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PRIVATE CREDIT: THE NEW FIXED INCOME

Private Credit is the New Fixed Income

Introduction

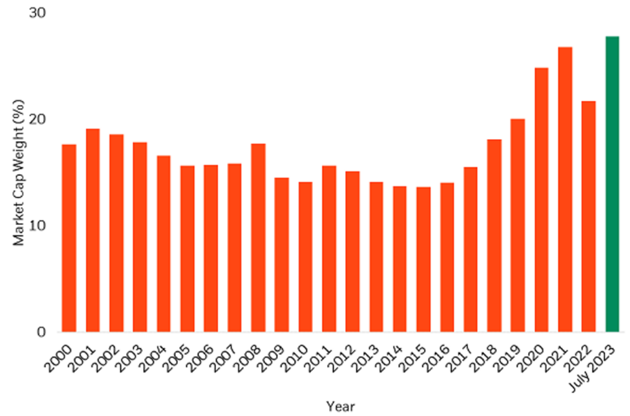
Many investors are stuck between a rock and a hard place, having lost the shared memory of clawing a few BPS past the risk-free rate or national inflation. Starting, practically speaking, after 2008's Great Recession (but in earnest beginning in early 2020), investors – institutional and retail alike – enjoyed skyrocketing stocks propped up by easy monetary policy.

But the situation is changing.

Even if the past few years' market whipsaws haven't happened in many traders' personal institutional memory, the situation isn't unique. The late 1990s saw former Fed Chair Alan Greenspan question whether we lived in a new economy.[1] The recent combination of innovative, exciting, but fundamentally unsound companies fed by cheap debt closely mirrors key conditions of 1998's Dot-Com exuberance. Like the Dot-Com reckoning, many of these companies met their match in 2022 as continuing down the same path proved untenable. WeWork, Virgin Galactic, a whole slew of SPACs – all met their match as ZIRP-era enthusiasm waned and fundamentals came back to the fore.

In the interim between 2022's rate hikes and today, realizing that stocks don't "just go up," many newer entrants got burned. Traditional asset classes seemed poison; the public equities market dropped nearly 25% and flatlined for the remainder of 2022, while bonds of all types proved insufficient despite continual rate hikes in the face of rising inflation. At the same time, even experienced fund managers fielded phone calls from angry clients demanding a game plan to transition into the global economic pivot into relative austerity.

Worse yet, before the lesson truly sunk in, a handful of stocks ballooned into a mega-concentrated position that carried the market back to all-time highs, despite the majority of stocks within any given index still fairly flat or even posting real negative losses.



Market cap of the top 7 stocks within the S&P 500 over time – demonstrating that a handful of companies are carrying the index today. Source: [BlackRock]

This further entrenched institutional and retail investors – keep cash in Treasurys, with solid real rates for the first time in decades and secure ~5% risk free, or bet on the new bubble, hoping that the "Magnificent 7" keep the streak going? Do the former and you risk underperforming; the latter did well over the past year, but for how long?

Perhaps that's why astute financial service professionals began to pivot into lesser-known asset classes that proved resilient and increasingly lucrative: alternative investments.

Not irrational or unsustainable alternatives that suffered as much or more as equities, like cryptocurrencies, but those that trended towards the more mundane yet reliable: private credit and private real estate lending. Today's economic landscape, different from the previous two years (and the preceding decade), is proving fruitful and fertile to funds and firms with the know-how and cash reserves to capitalize on a growing need for private lending practices.

There is no perfect panacea to our collective economic woes, especially as supply chain crunches and geopolitical turmoil continue unabated. Despite the difficulty, diversification into these asset classes while working alongside trusted professionals with experience is a quality cornerstone in a post-pandemic portfolio.

[1] Question: Is There a New Economy? September 1998. **Link.**

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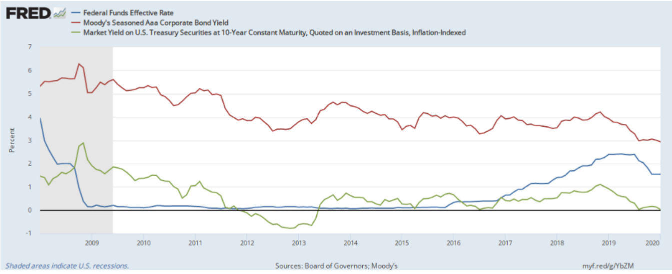
Market Landscapes

