Pensions&Investments

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Industry Voices

Commentary: The 800-basis-point gorilla in the room

A former allocator's view of private credit

By ANDY KIEHL

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Managing the investment portfolio of a pension plan requires a sometimes not-so-delicate balance between several, often competing factors, objectives and goals. Staff, committee and consultants must consider assumed rate of return (aka actuarial rate), liability stream (constituents' monthly benefits), risk tolerance, governance, cash flow needs, investment policy statements and the pension plan's funding ratio (which, by itself, can have a dramatic impact) as inputs in decision-making.

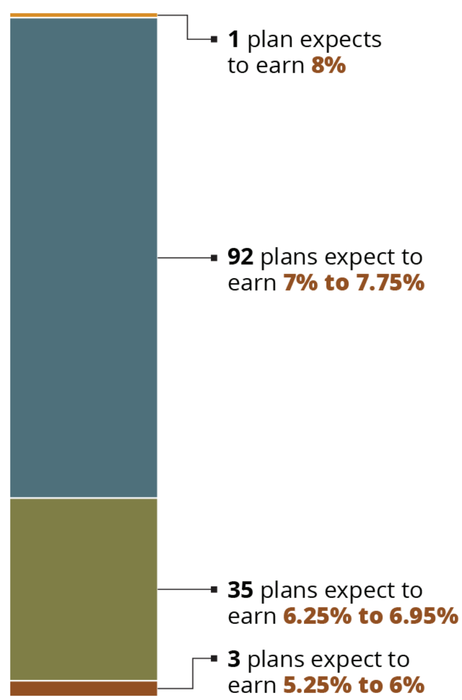
Diligence, debate and research are distilled to create the asset allocation model, the primary driver of portfolio construct. Deploying the pension plan's money into capital markets via multiple asset classes, vehicles and strategies to implement the asset allocation within the framework of the investment policy statement, is how the plan seeks to meet its stated objectives. And, in an ideal world, the asset allocation will lead to a portfolio construct that will deliver the returns needed to meet the assumed rate of return, thereby helping to protect and preserve the pension plan's funding ratio.

For perspective, according to the National Association of State Retirement Administrators, of 131 pension plans that announced an assumed rate of return as of January 2022, more than seven out of every 10 expect to earn 7% to 7.5%.

Consider these target rates of return against the backdrop of projected asset class returns for this year and into the near future. There are many sources of capital market assumptions, but like the markets themselves the majority move in the same direction at the same time. Although not an absolute consensus in all asset classes, review of several of these assumptions confirms most projections fit in definitive ranges, few of which meet the targets to the left. And the common

EXHIBIT 1 Pension plans' assumed rates of return

As of January 2022.



thread is that after multiyear advances, returns will likely be lower in the months and years ahead.

What is a pension plan to do when most of the asset classes prescribed in the asset allocation have a projected return profile that does not meet the assumed rate of return? Allocating to such an asset class puts additional burden on the remaining asset classes to make up the return deficit. This is exactly where pension plans find themselves in the current market environment. After multiyear runs in equity and over four decades of declining interest rates propping up bond returns, projected returns for several traditional and alternative asset classes are at or below the assumed rate of return for the total plan assumptions.

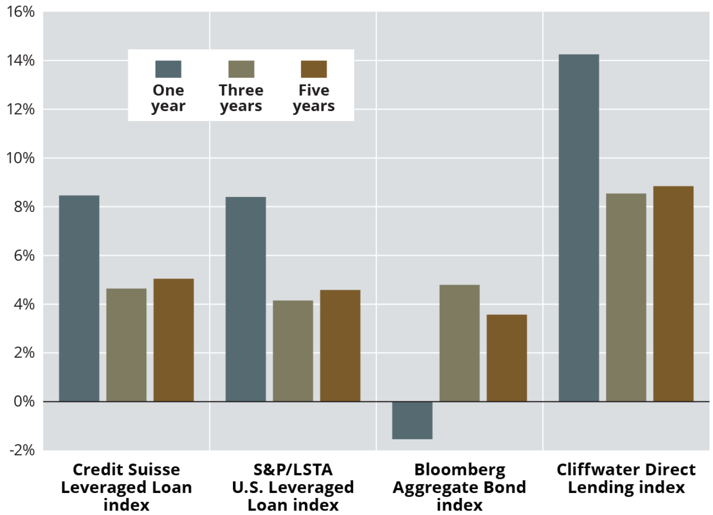
Within the confines of the stated asset allocation model, it is up to the staff and/or consultant to determine if there is an alternative available that offers acceptable risk characteristics, term, vehicle construct, liquidity requirements, cash flow profile, transparency and quality of vendor partner that has a higher probability of delivering returns at or above the assumed rate of return.

Enter private credit

Simply put, the efficiency and power of the capital markets has been on full display as private credit sector investing has grown following the global financial crisis. Banks and other traditional lenders, focused on de-risking and driven by the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act, exited the less liquid loan market, opening the door for private, direct lenders to fill the void. How big of a void?

