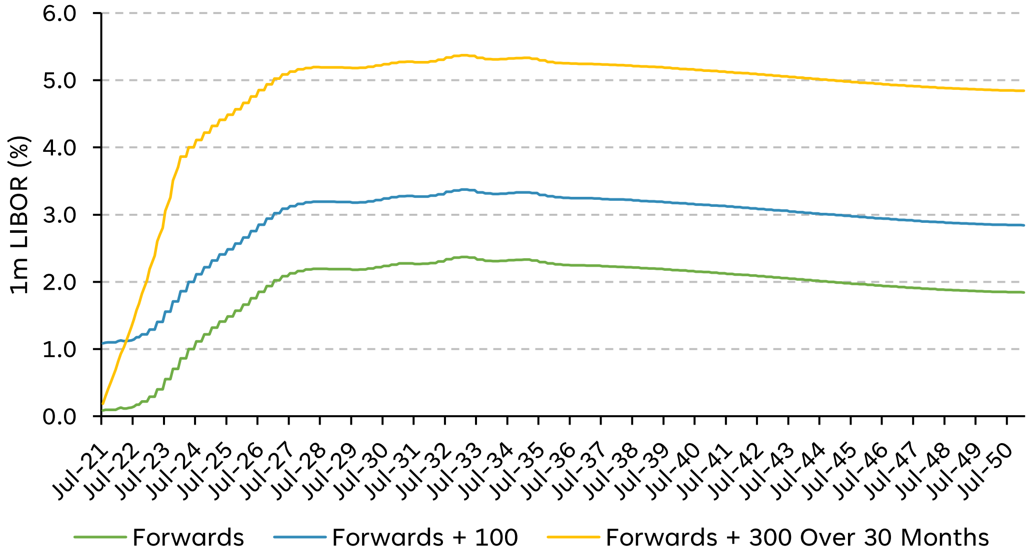
Source(s): Bloomberg

Impact of Inflation on Hildene Covered Sectors

In this section, we cover the impact of inflation on sectors that Hildene invests in:

- We model loss-adjusted yields for various securities under different inflation/interest rate assumptions. While the realized path of interest rates will likely differ from our assumptions, these scenarios help capture variability in yield profiles under a wide band of interest rates.
- We also evaluate various qualitative factors that may be at play in an environment characterized by moderate inflation and rising rates.

1-mo LIBOR under interest rate scenarios used for bond runs



Source(s): Intex; Hildene

1. Impact of Inflation on Bank TruPS and TruPS CDOs

Bank TruPS carry floating-rate coupons and are backed by regional bank credit risk.

Bank TruPS CDO Mezz Yield Comparison[1]

Rate Scenario →	Forwards	Forwards + 100bps (Parallel Shift)	Forwards + 300bps (Linear Increase over 30 months)
Bank TruPS CDO Mezz	8.8	10.2	12.3
Equivalent Fixed Rate Bond	8.8	8.8	8.8

Source(s): Intex; Hildene

- **Credit**: As the interest rate curve steepens, bank net interest margins (NIMs) are likely to expand. Strong economic growth in such a scenario should cause the portfolio credits to improve, boosting overall profitability and credit profile.
- **Prepay**: As coupon payments on TruPS obligations increase, strong banks may decide to retire their TruPS. Others may choose to refinance them into cheaper subordinate debt. These prepayment events can have a material additional positive impact on mezzanine TruPS CDO positions that are being carried at significant discounts to par.

[1]To demonstrate purely the first order effect of interest rates, we keep credit and prepayment assumptions constant across scenarios. Prepayments and improving credit risk profiles should lead to further upside.

2. Impact of Inflation on REIT TruPS CDOs

REIT TruPS share several characteristics with Bank TruPS, including floating rate coupons and long maturities. Stronger economic growth and a moderate inflation regime should improve the credit risk profile of names underlying a CDO. In certain situations, REIT TruPS may be prepaid, leading to significant price appreciation on discount dollar mezzanine positions. Similar to Bank TruPS CDO positions, rising rates improve yields for these floating rate securities.

REIT TruPS CDO Mezz Yield Comparison[2]

Rate Scenario →	Forwards	Forwards + 100bps (Parallel Shift)	Forwards + 300bps (Linear Increase over 30 months)
REIT TruPS CDO Mezz	11.2	12.8	15.6
Equivalent Fixed Rate Bond	11.2	11.2	11.2

Source(s): Intex; Hildene

3. Impact of Inflation on High Cash-on-Cash, Short Duration Securities

Hildene also has exposure to CLO equity and ABS residuals.

The credit-sensitive nature of these instruments, coupled with low interest rate duration, make them relatively immune to rate increases. Moreover, a moderately inflationary environment and strong economic growth improve their credit risk profile.

