Private Debt Graduates

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Central Issue of the Paper

Over the last few years, institutional investors have been increasing allocations to return-seeking fixed income strategies and illiquid alternative assets. Some investors are looking for higher yield, some for more diversification and some taking opportunistic positions resulting from market dislocations. Consistent with this development, Mercer highlights the importance and growth of private debt in "Private Debt in an Institutional Portfolio." He asserts that, as an asset class, private debt is attractive on a risk-adjusted basis and can play different roles in the portfolio context, and directly plays into the financing void which has arisen post the global financial crisis.

Approach Employed by Paper

Private debt is similar to a loan in that it is capital provided (as an investment) to an entity in exchange for interest (and possibly other payments) and the return of the original principal at a defined point in the future. The debt is typically secured and has various protections/covenants in place. The debt is also not widely held, and is customized to the borrower's requirements, thus rendering it illiquid. Private debt encompasses corporate debt, real estate debt and infrastructure debt, as well as some opportunistic credit strategies. With the long-term nature of liabilities, pension funds and other institutional investors are in a position to offer liquidity to the market and thereby realize an illiquidity premium. Considering the attractive return potential of private debt, it is one manner in which investors can diversify from equities and yet maintain a similar level of expected return.

Private debt portfolios are typically seen as a complement to existing return-seeking fixed income allocations, also called "growth-oriented fixed income." Subordinated (and some senior) private debt strategies with significant equity upside might also qualify as a complement in the private equity allocation or investors might implement this as a broader private markets allocation (across private equity, private debt, infrastructure and other real assets). As an example, private debt offers several advantages over high yield (incl. floating rate, lower mark-to-market volatility) or senior bank loans (incl. higher returns, prepayment protection) and often stronger covenants and better information/monitoring rights. This comes however at the price of

lower liquidity, access via closed-ended funds, and the need for more resource-intensive implementation and monitoring processes.

Compared to traditional asset classes and most other growth-fixed income categories, the private debt implementation process looks different and operates more in line with the implementation of private equity allocations. Private debt funds are typically less diversified (by number of positions) than senior bank loan funds so it is in the hands of investors to ensure adequate portfolio diversification exists. The challenge is that three simple inputs (return, risk, correlation to other asset classes) must be set to describe a complex asset class that doesn't have reliable, observable monthly return data to derive a return pattern.

Lastly, the paper goes on to highlight that a thorough due diligence process (which should combine a qualitative and quantitative assessment) is one of the most important elements of the private debt investment process. Unlike in the traditional fixed income world, there is no reference benchmark managers aim to replicate and the concentrated portfolios increase credit risk and the impact of single defaults.

Findings of the Paper

Private debt investing by institutions has witnessed tremendous growth since 2008 and continues to accelerate. What was once an opportunistic play has become a viable longer-term choice for investors as part of the SAA process. However, the allocation needs to be made in a thoughtful manner, recognizing the nuances of this asset class and requires more investor resources relative to traditional markets.

As the private debt market continues to grow and managers gain experience, choices will increase, and investors will become more familiar with the private debt market. We thus believe the window for private debt investing will continue to open wider over time, as will the need for increased resources and expertise, for both the implementation and monitoring of the allocation.