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Thoughts on Private Credit

By Richard Pilosof

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Over the last few years, I have been increasingly asked by clients and friends for my views on private credit – what I think of the space, where I think the opportunities and risks are. I have shared these views during many 1x1 conversations but wanted to share them more broadly here. There has been explosive growth in the capital allocated to private credit over the last decade but especially over the last five years. Growing in tandem with dollars allocated has been the number of questions from investors on the asset class. Last month, I was invited to speak at a global alternatives conference in Toronto and it felt like almost half of the agenda was focused on private assets – with most of that interest centered on private credit.

I will share my takeaways for investors at the end of this memo. Spoiler alert – I *do* think that private credit is here to stay and can potentially play a beneficial role in investor portfolios. *However*, I would caution investors that I believe the liquidity premium has eroded significantly in recent years as assets have flowed into the space. I also believe investors may be underestimating the benefits of liquidity and transparency in their credit portfolios at this point in the cycle. I'll discuss these topics in what follows and conclude with my thoughts and recommendations.

Background - Origin of the Asset Class

When I co-founded RPIA in 2009, it was in part to take advantage of the fact that after the 2007-08 Financial Crisis, global banks stepped away from many of the highly profitable market-making and proprietary trading businesses that they had engaged in prior to the crisis. This was partly a function of senior bank executives aiming to minimize earnings volatility going forward ("back to traditional lending"). But it was also a result of new bank regulations – Dodd Frank and Basel 3 – which either prohibited banks from engaging in certain activities (Dodd Frank) or made it more expensive for them to do so (Basel 3). As a result, there was an opportunity for buy-side firms to fill this void and launch strategies that would enable private investors to take advantage of the opportunities in trading corporate bonds.

Interestingly, private debt shares the same origin story coming out of the 2007-08 credit crunch. As banks dialed back their lending activities – particularly to mid-market corporates – it made sense for non-traditional lenders to step in and fill that void. Large banks typically have strict rules-based approaches to corporate lending.

If you happen to check off certain criteria and fit into certain boxes, then you can borrow. In more complex situations, corporations may not meet the criteria required so bank lending was harder to come by. These borrowers (typically smaller, more leveraged companies) had to turn to non-traditional lenders for financing. Though they have the same origin story, the way these two asset classes have evolved paint an interesting story for investors.

Revisiting the Reasons for Owning Privates

Let's think about the reasons why investors have embraced private credit allocations so enthusiastically over the last decade. I believe the main benefits can be grouped into three categories:

1. Diversifying portfolio exposures
2. Reduced portfolio volatility
3. More return (typically thought of as the "liquidity premium")

Let's dig into each of these benefits in more detail.

Reason #1 - Diversifying Credit Exposures

Corporate bond indices are typically made up of hundreds of different credit exposures across a wide range of industries and sectors. Issuers usually have a credit rating and need to be of a certain size and maturity to access public bond markets, enabling larger companies to have better access to public markets or banks for financing.

Private debt – certainly until very recently – was focused on lending to companies that were too small for the syndicated loan or high yield markets. These companies often have more leverage than traditional banks would be comfortable lending to. Companies using private financing tend to be less prevalent in public credit markets, which points to the potential for exposure diversification for investors. I qualified the statement above with "potential" as there has been significant convergence between public and private credit markets in recent years – and so diversification benefits can no longer be taken for granted. More on that later.

So, when we're talking about diversification, we must keep in mind that adding private debt often means lending to smaller, riskier borrowers. It does not necessarily mean broadening your exposure to different sectors of the economy.

Verdict – when investing in private debt, you need to understand which credit risks you are assuming compared to what you can get in the public markets. And ask yourself the questions, "do I need this diversification in my portfolio? Is this actually providing me real portfolio diversification and if so, at what cost?"

Reason #2 - Reduced Portfolio Volatility

As someone who has spent his whole career in public markets, I like the purity and honesty that comes with marking investments to market. I'm a bit of a broken record on mark-to-market. But I just appreciate the transparency it provides me regarding what my holdings are worth. **At any given time, I can look at what I own… look at the market valuation… and make investment decisions based on that information**. The flip side of owning public investments is that there will inevitably be volatility as the environment changes over time – whether that be driven by policy, the economy, credit fundamentals etc. But all things considered, I would rather take the transparency and the volatility that comes as a byproduct of mark-to-market.

