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WEALTH MANAGEMENT

The Role of Private Credit in a Portfolio

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Private credit has emerged as a compelling alternative asset class, attracting attention from investors seeking diversification and the potential for enhanced returns. **Allocating a portion of your portfolio to private credit can offer several advantages**, but understanding its complexity, and selecting the right investment manager, is key to accessing its unique opportunities.

What is Private Credit?

Private credit refers to non-publicly traded loans made to companies by non-bank institutions, or alternative investment managers. **These loans provide borrowers with customized financing solutions and investors with attractive starting yields.** Private credit categories include senior direct lending, subordinate debt, distressed debt, and specialty finance. While these are the core building blocks of the private credit space, they are not the only building blocks. Private credit has captured a lot of attention over the past several years, evolving from its niche asset class beginnings into a notable contender taking market share from other alternative and public investment opportunities.

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The Rise of an Emerging Asset

Alternative investment assets under management (AUM) are estimated to be $13 trillion, with private credit representing 12%, or $1.6 trillion, as of 3/31/2023 [1]. **Private credit has shown significant growth**, doubling in size since 2018 as a result of borrower preferences, investor demand, regulatory changes, and traditional banks becoming risk averse. Looking ahead, **private credit AUM is estimated to grow to $3.5 trillion by the end of 2028 [2].** While this growth rate is remarkable, the forecast appears to be achievable given the high level of investor demand and customization in private credit.

Unlocking Private Credit's Potential

An **allocation to private credit may provide additional diversification to an investment portfolio because it offers exposure to factors that aren't typically represented in public markets.** Private credit transactions are often customized between borrower and lender, who are commonly professionals with experience in niche credit sectors that generally have low correlation to broader markets. This low correlation can help dampen the impact of market downturns and provide a level of portfolio resiliency to keep the client invested during turbulent market periods. Although both public and private credit market returns are dependent upon credit selection, public markets are often additionally impacted by market technicals like supply and demand imbalances that impact security pricing.

Investors who are seeking the potential for an enhanced income stream and are comfortable investing in illiquid markets might find private credit to be a suitable option for their investment portfolio. According to Cliffwater, **private credit is anticipated to produce a net adjusted yield of 10.0% going forward.** Looking back over the past 10 years, private credit delivered an annualized return of 9.0% [3]. This is quite attractive relative to the historical performance of 0.5% for US Treasuries and 1.4% for the US AGG over the past 10 years [4]. High yield credit delivered a bit better performance at 3.3% over the past 10 years, but still largely underperformed its private credit counterpart [5].

Private credit is generally senior in the capital structure, providing a level of downside protection if the company were to experience a credit event, such as a default or bankruptcy. Also, private credit often includes collateral to secure the loan, providing further lender protection to recover a percentage of capital if a default occurs. Lenders also perform extensive underwriting due diligence and implement strong loan covenants aimed to keep the borrower honest. The covenants allow the lender to work with the borrower if a financial metric is triggered and address the problem areas before the event of a default. As a result, private credit annualized historical loss rates have been 1.0%, whereas commercial bank loans have been over 2.0% [6]. For some investors, these statistics may come as a surprise given the perceived risk associated with private credit.

This begs the question, why would a borrower opt for a non-bank loan? Well, **borrowers might choose private financing because of the flexibility in loan terms** non-bank lenders provide. Private financing often provides customized repayments and most importantly, the approval process is much faster than at a traditional bank.

The speed of financing makes private loans an attractive option for companies seeking immediate capital, allowing them to outcompete their marketplace peers. Also, non-bank lenders often specialize in certain industries, allowing them to partner with the borrower to create value for the business by using a relationship-based lending approach. Finally, non-bank lenders operate under different regulatory frameworks compared to traditional banks, simplifying the lending process even further.

The **benefits of private credit, in a well-diversified portfolio, are numerous and the growth of the asset class should continue to provide attractive entry points for investors**. Understanding the complexity and the nuance of private credit is paramount and we encourage you to assess the role of private credit in your portfolio before making an allocation. **Selecting the right private credit manager**, who has managed a loan portfolio through several market cycles and has a strong track record of success, **is key to generating the type of investment returns described earlier.** With its potential to deliver consistent income, downside protection, and attractive risk-adjusted returns, private credit is an essential component for meeting an investor's long-term financial goals.

[1] *Preqin, 2023.*
[2] *Blackrock, Private Debt Primer, November 2023.*
[3] *Cliffwater, Direct Lending for the Long Run, June 2024. 10% Yield = 3.0% SOFR Yield + 3.6% credit spread on non-investment grade credit + 0.9% Originator Discount + 3.5% illiquidity premium – 1.0% from losses from direct lending.*
[4] *US Treasury total return calculated from iShares 10-20 Year Treasury Bond ETF (TLH) as of 6/11/2024. US AGG Bond Index performance calculated from iShares Core US Agg Bond ETF (AGG) as of 6/12/204.*
[5] *High Yield index performance calculated from iShares iBoxx High Yield Corp (HYG) as of 6/12/2024.*
[6] *Loss rates for private credit based on Cliffwater Index. Loss rate for commercial bank loans based on Federal Reserve data. Loss rates annualized from 2005-2023.*

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