GRANT GUYURON, CFA, SENIOR MANAGING DIRECTOR

PRIVATE CREDIT – AN ALTERNATIVE SOURCE OF INCOME

BY GRANT GUYURON, CFA, SENIOR MANAGING DIRECTOR

INTRODUCTION

Income has long been a pillar of investment strategies. Be it dividend or interest, a steady income stream is useful to institutions and retirees alike. The problem is that we live in a low yield world today, so income or yield is hard to find. For example, as of 6/30/21, government money market rates were near zero, the 10-Year U.S. Treasury Yield was 1.47%, and U.S. high yield bonds were only yielding 3.75%[1]. Low yields were a problem several years after the Great Financial Crisis and have only moved lower in the post-COVID-19 pandemic world.

So, what is an investor to do? Many have turned to alternative sources of income (other than stocks and bonds) such as private real estate and infrastructure, while others have chosen to utilize private credit. At Clearstead, we believe that investors seeking income need to get creative, and private credit is a tool worth evaluating

WHAT IS PRIVATE CREDIT?

Private credit or private debt can be defined as privately originated or negotiated loans that are generally backed by assets or cash flows. These loans are typically

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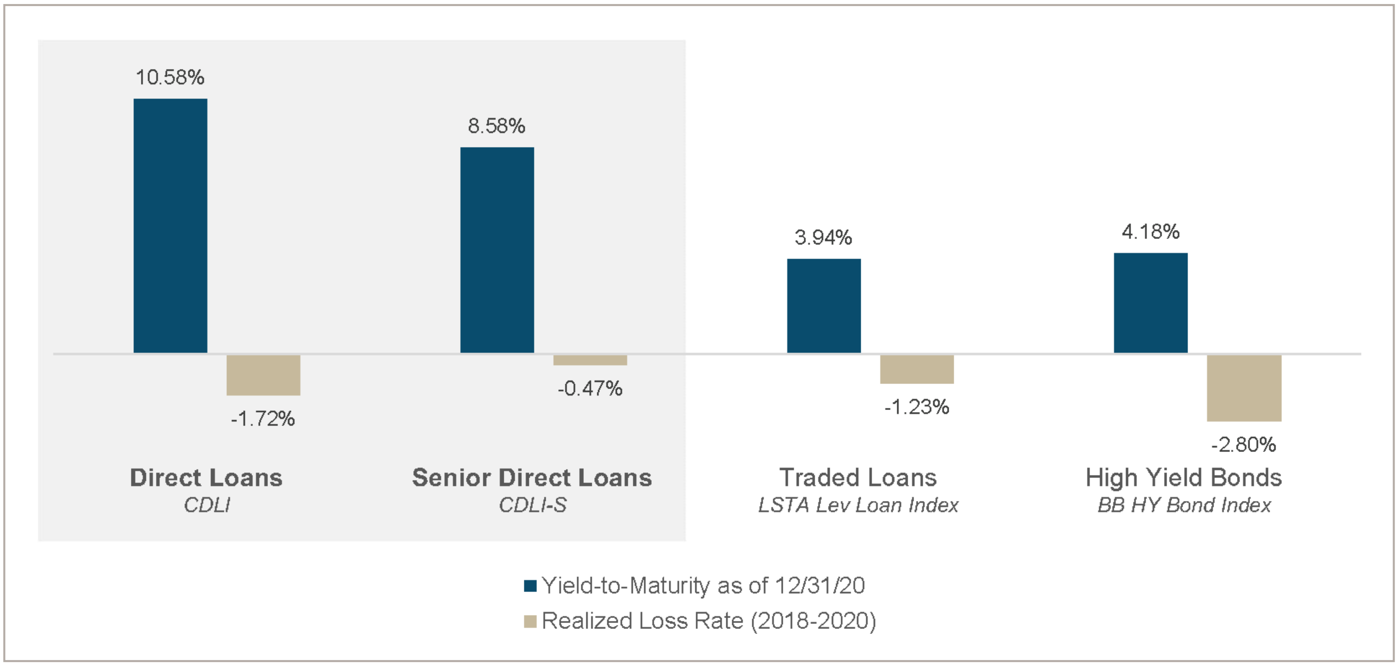
made to small or mid-size companies that do not produce enough fee revenue for large banks but are too small for the public markets. There are many strategies included in this asset class, including corporate direct lending, real estate and infrastructure debt, asset-based lending, collateralized loan obligations (CLOs), and mezzanine debt, among others. Corporate direct lending is the largest sector, with roughly $800 billion in outstanding loans[2].

PRIVATE CREDIT CATEGORIES (Not Exhaustive)	
	Corporate Direct Lending
	Asset-Based Lending
	Mezzanine Debt
	Collateralized Loan Obligations (CLOs)
	Real Estate / Infrastructure Debt
	Royalties
	Venture Debt
	Equipment/Aircraft Leasing
	Litigation Claims

Though the characteristics and risks of the various sectors on the left can vary meaningfully, the most common characteristics of private loans are that they are floating rate, offer covenants or other protections, have short-intermediate maturities, and offer a yield premium relative to public markets. Again, these terms and characteristics can be quite different based on the type of debt instrument. For example, mezzanine debt is a subordinate note that is just above equity in the capital structure and has more principal at risk than typical first lien asset-based loans; however, mezzanine debt should also offer higher yields, and often provides additional upside through equity warrants.

