The path to building an efficient private debt portfolio

The private debt market has grown significantly over the past decade and has become an increasingly important allocation for pension portfolios. This development has increased the complexity of portfolio construction. Klarphos, an alternative asset manager specialising in customised portfolio solutions for institutional clients, manages appx. €2.5 billion in total assets, of which more than half reside in private debt. In this interview, we examine how pension funds can strike a balance between maximising returns and effectively managing risk by using private debt as an all-weather solution.

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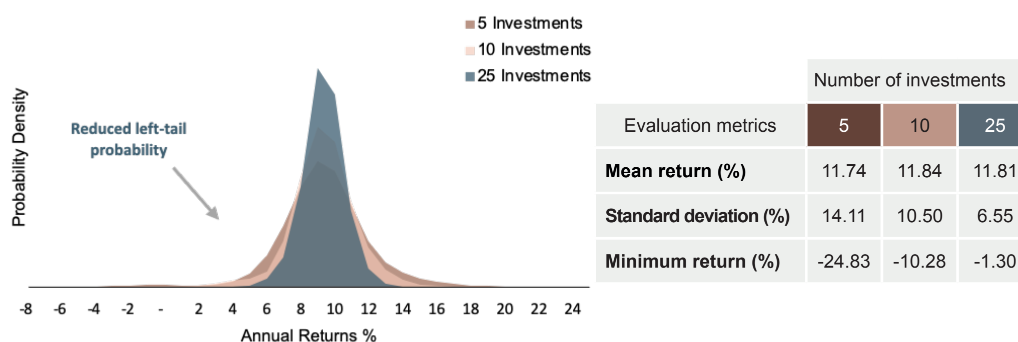
The benefits of increasing the number of target fund investments



Evaluation metrics	Number of investments: 5	10	25
Mean return (%)	11.74	11.84	11.81
Standard deviation (%)	14.11	10.50	6.55
Minimum return (%)	-24.83	-10.28	-1.30

Note: database of 1,546 fund performance (Private Debt, vintage years 1998 – 2022, Geo focus on EU and US

What do you consider to be the most important aspect of constructing private debt portfolios?

Private debt offers an attractive risk/return profile, particularly in the current high-base-rate environment, with senior direct lending offering an unlevered net IRR of 10-11%[1]. Its tighter documentation and stewardship by GPs with an expertise in workouts have helped to lower loss rates during periods of stress compared to public markets. Private debt is generally self-liquidating, providing downside protection and favourable exit guarantees, and its floating rate nature shields it from interest rate volatility, often backed by interest rate floors. The historical maximum drawdown for direct private debt (7.7%[2]) is also lower than for public and private market peers. Nevertheless, it is crucial to adequately diversify when allocating to private debt in order to sufficiently mitigate left tail risk (see chart).

How do you see private debt relative to other asset classes?

While return dispersion in private debt is lower than in private equity, it remains higher than in public markets. We recommend focusing on private debt managers with long, top-quartile track records over multiple market cycles and in-house workout capabilities. Analysis of transition matrices within the asset class reveals significant resilience among top performers. Rigorous due diligence to assess managers' expertise, sourcing channels, and alignment of interests is essential, with a multi-step process to help investors make informed decisions about the risks of private debt investments.

What role does manager selection play?

Manager selection remains important for private debt. While return dispersion in private debt is lower than in private equity, it remains higher than in public markets. We recommend focusing on private debt managers with long, top-quartile track records over multiple market cycles and in-house workout capabilities. Rigorous due diligence to assess managers' expertise, sourcing channels, and alignment of interests is essential, with a multi-step process to help investors make informed decisions about the risks of private debt investments.

How can you achieve an efficient capital deployment?

A portfolio is likely to achieve sub-optimal returns if capital deployment is managed solely on TVPI or IRR, as most committed capital is not fully drawn down over the life of a fund. We track additional metrics beyond IRR and return multiples, such as Return on Committed Capital (ROCC) and Multiple on Committed Capital (MOCC), to better understand deployment efficiency.

With this knowledge, portfolio management tools can improve capital deployment, including effective management of the overcommitment ratio (OCR) to achieve near-full deployment. This is achieved by committing more than 100% of targeted investments, typically in the range of 110-115%, and up to 130% where necessary. Other measures include evergreen funds, secondaries or late primaries to accelerate deployment and improve ROCC and MOCC compared to primary market deployment alone.

As a manager of pension funds and not only private market portfolios, what would you suggest that fellow pension managers consider when building an efficient private debt portfolio?

One of Klarphos' mandates is to manage a pension fund for a European financial institution. We advocate private debt based on our market views and successful implementation of the investment strategies. We remain enthusiastic about private debt because it increases portfolio efficiency - thanks to its floating rate structure and low asset correlation – while diversifying our portfolio and reducing the risk of funding shortfalls. We recognise that managing private debt requires significant internal resources, which can be limited even for large pension funds as private market investment process differs from traditional investments, requiring expertise, due diligence, adaptability to different IT systems, tax and accounting frameworks, and ongoing monitoring. Private credit reporting also requires significant resources and expertise. Klarphos excels in these areas and can assist other pension funds by sharing our experience and insights to help them overcome resource constraints and achieve their strategic goals.

Learn more about Klarphos' private debt solutions

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[1] This doesn't account credit losses [2] Time period: September 30, 2004 to December 31, 2023

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