Private investments don't behave in the same way. A private credit portfolio won't be marked-to-market as there is no liquid secondary market for the loans in the portfolio. Loans will generally be marked at face value during their life as long as they are performing – whether that be making scheduled payments or payments-in-kind. If the borrower is unable to make payment when the loan becomes due, then the loan will generally be marked down (potentially by a lot) at that point. As long as the loans perform, the performance of this portfolio will be a smooth straight line, with none of the volatility you would see from a public credit portfolio. However, the catch is, if or when loans go bad, the markdowns can be sharp.

I want to make the following point though – both public and private credit investments are ultimately driven by the same factors. These include monetary policy, the strength of the economy, corporate balance sheets, refinancing costs, and so on. In both cases you are lending money to an entity and getting paid to assume the risk of not getting your money back. **That risk changes over time based on many factors. However, one class of credit investments are factoring in the changing risk of default over time into the valuation, and with the other, you are more like the proverbial ostrich.**

It's important to recognize this. I believe one reason for the increased popularity of private debt is this smoothing effect which helps make portfolio returns look more steady and less volatile. Cliff Asness at AQR has talked about "volatility laundering" and I think this is what he was referring to. By replacing some public credit with private credit, your reported portfolio metrics will likely improve (smoother return and less volatility – meaning a higher Sharpe ratio), but the case can be made that these benefits are misleading. I've joked with my colleagues in the past that another way to accomplish a similar outcome would be to invest in public credit but refuse to look at your monthly statements. I'm being a little tongue in cheek here, but I'm sure you get the point. Credit – whether public or private – is credit. Some of our institutional investors that have private credit allocations use public market proxies when modelling these exposures in their risk system. This strikes me as a prudent thing to do.

Verdict – I don't see reduced portfolio volatility from privates as a real benefit. While it can provide psychological comfort when times are good, investors should not fool themselves by thinking that switching from public credit to private credit reduces potential volatility in the portfolio

Reason #3 – The Liquidity Premium

The other critical area to explore is the liquidity premium. Finance theory tells us that you can only earn more return if you are willing to take more risk. In giving up liquidity, investors will demand additional compensation. This raises the question – how much additional return is enough to give up liquidity? I wrote a letter to RPIA investors earlier this year posing this exact question – what's liquidity worth to you?

But before we get there, I think it's important to dig into this concept a bit. Estimating the liquidity premium is not as simple as you might think. As a starting point, you might be tempted to look at corporate bond returns (either investment grade or high yield) and compare the performance of those asset classes to the returns of a private debt fund or an index of several funds. However, this return difference won't just be a function of the liquidity difference. As I mentioned earlier, companies in private debt funds are smaller and have higher leverage, which could add another layer of complexity to the return difference. You would also need to adjust for the different credit risk profiles of the portfolios, any sector-biases, duration differences, and more... before you're even getting close to an apples-to-apples comparison of the two return series. In general, I believe there is usually more credit risk in private credit portfolios.

Much academic work has been done to estimate the liquidity premium, but the findings are mixed to say the least. I'll provide the links to a couple of interesting studies in the footnotes. The first article looks at private versus public equity. Although headline returns look better for privates, once you adjust the return streams to account for company size, leverage and sector biases, they found no evidence of any liquidity premium.[1] Likewise, another recent paper found that over a 24-year period, private real estate produced average net returns that were noticeably less than public REITs.[2]

I reference these two studies to illustrate that while there's a lot of thought leadership promoting the benefits of private assets, it's difficult to pinpoint if there is a liquidity premium and if so, what it is. The liquidity premium used to be estimated at 3-4% per annum, but recent estimates are more like 1-2%. I am a bit cautious when using estimates as this return difference may capture other things in addition to the liquidity difference (like more credit risk). However, one thing I do feel confident saying is – **with all the assets that have poured into private debt recently, whatever liquidity premium existed before has certainly been compressed. This is always the way in the markets. Being early to the trade typically has benefits.**

Verdict – while there may be a positive liquidity premium, I believe it has been reduced considerably in recent years due to the flow of capital into the private space. At this juncture investors should think carefully about what they are giving up in order to capture whatever premium exists.

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[1] L'Her, Jean-Francois et al, "A Bottom-Up Approach to the Risk-Adjusted Performance of the Buyout Fund Market", Financial Analysts Journal (2016), 72:4, 36-48, DOI: 10.2469/faj.v72.n4.1, December 2018.