Ultimately, the combination of higher yield and increased principal protection have been the main factors that have pushed investors into this category over the last several years. The chart below compares yield to maturity and 3-year loss rates of direct loans to publicly traded loans and high yield bonds. The yield advantage of direct loans is meaningful and loss rates of senior secured loans in particular has been attractive.



Source: Cliffwater LLC.
For informational purposes only. Past performance is not an indicator of future results.

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INVESTMENT CONSIDERATIONS AND RISK

Strategies that invest in private debt instruments also come in various forms. Some vehicles are structured like private equity, wherein capital is called over time and the fund has a defined life. There are also evergreen funds, business development companies (BDCs), and interval funds that offer some level of liquidity to investors seeking to redeem their positions. Some funds utilize more leverage than others, some focus on higher quality credits or capital structure positioning, and some take more credit risk in search of return. Investors must be careful to choose a manager and vehicle that matches their return objectives, risk tolerance, and liquidity needs.

While the ability to liquidate one's position depends on the vehicle terms, what is consistent among private credit strategies is that the underlying credits or loans are not publicly traded. This means that there can be a liquidity mismatch if a strategy offers quarterly redemptions, for example. Much like hedge funds and open-end real estate funds, this can lead to the use of gates by managers if redemption requests exceed available capital on a given redemption date. Investors need to consider this possibility as they model liquidity for their portfolios.

Private credit can be less risky than private equity in terms of principal risk, but this depends greatly on how the credits are structured. For example, first lien positions that have minimal leverage applied are apt to be more stable and have lower probability of realized loss than subordinate debt with more leverage applied. Thus evaluation of a strategy's focus, underwriting requirements, and risk management practices are critical prior to making new investments. The chart below illustrates performance of the Cliffwater Direct Lending Index, which is a reasonable proxy for the private credit market.

Index	Return	Std Dev	Sharpe Ratio	Max Drawdown	Alpha	Beta	Correlation
Cambridge Associates US Private Equity	14.0	11.1	1.1	-25.4	11.6	0.1	0.2
Cliffwater Direct Lending Index	**9.3**	**5.2**	**1.5**	**-7.7**	**7.4**	**0.0**	**0.1**
BBgBarc US Agg Bond TR USD	4.4	3.2	1.0	-3.8	3.0	0.0	0.1
BBgBarc US Corporate High Yield TR USD	7.0	9.5	0.6	-33.3	2.7	0.5	0.8
Credit Suisse Leveraged Loan USD	4.4	7.1	0.4	-29.9	1.2	0.3	0.6
MSCI World NR USD	*6.9*	*15.3*	*0.4*	*-54.0*	*0.0*	*1.0*	*1.0*

Source: Morningstar, 12/1/2004 – 9/30/2020.
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The Cliffwater Index has produced excellent returns since inception in 2004, with meaningfully lower standard deviation and maximum drawdown relative to public equity, private equity, leveraged loan (publicly traded loans), and high yield bond indices. While the historical standard deviation has been higher than that of investment grade fixed income, the excess returns over that time period were greater, at 4.9% annualized. The Credit Suisse Leveraged Loan Index may be the best public market proxy for private credit and direct lending strategies. The Cliffwater Index has generated annualized excess returns of more than double the public market equivalent Credit Suisse Leverage Loans Index, during the time period shown, with better standard deviation and drawdown metrics and a lower correlation to public equities. It should be noted that some of the suppression of standard deviation and drawdown risk is related to the fact that the securities are not traded.

INVESTOR ADOPTION

Private credit has experienced tremendous growth over the last twenty years, partly due to a more onerous regulatory environment and decreased risk appetite for banks. This growth has coincided with declining yields across nearly every asset class. According to Preqin, the private credit category had $850 billion in assets under management as of 12/31/2019, having doubled since 2012:

