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The public vs private debate (on debt)

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I am increasingly finding myself the lone voice for public market debt offerings these days when invited to speak on panels to the investment industry. When I look left and right, I see experts in private credit, private equity, unlisted property and venture capital.

Depending on your investment goals, there are solid reasons for each of these things to feature in your portfolio.

What makes me uncomfortable is the use of private debt to replace the job that active bonds are supposed to do.

What is private debt (otherwise known as private credit or direct lending)?

Credit is a sub-asset class of fixed income, where investors serve the role of lenders and companies are the borrowers.

In the public debt space, these loans take the shape of either bonds or syndicated loans. Both are freely traded instruments whose values may change with every transaction. Sometimes in the absence of any transaction, prices can also change as market conditions change.

Private debt is a type of credit where the lending has been done directly between investors and companies. Investors will take the shape of private debt funds, insurance companies and so on.

Borrowers are typically companies who find more advantageous terms from direct debt investors than from banks. More onerous bank lending terms to these companies may be due to lower credit quality, an unproven business concept, or the riskiness of projects being undertaken.

In Australia, private debt funds often benefit from the conservative nature of our major banks. They leave a large slice of the smaller and medium sized enterprises unbanked. This also leaves return opportunity on the table for private debt managers who have the risk appetite and capability to assess and manage the risks.

As a result, private credit portfolios are able to generate higher levels of yield and income than portfolios of investment grade corporate bonds.

Unprecedented growth

Rewind 5 to 10 years and most private debt funds in Australia would have had only 20 – 30% exposure to the residential property market. What followed was an unprecedented period of strong inflows into these funds as end investors searched for yield in a low interest rate world.

Today, the average private debt portfolio in Australia would have 50% or more exposure to the residential market. This alters the risk and compositions of these portfolios compared to a more diversified position a decade ago. The growth in these exposures have been forced rather than intended, as there simply have not been enough non-property opportunities to participate in.

In the world of equities, small and micro-cap fund managers are usually frank about the capacity of their offerings. Good managers will cap the growth of their funds to sizes that are commensurate with the liquidity and the likely pool of good opportunities in their market.

Private debt funds have generally not done this in the face of strong inflows. As a result, the quality of the overall portfolios will continue to get dragged by the concentration to property.

No volatility

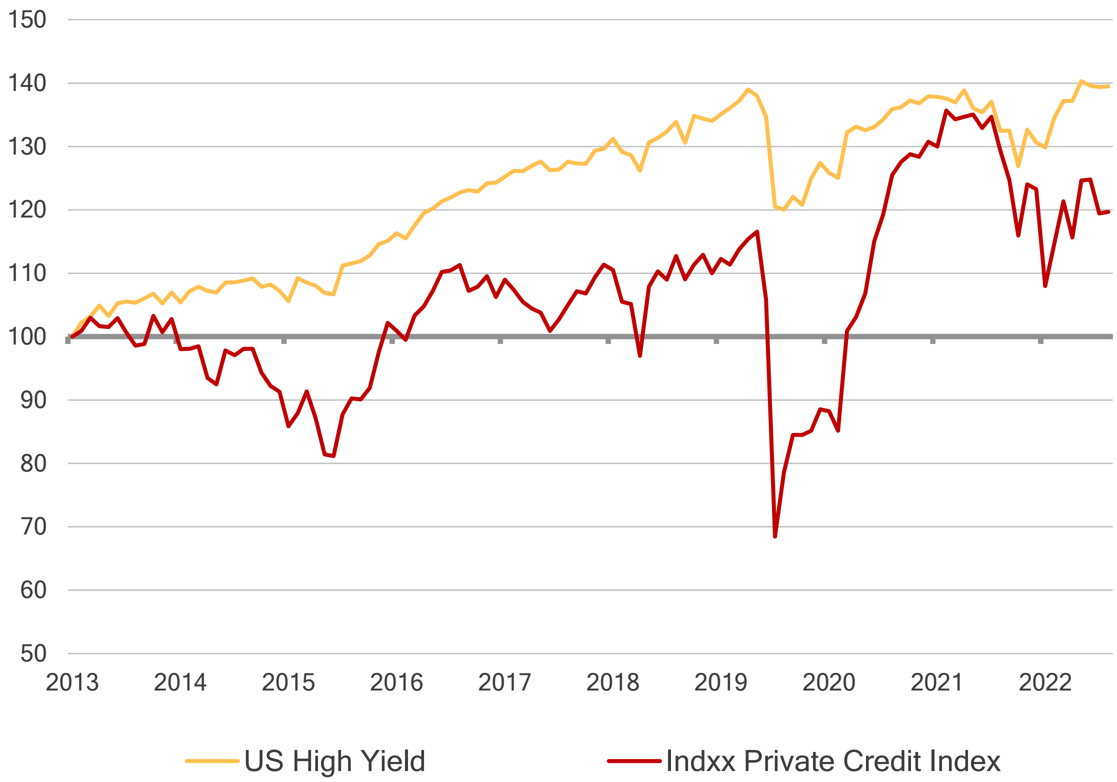
The other attraction of private debt funds over publicly traded bonds has been the lack of market volatility. This was a particularly strong draw in the wake of the 2022 experience where every asset class apart from cash and oil was under water.

