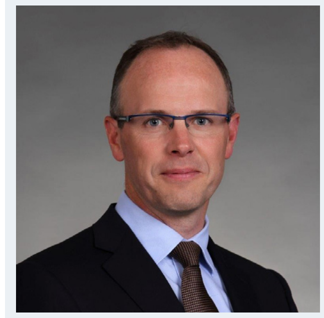
INSIGHTS

INVESTMENT

Long-duration investment-grade private credit – a missed opportunity for LDI investors?



Tom Murphy
Head of Affiliate Development and Business Strategy

Sam Tillinghast
President,
U.S. Private Credit

The asset class can be an ideal fit for a liability-hedging portfolio

There has been a buzz associated with private credit for some time now. Institutional investors have been turning to this high-profile asset class as evidenced by over $540 billion[1] in global private debt fundraising over the past five years.

They are doing so primarily because they are seeking diversification from traditional equities, which many believe have lower expected future returns given recent market highs and the prevailing macro landscape. In fact, most pension plans have adopted private credit within their growth portfolio, targeting equity-like returns with a reasonable level of associated investment risk.

However, with all the hype surrounding private credit, many pension plans have overlooked an important segment of this market – long-duration investment-grade private credit. Insurance companies have been active in this market for decades as they seek liability-hedging assets with additional yield. Pension plans have been missing out.

"A lot of institutional investors, when they hear 'private credit' don't think about investment grade," said Tom Murphy, head of affiliate development and business strategy at Sun Life Investment Management. "We firmly believe that investment-grade private credit provides tangible benefits to pension plans as they seek to make their liability-hedging portfolios work harder and smarter while continuing to carefully manage funded-status risk."

Murphy noted that the applicability of investment-grade private credit to a pension plan is not as an equity replacement within their growth portfolio. Instead, it should be viewed as a complement to public investment-grade credit.

Murphy explained: "Compared to public fixed income, investment-grade private credit has similar liability-matching characteristics. It can also provide a meaningful yield pick-up to help mitigate against rising Pension Benefit Guaranty Corporation premiums and unexpected improvements in mortality among other things." Finally, it can offer better covenants compared with similarly rated public bonds, along with increased diversification, because private credit involves transactions and issuers that you often can't access in the public markets.

Hence it can be an ideal complement to traditional fixed income in a liability-hedging portfolio.

[1]Source: Preqin, as of March 31, 2019.
[2]Source: NAIC (National Association of Insurance Commissioners), The Centre for Insurance Policy and Research, January 9, 2019.

THE PROMISE OF HIGHER YIELD

According to Sam Tillinghast, Sun Life Investment Management's president of U.S. private credit, the excess spread that investment-grade private credit has historically offered over investment-grade public corporate bonds stems from several sources. A primary source is liquidity risk. Not surprisingly, private credit typically has lower levels of liquidity, and so investors demand appropriate compensation.

Understandably, certain pension plans, such as those close to termination, have little appetite for illiquidity. But for those planning to hold fixed-income assets for longer periods, illiquid investments that hedge liabilities can be a great fit.

A second source of higher returns on certain private credit investments is the so-called "structuring premium." Many private credit investments are often highly structured transactions that take specialized expertise and skill to put together. "In our experience, the illiquidity and structuring premiums have resulted in an aggregate additional yield pick-up of more than 70 basis points over the last five years," Tillinghast said.

ENHANCED SECURITY

Despite its higher expected returns, investment-grade private credit can be in many ways more secure than its public counterparts. This is a result of several features inherent to the process and structure.

"You have greater access to the management team, so you can perform enhanced due diligence and ask more detailed questions," Tillinghast said.

Another feature is financial covenants, which are rare on the public side. "These are performance triggers that bring you back to the table if performance starts to deteriorate." Tillinghast noted that covenants allow an investor facing deteriorating performance to ask for more collateral or additional fees, or the investor can even set up a workout plan.

Since private transactions tend to involve smaller lending groups, these groups are typically aligned around the outcome of any such workout plan. This alignment doesn't usually exist in the public market equivalent, where investors can have conflicting goals that can actually accelerate a default.

Historically, the unique features of private credit such as covenants and collateral have translated to a lower risk of default and higher rates of recovery when a default has occurred.[2]

IMPLEMENTATION

Within an LDI framework, investment-grade private credit, just like public fixed income, can also be used to match the plan's cash flow and liability profile.

By moving from public into investment-grade private credit and realizing the additional yield pick-up, plan sponsors can "target the same level of funded status volatility while potentially increasing their funding level over time," Murphy said. "Depending on the size of the plan and the allocation, adding investment grade private fixed income can potentially put a significant amount of dollars back into the pension plan for broadly the same level of risk."

Plan sponsors who are sold on private credit but still think of it as only high octane, leveraged buyout-driven deals, have largely missed an opportunity in investment-grade private credit. And as the credit cycle turns, the benefits over investment grade public fixed income — of higher yields, diversification, stronger covenants and collateral in many cases — will become even more prized.

Historically, insurance companies have maintained a strong position in this segment of the market. The majority of them closely guard their access to investment-grade private credit, as it's a great match for their long-term liabilities, just like it is for pension plans. Few firms have the experience to originate these deals — and fewer still have the ability to share the benefits with the external market.

Murphy concluded, "Investment-grade private credit may be at the duller end of the private-credit spectrum, but a dull and boring investment that matches liabilities and offers excess yield is exactly where many pension plans aspire to be."

www.pionline.com/Sun_Life_Investment_Management

P&I CONTENT SOLUTIONS GROUP

This sponsored Investment Insights is published by the P&I Content Solutions Group, a division of **Pensions & Investments**. The content was not produced by the editors of **Pensions & Investments** and **www.pionline.com** and does not represent the views of the publication or its parent company, Crain Communications Inc.