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CAPITAL MANAGEMENT

PRIVATE CREDIT

WHAT'S MISSING FROM INVESTORS' PORTFOLIOS

Private credit is largely absent from institutional investors' asset allocations. Yet the opportunity set offers what nearly all investors need: yield, diversification and attractive risk-adjusted returns. Is there some way for this underserved asset class to fit within an asset allocation framework or is it in a Catch-22?

The problem – and opportunity – begins with a simple but fundamental issue: lack of definition. Some people think private credit is solely mezzanine debt or corporate distressed debt. Estimated to be over $4 trillion, the opportunity set is significantly larger and includes strategies such as non-performing loans (NPLs), trade claims, consumer insolvency pools, rescue/bridge finance, middle market direct lending and commercial real estate loans, to name a few. What links these diverse strategies is their debt-like characteristics and lack of broad syndication. The latter – how private debt transacts through either tightly-controlled auctions or privately-negotiated transactions – makes sourcing a key competitive advantage.

Another shared trait across private credit strategies is that they do not fit neatly into an asset allocation framework. Like most private investments where daily marks are not available, volatility is not a meaningful statistic. Betas and correlations are also difficult to assign. Another difficulty relates to benchmarking as there is not an equivalent to the S&P 500 or something akin to Thomson Venture Economics (universes that are widely used for private equity) for private credit.

Private credit, however, can still serve as an attractive replacement for traditional fixed income (FI) or private equity (PE). While capitalizing on an illiquidity premium, private credit can offer significantly better liquidity than PE (many private credit investments have a duration of three to five years) while, in some cases, offering an income distribution. In the case of middle market direct lending where income/yield account for nearly all of the total return, net expected returns (7-12%) are significantly above prospective returns for traditional FI, while being senior in the capital structure. Higher expected returns are available to investors willing to sacrifice further liquidity in, for example, European NPLs (18-22%). In both mid market direct lending and NPLs, as well as other private credit strategies, a key difference to FI and PE relates to the monetization. Value for private credit is achieved through loan modifications, legal restructurings or self-liquidation – i.e., monetization strategies that are not dependent upon a capital markets exit. This explains the why private credit offers compelling diversification across different market environments.

Implementation in private credit is critical. Not only is there is no ability to passively replicate this space, the distribution of returns at the manager level is quite wide. But the challenges are worth the trouble, particularly in today's market environment where there are no easy beta-driven answers. For those willing to think creatively private credit does not need to be caught in a Catch-22.