Looking at things in a different way

Brett Jefferson

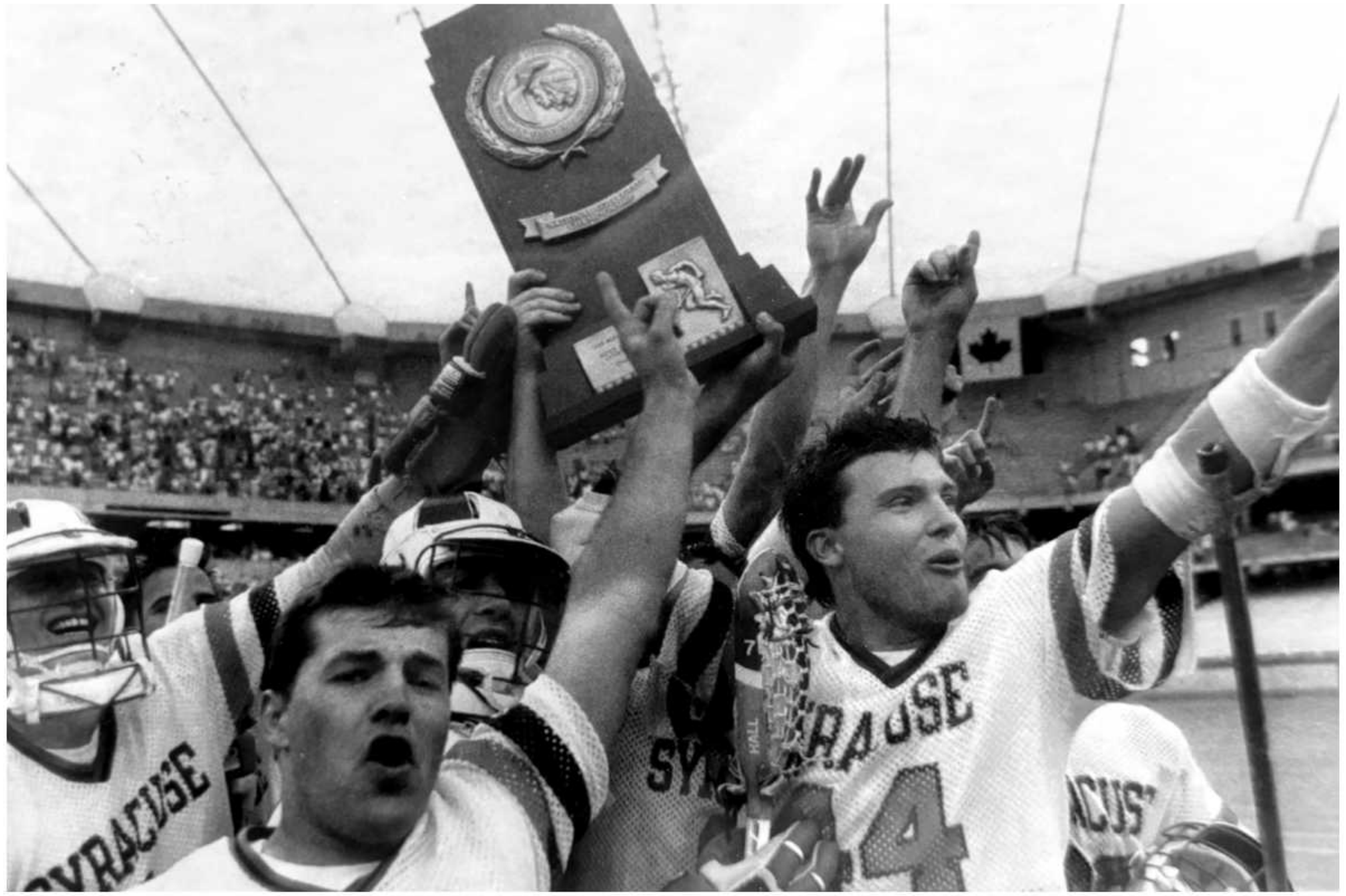
HILDENE CAPITAL MANAGEMENT

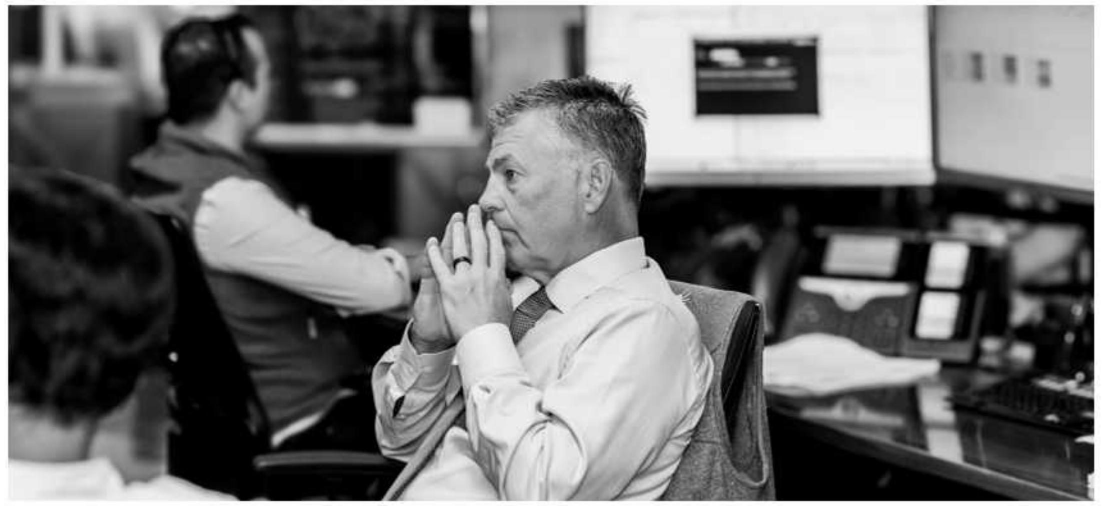
Hildene Capital Management's founder, Brett Jefferson, views credit markets through a proprietary lens that has consistently uncovered mispriced value. Jefferson's framework for evaluating structured credit upended and radically improved upon the traditional approach. "So many smart people were using a suboptimal methodology and were overcomplicating their analysis. When we assess value, we take into account the value of the assets, structure and options," says Jefferson.

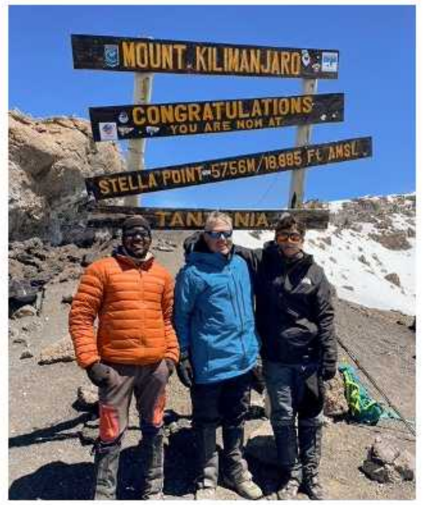
At Hildene, Jefferson's paradigm has been applied in his signature Trust Preferred Securities (TruPS) trade, as well as in his creative and innovative approach to activism in structured credit, sourcing and structuring mortgages, and the development of a recently launched reinsurance entity. Today, Hildene is a diversified asset manager focused on asset-based and credit opportunities, with a broad range of clients across its flagship private funds, tailored managed accounts, insurance accounts and securitized asset structures.

Jefferson's three-generation seafaring family background, education and career trajectory were unconventional: "I struggled in school at times, but my ability to look at things differently from others is now my greatest asset," says Jefferson. Jefferson's lateral thinking has been repeatedly deployed across multiple asset classes, unearthing value that other investors may have overlooked.

