Building private credit portfolios

As investors seek to deepen their understanding of the risks and characteristics of different types of alternative investments, an important area of focus is on integrating private credit into portfolios. We believe there will be increased demand[1] for the democratization of private market investments.

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Private credit has evolved into a diversified[2] asset class that offers the potential for return enhancement and diversification relative to public credit investments. Having grown seven-fold since the global financial crisis, private credit stands at $ 1.7 trillion in assets under management.[3] Encompassing a wide array of investment strategies across different risk and seniority levels, private credit can offer exposures ranging from pure credit to solutions structured as credit/equity hybrid vehicles, lending against a variety of underlying assets, and borrowers. This growth and maturation, as well as greater recognition of the attractive features of private credit (including a 5% annualized outperformance over broadly syndicated loans in the past decade),[4] seems to have increasingly led investors to assign it a dedicated portfolio allocation. A dedicated allocation calls for a strategic approach to portfolio construction that considers investment exposures, sizing, and positioning.

Public-private parallels

Private credit strategies can play different roles in a portfolio, in alignment with the overall asset allocation. Investors can access varying positions on the credit quality spectrum, risk and return targets, yield versus growth profiles, and the degree of sensitivity to the economic cycle. We believe investors should look beyond a single, monolithic definition of private credit, employing a more granular and sophisticated approach to allocating across private credit strategies. This approach can start with a framework for classifying available opportunities. One potential framework is to draw parallels between private credit investment strategies and their closest counterparts in public markets. This framework can help define portfolio characteristics, roles, and diversification approaches for a private credit portfolio.

Framework for private and public credit strategies

Private credit strategies can be broadly classified into three categories based on the underlying borrower and collateral type: corporate credit, real asset credit, and specialty and alternative finance. Corporate credit includes lending to companies for operations or business expansion, and to private equity managers to finance leveraged buyout transactions. This is the largest segment of private credit ($ 1.5 trillion AUM) and is the core of most investors' private credit portfolios.[5] Real asset credit ($ 400 billion AUM) comprises lending to owners or developers of real estate or infrastructure assets for acquisition, improvement, maintenance (including refinancing), or development.[6] The third segment, specialty finance, includes niche strategies that provide loans that are backed by equipment, future revenue streams like royalty payments, or financial asset pools such as consumer lending and investment fund financing.

The key components of return, and their associated key risks, can be grouped across the spectrum of private credit strategies. These return components contain elements of both market beta[7] (broad market exposure) and manager alpha[8] (manager-specific return), with the balance differing by strategy as well. Beta exposures generally form the core of an allocation to a particular asset class as they offer access to desired sources of return. Alpha is opportunistic and dependent on implementation and manager selection.

Risk and return drivers in private credit

The base rate (typically the Secured Overnight Financing Rate) is pure beta, compensation for the time value of money. The credit spread over this base rate has elements of market-wide levels (beta) and manager-specific premium (alpha). This

PHOTOS: ARCHIVE GOLDMAN SACHS ASSET MANAGEMENT alpha may come from loan parameter customization associated with more complex businesses, assets that require meaningful skill to accurately underwrite, or the ability to offer one-stop solutions in size. Structuring likewise has both beta and alpha components. Loan covenants and structural protections act as a source of potential credit alpha. Investment structures that offer potential equity upside, such as warrants and convertibles, represent equity beta exposure, while also offering the potential for alpha (this is the case particularly in structured solutions). Finally, we believe write-downs, or the avoidance thereof, represent the largest alpha-based opportunity. They reflect the investment manager's skill in minimizing defaults and maximizing recoveries.

We believe diversifying[2] across the underlying sources of risk is an important part of risk management[9] in private credit portfolio construction. This includes evaluating the nature of risks in each strategy and the trade-offs the investor wishes to make among them.

Investing across the capital structure can be an intuitive way of diversifying underlying beta exposures.

Performing credit tends to move with the economic cycle, with junior credit being more sensitive to the cycle than senior credit. Distressed and opportunistic strategies may be counter-cyclical, finding a greater number of attractive investment opportunities when the economy is challenged. Hybrid capital opportunities may be less cyclical, with opportunities across market environments.

Diversifying across borrower type can be another risk management strategy. Different underlying collateral types may have different sensitivities in a particular economic environment. Real estate or infrastructure assets will not move perfectly with the corporate cycle. In infrastructure, for instance, many assets are engaged in providing essential services – transportation, energy, waste management – that are less sensitive to the overall economy. In real estate, demand for residential multi-family property is sensitive to the health of the economy, but sector-specific supply factors have offset some of this sensitivity in the current cycle. In specialty finance, the idiosyncratic nature of many loans and underlying collateral assets makes for lower sensitivity to the economic cycle and lower correlations to other investment strategies.

Diversifying across these segments will not diversify away all risk. The various strategies are not uncorrelated. Rather, they are imperfectly correlated to each other. Some systematic return drivers, such as overall credit availability and risk appetite, are related to the broader economy and therefore shared across investment strategies. We believe the variability of alpha across funds represents idiosyncratic risk and makes the decision of how many and what kind of private credit managers to invest in, a critical part of risk management.

SUMMARY

With the growth and maturity of private credit, and greater recognition of its attractive features, investors appear to be allocating a larger share of their portfolios to it.

Investors should look beyond a single, monolithic definition of private credit, employing a more granular and sophisticated approach to allocating across private credit strategies.

Diversifying across the underlying sources of risk is an important part of risk management in private credit portfolio construction.