Private debt: aligning investment needs with the means to deliver

An asset class that is now a core part of institutional portfolios, Mercer's Private Debt offering combines expertise and opportunities to deliver amid a complex macro environment

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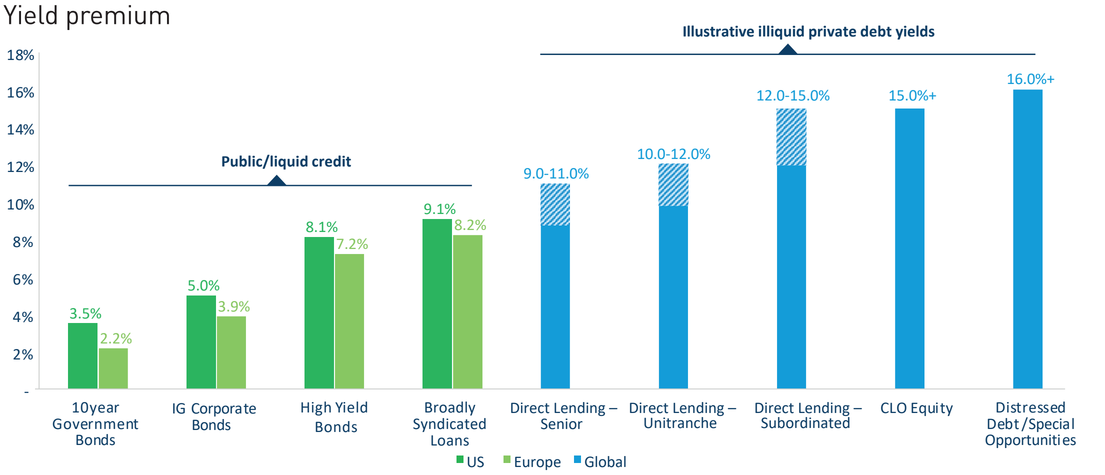
Uncertainty in market expectations presents a conundrum for institutional investors. Prospects of near-term volatility are baked into allocations, while doubts surrounding market conditions, inflation, Russia-Ukraine conflict, and wider macro-outlook create a need to limit potential downside risk while taking advantage of dynamic asset allocations.

In an environment where future return expectations for most asset classes are lower than returns in recent years, the private debt space presents investors with the potential to diversify exposures while leaning into areas expected to benefit from volatility. However, with default rates anticipated to rise, it is more important than ever to construct portfolios appropriately, limiting concentration risk, and ensuring investment strategies can be accessed and leveraged to meet long-term investment needs.

For investors eyeing the $1.2 trillion asset class, the ability to sculpt strategies around risk, ESG and geographies present an opportunity to deliver on investment goals.

Yield comparison to public markets
Yield premium



Notes: For illustration purposes and educational purposes only. DataStream and S&P LCD, as at January 27, 2023. Public/liquid credit figures for 10 year government bonds: Bloomberg Barclays US Treasury Bellwether 10 year and Germany Government Stored Yield Curve 10 year; investment grade corporate bonds: Bloomberg Barclays US Corporate Investment Grade and Bloomberg Barclays Euro Aggregate Corporates; high yield bonds: Bloomberg Barclays US High Yield 2% Issuer Cap and Bloomberg Barclays Pan European High Yield; and, broadly syndicated loans: Morningstar LSTA Leveraged Loan 100 Index and Morningstar European Leveraged Loan Index. Private debt spreads are estimates based on Mercer analysis.

Constructing a solution

From a relative value perspective, market conditions paint a favourable picture for the private debt space, says Joe Abrams, head of private debt, Europe, at Mercer, particularly in comparison to other classes.

Abrams says fundamental qualities lean positively towards the private debt space, including the affordance of a floating rate, offering investors potential safeguard from inflation ebbing away at returns. In comparison, fixed-rate bonds will cede value in a rising interest-rate environment, and allocations to private debt often offer greater protection, softening the impact of volatility.

"While private debt may look great from a relative perspective, it's never been more important or critical to build portfolios or to access the asset class in the right way," says Abrams.

In building access to the asset class, a diversified approach while retaining excellent manager selection underpins many of the potential positives the space can offer. Layering forms of geographic, strategic and vintage forms of diversification, investors can reduce concentration risk, which is critical in this space, whilst taking advantage of the higher yields that may be on offer.

As the lines of public and private debt continue to converge, and distinctions between the two become blurred, it is important to revisit the unique merits of the private space given ongoing market volatility, says David Scopelliti, global head of private credit at Mercer.

For chief investment officers and key decision makers, one of the main reasons to think about portfolio construction through the lens of private debt is the distinction between fundamentally valued asset classes and those based on market technicalities.

"Buyers and sellers in public credit are not necessarily trading on credit fundamentals, but on news and liquidity needs," says Scopelliti. Whereas private debt is valued on fundamental factors, a feature that is a "pillar" of the private markets space. In practice, this means that technical volatility within the assets' pricing is diminished, resulting in a valuation more aligned to the underlying asset value.

Of course, private debt is not the only source of diversification, but the space offers avenues that look beyond direct, corporate cashflow lending.

"We're looking at other areas like structured credit, speciality finance, asset-based lending, and opportunistic strategies which are governed by the nature of different underlying risk exposures," says Scopelliti. "One area that we see emerging is capital solutions funds that have the flexibility to solve for different capital needs of borrowers and that can operate through a credit cycle", he added.

Demand for performance

Shortfall in capital within bank lending markets has opened the door to asset owners of all types – pension funds, endowments, foundations, insurance companies, family offices, and individuals – to pick up the demand for this capital. Scopelliti points to a "demand-supply imbalance", which has created opportunity for institutional investors to step into funding roles previously held by banks.

"Banks have retrenched from providing capital to mid-market companies and, at the same time, the private equity industry has grown. The demand for debt finance is growing and that macro-tailwind is likely to strengthen over time," Scopelliti notes.

Given current conditions, private debt allocations can not only reduce volatility, but offer potential to generate equity-like returns, notes Abrams.

"Many other asset classes look unattractive at this point in time, whereas private debt looks more attractive from both a risk and return perspective," he says.

Dispersion in returns is highest during periods of extended volatility, making manager selection imperative for investment decision makers. "We have been in a benign environment for a long period of time," says Abrams, but now we will likely see some asset managers posting higher loss rates while others deliver expected returns.

"Some would say that's a speed bump, but ultimately I think this differentiation will be a great thing for the asset class," notes Abrams. Mercer's manager selection process is designed to identify who is well placed to meet an investor's objectives.

Unmatched expertise and opportunity

Underpinning Mercer's manager selection process are questions on flexibility, performance and overall success. Does the manager have a track record of investing during turbulence? How have they performed during asset restructurings? How do their loss rates and recovery rates compare to their peers? These findings, along with an investor's risk budget, can be used to create an aligned private debt allocation that incorporates the myriad of relevant factors.

The capabilities of Mercer continually feed into the private debt offering, with a spectrum of expertise being drawn upon across the firm, including ESG integration. Backed by independent research carried out across Mercer, and used by the private debt team in a way to leverage the various insights.

The framework has been laid for investors to steer solutions through Mercer's continuum of services, leveraging the best ideas for both Mercer's advisory and discretionary clients.

Not only does this result in benefits from economies of scale, but it allows clients – as varied as Mercer itself – to benefit from the intertwined network of sector specialists.

Mercer's analysis covers all major asset classes, strategies, geographies and styles to help fuse together flexible solutions for each client's needs. After all, private debt is about accessing unique opportunities – something Mercer is at the cutting edge of.