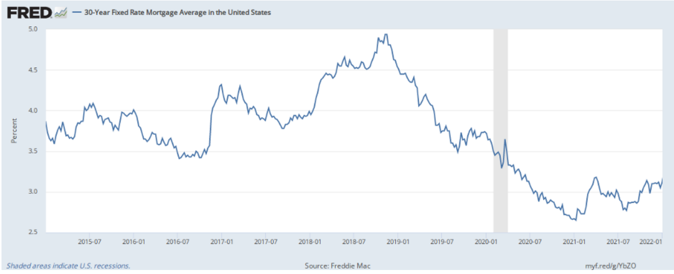
Calling the preceding years in capital equity and debt markets a rollercoaster is an understatement. After the destruction of the 2008 Great Financial Crisis, the whiplash decade saw an increasingly euphoric market. Although marked by a few inflection points, like 2018's December surprise flash crash triggered by high-frequency traders, equities reigned supreme. Suppressed interest rates meant treasury and corporate bond yields fell, benefiting active traders but leaving fixed-income adherents in the lurch.



Active Federal Reserve intervention meant that passive fixed-income investing generated minimal returns, but it mattered little – riskier assets were on fire, and analysts found little to fear. Around the end of the decade, these analysts bemoaned limited opportunities[2] in value stock picks presented by high valuations and returns, touted the performance of private equity[3], and praised the Fed's ongoing interest rate suppression[4] despite geopolitical uncertainty and intermittent (but brief) blips of volatility.

That all changed in early 2020 as uncertainty surrounding the COVID-19 pandemic dropped the equities market by nearly 40%. Fear compounded as circuit breakers triggered on successive days, and much of the capital gains over the previous few years seemingly dried up. That changed, however, as the steep drop rebounded just as quickly. The equities market gained over 100% by December 31st, 2021, from its March 2020 low, as measured by the S&P 500 benchmark.

Despite volatility, borrowers benefited nearly as much throughout the period as their investor counterparts. Home buyers saw falling mortgage rates tank even further in the middle of the pandemic, falling as low as 2.66% for a 30-year fixed rate and representing an unbelievable opportunity as home prices rose alongside the falling rates.



The debt market, too, expanded as firms targeted investors with comparatively sky-high yields to offset the opportunity loss in treasuries.

The venture capital and private equity markets, slower to react, were firing on all cylinders by mid-2021. Investors flush with cash flocked to startups in search of the next unicorn in a series of moves reminiscent of the late-1990s – fearful of missing the next "big thing," late-stage capital investments in venture capital peaked at $58B in Q4 2021, almost 200% higher than the same period pre-pandemic. This gold rush mentality underscores the exuberance caused by low rates and high valuations, as Q4 2019 was an intense market period in its own right. The doubling of venture capital investments shows that institutional and NNWI investors had a near-unlimited appetite for risk, and the public equities market wasn't satisfying their cravings.

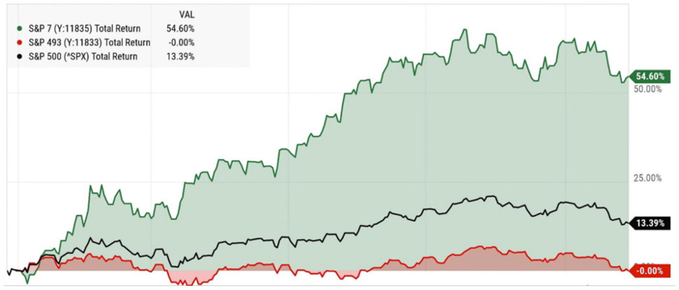
Capital Markets Today

Overall, high interest rates wreaked havoc on equities – for a time.

After falling 20% or so below ZIRP-era's all-time highs, the S&P 500 quickly re-righted itself, entering 2024 roughly around the same point we left 2021; the index marked new all-time highs on a nominal basis and just slightly below 2021's highs on a real basis.

But is it all smoke and mirrors? Like we alluded to previously, a handful of stocks – known as the Magnificent 7, or 2023's answer to past years' FAANG gang, are essentially carrying the market while the majority of stocks remain fairly flat.

[2] Stock Market Outlook: Scarce Opportunities, but Pockets of Value Remain; April 2019. **Link.**
[3] Private Equity: PE Outperforms and Closes the Valuation Gap; December 2018. **Link.**
[4] Credit Market Insights: A Solid Quarter for the Bond Markets; September 2017. **Link.**
[5] Data from PWC Q3 2022 Capital Market Watch report. **Link.**



Though this chart stops in mid-September, 2023, the point remains – a handful of top stocks are carrying the market's relative outperformance, mostly on the heels of an artificial intelligence goldrush that's increasingly seeming as though it's as illusory as the returns it generated.

