The Rise of Private Credit

Kevin Adams, CFA | Senior Portfolio Manager & Principal

Private credit, in its most basic form, has been utilized for centuries as it involved loans made by wealthy individuals to businesses or entrepreneurs. In the modern era, private credit became prevalent during the leveraged buyout period in the 1980s when insurance companies and other non-bank lenders began to provide capital. Following the Financial Crisis in 2008, banking regulations were significantly tightened, resulting in fewer loans made by banks to small and medium-sized businesses. With banks reducing lending to this segment, private credit funds and managers began filling the gap and growth in private credit lending has surged as a result. Private credit has emerged as a compelling alternative asset class for investors as it can offer substantial yields, lower correlation to investment grade fixed income bonds, diversified issuers and structures, and strategies that vary in their risk profiles and potential returns.

What is Private Credit?

Private credit consists of loans made to private companies by non-bank lenders that are not regulated or traded in public markets. The typical borrowers in private credit transactions consist of lower middle market companies with less than $1 billion in enterprise value. While there are several types of private credit loans, including mezzanine finance, distressed debt, venture debt, special situations, infrastructure debt, real estate finance, rescue finance, and trade finance, the most prevalent types are direct lending and asset-based finance. As the name implies, direct lending consists of companies borrowing directly from a non-bank lender. Asset-based finance differs from direct lending in that loans of this type are backed by specific assets such as mortgage collateral, equipment, aircraft, royalties, etc.

Why do Companies Utilize Private Credit for Borrowing?

There are a variety of reasons why companies borrow via private credit instead of using more traditional methods. Private credit loans can be customized to meet a company's specific needs regarding covenants, loan structure, and repayment terms. This flexibility allows companies to tailor their borrowing in a bespoke manner. Private credit loans can also be originated more rapidly and with greater certainty of execution. Traditional public debt involves an extensive underwriting process, rating agency review, and marketing of the issue to entice investors. Private credit forgoes these steps and allows companies to take advantage of opportunities that may expire if not acted upon in a timely manner. As the loans are not marketed extensively, the transactions offer more confidentiality for the borrower. They are able to maintain privacy around their financing strategies and avoid broad dissemination of proprietary information. Lastly, private credit serves as an important alternative to traditional lending when banks are constrained or unavailable. Multiple sources of lending can be critical during times of banking sector strain.

Why Invest in Private Credit?

There are several reasons to invest in private credit, with the primary reason being the yield advantage over traditional fixed income investments. While the average yield spread over treasuries of a private credit investment can vary depending on credit quality, market conditions, deal structure, etc., it has tended to be in the 3%-6% range[1]. In today's market, that translates to a yield of 7% on the low end to 10% or more on the high end. In addition to higher yields, private credit has typically exhibited a lower correlation to public debt. The illiquidity of the sector means prices don't react as quickly to daily market or economic fluctuations, and private credit debt tends to be issued as floating-rate loans, which reduces their sensitivity to the impact of changing interest rates on prices. Since private credit loans are negotiated directly with the borrower, the collateral and covenants can be structured to provide improved downside protection for the lender. As a final reason, adding private credit to an investment strategy improves the portfolio's overall diversification.

What are the Risks of Investing in Private Credit?

While potentially attractive, private credit also comes with risks that are unique to the asset class. Since the loans tend to be custom, smaller in size, and do not trade on a public exchange or market, liquidity for private credit issues may be challenging or, at times, non-existent. Growth of the asset class over the last decade and a half has improved the ability to sell a loan in the secondary market, but liquidity tends to tighten during economic downturns. As such, investors in the asset class should be prepared to hold the loans until maturity. Another risk is the lack of transparency regarding the borrower's credit profile. Since private credit consists primarily of unrated or lower-rated companies, financial information may be less timely or inadequate, and the risk of default is elevated. Determining the market value of loans is also challenging due to limited secondary market trading. Other risks in private credit are more structural in nature. For example, a high percentage of private credit loans are issued with floating

1 Cliffwater 2023 Q4 Report on US Direct Lending. JP Morgan Markets. Cliffwater Direct Lending Index (CDL Income Return and Realized Credit Losses).

interest rates. While this benefits the investor in a rising rate environment, the opposite occurs when interest rates decline. Given these risks, investors should perform extensive due diligence on the issuers if investing in private credit directly and the strategies of the manager if investing through a third party.

Historical Performance and Losses

From a performance perspective, private credit has historically produced high risk-adjusted returns. Over the past fifteen years, private credit has delivered annualized returns of 10.1% compared to 8.6% for high yield and 1.8% for investment grade bonds (Exhibit 1). The volatility of these returns, as measured by annualized standard deviations, is only slightly higher than those of the Bloomberg Aggregate Investment Grade Bond Index and less than half the volatility of the Bloomberg Global High Yield Index. Equity performance over the same timeframe has been impressive. However, the volatility of those returns was almost three times higher than the volatility of private credit. Another factor to consider is how the sector has performed during periods of market stress. While the US hasn't experienced an extended recession during the measurement period of returns, private credit performed much better than high yield and equities during the COVID-19 pandemic. In the 1st quarter of 2020, private credit declined -7.6% versus declines of -15.0% and -19.6% for high yield and the S&P 500, respectively. From a risk versus return perspective, adding private credit to an insurance company portfolio has historically increased returns while reducing overall volatility.

