RPIA
Global Fixed Income Experts

The Right Mix

Active Credit as a Complement to Private Debt

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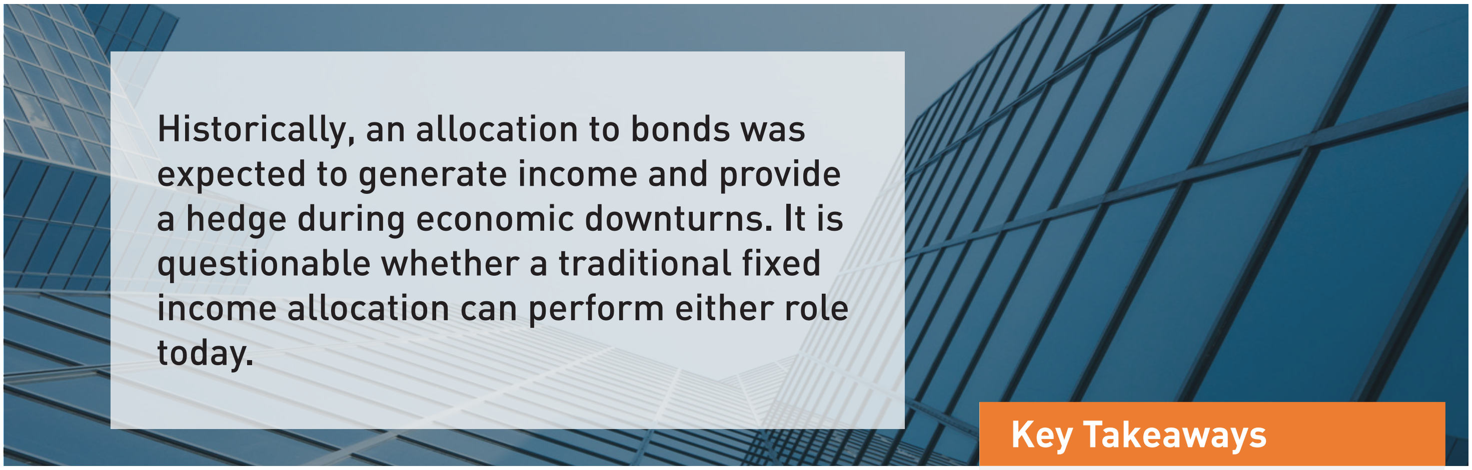

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Rethinking Bond Allocations

After two years of fiscal and monetary largesse, the year ahead is expected to be one of policy transition. Ultimately, we expect the speed of policy adjustments to be conditioned by the path of the pandemic and inflation. In this environment, a thorough review of the make-up of an institution's Policy Portfolio seems prudent. As a starting point, a traditional fixed income allocation is unlikely to play the role in a portfolio that it once did.

Historically, an allocation to bonds was expected to generate income and provide a hedge during economic downturns. It is questionable whether a traditional fixed income allocation can perform either role today. With yields this low - for example, the DEX Universe bond yield is now around 1.9% - the income produced is likely below the rate of expected inflation. It is also questionable how much downside protection fixed income can give you; particularly as central banks are starting to raise interest rates toward a more normal level.

Key Takeaways

Many plan sponsors have addressed the yield challenge by allocating to private debt in recent years.

We believe Active Credit strategies make an ideal complement to private debt allocations.

These strategies can deliver an enhanced – and differentiated – return stream while performing the liquidity function many plans need.

In response to the "yield challenge" many Canadian plans have embraced private debt strategies. Although often viewed as a single asset class, "private debt" encompasses a broad range of investment types with varying risk profiles. At one end of the spectrum are strategies focused on infrastructure debt and mortgages which generally have an investment-grade-quality risk profile. Further out the continuum are direct lending strategies. Firms managing this type of strategy typically provide loans to small middle-market companies, usually backed by private equity sponsors. There is clearly more credit risk involved in this type of lending than is found in an investment grade corporate bond allocation. These two types of allocation have quite different credit risk profiles, but one feature they share is a lack of liquidity. Once you have committed to an allocation you are effectively locked in for the investment period.

[1] Source: PC - Bond Index. As of Dec 2021.

In an environment where retaining flexibility will be important, Active Credit strategies can be an ideal complement to private debt allocations. Given the lack of secondary market liquidity in private debt strategies, plan sponsors must size their private allocations carefully, mindful of the liquidity needs of their plan. Many plan sponsors that we speak with, complement their private debt allocation with a "Universe" or "Core" bond allocation. These strategies offer daily liquidity which is useful for meeting spending obligations or for rebalancing purposes. However, since these strategies are heavily weighted to low-yielding government bonds, they don't offer much return potential in the current environment. For this reason, some institutional managers are exploring the use of a dedicated 'active' credit allocation either as a substitute or a complement to a "Core" bond allocation.

Capitalizing on Inefficiencies Through Active Credit

Active credit strategies can deliver excess returns that nicely complement the returns from a private debt allocation. With a private debt allocation, the lending decision happens at the origination of the loan and any excess returns that are realized over time depend on that original decision. Active credit strategies also have the potential for significant excess returns, but those excess returns are generated quite differently - on an ongoing basis. There is a lack of transparency in the public credit market as securities change hands bilaterally between investors. In addition, many investors in the corporate bond market have strict investment restrictions. As a result, there is considerable potential for alpha for those active managers with increased breadth that can seek out the best risk-adjusted opportunities and reposition their portfolio to benefit from market dislocations and emerging opportunities[2].

1 There is considerable opportunity for active credit managers that can dynamically reposition to benefit from market dislocations and emerging opportunities.

2 Excess returns from active credit strategies are distinct from those generated by private allocations - and are therefore complementary.