There is no volatility because there is next-to-no liquidity in private debt. From time to time, private debt positions may transition between different fund managers, but these are bilaterally arranged deals that are not seen by the rest of the market. Even if a manager sells a position from her portfolio to another manager at a sub-par value, it does not force every other private debt manager to take a paper loss on similar assets in their portfolios.

By no means does the red line in Figure 1 paint the lived experience of every private debt investor, but it serves as a reminder that just because something doesn't move won't mean it's sellable at the price it was bought.

Figure 1: What if private debt were publicly traded?

US high yield and an index of asset managers who specialise in private debt



Source: Bloomberg

Of course, there is no private credit index that has enough history to tell us anything reliable about the true volatility of the sub-asset class. But we highlight the red line above as a way to proxy the idea.

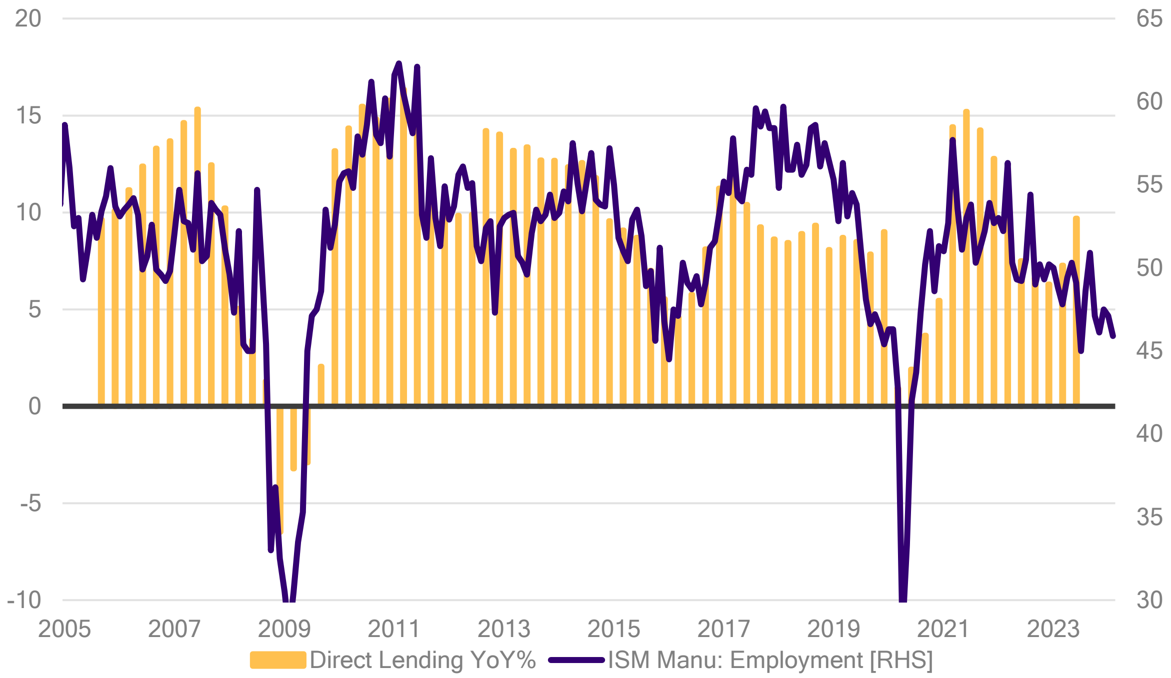
It tracks the share prices of listed companies whose main business is in direct lending and private credit. It is no surprise that the undulations of the red line follow those of public high yield markets, but the drawdowns are deeper reflecting greater risks in private debt.