Identifying and valuing optionality
Jefferson's first finance job, trading options at Chicago Board of Trade (CBOT), provided problem-solving skills that would later be applied to structured credit. After honing his structured credit modeling skills at Smith Barney and Chase, he joined Marathon Asset Management.







Clockwise from top: Jefferson and his Syracuse University teammates after winning the 1988 NCAA Division I Men's Lacrosse National Championship; Jefferson and his son at the Peak of Mount Kilimanjaro after completing the hike in 2024; On the Hildene Capital trading desk in Stamford, Connecticut.

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At Marathon, he developed his framework for assessing value in structured products by determining the value of the options embedded in deal structures: "Investors often incorrectly analyze the senior tranches of capital structures by assuming deals always price to maturity; however, there are early redemption options that exist. There is value in the 'option', meaning the ability to accelerate a maturity or reset or refinance a deal. For this reason, we have a motto at Hildene: 'You have to be proactive to be reactive'. We constantly analyze the intricacies of deal structures to respond to the market in real time, as response times are critical".

After leaving Marathon, Jefferson launched Hildene and has achieved spectacular growth, growing assets from $5 million at inception in 2008 to over $15 billion in 2024.

TruPS CDOs

When Jefferson launched Hildene, he applied his analytical techniques to a lucrative niche: Trust Preferred Securities (TruPS) and pooled TruPS CDOs. These securities demanded deep research to ascertain value and sidestep risks: "We built a database of CDOs and encountered challenges in gathering key information on the underlying issuers, such as the identity of the issuer and the issuer's trustee. Issuers were often small community banks with assets below $15 billion". Jefferson worked out which banks he believed would be able to survive: "Between 2007 and 2012, approximately 500 US banks did fail, of which around 250 had TruPS, which saw low recoveries. We had very little direct exposure to the TruPS that defaulted," recalls Jefferson.

Though other bank-related investments were very lucrative, a significant portion of returns came from relative value selection of TruPS issuers and TruPS CDO tranches from the broader universe. At the time, TruPS were misunderstood because while they were debt, they counted as Tier 1 Equity on a bank's balance sheet. Banks have the ability to defer interest payments on TruPS for up to five years until they enter an event of default, but rating agencies prematurely branded many TruPS as "defaulted" prior to the end of the five-year deferral period. Jefferson had the tenacity to do grassroots research, phoning banks all over the US, and found that, in many cases, interest payments were only being deferred under pressure from government regulators, while the underlying credit was still intact. In many cases, TruPS were a treasure trove of accrued interest, on top of their discounted price.

Activism - litigation

At times, there are potential conflicts of interest between different stakeholders, including other TruPS CDO holders and the issuing banks. When necessary, Jefferson has litigated against other stakeholders, including some much larger hedge fund managers, who were pursuing opportunistic shorter term activist strategies, including "asset stripping" and "cherry picking" to the detriment of CDO investors. Hildene has spearheaded and led efforts in multiple legal proceedings that have established important precedents in the space.

Harnessing optionality

Today, Hildene has expanded beyond TruPS into other asset classes, with Dushyant Mehra joining as Co-CIO in 2016 to help expand the firm's capabilities. The team has continued to leverage Jefferson's framework, which has been deployed into additional asset types, such as CLOs, ABS and RMBS securities. In reviewing the value of the option, Hildene scrutinizes indentures and other applicable legal agreements. "We utilize proprietary models and analytics to review assets, and our legal team interprets the nuances. We have applied this infrastructure across the structured product universe," says Jefferson.

Jefferson and Mehra utilize creative techniques to restructure deals through refinancing, resetting, reissuing, and even replacing management when necessary. They flex strategies around the larger interest rate market: "When rates are low, the optionality may lie in refinancing. At higher rates, the optionality shifts gears into resets of maturities and reinvestment periods. As rates fall again and spreads tighten, the pendulum could swing back to lowering debt costs," says Mehra.