Today's S&P 500 P/E ratio, a standard valuation ratio that gives investors a snapshot of fair pricing, hovers around 25[6]. And, again, it's safe to assume the same handful of tech stocks are inflating the index's overall P/E, as Nvidia trades at 72x earnings, Tesla at 61x, etc. The upside, in this case, is that many smaller companies who survived 2022's onslaught are correctly priced and, in some cases, offer value-based investment opportunities.

But that's little consolation to index investors overexposed to a handful of tech companies skyrocketing on shaky ground.

Private equity markets are harder to pin down from a current fair valuation perspective. But many lamenting the effects of rate hikes and macroeconomic conditions indicate that the private equity market in toto is faring little better than its public counterpart. From capital market industry giant PitchBook: "Activity has been comping down all year, and the shortfalls have been getting worse with each successive quarter both year-on-year and sequentially. The value of Q3 exits came in at just 30.1% of 2021's Q3 total. […] [T]he mis-match between PE investors lining up to buy rather than sell cheap assets is likely to get worse before it gets better."[7]

As rates increase substantially, investors without the full context of today's market may see Treasuries as a haven. In "normal" conditions, this would undoubtedly be the case. But today is far from ordinary. As fast as equities fell, inflation rose by 7.7% for the year. As the dollar rapidly lost value, even fixed-income investors saw net losses when accounting for inflation. 10-Year Treasury peaked at slightly more than half of net inflation, and CDs hovered around the same. Municipal bonds became as unattractive as their federal cousins, as the ~2% yield didn't come close to compensating for inflation even with their vaunted tax advantages.

In short, across nearly all markets:

- Cheap cash and debt dried up, forcing both public and private firms to focus on financial fundamentals as they saw valuations bleed.
- Despite substantial drops, many see overvaluation in public and private markets, leading to fears that a correction has yet to occur.
- Fixed-income assets couldn't keep up with rampant inflation. Many investors found themselves stuck between a cash-heavy position that lost value daily and increased risk exposure in public or private equities within already-destabilized portfolios.
- Fear, uncertainty, and volatility spooked investors. It led to rapid departures from private and public equities and increased hesitation in opening new, significant positions: "[B]uyers are more timid given macroeconomic factors, leading to a gap in expectations and, subsequently, valuations. That said, multiples are still high across the board."[8]
- Borrowers saw similar propositions as public debt issuers fought to offer bonds that beat inflation. Investment-grade bonds peaked above Treasuries at 4.9% but fell well below inflation.
- However, private credit presented some unique benefits, with distressed assets on sale and floating rates aligned with rate increases. We'll see further details below, but a growing minority quickly identified private credit and lending as the remedy for equity ills.

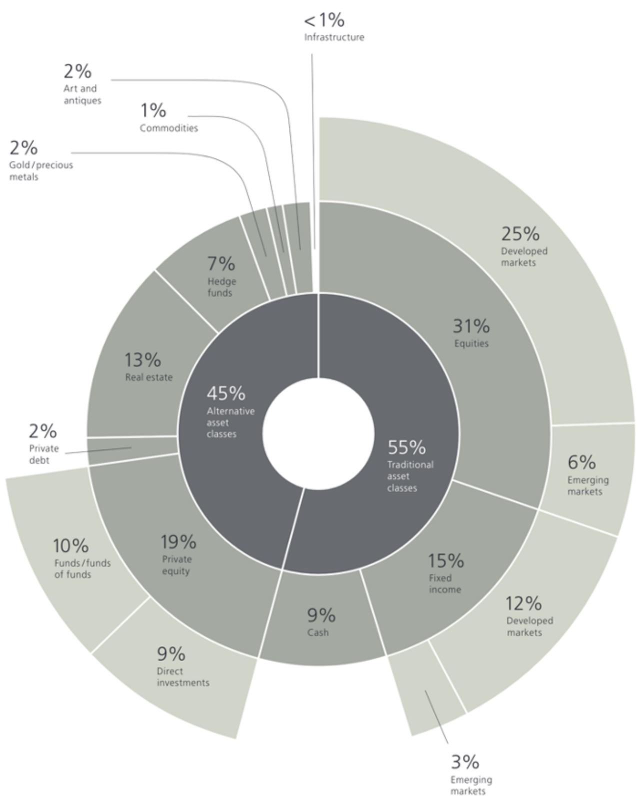
The Emergence of Alternative Assets: Anchoring Diversified Portfolios

This confluence of economic factors combined creates a new paradigm: the dominance of portfolio diversification through alternative assets.
While available alternative investments are as varied as financial engineers' imaginations allow, these

[6] Wall Street Journal P/E and Yields. **Link.**
[7] PitchBook 2022 US Private Equity Report. **Link.**
[8] Ibid.

vehicles are rapidly taking the forefront in sophisticated investors' and managers' portfolios. But something needs to be added to the equation for investors focused on stability, predictability, and relative safety.