Historically, this has been true of every private version of asset classes, from debt to equity to property.

A cyclical asset class

The market volatility makes sense when you see that private debt is a cyclical asset class.

Figure 2: The cyclicality of private debt



Source: Bloomberg

The source of the direct lending data comes from the Cliffwater Direct Lending Total Return Index. This index measures the unlevered and gross-of-fee performance of US direct loans by looking at the asset-weighted performance of the underlying assets of the direct lending companies.

The ISM manufacturing employment index signals the cyclicality of the overall economy. When overlaid to the year-over-year returns of the Cliffwater index, we can see that the returns to direct lending follow the cycle.

The data for the latest periods of returns from US direct lending are not yet available, but we can see from the ISM index that the trajectory of those returns are likely to be headed lower as the economic cycle softens. Government bonds, on the other hand, have always rallied into every economic recession.

Valuations

Rather than speculate about private debt valuations and methodology, I'd look to recent findings from KBRA Direct Lending Deals on the state of valuations ahead of defaults among the US community of private debt managers. The same data is currently unavailable in Australia, but the KBRA analysis references a US$1.7trn industry.

The study addresses a key assertion of the private debt industry that they are in stronger lender positions than banks. The reasoning includes closer relationships with companies, more senior positions in the capital structure and stronger protections when borrowers get into trouble.

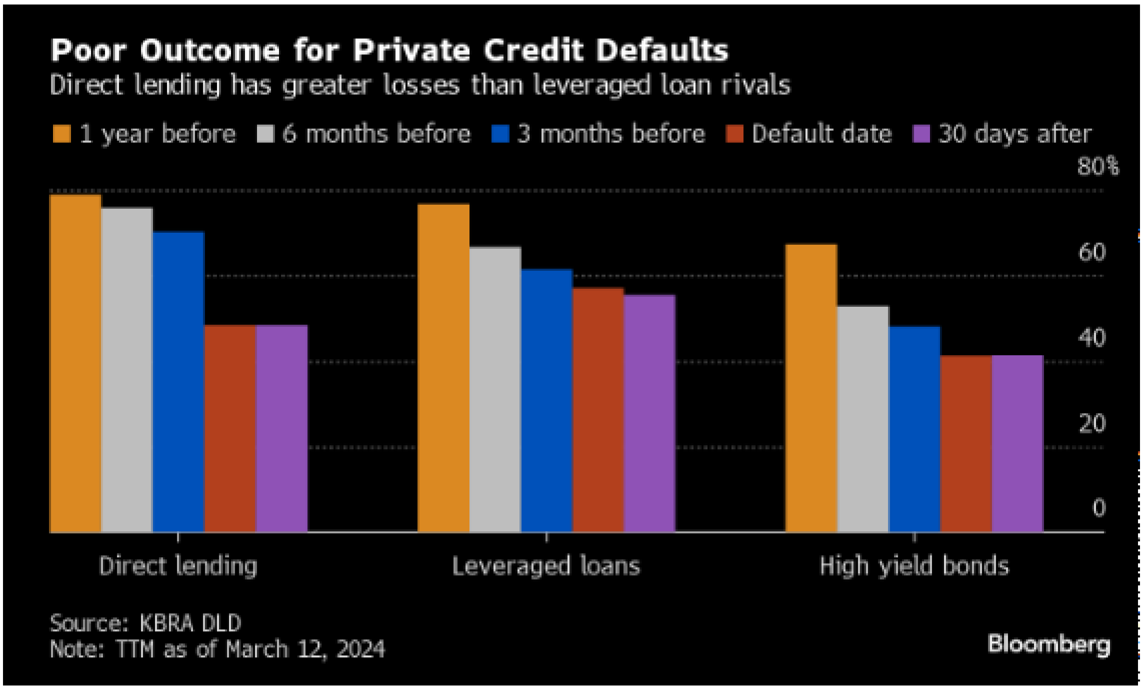
If that were true, you should expect that recovery rates on defaulted positions in private credit portfolios should have an average value in excess of what is achieved in public bond and loan markets. The KBRA results showed the opposite.