Mehra explains: "CLOs can be restructured in multiple ways. The simplest is refinancing the debt and resetting it or reissuing it into a new CLO. Our multi-pronged activist strategy is always weighing different paths and picking the one with the highest probabilistic NAV using our option-based framework. We are also always looking to define new paths". Recent deal documentation can require 100% equity consent to reset, but only 50% to call. Even when Hildene holds the majority of the equity, minority holdouts can potentially destroy value by delaying or preventing a reset. "We have sometimes objected and not consented to managers seeking resets, and the majority holder was not able to enforce this for the minority equity," explains Mehra.

On occasion, Jefferson has acquired equity ownership to obtain the ability to monetize an option. "Buying a control position in equity provides us with the option to call the deal. Even if we lose a bit on the equity, there is value in the optionality," says Jefferson. Mehra adds: "We do not buy equity specifically for veto power, but we understand where voting rights lie and find that these rights are not always correctly priced. It is sometimes worth paying a premium for control".

Jefferson also applies restructuring acumen to maximize value from TruPS CDOs: "TruPS CDOs that issued debt to real estate companies and legacy bank TruPS CDOs can be liquidated to pay off the debt, and the assets can be purchased at a discount and then re-securitized. To date, we have called seven deals where we owned the lower tranches, allowing us to re-securitize the assets, retain new equity, and sell senior assets to insurers and reinsurers," Jefferson explains.

Driving CLO reset innovation

The pair have been instrumental in driving market innovation: "Since 2011, CLOs have introduced reset and refinancing options, which has allowed for more flexibility. In 2018, the triple A market tightened, but not enough to reset certain deals. A typical reset had called all debt at par and reissued it with a new five-year investment period. As the term structure developed, we realized it could be more accretive to reinvest for two years rather than five, and this tightened the triple A to 90 basis points versus 130 for a five-year deal. We were one of the first managers to do a reset with a shorter reinvestment period, which is now part of the broader market's toolkit," says Mehra.

Mehra and Jefferson also realized that a new SPV enabled *de facto* resets: "Where resets were not possible, we took control of the underlying collateral, moved it to a new SPV and issued a new CLO, which functionally is akin to a reset," explains Mehra.

A full vista of the CLO landscape

Unlike ratings- and manager-constrained investors, Hildene hunts for value across the gamut of US CLOs. "We look at the whole capital structure, assets and liabilities, primary and secondary deals and any CLO manager. There is never a bad CLO, just a bad price. We live and breathe a universe of loss-adjusted relative value opportunities, mainly in BSL (broadly syndicated loans), though middle market loans are growing. Our option adjusted framework is agnostic to labels and names," explains Mehra.

Hotspots move around with the market environment. "Generally, in benign times, we invest in shorter duration, cash-flowing assets such as CLOs, RMBS and ABS. When volatility spikes, liability stacks become dislocated due to rates or credit risk, and we see more interesting opportunities in the secondary market to add duration and convexity to our portfolio," says Mehra.

Hildene also partners directly with third party CLO managers, via minority acceleration capital stakes. "We provide equity capital and expertise around warehousing and structuring to help CLO managers scale. We have upside if the CLO manager grows. We exited one deal very profitably and remain in two others," says Jefferson.

Sourcing longer term assets – residential mortgages

Today, Hildene is focused on assets with longer duration profiles, namely in residential mortgages. Jefferson had explored several ways of sourcing mortgages, including working with multiple originators and aggregating bulk in the market, before executing a partnership with CrossCountry Mortgage, the largest retail mortgage originator in the US. The partnership allows Hildene to source residential non-qualified mortgages (non-QM), a type of mortgage often taken out by creditworthy borrowers who are unable to meet traditional mortgage eligibility requirements. These borrowers are typically self-employed, such as doctors and lawyers, and do not receive a W-2 or pay stub to verify their income.

