The Third Lever of Yield

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Individual retail investors have historically had to accept that generating increased yield from their fixed income portfolios is accompanied by accepting greater risk – whether through decreasing credit quality or increasing term.

Bonds below investment-grade typically offer a higher yield premium than investment-grade bonds to compensate for a higher risk of default. Similarly, long-maturity bonds typically offer a higher yield premium than short-maturity bonds. This is to compensate for interest rate risk due to the investor holding bonds over a longer time period.

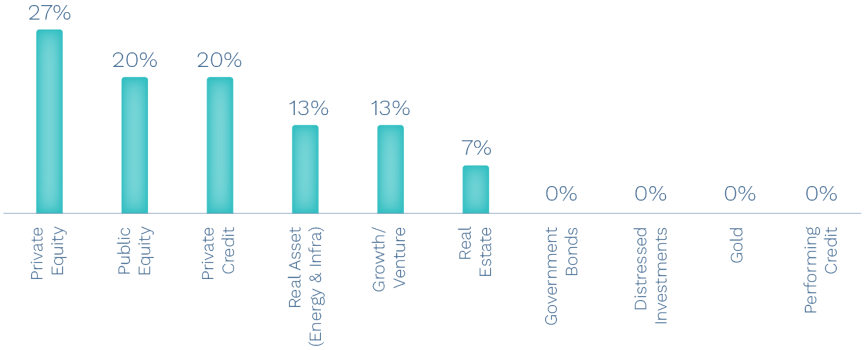
But there is a third lever that fixed income investors can pull: liquidity. In other words, investors that accept lower liquidity can earn higher yields.

AN ALTERNATIVE LEVER: ILLIQUID PRIVATE CREDIT

Illiquid private credit can offer much more attractive yields than public credit due to an opportunistic focus on companies with limited funding options. In addition, if markets turn downward, loan funding becomes scarce and some private lenders can often charge a premium for access to capital.

The 2019 KKR Global Institute CIO Survey suggests a strong appreciation for the value of the illiquidity premium.[1]

2019 CIO Survey Suggests a Strong Appreciation for the Value of the Illiquidity Premium



Data as at September 18, 2019. Source KKR CIO Symposium

These loans typically comprise senior secured notes, which are at the top of the capital structure and can be backed with recourse to assets or stock, offering risk mitigation. The historical recovery rate for these types of securities is 81% - much higher than most other types of higher-yielding debt.[2]

PORTFOLIO UTILITY: LOWER CORRELATION TO PUBLIC INVESTMENTS

While private credit can offer more attractive yield, it can also provide further portfolio utility – especially during the late stage of the business cycle. Because loans are not traded on public exchanges, they have low correlations to public debt and equity instruments. This makes them a viable source of portfolio diversification.

The fastest-growing sub-asset class within diversified private credit is direct lending – bilateral agreements between one borrower and one lender. Direct lending typically focuses on middle market credits, which are considered by investors because they can offer diversity across both geographies and industry sectors. They have also shown resilience, and outperformed during 2007–2010, the depth of the GFC, by adding 2.2 million jobs.[3]

The chart at the top of the right column details the correlations of middle market loans to public investments in broad equity markets and global bonds. A moderate correlation to equities and a negative correlation to global bonds speak to the diversification opportunity. While correlation to public high yield bonds is somewhat higher, this is to be expected as both categories are below investment grade.

Correlations of Private Credit and Public Bonds and Equities, 1998-2017

	Middle Market Loans
High Yield Bonds	0.75
Global Bonds	-0.11
U.S. Equities	0.52

Asset classes are represented by the following indices: Middle market loans: S&P/LSTA Leveraged Loan Index (EBITDA $50MM or less); High yield bonds: BoA Merrill Lynch US High Yield Index; global bonds (Bloomberg Barclays Global Aggregate Bond Index); U.S. Equities: Russell 3000 Index. Source: Nuveen, a TIAA company. "Private Debt: The Opportunity for Income and Diversification with Illiquid Assets, Winter 2018.

INVESTING IN PRIVATE CREDIT: THE MANAGER MATTERS

The most experienced managers in the direct lending space have a vigorous approach when it comes to the investing process. This means bottom-up, credit-analytical work. Managers spend, sometimes, three to six months plus in due diligence with a company. This enables them to understand the ins and outs of business including their balance sheet, talent, collateral, growth plans and risk.

Once managers make an investment, they have a tendency to hold the loans long term which allows them to be a part of the growth strategy over many business cycles. Most managers tend to invest in senior loans, which can offer more risk mitigation as they sit at or near the top of the capital structure.

Direct lending requires intensive, bottom-up fundamental research and thorough due diligence. Manager success in this asset class can depend on access to capital, experience and expertise across all stages of the business cycle. In addition, if markets turn downward, volatility increases, and loan funding becomes scarce, larger investors can likely charge an even higher premium for access to capital.

HOW CAN RETAIL INVESTORS ACCESS THEM?

Because private credit strategies require long-term investing in assets that are not traded on exchanges, they are considered to be illiquid. This lack of liquidity is the third lever of yield – and an innovative structure, the interval fund, now makes this lever available to individual retail investors – as long as they can accept periodic liquidity.

RISKS

As with any asset class, there are certain risks associated with private credit. Credit risk is the risk of nonpayment of scheduled interest or principal payments on a debt investment. Because private credit can be debt investments in non-investment grade borrowers, the risk of default may be greater. Should a borrower fail to make a payment, or default, this may affect the overall return to the lender. Further, private credit investments are generally illiquid which require longer investment time horizons than other investments. For these and other reasons, this asset class is considered speculative and may not be suitable for everyone.

To learn more about private credit, please contact your financial professional.

[1] Data as at September 18, 2019. Source: KKR CIO Symposium

[2] S&P Credit Pro; 1998-2015

[3] National Center for the Middle Market, 2Q 2019 Middle Market Indicator.