According to a recent report, at the end of 2022, family offices held 45% of their portfolio in alternative assets ranging from art and antiques to traditional hedge funds. But the standouts in that portfolio slice are private equity and real estate at 19% and 13% holdings, respectively –the net most significant alternative asset allocations by percentage.[9] That flight to private equity is particularly stark, with a total investment increase of more than 30% in less than two years.



To be sure, much of this private equity movement results from overall market exuberance. One office manager from the same report says, "We believe that the growth rates we have seen in the past are not sustainable, and we need to diversify a bit more with alternative type strategies." The same office managers acknowledge the growth and valuation problem and its effect on finding uncorrelated returns.

What's Missing?

There's a solid argument to be made about the relative safety and stability of private credit and real estate lending markets. For every dollar in public equity investment, there are more than two in traditional fixed income like Treasuries, corporate bonds, and municipal bonds.[10] But the private credit and real estate lending markets need to catch up to their public peers in total investor interest.

The same family office report previously cited, with managers bemoaning the lack of uncorrelated diversification, also found only 2% invested in private debt from the 43% average portfolio allocation to alternatives. Still, even those firms behind the curve are beginning to see the light, noting that private debt is a viable "source of unconventional yield, as loans' relatively high floating rates and low correlations with public markets appeal in today's market environment."

The real estate lending side of the equation, too, needs to be more balanced when considering investment focus. Fund managers seeking diversification flock to real estate holdings; 21% of the offices prefer real estate as an alternative yield asset. This focus is despite the current real estate bubble and inarguable economic effects as we see real incomes fall, possibly impacting rent and lease payers' ability to provide that yield.

Concurrently, mortgage rates are rising and increasing the cost of capital and risk for investors as they remain "on the hook" for mortgage payments if rentees cannot pay. It's curious, then, that so many see illiquid real estate investing as one of the best diversification vehicles. A better alternative may be the lending side that generates a predictable yield with less risk than buying a slew of single-family homes and hoping they'll continue paying rent.

Private Credit and Real Estate Lending

We've established a few core themes thus far:

1. Public and private equities are highly volatile, and we likely haven't seen a market bottom as many industries and companies remain overvalued.

[9] UBS Global Family Office Report, 2022. **Link.**
[10] Capital Markets Factbook. **Link.**

2. While returning higher fixed-income rates than in past years, Treasuries and municipal bonds lag far behind rampant inflation.
3. Portfolio managers and sophisticated investors are desperately looking for uncorrelated returns. In their search, many are increasingly moving into alternative assets, particularly private equity and real estate – both of which suffer from the same market effects of overvaluation and interest rate hikes.
4. The obverse of both private equity and real estate investing, corporate credit and real estate lending, are tiny fractions of the overall average alternative asset holdings in most firm and fund portfolios.

The market does see some slowly waking to the idea of staking a more significant percentage of alternative yield fixed-income assets into real estate lending and private credit. Still, both are underrepresented in the overall landscape when considering diversified, lower-risk, higher-yield, and predictable fixed-income investments.

What is Private Credit?

We've name-dropped private credit a few times, but the conceptual underpinning of the sector is a relatively obscure asset class for many. Lacking the flash and outsized returns of the past decade, many investors lack a firm grasp on the concept or mechanics behind private credit as an asset.

When public or private companies offer equity, they sell a portion of the company itself to the investor. The total shares of stock represent that portion of company ownership bought relative to the total amount available. Equity offerings, in general, are the least preferable fundraising option for directors, executives, or founders as they're trading a portion of their control of the company for cash.

