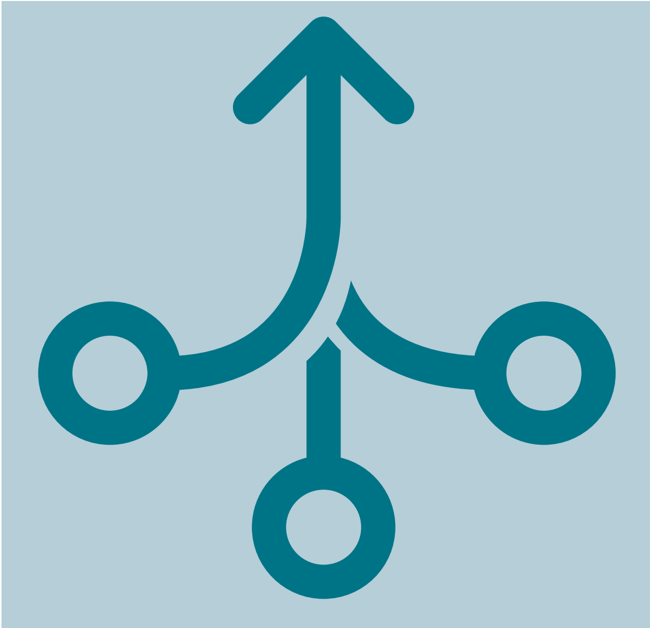
Credit is an 'asset-pickers' market



Despite private credit seeing tremendous growth over the last decade, asset selection remains vital given the varying quality of broad credit indices.

By *Robin Doumar*

Loans are inherently a non-standard product, lacking the uniformity and consistency found in public equities or investment grade bonds that make for easy performance comparisons. They are offered in many different flavours of leverage, currency, sector, geography and documentary strength, not to mention different fund structures and vintages.

Recently, a trio of academics have struggled trying to conjure a private credit benchmark from a combination of debt and equity markets.[1] While this approach may be appropriate for the riskiest elements of credit investing, it seems overkill for senior loans which are very similar to those in the broadly syndicated loan (BSL) market.

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The most straightforward methodology is to use the US or European Leveraged Loan Indices (LLI) which contain over one thousand loans and trade daily in a private marketplace with fairly good liquidity. Depending on the segment of the private debt market one is targeting, an investor can add a spread premium to the LLI to compensate for illiquidity or other additional risks.

Supporting this idea of benchmarking private credit loans to the broader BSL market is the fact that the two markets have increasingly converged over the past several years. In fact, today middle-market direct lending can be increasingly divided into subsegments of lower, middle and large-sized borrowers. The large end of this private debt market starts to blend seamlessly into the broader BSL market, with both markets competing to finance larger deals.

Equity market performance is driven by winners, credit market performance is driven by avoiding losers. Unlike equities, where the upside can be limitless, credit investments offer a modest return, typically 1.35x your money in senior debt. No single winner in the credit market is likely to compensate you for losses.

Exposure to a broad credit index is vastly different from exposure to a broad equity index. The quality of a private credit deal depends on factors such as the defensiveness and stability of the borrower, total leverage, cashflow coverage, sponsor equity contribution and documentary protections.

In our experience, private credit is about picking the right opportunities. Think of it like buying a used car - you want one with low mileage, no rust, a full-service history and no

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‘Investors who are patient and selective can acquire fundamentally strong credits at attractive discounts in the secondary market, potentially improving a portfolio’s risk return profile.’

hidden problems under the hood. In private credit you need to focus on high-quality companies and perform rigorous due diligence on the borrower and the documentation to ensure you make intelligent investments.

New companies frequently enter the leveraged loan market, and the vetting process can be inconsistent. Many credit investors such as CLOs (who are major buyers of leveraged loans) are technically driven and strongly incentivised to invest quickly in a very diversified way. These drivers arguably make these investors lack investment discipline.

As a result, there are a lot of unattractive borrowers in the LLI, and it is essential to avoid the ‘crud’. In fact, there are entire sectors that we find unappealing, and many companies we believe should not be leveraged at all. This is equally true in private credit and BSL markets. You simply are not compensated at original issuance for taking a risk by investing in the ‘crud’. Selectivity is not just important – it’s essential.

Of course, diversification has its place, but too much diversity reduces the overall quality of the portfolio as there is a limited number of good credits. Moreover, when you add in sectors which we believe just shouldn’t be levered, this additional ‘diversification’ actually adds risk to the portfolio.

Within our organisation, we typically target somewhere between 30-60 companies per fund, depending on strategy, which is far fewer than the approximately 200 in a typical CLO or the circa 1,500 in the leveraged loan market. This allows us to stay laser-focused on investing only in high-quality businesses with favourable structures.

Given this, private credit managers with highly diversified portfolios – or those following a passive ‘buy the market’ strategy – are likely to sacrifice quality and face higher default rates and lower returns, thereby eroding alpha. These are effectively ‘beta’ managers, which may be the target of the recent NBER academic paper. Unlike equity markets, where passive strategies such as ETFs are low-cost at about 4 basis points, passive credit strategies are comparatively expensive at about 50 basis points. Overall, active management in credit is even more important than in equities because the odds and the costs do not favour passive credit strategies.

Selectivity goes beyond choosing the right credits – it is also about patience. As Warren Buffett wisely noted: ‘Whether we’re talking about socks or stocks, the time to buy quality merchandise is when it’s on sale’. This principle applies directly to the BSL market, where periods of economic stress or geopolitical tensions can cause dislocations, leading to temporary mispricing.

CLOs play a significant role in market dynamics. When new CLO formation slows, demand for loans decreases, driving prices down. Additionally, forced selling by CLOs – triggered by rating downgrades or covenant breaches – can flood the market with loans, exacerbating price declines. This is particularly true in Europe, where capital markets are less developed than in the US, and where liquidity is thinner.

Such dislocations – whether caused by external shocks or CLO technicals – can create compelling buying opportunities. Investors who are patient and selective can acquire fundamentally strong credits at attractive discounts in the secondary market, potentially improving a portfolio’s risk return profile. ■

1 Erel, Flanagan and Weisbach, ‘Risk-Adjusting the Returns to Private Debt Funds’, National Bureau of Economic Research, March 2024

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SUMMARY

Private credit investors are becoming more sanguine about the risks and more discerning as the asset class matures.

Managers who lack long-term track records can prioritise gathering assets over disciplined investing.

The broad market is of very mixed quality, therefore asset and manager selection is critical.

Private credit provides excellent opportunities for ‘asset-pickers’ to generate alpha.