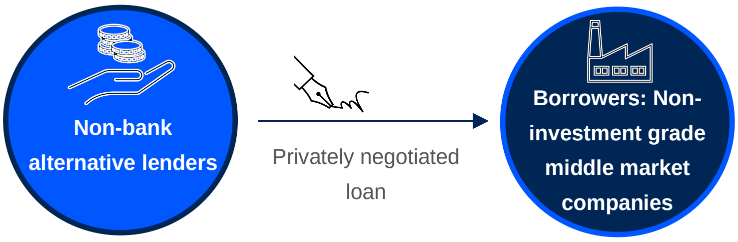
Breaking bonds: How private credit is reshaping investment portfolios

Private credit strategies are gaining traction as compelling additions to investors' portfolios, offering the potential for higher returns compared to traditional publicly traded fixed income products. Moreover, they provide a means to diversify away from these more common assets.

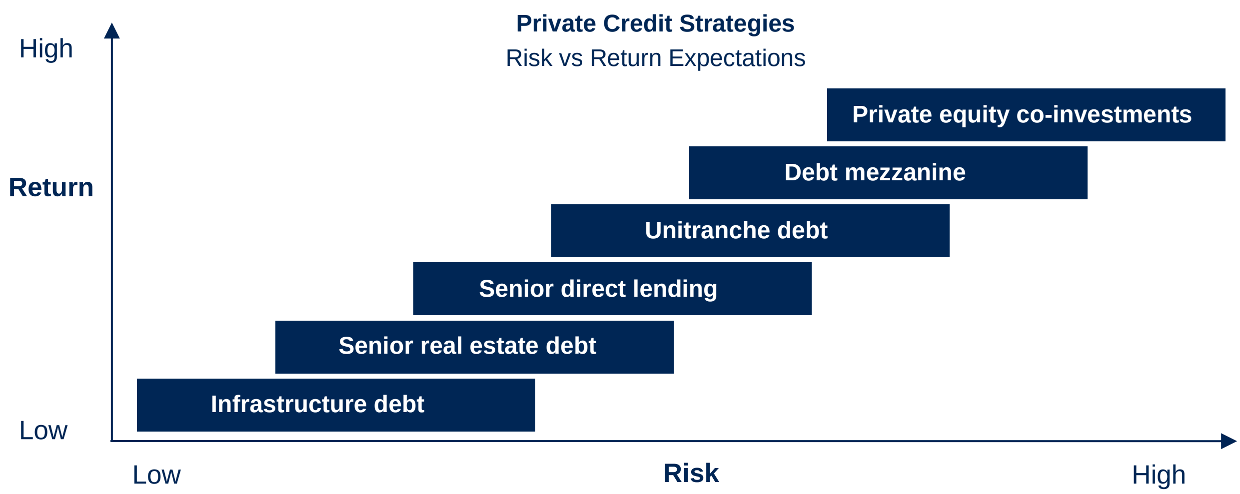
The prominence of these strategies has grown swiftly, becoming a sought-after asset class among a diverse array of investors. This expansion is not just in terms of volume but also in the diversity of strategies now available in the market. From direct lending to distressed debt, mezzanine financing to special situations, the spectrum of private credit strategies available to Australian investors has broadened.

As this asset class gains a foothold, it prompts critical questions: How should investors strategically allocate to private credit? Is private credit truly the new hero of the investment world, poised to deliver superior returns and diversification, or is it a trend riding the wave of current market dynamics? This paper delves into these pertinent questions, exploring the role and impact of private credit in shaping the future of investment portfolios.

What is private credit?



Private credit is a broad term that encompasses a wide range of investment strategies with different risk and return profiles (see chart below). According to the CFA Institute, private credit refers to *"various forms of debt provided by investors directly to private entities."* Simply put, an investment into private credit normally involves lending money to companies (but occasionally to individuals) where the borrowers receive private, non-bank loans. These borrowers often have credit ratings that are below investment grade and generally pay higher interest rates. In addition, private credit is an illiquid investment, requiring investors to commit their capital over long time frames.



The rise of private credit

The rise of private credit in the last decade and a half has been fuelled by a combination of economic, regulatory, and market dynamics. Post the 2008 Global Financial Crisis (GFC), banks faced stricter regulatory requirements, making it challenging for traditional financial institutions to lend to middle-market companies and projects. Concurrently, a low interest rate environment that post-dated the GFC incentivised investors to move up the risk curve in search of higher returns. The culmination of these two factors were key in private credit filling the gap and seeing significant investment inflows.

In addition, the rise of private equity firms has driven further investment into private credit, as more of these firms have shifted reliance from traditional bank financing to private credit for funding their deals. This transition has largely stemmed from tighter banking regulations and the swift, tailored offerings provided by private credit funds. In more recent times, as the correlations between traditional bonds and equities have increased, private credit has gained traction as an effective diversifier, aiding in risk management, and promoting smoother overall portfolio returns.

Looking forward, we are confident the rationale for maintaining an allocation to private credit will persist. Supply will be driven by borrowers' need to refinance as well as source more capital to finance new leveraged buyouts. On the flip side, demand is projected to persist, driven by the allure of higher yields and the diversification advantages it offers.

