Income is in

For the first time in a long time, investors can earn attractive income in debt markets. This includes of course public fixed income, but also the spectrum of private debt/private credit, from traditional direct lending to crowded markets such as specialty finance or asset-based lending.

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Coupon income is higher across the board, attractive indeed, but the weight of paying that interest expense is likely to impact borrowers, particularly those that are completing a business plan (transitional lending) in corporate credit or real estate credit. With much higher interest cost, less profitable companies and projects should be where idiosyncratic risk manifests.

Are we seeing the end of the "zombies"? Not yet, but certainly the effects of higher interest expense and an increase in idiosyncratic risk will increase the importance of quality, discernment, structure and alpha. A focus on stronger fundamentals, critical assets is critical, more so now, than over the last decade.

Over the last six or nine months, markets feel characterized by FOMO. The pursuit of risk assets has felt frenzied, and we have seen material reduction in compensation for risk across syndicated credit markets that has bled into markets we would have considered inefficient only a year ago. Is it possible that even some "private debt markets" are becoming more crowded and behaving more like traditional markets, with some expansion in risk characteristics?

In a market characterised by high yields and low risk premiums, it is important to consider where the crowds are and where inefficiency persists.

We believe incorporating a broad perspective, across public and private markets, across difference borrowers and different asset classes is critical. Without this perspective, it can be difficult to see the forest for the trees. As a specialist, if you cover only a single format of debt, you risk drinking your own Kool-Aid, failing to notice the gradual compromises you may be making (or justifying). The "specialist silo" can result in an allocation approach that is too passive, too generic, too slow to adapt to new risks.

The lender continuum can include banks, insurers, private funds, and syndicated markets. A robust syndicated market is likely to offer the lowest lending rate. Markets such as broadly syndicated leveraged loans (CLOs), or commercial real estate loans (CMBS) or consumer loans (ABS) are highly competitive today. Where syndicated or securitized markets compete with private lenders, the opportunity may change quickly, and it is important to monitor.

We believe a flexible toolkit promotes better objectivity. Few investments work always, in all cycles. Recall the view on US housing, right up until the Global Financial Crisis. Perspective is everything.

Is this the "Golden Age" of private debt? It may be, given the attractive level of yields, but we wonder with a risk on environment and robust demand for all credit in public markets, there may be more competition, lower margins, and the lustre may be iron pyrite (fool's gold).

Private debt is a story about relative income: higher income without giving up quality, aka liquidity premium. But illiquidity premium must have a cause, there must be inefficiency among mainstream credit providers. The bank regulation narrative is not new, over more than two decades, markets such as direct lending, syndicated loans, CLOs of broadly syndicated loans and lately "private credit" CLOs have grown tremendously. Risks increase in this space when these markets compete, when demand is more "feast" and supply is more "famine."

In 2022 and 2023, the syndicated markets were less effective. Many loans previously syndicated were refinanced in the direct lending markets. In 2024 the CLO machine is robust, and the "private credit" CLO market is growing rapidly and an outsized amount of what was previously originated by direct lenders has been refinanced by the syndicated loan markets. That shift will significantly change the characteristics of the 2024 vintage when compared to 2022-2023, for many lenders.

If you are competing with a robust syndicated market, what do you have to do today that you did not have to do two years ago? That is the new risk.

With higher interest rates many companies cannot cover the full coupon on their debt. The solution might look like a PIK (payment-in-kind) note. This is not a loan that CLOs can easily acquire. Is this the corporate equivalent of an "option Adjustable-Rate Mortgage (ARM)" or pick-a-pay loan? Perspective is everything.

When the syndicated markets are efficient, the private alternative is likely to offer less inefficiency premium for the same risk and may not be best opportunity today, at least not from in the most basic form.

Specialty finance, commonly with diversified pools of loans, receivables, or assets, is a diversified exposure. In a market where idiosyncratic risk is prominent, or volatility is increasing, this diversification can be insulating.

Speciality finance can offer a broad range of risk premia. Sectors can be un- correlated to the macroeconomy (insurance-linked securities). So, when considering exposures like risk transfer, risk transfer from insurers, can be particularly additive to a toolkit and a good partner to risk premium already held such as corporate risk, or bank risk transfer.

While risk premium has clearly reduced in the syndicated loan market, Schroders Capital observations from private credit CLO's have shown that compression has moved to direct lending, and risk premium declined 1 to 1.5 percent depending on who you ask. This compression is indicative of competition/ increased efficiency.

Speciality finance includes sectors with far less risk premium compression, these sectors offer some insulation should we see a turn-around in the direction of risk asset pricing. Infrastructure debt, receivables and claims finance, certain growing areas in mortgage finance, are among those we find attractive. Sectors where there are less well-developed securities markets and where deals tend to be more structurally intensive, we think those are quite interesting.

Sectors facing headline risk and negative emotional bias, can offer an alpha opportunity. Real estate is anything but one market, though the headlines paint much of the market with the same brush. Mid-market real estate debt markets are a source of opportunistic income where fundamentals are strong, and capital is scarce.

The compression of risk premiums is instructive: when syndicated markets see return compression this is when private markets come into play. Hence, it pays for investors to look at opportunities across the continuum from public to private, and to seek perspective beyond the "traditional, well-travelled, private markets."

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