As an alternative, companies often first turn to debt offerings. Public corporations sell bonds, which represent a loan agreement wherein the buyer gives the corporation cash today in exchange for an agreed-upon return of the money at a predetermined expiration date, in addition to recurring payments that are a percentage of the principal (bond coupons). Essentially, a corporate bond is a loan with interest dressed up in corporate finance language.
Private credit is the same but more straightforward to envision – an investor lends a private company money, the company pays interest according to a schedule and eventually pays back the entirety of the loan. While specificities vary, and there are many different loan structuring options, the core concept remains the same. Private companies can raise money without handing over control of their firm, and lenders enjoy a fixed, predictable return dependent upon the agreed-upon loan terms.

Frequently, firms soliciting private lending solutions are either too small to represent a sizeable return for institutional investors or carry an inherent risk that makes public debt offerings untenable. While this does increase risk, which we'll cover in more depth shortly, exposure to debt offerings to middle-market companies and similar untapped resources represents an oft-ignored opportunity for many investors.
And, despite the increase in risk, a quality management firm or representative experienced in the field can more than mitigate any imbalance.

Lenders usually enjoy unprecedented access to private company financials when considering a loan offer, so thorough due diligence ensures lenders are comfortable with their prospect of being paid back (or the risk/reward profile is sufficiently attractive). And, if due diligence reveals riskiness, the lender can demand a higher rate of return from the company in exchange for that risk in the form of higher interest payments.

But the private credit markets, like their nonbank real estate lending counterparts, also serve an essential economic function in addition to generating returns for investors. In the event of broad downturns and decreased access to cash, through either equity sales due to investor fear or bank loans based on credit risk, private credit opens a channel into an otherwise closed system. A 2019 University of Pennsylvania paper on nonbanking credit trends found the same, noting that "private credit funds can lend capital when it's otherwise unavailable, which can smooth the credit cycle and, as a result, stabilize the market."[11]

[11] Private Credit Funds Stabilize Markets, Research Shows; February 2019. **Link.**

The Relationship Between Private Equity and Private Credit

For investors, bullish on private equity prospects, investing in private credit isn't an either/or proposition. Instead, diversification into private credit is a perfect complement to equity investing. A complete 75% of the demand in private credit is from private equity[12] because it can enhance a core private equity holding by:

1. Generating consistent, fixed returns throughout the life of the loan to offset the waiting game associated with qualified exits in private equity.
2. Enhancing yield by letting private equity, invested financially and emotionally in the company's success, further infuse needed operational cash to improve the chances of success in the equity investment without forcing the founders to stake further equity.
3. Streamlining cash infusions through direct lending via networking – if a private equity firm is authoritative and trusted, their vouching for viability will assure creditors and expedite due diligence.

The intertwinement of private equity and credit is most beneficial within the lattermost point. Whereas traditional lenders, like banks, can wait for borrowers to approach them, direct lenders don't have that luxury. Instead, they must be proactive and source their own deals. Therefore, having a quality relationship and network within the private equity world will assist lenders in identifying deal flow and originating loans for investors.

There is a balance necessary that many managers struggle to maintain. While the private equity/credit relationship is critical, many lenders overprioritize that relationship over building one with the portfolio company. A quality fund manager or alternative investing firm will do both. Keeping active and open lines of communication with the portfolio company and the private equity counterparts is the highest degree of fiduciary responsibility investors should look for in their manager.

The Great Financial Crisis' Effects on Private Lending

Another historical aside – since 2008's Great Financial Crisis, coupled with increased access to technology and digitization, alternative real estate lending is reaching peaks previously unthinkable.
Without litigating the legacy bank influences on the crisis more than they already have been, borrowers are speaking with their wallets. Both average citizens and larger corporate borrowers are increasingly showing a preference for nonbank real estate lenders because of both inherent mistrust in the legacy loan management process and, for riskier borrowers, higher bars to lending from the banks themselves. Post-2008 limitations on bank leveraging amplify the flight from traditional lending, as investment banks have less ability to extend themselves too deeply into the long-term loans that typically comprise the private market.

This increased movement away from traditional lending practices and concurrent increase in legacy banking struggles with both digital reach and interest rates means that, according to a 2019 Conference of State Bank Supervisors report, nonbank financial service companies have already snatched up two-thirds of the real estate lending market share and represent the primary source of new mortgage originations.[13]

Risk of Private Credit and Real Estate Lending

Investments come with risk; the private credit and real estate lending markets are no different. Primarily, the risk for both centers around borrower nonpayment or default – all loans come with this risk, and private lending is no different. Instead, the risk is magnified in many instances, as the principal can be irrecoverable. Banks and nonbank lenders can sell personal loans to collections agencies, and mortgages use the property as collateral. In most private credit arrangements, if a debt-fueled startup goes bust or a new office park fails to break ground, the lender could lose the principal and expected cash flow from recurring interest payments.

