Active management comes for private credit

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After more than a decade of consistent growth, private credit markets are maturing. They are no longer solely about gaining access to a new asset class and capturing a perceived illiquidity premium. Now, higher rates and growing economic uncertainty are reintroducing more traditional cyclical forces, particularly to lower-quality credit markets.

Meanwhile, changes to bank business models – spurred by elevated rates, evolving regulations, and stress in real estate markets – are fueling growth across various forms of corporate and asset-based finance. Investors now have access to a more diverse array of credit types, each with distinct characteristics, risk profiles, and starting conditions.

The boundaries between public and private markets are also blurring, allowing investors to pursue relative value across a much broader landscape. This new environment should favour investors who can master asset selection and portfolio construction.

We see increasing opportunities for well-resourced investment managers in three main areas:

1. **Finding relative value across public and private markets**: Comparing similar credit profiles to identify opportunities.
2. **Focusing on sector and asset selection**: Carefully evaluating risks and rewards across different subsectors, and analyzing individual assets and deal structures.
3. **Capitalizing on structural alpha**: Leveraging market inefficiencies to uncover additional value.

Public versus private credit market relative value

The rising interplay between public and private markets can be seen in various forms:

- Collateralized loan obligations (CLOs) – structured credit products backed by corporate syndicated leveraged loans – are becoming an increasingly important financing tool for private credit, with private credit CLOs now accounting for nearly 12% of the CLO market and 18% of CLO issuance in 2024, according to J.P. Morgan data.
- Other private asset classes such as residential mortgages, aviation finance, and music royalties are often originated in private markets and then sold to public markets through securitizations, which involve pooling these assets and selling them as securities.
- Synthetic risk transfer (SRT) transactions are an increasingly popular tool for banks to offload risk through custom private deal structures that reference the performance of portfolios of public and private credit exposure.

Volatility in public markets has highlighted the perceived stability of private credit. However, this stability often comes with a tradeoff: Lending terms may be less favorable than those in public markets, and the much-touted "certainty of execution" tends to benefit borrowers more than investors.

The pathways to secondary transactions in private credit are also expanding, What began as a niche focused on secondary fund sales and transfers of limited partner interests – ownership stakes in private credit funds – is evolving into a broader marketplace that includes fund finance, risk transfer tools, and portfolio and single-asset sales.

The real challenge is not choosing one market over the other, but navigating an expanding array of structures, sectors, and technical factors to find the optimal balance of risk and return.

Sector and asset selection

In public fixed income, the largest fund categories typically use flexible approaches that span multiple sectors instead of focusing on just one. By contrast, the private credit fund landscape has largely favored sector-specific strategies.

Private credit investors shouldn't rely solely on corporate direct lending. Instead, investors should use diversification as a tool to navigate cycles. Flexible, actively managed funds are well-positioned to look across different sectors and invest based on relative value rather than following rigid mandates. We see an increasing, largely untapped opportunity in private markets to extract value and enhance risk-adjusted returns through diversification, sector allocation, and asset selection – an approach PIMCO has honed for more than 50 years.

Starting conditions and valuations can differ significantly across sectors. In corporate lending, leverage levels are elevated versus historical norms. In asset-based finance, valuations and deal structures appear more attractive. Meanwhile, real estate markets are recovering from a challenging cycle. Today, we find higher-quality, private, consumer-related credit is far more attractive than most forms of corporate credit, due to a combination of stronger lending standards, lower starting leverage levels, and favorable valuations.

Structural alpha

We also see structural alpha playing a growing role in private credit. This concept involves identifying repeatable structural inefficiencies in markets – e.g., decisions made by noneconomic investors such as insurance companies, whose primary objectives often emphasize net investment income versus total return – and creating a diversified portfolio of these inefficiencies, allowing investors to capitalize on value dislocations.

Conclusion

As private credit matures, it is no longer defined by the pursuit of access or the novelty of alternative lending. Today, it represents a multi-faceted arena offering exposure to diverse borrower profiles and deal structures. The blurring lines between public and private markets, the proliferation of asset types, and the growing influence of technical and structural factors have created a landscape rich with opportunity.

Success in this new era will depend less on being early and more on being discerning. Investors must be able to assess relative value, understand the nuances of different vehicles and structures, and respond nimbly to shifting market dynamics. The toolkit for pursuing returns is larger than ever, but so too is the need for rigorous analysis and active management.

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