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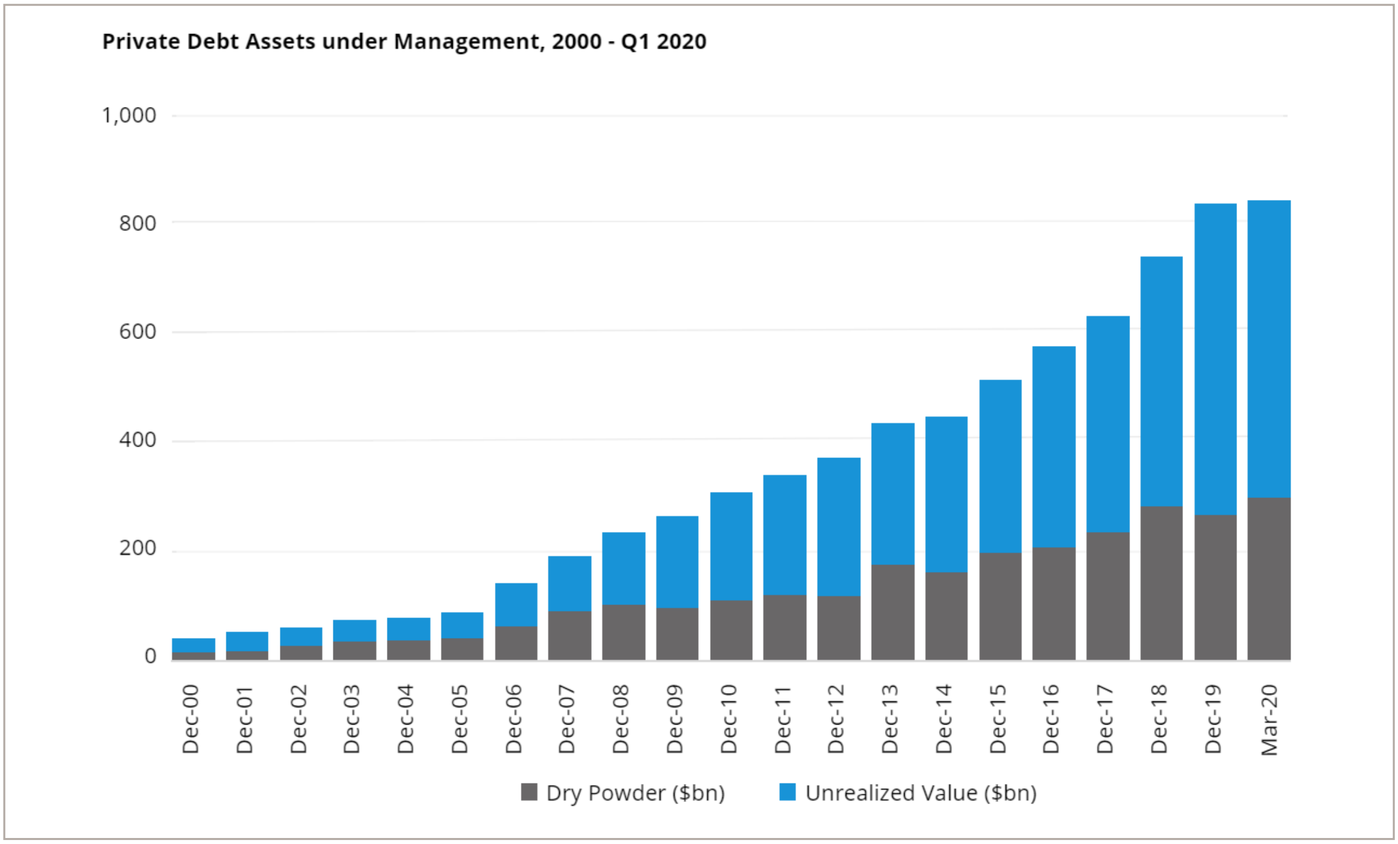

Source: Preqin.

Among institutional investors, use of private credit varies by the type and size of institution. For example, large insurance companies enjoy the income and stability offered by private credit. For university endowments, private credit is a modest allocation, making up only 1.3% of assets on average as of 6/30/20, which was up slightly from 2019[3].

CONCLUSION

Private credit has drawn interest and attention from many investors, and rightfully so. Given the lack of options available to generate high income with limited risk to principal, private credit could be an appealing option for investors willing to give up some portfolio liquidity. At Clearstead, we have been recommending private credit to our clients for many years and believe that the right managers are capable of delivering higher yield, low principal risk, and stability in an otherwise very uncertain world. While there are certainly many risks to this investment category, we believe an allocation should be considered for those seeking an alternative source of income.

Sources:

(1) Bloomberg. Bloomberg Barclays U.S. Corporate High Yield Index.

(2) Cliffwater.

(3) NACUBO-TIAA Study of Endowments.

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MARKET BENCHMARK RETURNS

June 30, 2021		1M	3M	12M	YTD
US Large Cap	S&P 500	2.3%	8.5%	40.8%	15.3%
US Small Cap	Russell 2000	1.9%	4.3%	62.0%	17.5%
Developed Intl	MSCI EAFE	-1.4%	4.8%	31.9%	8.5%
Emerging Intl	MSCI Em Mkt	1.3%	6.3%	42.5%	8.7%
Real Estate	NAREIT	2.7%	11.7%	34.2%	21.2%
Core Fixed	BarCap Agg	0.7%	1.8%	-0.3%	-1.6%
Short Fixed	BarCap 1-3Yr	-0.2%	0.0%	0.4%	0.0%
Long Fixed	BarCap LT G/C	3.6%	6.4%	-1.9%	-4.6%
Corp Debt	BarCap Corp	1.5%	3.3%	3.0%	-1.3%

Source: Bloomberg

The performance data shown represents past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.