In 2022, funds dedicated to private credit strategies globally raised over US$200 billion, showcasing the escalating investor interest in this sector. This marked a fifth consecutive annual increase, demonstrating its rapid expansion as one of the fastest-growing segments among all private asset classes, growing at an annual rate of 12 percent since 2013[1].

Navigating private credit: Opportunities and obstacles

Private credit entails distinct advantages and disadvantages when compared with publicly traded equivalents. The table below outlines common characteristics for sub-asset classes within private credit. However, note that these attributes might not universally apply due to variations in underlying strategies and structures.

In an economic landscape where interest rates have risen sharply, private credit has emerged as a robust contender. The unique structure of private credit – typically with floating-rate corporate loans – offers a potential buffer against inflation. This is because any hikes in interest rates, often in response to inflationary pressures, are transferred to borrowers at the commencement of each interest rate roll period.

This characteristic sets private credit apart from other asset classes like fixed income and real estate, which generally exhibit an inverse relationship with interest rates. For instance, as interest rates rise, fixed rate bond prices tend to fall, leading to potential capital losses for fixed income investors.

Moreover, as interest rates climb, fixed income and real estate investors may find it challenging to secure a yield that is satisfactory compared to other investment opportunities in the market. On the other hand, private credit stands to gain from rising rates, as the increases are passed on to borrowers.

Advantages	Disadvantages
• Generally higher returns • Low correlation to public markets • Portfolio diversification • Accesses private markets with lower risk than equity investments	• Illiquidity • Potentially higher credit risks • Higher fees • Manager selection risk • Less transparency / regulation

[1] Source: Preqin

Diversification

Private credit strategies offer unique diversification benefits for investors. Some of this benefit stems from their distinct sources of risk and return, often driven by smaller-cap companies or unique collateral structures. Additionally, private credit grants access to corporate lending opportunities that, due to not being publicly listed on exchanges, were previously inaccessible to the majority of investors.

Whilst private credit generally exhibits lower volatility and low correlation with traditional asset classes, this is partly due to valuation methods. Appraisals occur periodically, unlike the constant market pricing of public assets. This can mask underlying risks, requiring extra diligence during risk assessments. However, the reduced volatility, combined with the diversification benefits, can help portfolios weather market downturns, as Figure 1 illustrates.

Income generation

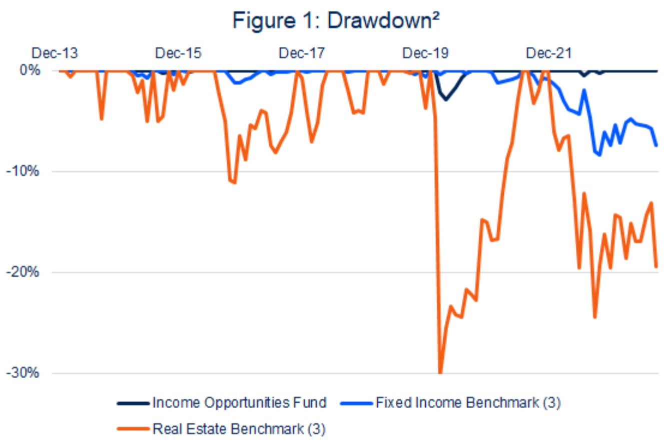
The allure of private credit stems from its capacity to deliver higher income returns compared to traded investment grade corporates or government bonds. This is driven in part by its risk profile but is also due to the ease and flexibility of its transaction structures.

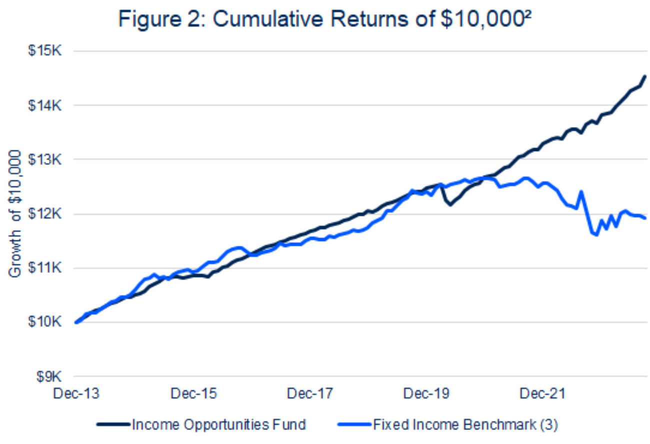
Over the last decade, this asset class has consistently yielded higher returns compared to most others, yielding rates between 3-6% higher than public high yield and broadly syndicated loans. Borrowers are willing to pay higher yields for more tailored, borrower-friendly terms, and a quicker, more straightforward execution process compared to traditional lending channels. This efficiency and customisation in deal structuring make it an attractive option for borrowers, despite the higher cost.

Higher expected return

Private credit often generates better total returns when compared with its liquid counterparts driven by the higher yield potential and lower correlation with traditional market instruments.