And, since borrowers sometimes turn to private lending when they cannot get a traditional loan due to idiosyncratic risk, the default risk is higher. This extra

[12] Private Credit: Strong Pockets of Opportunity; October 2022. **Link.**
[13] Conference of State Bank Supervisors, Reengineering Nonbank Supervision; September 2019. (archive) **Link.**

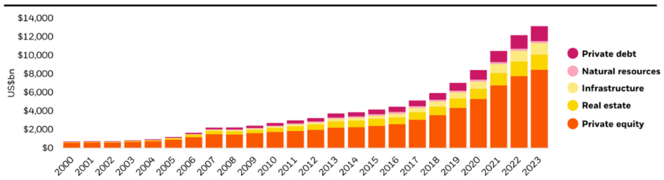
level of risk is why lenders must be thorough in due diligence, although the added risk comes with a higher reward in the form of more favorable terms to the creditor, much like non-investment grade (junk) bonds on the public market.
Both private credit and real estate investing are also highly illiquid, so the assets (loans) cannot be quickly or immediately redeemed for cash if the investor has a sudden emergent need. Since these loans target longer-term outcomes, like construction or bringing a new product to market, the time horizon is often long.

Still, prospective investors must remember that the principal will be unavailable for the investment's duration in most cases. Predictable cash flow for the life of the loan offsets this lockup and illiquidity somewhat.

Private Credit Today

Although private credit as a distinct asset class may have yet to reach the general investor zeitgeist, a core group of forward-thinking firms and fund managers have rapidly accumulated an ever-growing position in the market. Alternative asset data collection giant Preqin saw the private credit market swell to $1.2T at the end of 2021 after a decade of relatively nominal growth – indicating that many sophisticated managers saw the turning tide and began cycling into these safer fixed-income vehicles.

Furthermore, investment giant BlackRock calls private credit "an increasingly essential asset," with the asset class representing 12% of total alternative assets currently under management, or $1.6 trillion globally.[14]



Leveraging Private Credit Opportunities

To summarize, private credit and real estate lending offer new vistas in fixed-income portfolio management that offset much of today's adverse market and economic factors:

1. **Returns outperform traditional fixed income:**
   - US Treasuries and municipal bonds can't compete with inflation despite ongoing interest rate hikes. Because private credit and real estate lending have slightly higher idiosyncratic risk, creditors can demand higher rates of return that ultimately outperform traditional fixed-income portfolio allocations.
   - As a corollary to their outperformance, many of the loans in the market are floating-rate loans. These terms help offset inflation by increasing investor returns alongside interest rate increases.

2. **Divorced from market returns and volatility:**
   - Private credit risk is tied to specific loans or borrowers, so there's no private credit market-wide beta to compare. Still, it's well-known and acknowledged in the industry that private lending is uncorrelated[15] with broader market trends and less volatile than market benchmarks, providing a refuge in choppy equity seas.
   - Not only is private credit as an asset class diversifying portfolios, but investors can diversify across industries and sectors even further with specific loans to reduce idiosyncratic risk. For example, a well-diversified private credit investor could hold a basket of loans of various time horizons and payment schedules (similar to a bond or CD ladder) that includes borrowers from:
     - **i.** Agriculture and farming equipment
     - **ii.** A high-growth technology startup
     - **iii.** A commercial office park developer
     - **iv.** A luxury resort and hotel about to break ground in Hawaii
     - **v.** A small utilities equipment manufacturer and servicer

[14] 2024 Private Markets Outlook. **Link.**
[15] Performance of Private Credit Funds: A First Look; June 2018. **Link.**

3. **Stability:**
   - The hallmark of fixed-income investing is recurring, predictable cash flow. Private credit and real estate lending provide both in the form of loan interest payments back to the creditor. And generally, the lender can dictate favorable terms to its investors through covenants and documentation.

Ultimately none of us can predict the future, whether short or long-term. What is clear, though, is that the carnage isn't yet over as the Fed signals maintenance of the status quo, if not further hikes in 2023. Valuations still appear high in public and private equities, and higher capital costs mean large lenders are stingier and pricier.

These factors mean that many mid-size borrowers, whether companies needing a push into a more mature phase or growing manufacturing firms searching for assistance in physical plant expansion, are turning to private credit and real estate lending to fill a growing gap.

And filling that gap is proving profitable.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