CLO Equity Yield Comparison[2]

Rate Scenario →	Forwards	Forwards + 100bps (Parallel Shift)	Forwards + 300bps (Linear Increase over 30 months)
CLO Equity	14.0	13.7	15.4
Equivalent Fixed Rate Bond	14.0	14.0	14.0

Source(s): Intex; Hildene

The above table shows the impact of rising rates on CLO Equity. As LIBOR floors embedded in leveraged loans move out-of-the money, initially CLO equity yields may dip. However, if rates rise substantially, CLO Equity stands to benefit due to its floating-rate nature.

Further, the high cash-on-cash nature of such positions continually returns cash to be redeployed into higher yielding opportunities as rates rise, improving portfolio returns (compared to a static portfolio).

[2, 3] To demonstrate purely the first order effect of interest rates, we keep credit and prepayment assumptions constant across scenarios. Prepayments and improving credit risk profiles should lead to further upside..

Contact Information

HILDENE CAPITAL MANAGEMENT, LLC
333 Ludlow Street | South Tower | 5th Floor
Stamford, CT 06902

PHONE: 203.517.2500
FAX: 203.517.2548
EMAIL: InvestorRelations@hildenecap.com

Notes and Disclaimers

This report was produced by Hildene Capital Management, LLC ("HCM"). This report is not to be reproduced, copied or otherwise distributed, in whole or in part, without HCM's express prior written permission.

The information contained herein regarding HCM and its affiliates, and/or any investment products managed by HCM (collectively, "Hildene"), has been prepared solely for informational purposes and is not an offer to buy or sell or a solicitation of an offer to buy or sell any securities, or to participate in any trading strategy. If any offer of securities is made, it shall be made pursuant to definitive offering documents prepared by or on behalf of the relevant issuer, which would contain material information not contained herein and which shall supersede this information in its entirety. Any decision to invest in securities should be made only after reviewing the definitive offering documents for the relevant issuer, conducting such investigations as the investor deems necessary and consulting the investor's own investment, legal, accounting, and tax advisors in order to make an independent determination of the suitability and consequences of an investment. Such an investment may not be suitable for all investors, and may involve a high degree of risk.

Current and/or past performance is not indicative of future results. Projections, including scenario analyses, are based on assumptions by HCM regarding market conditions and other factors. These assumptions may be correct or they may be incorrect. Projections are not a profit forecast. There can be no assurance that investments will perform as projected and investors should place no reliance on such projections when making an investment decision. Information provided in this presentation related to specific securities or classes of securities is intended to be illustrative only and is not designed to predict the future performance of any investment. There can be no assurance and no representation is made that any investment strategies contemplated in this presentation will make any profit, and a total loss of principal may occur. Performance is subject to market and economic conditions.

Hildene's views may prove to be accurate, or they may be substantially inaccurate or based upon flawed reasoning and assumptions and are inherently subject to significant risks and uncertainties beyond the control of Hildene.

This report is not investment advice or a recommendation, nor is it a solicitation to buy or sell any securities mentioned herein or otherwise. This report speaks as of the date it was prepared, or such other date as may be indicated in this presentation with respect to specific information contained herein, and Hildene undertakes no obligation to correct, update, or revise this report or to otherwise provide any additional materials. Hildene also makes no representation or warranty, express or implied, as to the accuracy or completeness of the information and expressly disclaims any liability relating to this report (or any inaccuracies or omissions herein). You should not rely upon this report and should conduct your own investigation and analysis of the information herein. Hildene may change its view at any time or for any reason and without incurring a duty to inform you or any third party. This presentation has been distributed to you on a stand-alone basis and is not to be combined with, consolidated, incorporated or otherwise used with any other written materials provided by Hildene.

Firm AUM is presented as of December 31, 2021 and includes: (i) approximately $2.9 billion in hedge fund and separate account assets managed by Hildene Capital Management, LLC ("HCM"); (ii) approximately $8.3 billion par notional value of collateralized debt obligations managed by affiliates of HCM, including Hildene Collateral Management Company, LLC ("HCMC"), HCMC II, LLC ("HCMC II") and HCMC III, LLC ("HCMC III"); and (iii) approximately $1.1 billion par notional value (or fair value, if available) of collateralized debt obligations ("Sponsored CDO AUM") managed by Hildene Structured Advisors, LLC ("HSA"). To avoid double-counting of Firm AUM, Sponsored CDO AUM excludes the fair value of securities issued by HSA-sponsored CDOs that are retained by HCM-managed accounts. HCMC, HCMC II, HCMC III and HSA are each relying advisers of HCM.