Illiquidity, strategy complexity, and manager risk, all generate a premium that contribute to total return. In large, private credit strategies, have exhibited outperformance over traditional Fixed Income investments in the long term, notably in the post-Covid rising rate environment. This is indicated in figure 2 below, where the returns of Perpetual's Income Opportunities Fund (which predominantly consists of private credit strategies) and the Fixed income benchmark have been indexed to $10,000.





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[2] Source: FactSet, Perpetual Private, September 2023. All returns are in AUD and net of fees. Past performance is not indicative of future performance.

[3] Fixed Income Benchmark - The Fixed Income Composite benchmark, prior to 30th June 2022, consisted of 60% Bloomberg AusBond Bank Bill Index, 20% Bloomberg AusBond Composite Index & 20% Bloomberg Barclays Global Aggregate (AUD Hedged); effective from 30th June 22, it changed to 100% Bloomberg Global Aggregate Index (AUD Hedged) , Real Estate Benchmark - The Real Estate Composite benchmark consists of 50% S&P/ASX 300 A-REIT Accumulation Index & 50% FTSE EPRA/NAREIT Developed Index Net Return (Unhedged in AUD), reflecting the portfolio's investment strategy.

Portfolio construction: Balancing public and private credit

Incorporating private credit funds into a multi-asset portfolio offers numerous advantages, yet it also presents challenges for investors. Private credit strategies are inherently illiquid, often structured as private partnerships or trusts, setting high investment minimums, and have limited transparency. Moreover, the vast variation in underlying strategies contributes to wide-ranging risk and return expectations across the private credit universe and among different fund managers. Consequently, blending public and private credit through a hybrid approach is thought to be the optimal approach when investing in these asset classes.

How Perpetual Private allocates to private credit

We believe that evaluating available risk premiums across fixed income markets and efficiently allocating capital enhances risk efficiency by jointly considering public and private investments, managing industry, sector, and credit-quality attributes within the portfolio. By blending public and private credit strategies, we enhance liquidity characteristics and can better optimise the portfolio's adaptability during stressed financial conditions. This flexibility also allows us to utilise liquidity at both market levels, seizing opportunities during market dislocations. Additionally, integrating innovative new structures alongside existing public and private investments ensures our portfolios remain agile and adaptable within a constantly evolving market landscape.

At Perpetual Private, we allocate to private credit through a range of specialist managers within our Income Opportunities Fund (IOF). We believe in a multi-manager approach because selecting private credit investments requires a very specialist skillset including expertise in loan workouts and debt restructuring.

Specialist managers also typically have better access to deal flow enabling them to better identify and capitalise on attractive investment opportunities that may not be readily available to other investors.

Selecting the right managers to do this is critical. Our process is grounded in thorough due diligence and on-going monitoring. Comprehensive research before making investments, particularly illiquid investments, is essential in ensuring a deep understanding of each opportunity's risks. We screen investment opportunities for expected returns, risk evaluation, downside protection attributes, and portfolio alignment and consider them within the broader context of a diversified portfolio.

This fund maintains high diversification across two main investment strategies: Corporate (including private debt, high yield, loans, and structured products) and Asset Backed (including property and infrastructure private debt, some direct property, structured products, and specialty finance). Additionally, the fund explores other uncorrelated income-producing assets (including royalties and insurance linked strategies).

Below is a summary of some of the benefits of using a multi-manager approach, like Perpetual Private, to invest in private credit strategies:

Manager due diligence	Specialist manager network	Risk management	Credit market insights
• In-depth scrutiny of managers is crucial due to the significant performance gap between top and bottom quartile performers. Thorough manager due diligence can significantly enhance investors' potential returns.	• Multi-managers often possess superior access to deal opportunities, enabling them to identify and leverage attractive investments that might not be readily available to other investors.	• Our team adeptly evaluates and handles the distinctive risks inherent in private credit investments. This includes managing optimal leverage, navigating complex structures, and addressing illiquidity concerns.	• Perpetual Private conducts regular research and analysis on the private credit market trends and insights, providing guidance for informed investment and manager selection decisions.

To wrap up

Over the past few years, investors have experienced significant shifts in the investment landscape. Private assets and, notably, private credit have experienced substantial growth due to increased accessibility. Simultaneously, interest rates have surged considerably from their pre-Covid levels, coinciding with extended periods of macroeconomic and geopolitical uncertainty.

These factors emphasise the need for investors to reassess their portfolio asset allocation to navigate the evolving investment environment effectively. Given the uncertainties surrounding interest rates, corporate earnings, and equity valuations, private credit strategies seem poised to assert a more influential role in client portfolios. This is based on their potential to provide higher returns compared to traditional publicly traded fixed income products as well as diversification away from traditional drivers of return in portfolios. Private credit is also ideally suited to generating a steady income stream through the streaming of contractual interest payments between borrower and lender.

Exercising prudent caution when investing in private credit strategies remains crucial due to its lack of transparency and limited liquidity. The role of astute managerial expertise in evaluating and selecting deals and managers that optimise outcomes within this dynamic asset class remains key to navigating and capitalising on opportunities within the private credit universe.

More information

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