Consider that in the U.S., there are over 17,000 private companies with annual revenues over $100 million, vs. approximately 2,600 public companies with the same revenues. (By this measure, investors only allocating to public markets are limiting their opportunity set to just 15% of the largest firms in the U.S.) By current estimates, from near zero in 2000, and just over $200 billion in late 2008, the private credit market grew to around $1.2 trillion in 20213, with no slowdown in sight.

EXHIBIT 2 Fixed income benchmarks



There has been much written about private credit as it has grown, specifically about the benefits and considerations of allocating to the asset class, relative to traditional and other private asset classes. Agreed-upon benefits include:

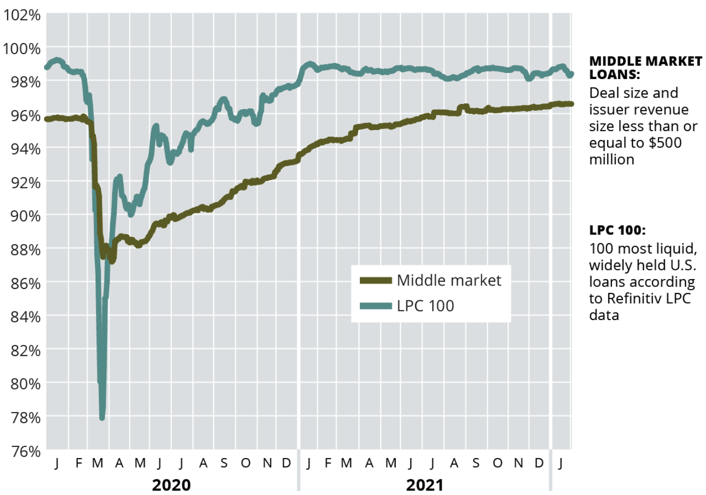
- Portfolio diversification. Private credit has low correlation with traditional asset classes.
- Attractive risk-adjusted returns in various rate environments via floating-rate mechanism.
- Predictable and contractual income flows.
- Lower risk than private equity, since senior debt sits higher in the capital structure.
- Shorter time commitment than other private investments
- Additional yield. Floating-rate loans and an illiquidity premium offer substantial cash yield advantage to public market securities.
- Access to additional company financials vs. public or large private companies
- Strategy/vehicle diversity. Options to craft a portfolio meeting various risk/return profiles.

Public vs. private?

Private credit has outperformed its public counterpart (Credit Suisse Leveraged Loan index) in 20 of the last 20 vintage years by an average of 5.48%.

EXHIBIT 3 Secondary bids: Middle market & LPC 100

Percent of par.



Stress tested

In times of negative calendar-year returns seen in high yield markets, such as 2008, 2015 and 2018, data shows that the Cliffwater Direct Lending index outperformed the Bloomberg Barclays High Yield index by an average of 13.26% each year. Using standard deviation as a proxy for risk, in the period between 2004 and 2017, direct loan risk-adjusted performance was far superior to equities, government bonds, leveraged loans, high-yield bonds, real estate, and private equity. The maximum drawdown in direct lending loans in 2008, during the global financial crisis, was -7.7%, far better than the next best performing risk assets, real estate and private equity, at -24%. And in more recent times of pandemic-related stress, prices for middle market loans were less volatile less and snapped back quickly.

Is private credit a magic bullet?

Private credit is absolutely not the only attractive asset category available to investors. Growth has created a highly competitive landscape in private credit management, and made way for dozens if not hundreds of new firms and strategies. It is imperative to evaluate private credit investment opportunities with the understanding that "all direct lenders are not created equally." Like any industry with explosive growth: tenure, experience, character of firm and stability of team should be viewed as premiums. Additionally, factors such as sector expertise, loan position in the capital structure, EBITDA focus (e.g. $3M - $35M), private equity sponsored vs. non-sponsored transactions, strength of covenants, breadth of team and integrity of process are critical to evaluating one manager and strategy relative to another.

For allocators charged with achieving a specific rate of return, it's only becoming more difficult to reach financial objectives, particularly as return projections for nearly every other asset class fall short of the average stated rates public pensions are plugging into their performance assumptions. In traditional fixed income, the headlines are particularly gloomy as the prospect for rising rates is expected to cut into the performance for long-duration strategies. The positioning of most private credit strategies — and high probability the asset class will reach even the most aggressive rate-of-return assumptions — means this asset class should not be ignored, like an 800-pound gorilla in the room.

As a former deputy CIO of the Kentucky Retirement Systems, I am all too familiar with the challenges of achieving an assumed rate of return when it is prescribed to allocate a meaningful percentage of plan assets to asset classes that have a projected return well below the very assumed rate we were charged with achieving. Additionally, like many pension plans, our cash flow profile made periodic return of capital (income/cash yield) extremely valuable to us.

It is no surprise that private credit has grown, and will continue to grow. In my opinion, risk profile, periodic cash flow, illiquidity premium and projected returns that much more closely match assumed rates make private credit impossible to ignore.

Andy Kiehl is a managing director at Monroe Capital LLC. This content represents the views of the author. It was submitted and edited under P&I guidelines but is not a product of P&I's editorial team.