

# Why are Institutions Gravitating to Private Credit?

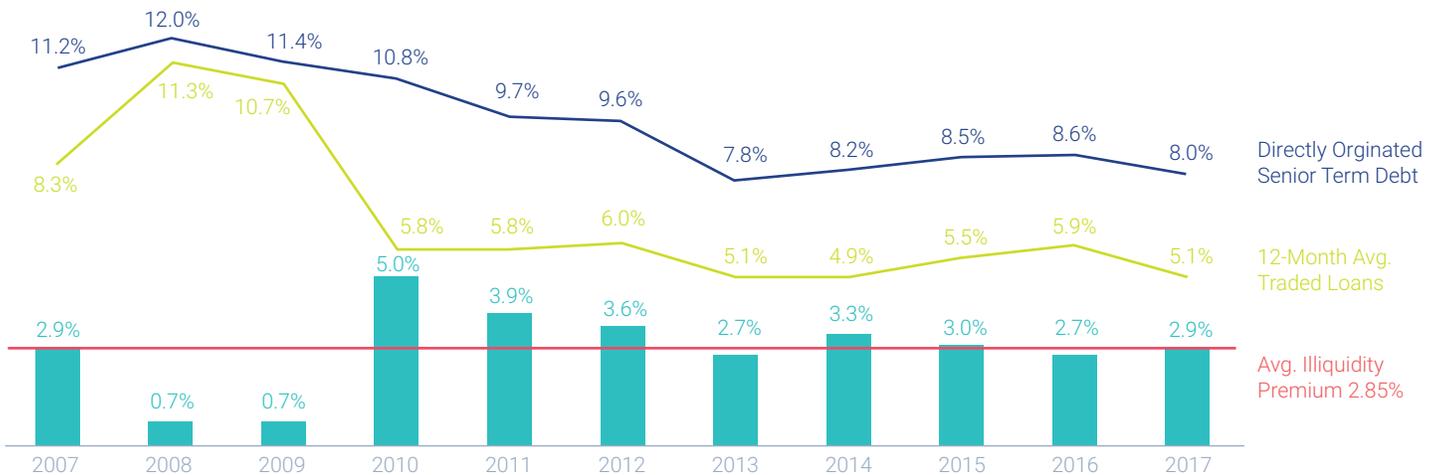
2017 was a year of tremendous growth in U.S. Equity markets as the S&P 500 posted a 21.83% gain against a backdrop of record low volatility. As we reach the later stages of this business cycle, many are wary of excessive equity exposure in favor of more defensive strategies. A Preqin global survey of institutional investors revealed

that 98% of institutions are planning to maintain or increase their allocation to private credit over the long term. What is it about private credit that has major money managers taking notice? Let's take a look at five big reasons driving the shift in assets.

## 1. ILLIQUID DEBT ASSETS HAVE DEMONSTRATED A RETURN PREMIUM OVER THEIR LIQUID COUNTERPARTS

There exists a significant illiquidity premium that institutional managers seek to exploit. Liquidity is not a major concern for managers that intend to hold a bond or loan through to maturity.

*Directly originated senior loans have generated an average 285 bps premium over traded loans over the last ten years.*



Source: Ares filings and KKR Credit Analysis.

## 2. FIXED INCOME INSTRUMENTS STRUGGLE IN PERIODS OF RISING RATES

With the Fed expected to continue raising the fed funds rate during the remainder of 2018 and into 2019, it is reasonable to expect interest rates 12 months from now to be higher than they are today.

*In the last six periods in which the 10-year Treasury yield rose by 60 basis points or more, bonds have delivered inconsistent returns.*



<sup>1</sup> Bloomberg Barclays U.S. Aggregate Bond Index Returns.  
Source: Bloomberg, TIAA Investments.

## 3. AFTER A YEAR OF HISTORIC LOWS IN VOLATILITY, THE MARKETS ARE REVERTING TO THE MEAN

Global financial markets in 2017 featured uncharacteristically low volatility – the lowest level seen since 1963. Early signs in 2018 are showing volatility reverting to historical averages.

*The S&P 500 experienced 9 days with moves of 1 percent or more in all of 2017. Through Q3 of 2018 there were 31 such days.*



Source: Bloomberg – “VIX Up 81% Shows Extent of Stock Market Pain in Jarring Quarter.”

#### 4. CROSS-ASSET CORRELATION REDUCES THE IMPACT OF PORTFOLIO DIVERSIFICATION

Private credit assets are not traded on any public exchange, potentially reducing their correlation to broader public markets. True diversification is contingent on the inclusion of uncorrelated assets.

*Both the S&P 500 and Barclays Aggregate lost more than 1 percent in Q1. This marks only the **fourth time** this has happened in the past **three decades**.*

Source: Financial Times – “New correlations spell concern for bond and equity investors.”

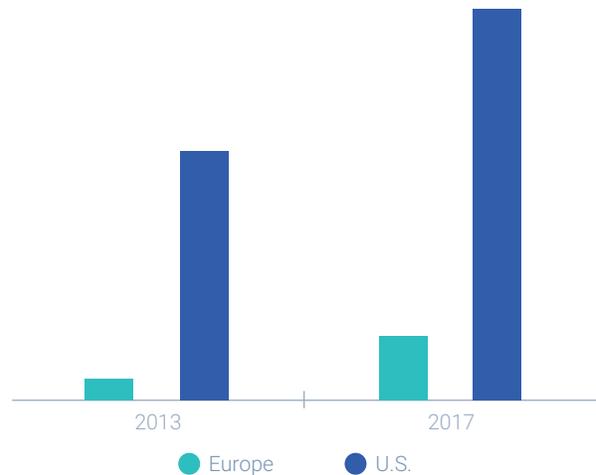
#### 5. THE OPPORTUNITY SET IS GROWING OUTSIDE OF THE UNITED STATES

Private debt markets elsewhere in the world are not as developed as the more mature domestic market.

Experienced managers are finding value in the rapidly-growing European arena.

*European CLOs priced about 20 billion euros in 2017, up 160% from 2013's 7.7 billion total. The U.S. market priced six times that amount.*

Source: Bloomberg – “Survival of Fittest for Debut CLO Managers in Expansion Drive.”



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The structural changes that have led to the emergence of private credit as an established asset class remain firmly in place, with continuing macroeconomic trends supporting the current investment environment. Uncertainty and inefficiencies in the marketplace, enemies of traditional debt investments, create new relative value opportunities

across private credit every day. We strongly believe that private credit should not be viewed as a short-term investment thesis or a trade, but rather a long-term investment opportunity in an established and growing asset class.



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