Exhibit 1

Historical Analytics	Preqin Private Debt Index	Bloomberg Aggregate Index	Bloomberg Global High Yield Index (LG30TRUU)	S&P 500
5Y Avg Ret	9.7%	1.1%	10.9%	15.7%
10Y Avg Ret	8.3%	1.8%	3.6%	12.0%
15Y Avg Ret	10.1%	2.7%	8.6%	14.0%
5Y Volatility	5.7%	6.4%	12.9%	19.2%
10Y Volatility	4.7%	5.0%	9.9%	15.3%
15Y Volatility	5.5%	4.5%	11.5%	16.0%

Source: S&P Capital IQ, Preqin Private Debt Index, Bloomberg

Historical loss rates for private credit have generally been lower than high yield bonds, but statistics vary depending on the segment of private credit and the timeframe of the measurement period. Based on the Cliffwater Direct Lending Index (Realized Credit Losses) report[1] measuring credit losses from 2005 to 2023, high yield bonds have averaged 1.48% credit losses per year versus an average of 1.02% for the CDLI Middle Market Debt Index. However, there have been episodes of higher losses for private credit. During periods of economic stress, such as the 2008 financial crisis, default rates for private credit were elevated. For example, in 2009, the loss rate for private credit reached 6.91% versus 6.59% for high yield bonds and remained elevated until 2012. Over the last 10 years, high yield bonds have experienced losses of 1.58% against losses of 0.96% for CDLI Middle Market Debt Index[1].

Considerations for Insurance Companies

In addition to the factors outlined earlier, insurance companies looking to invest in private credit have several other unique considerations. Private credit investments carry a higher Risk Based Capital (RBC) charge than investment grade bonds, so allocations to the sector need to consider the form of the investment (direct investment, equity structure, etc.) and its impact on the RBC calculation. An insurance company also needs to look at an investment in private credit within the scope of its entire investment strategy and liabilities. If the company has a large percentage of its surplus invested in higher risk strategies, it may need to reduce exposure to those asset classes or forego an investment in private credit. Because private credit markets are opaque, insurers must carefully monitor investments after they are made. It is necessary to have efficient procedures in place to monitor performance and make sure the portfolio stays within reasonable risk limits. While previously mentioned, the illiquidity of the sector is worth reiterating as it would be challenging to sell the investment(s) quickly if the need arose to meet operational payments.

In closing, private credit offers insurance companies a compelling opportunity to improve their portfolios' yield and diversification. However, it requires careful consideration of the risks and illiquidity involved. Working with experienced managers can help navigate this complex but potentially rewarding asset class.

Kevin Adams, CFA, *is a Principal, Vice President and Senior Portfolio Manager at AAM with 30 years of investment experience. Kevin is responsible for constructing portfolios based on client-specific objectives, constraints, and risk preferences. He is also responsible for communicating market developments and portfolio updates to clients. Prior to joining AAM, Kevin worked as a Registered Representative for the National Business Association. He earned a BS in Corporate Communications from Northern Illinois University. Additionally, Kevin is a CFA Charterholder and a member of the CFA Society of Chicago.*

Disclaimer: Asset Allocation & Management Company, LLC (AAM) is an investment adviser registered with the Securities and Exchange Commission, specializing in fixed-income asset management services for insurance companies. Registration does not imply a certain level of skill or training. This information was developed using publicly available information, internally developed data and outside sources believed to be reliable. While all reasonable care has been taken to ensure that the facts stated and the opinions given are accurate, complete and reasonable, liability is expressly disclaimed by AAM and any affiliates (collectively known as "AAM"), and their representative officers and employees. Any views or opinions expressed are subject to change without notice, should not be construed as investment advice and should be considered only as part of a diversified portfolio. Any opinions and/or recommendations expressed are subject to change without notice and should be considered only as part of a diversified portfolio. Any opinions and statements contained herein of financial market trends based on market conditions constitute our judgment. This material may contain projections or other forward-looking statements regarding future events, targets or expectations, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different than that discussed here. The information presented, including any statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Although the assumptions underlying the forward-looking statements that may be contained herein are believed to be reasonable they can be affected by inaccurate assumptions or by known or unknown risks and uncertainties. AAM assumes no duty to provide updates to any analysis contained herein. A complete list of investment recommendations made during the past year is available upon request. Past performance is not an indication of future returns. This information is distributed to recipients including AAM, any of which may have acted on the basis of the information, or may have an ownership interest in securities to which the information relates. It may also be distributed to clients of AAM, as well as to other recipients with whom no such client relationship exists. Providing this information does not, in and of itself, constitute a recommendation by AAM, nor does it imply that the purchase or sale of any security is suitable for the recipient. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, inflation, liquidity, valuation, volatility, prepayment and extension. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission. Opinions and statements of financial market trends that are based on market conditions constitute our judgment and are subject to change without notice. Historic market trends are not reliable indicators of actual future market behavior. This material may contain projections or other forward-looking statements regarding future events, targets or expectations, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different than that shown here. Diversification does not assure a profit or protect against loss.