[2] Beath, Alexander and Flynn, Chris, "Asset Allocation and Fund Performance of Defined Benefit Pension Funds in the United States 1998-2021", CEM Benchmarking Inc., October 2023.

The Importance of the Speed of Deployment

A separate topic – but another area to be careful – is comparing returns for public credit strategies (where your capital is invested and begins to earn return immediately) versus drawdown private strategies where it may take a significant amount of time for the capital to be deployed. These latter strategies may have significant "cash drag," which can make a big impact on the overall return of your investment. A recent paper I came across compared an evergreen fund where investor cash is invested right away versus a drawdown structure where the investor's money is invested gradually.[3] They found that an investor would have needed to have generated an IRR of over 16% in a drawdown structure to be as well off in dollar terms as they would have been with a 10% return in an evergreen structure. In other words, if you are looking at drawdown structures, **you need to earn a much bigger return on your invested capital compared to what you can expect to earn in a liquid strategy.**

The Convergence of Public and Private

I mentioned earlier that public and private credit markets have started to converge and so I want to expand on that. Private debt has been one of the fastest growing segments of the market. To put that into perspective, "After quadrupling in the past decade to nearly $2 trillion in assets, private credit is as big as the market for banks' syndicated loans."[4] Now, with more capital chasing fewer deals, private credit managers have had to look beyond their historical niche to put investor capital to work. In recent years, private lenders have pivoted from traditional mid-market lending to now competing with the broader syndicated loan market. In other words, private credit managers are now competing directly with banks and public credit managers in order to deploy this massive volume of capital.

We often see sponsors these days exploring funding options in both public and private markets. These sponsors will weigh pricing with the covenants associated with the financing and make their decision on that basis. Sometimes they tap both markets. In recent quarters, we have started to see private credit loans increasingly get refinanced with the broadly syndicated loan market as credit improves and the companies want to access cheaper financing.

Historically, the public and private markets were segmented. **Now, interestingly, public and private credit look more like a Venn diagram with a significant area of overlap**. Borrowers can explore financing options in both markets. I would expect this trend to continue, and so the degree to which investors can expect diversification benefits from private credit going forward will be a function of the manager and strategy they choose.

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[3] O'Hara, Sean, "Evergreen Private Funds – A Performance Analysis," https://www.obsiido.com/learning-hub/research-whitepapers/, Obsiido Alternative Investments Inc., October 2024.

[4] Alpert, Bill, "Move Over, Banks. Alternative Asset Giants Plunge Into Private Credit." https://www.barrons.com/articles/banks-alternative-assets-private-credit-0f76bdbd?st=U8xU7g, Barron's, Dow Jones & Company, Inc., October 2024.

Final Thoughts

Clearly this is a fascinating topic and one where I have strong views. But I wanted to wrap up by providing some takeaways I have given to others when thinking about investing in private debt at the present time.

- There has been significant innovation in lending markets over the last decade. The growth of private credit as a new asset class provides investors with more choice. Before making a decision, **investors need to think about their goals and understand how private assets may either help or hinder those goals in being achieved**. Investment goals will vary depending on many factors so what's right for others may not be right for you. For example, what may make sense for an institutional investor may not be optimal for a family office portfolio.
- The devil really is in the details. Private credit has changed a lot over the last decade. It used to be synonymous with mid-market lending, but now encompasses a diverse ecosystem. In some areas, public and private credit managers are directly competing to lend to borrowers. Before you invest in private credit, **it is critical to pick the right manager, especially as we are at the cusp of a convergence**. You also want to think about the potential benefits of the allocation – summarized above as diversification benefits, portfolio volatility, and liquidity premium. **Are you getting sufficient benefit across these three areas to justify the liquidity you are sacrificing? Or can you achieve similar outcomes with public market allocations?**
- Finally, at this juncture, I believe investors should be leaning more toward public credit over private credit. It will not be lost on you that I have a horse in this race. But I say this because I believe the liquidity premium has been eroded significantly in recent years as a flood of capital has poured into privates. At the same time, there has been significant innovation in public credit markets – for example with the growth of liquid alternative strategies. **I also believe we are at a point in the cycle where we expect more volatility ahead and we think there will be opportunities for investors to take advantage of dislocations in the market if they have sufficient liquidity in their portfolios. I would encourage you to think carefully about what you do with your marginal dollars.**

I hope you have found this memo to be helpful and I would welcome your comments,

Richard

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