Private credit firms were able to recover only 48 per cent of the value of loans made to defaulted companies over the last year, compared to 55 per cent in syndicated loans.

The seniority and protected position assertions may also lead managers and valuation agents to be overly optimistic when assessing potential loss in their portfolios.

Figure 3: Mind the gap

Private vs public debt valuations ahead of defaults



Source: Bloomberg

As Figure 3 illustrates, in the three months leading up to default, direct lending portfolios tend to mark troubled assets at a higher value than both the markets of leveraged loans and high yield bonds.

The phenomenon may be more simply explained by the wisdom of crowds. Given many market participants are looking at the same thing in leveraged loans and high yield bonds, there are more opinions weighing in on what the right asset value should be at any point in time. In private debt, it's usually just the opinion of the manager and a third-party valuation agent.

The dangers of private debt replacing traditional fixed income

Even the most conservative private debt managers in Australia will have a higher level of credit risk through their portfolios than a bond or credit manager.

In addition, even the most liquid of private debt funds will not be able to offer daily liquidity for their clients.

I highlight these two points because I think they get to the heart of how most investors see the role of fixed income in their portfolios.

At the very least, it is a part of the portfolio that they don't expect to worry about when their equities, property and Bitcoins are falling out of bed.

Most investors also expect to be able to tap their fixed income allocations for some liquidity once their cash has been used up.

In orderly normal market sell-offs, high quality investment grade bonds being sold by one manager will usually be able to find a home with another, even if it's at a lower price that the former would like. Perhaps the same can be said of private debt, but the discounts would have to be far steeper.

This highlights the need for some non-credit fixed income in the portfolio as well. This is where exposure to government bonds comes in.

In and of themselves, government bonds don't *have to be* defensive. The experience of 2022 reminded markets that bonds move as much with inflation as they do with growth. Since inflation was the bigger problem then, bonds could not rally as equities sold off.

If growth becomes the bigger problem, bonds will perform, just as they have in every recession in the past. This has been regardless of the starting point in yields.

Recession is the worst-feared scenario for equities, property and probably Bitcoin. It is also the worst-feared scenario for leveraged and private credit because corporate defaults skyrocket.

As KRBA's findings have shown, the relatively benign valuations on private debt portfolios may only mask the impending shock to come in such an environment. With most private credit funds requiring investors to provide 2 – 4 months' notice on capital redemptions, that may be just the perfect amount of time for the value of their investments to go from whole to sub-par.

Conclusions

Asset classes such as private credit have important roles to play in portfolios. They are a way to amplify returns and in some cases, even diversify the sources of those returns.

In times of ultra-low interest rates, the space they occupy in portfolios have grown to crowd out traditional fixed income.

Now that interest rates have normalised, it is time to ask whether traditional fixed income needs to find its way back in. If fixed income is supposed to be the true diversifier, with an ability to protect or defend in times of economic stress, private debt will not fulfil that purpose.

If fixed income is supposed to be a source of liquidity in times of market stress, a greater consideration needs to be made for government bonds. That liquidity was available even in the depths of severe financial crises. It proved invaluable for investors who used that flexibility to take advantage of beaten down prices in other asset classes.

Again, private credit will not serve investors well who are in need of that liquidity or flexibility in those stressed market environments.

It's been easy to get away with replacing private debt for traditional fixed income for a decade. Let's not wait for a deeper episode of economic stress to remind ourselves of the value of bonds.

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