Hildene has securitized these mortgages into RMBS securitizations and generally sells at least the top 90% of the structure while retaining the bottom 6-10% equity and junior mezzanine tranches.

Reinsurance

In 2022, Hildene launched Hildene Re, a Class B(iii) insurance company that offers reinsurance to the global insurance market. In January 2023, Hildene formed a long-term strategic partnership with SILAC Insurance, which is symbiotic for Hildene and SILAC. "We have about $5 billion of reinsurance flow today through SILAC and other carriers. SILAC is an experienced underwriter, and we bring investment management expertise," says Jefferson.

Jefferson explains: "Reinsuring tax advantaged fixed index annuities involves a liability of around 6% per year, which means assets need to roughly double every 10 years. We need to find assets with the right duration and yield profile to match these liabilities. On the asset side, we need to manage two key risks: prepayments and credit risk. On the liabilities side, we look at deaths and surrenders, though most policies have significant surrender penalties. Some policies have more rate exposure than others, which we seek to hedge. Being experts in structured products helps us get our arms around this complexity."

"TruPS are a strong fit for the reinsurance company given their duration, discount and credit profile. TruPS are floating rate securities, so we use a few different tools to manage interest rate risk and reduce the variability of the bond's cash flows," says Jefferson.

Alignment with investors

If risk is not being attractively rewarded, as in 2019, Jefferson would rather play defense with shorter term and idiosyncratic trades. If no compelling opportunities exist, Jefferson may close a fund and return capital: in 2015, he sold TruPS well above Hildene's fundamental valuations and returned around $1 billion of capital to investors, then circa 40% of firm assets of $2.4 billion. Many investors who received distributions at the time later returned to reinvest with the firm.

A well aligned strategic partner

After purchasing a secondary interest in a Hildene fund in 2020, Hildene's relationship with Jefferies blossomed. In March 2022, Hildene entered into a strategic relationship with Leucadia Asset Management ("Leucadia"), a division of Jefferies, whereby Leucadia purchased a non-controlling financial interest in Hildene and agreed to provide seed capital in connection with certain new Hildene investment vehicles and businesses. Respect for alignment with investors was essential when Jefferson sought a strategic partner. "While some providers of seed and acceleration capital may push managers to grow assets above an optimal level, Jefferies respects our judgment on strategy capacity and returning capital," says Jefferson.

Philanthropy

"At Syracuse University, I enjoyed my first love of lacrosse and later coached high school lacrosse to pay for Northwestern business school," recalls Jefferson. The Catherine Jefferson Foundation, named after his wife and mother – who were both coincidentally named Catherine – supports the Syracuse University Lacrosse program, of which Jefferson was a member of the 1988 NCAA Division I Men's Lacrosse National Champion team. Lacrosse was started by Native Americans, and Jefferson sits on the board of a charity that both helps to widen access to lacrosse and supports Native Americans. Jefferson has endowed scholarships at his alma maters Northwestern University and Syracuse University, as well as at Duke University and New Canaan Country School.

Jefferson has consistently been recognized for his philanthropic efforts. He was the recipient of the Syracuse University 2023 Letterwinner of Distinction in recognition of his success after graduation and his mark on the athletics program. Most recently, he received Avon Old Farms School's 2024 Distinguished Alumnus Award, acknowledging his distinction in professional leadership and philanthropic endeavors, including endowing a memorial scholarship in honor of a former roommate and teammate.

Constructive outlook

Jefferson continues to be optimistic about growth for all pillars of the firm. "Our reinsurance subsidiary, Hildene Re, provides the firm with a competitive advantage through long-term, flexible capital. Our strategic relationship with CrossCountry Mortgage provides a long runway for various types of mortgages, allowing us to continue to expand our capabilities into additional asset classes. We are always thinking creatively and looking to uncover value in structured products. I am so optimistic about the future of Hildene that all my eggs are here; I am not going anywhere for a while." ◆

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