Increased market volatility seems certain to lie ahead, which favors active credit strategies that can reposition quickly. The outlook at present is highly uncertain, with central banks looking to tighten monetary policy after more than a decade of ultra-loose policy. This is occurring against a backdrop of a new strain of COVID-19 and asset valuations at elevated levels. We believe that increased volatility in markets in the coming quarters will present considerable opportunity for active credit strategies that can dynamically allocate as the relative value in the market evolves.

Although a traditional, passively managed fixed income allocation has performed well over the past decade, today's environment calls for a fresh look at this segment of the portfolio. Private debt can be part of the solution, and investors have embraced this asset class in recent years. However, we believe plan sponsors should consider complementing their private allocations with active credit strategies.

[2] Also note that by incorporating a relatively simple duration overlay, an active credit manager can adjust the interest rate risk embedded in the strategy – either shortening or lengthening the underlying duration exposure.

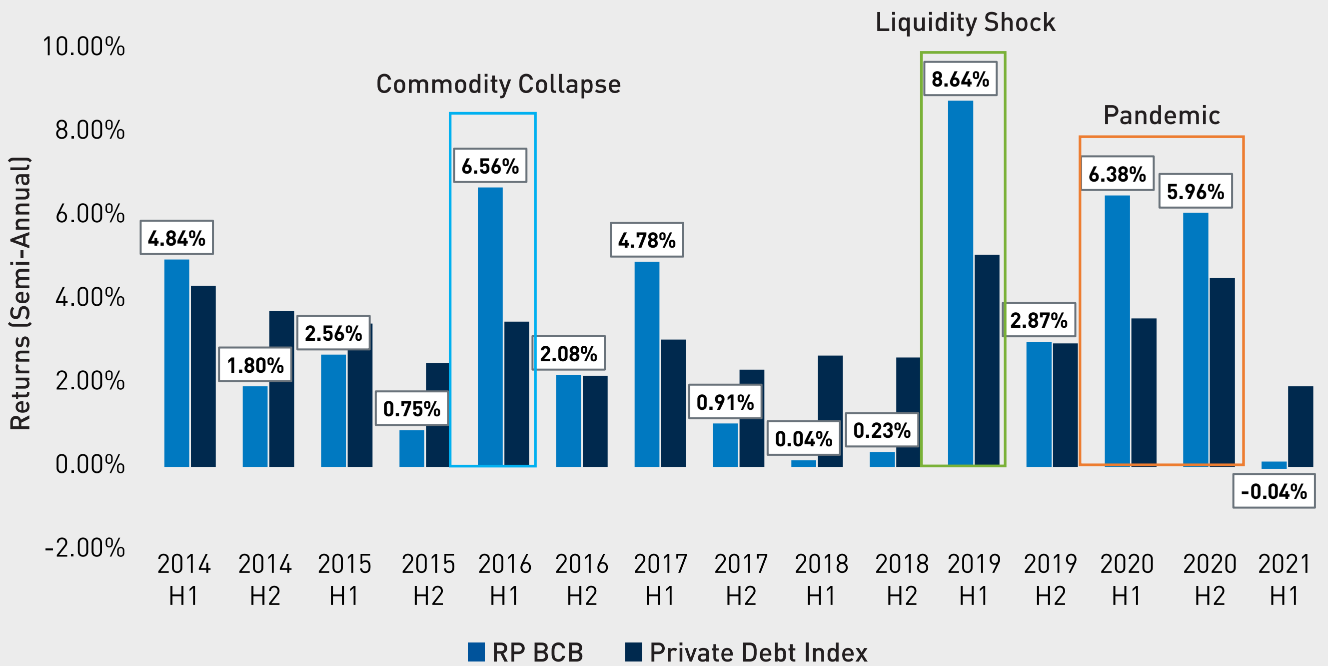
These strategies can perform the liquidity function plans often need, while also offering an enhanced return versus a Universe or Core Bond allocation. By marrying private debt with active credit, investors can potentially capture two distinct and complementary alpha streams, which in this low yield environment can go a long way in helping plan sponsors achieve their risk and return objectives.

Case Study: The Role of Active Credit

- The role active credit can play is illustrated in the following chart where we show semi-annual returns for an active credit strategy versus a private debt index.
- The active credit strategy is represented by RP Broad Corporate Bond ("RP BCB"), an actively managed corporate bond strategy with an investment-grade focus. Performance of "Private Debt" is represented by an equally weighted basket of infrastructure debt, mortgages, and direct lending[3].
- The complementary return streams are partly attributed to differences in liquidity. Since active credit strategies are marked-to-market, these strategies will typically underperform private strategies during volatile periods. However, in the period following these dislocations, active credit strategies can reposition their portfolios and capture the best opportunities at that time. Private debt strategies do not have this flexibility.

ACTIVE CREDIT STRATEGIES CAN DELIVER RETURNS THAT COMPLEMENT THOSE FROM PRIVATE DEBT

Active Credit performs particularly well after periods of volatility - as managers can opportunistically rebalance portfolios



Please contact liam.osullivan@rpia.ca to discuss our active credit strategies and the role they could potentially play in your portfolio.

[3] We use Cliffwater Direct Lending Index for Direct Lending, FTSE Canada Mortgage Index for Mortgage, and a median of Infrastructure Debt product return from eVestment (including products from Canada Life, Canso, CIBC, RBC, SLC and TD) for Infrastructure.

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As Head of Client Portfolio Management, Liam leads the team responsible for developing client relationships and developing new investment solutions. Prior to this role, Liam spent several years managing corporate bond portfolios for the firm, with a focus on the Canadian corporate bond market.

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Zack joined RPIA in 2020 and is responsible for developing relationships with institutional investors and their consultants. In this role, he supports the Client Portfolio Management Team's sales efforts through market insights, investment strategy, and portfolio solutions.

Important Information

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