Floaters in Alternative Credit will help keep portfolios buoyant

➤ Floating coupons offer the ability to benefit from a rising rate environment

➤ Alternative Credit offers an attractive yield pick-up and gives insurers and pensions funds a relatively new way of matching their assets with their liabilities

Petra Stassen-van Lochem
Petra is Client Portfolio Manager of the Alternative Credit Boutique

The future is looking less certain for investors, also in fixed income. After a bull run lasting more than three decades, the prospect of western economies winding down quantitative easing and normalising their monetary policies creates the prospect of a more challenging, rising rate environment. How can investors navigate the tricky waters ahead?

For many of those wishing to keep their portfolios afloat, the answer is to look to an asset class that has grown increasingly important over the last decade – Alternative Credit.

Alternative Credit is an umbrella term for a wide range of investments with various sub-asset classes, ranging from granting loans for residential and commercial real estate (CRE) to building infrastructure, funding exports and financing corporates.

For the purposes of this article, the assets to which we think investors should give their particular attention include commercial real estate (CRE) and export credit agency (ECA) loans.

CRE assets are income-producing properties held exclusively for investment purposes, such as shopping centres, office buildings, logistics centres and residential rental assets. They provide diversification versus traditional asset classes and offer an attractive yield pick-up compared to publicly traded fixed income with similar duration and credit quality. They can act as an alternative to investment grade credits. Demand and occupancy rates generally increase as economic growth accelerates.

"Loans that have a floating rate coupon provide a natural hedge against interest rate rises."

Export Credit Agencies (ECAs) are government-sponsored institutions set up to promote a country's industries by helping buyers of exported products and services to finance their purchases at competitive rates. ECA loans are guaranteed by high-rated sovereigns and carry the same credit risk. These loans can therefore be an attractive alternative for government bonds. Industry sectors in which exports are often financed by ECAs include aviation, shipping, renewable energy, infrastructure and small/medium-sized enterprises.

Two main economic scenarios

Given the high number of variables that influence economic growth, many specific scenarios are possible and some more likely than others. In broad terms though we see two main scenarios: one in which global economic growth remains within its narrow range of the past six years and a second in which it breaks out of that range to exceed 3.5%.

Our view is that the Alternative Credit classes listed above offer investors attractive solutions in either of these two economic scenarios.

The virtues of a floating rate coupon

The principal virtue of these particular Alternative Credit asset classes is their floating rate coupons, which offer the ability to benefit from a rising rate environment. On top of that, a common feature of these and other sub-asset classes within Alternative Credit is that they generate an attractive yield pick-up versus comparable liquid instruments with a similar credit profile and duration. Also, they provide better downside protection through tailor-made documentation and the ability to step in and have a seat at the table (active engagement) at an early stage in case of financial distress.

Compared to the publicly traded bond market, the availability of floaters is much higher in the private market. Loans that have a floating rate coupon provide a natural hedge against interest rate rises. This is because the interest rate that a borrower pays on loans with a floating rate is usually linked to a base rate such as Euribor or Libor and is adjusted on a monthly, quarterly or semi-annual basis. In both of the above economic scenarios, interest rates are likely to rise to some extent.

A natural fit for matching portfolios

Alternative Credit offers more than floating rate coupons. It also gives insurers and pensions funds a relatively new way of matching their assets with their liabilities.

High-quality loans can be used to build a portfolio that matches the structure of these liabilities, in which case "performance" is evaluated not only by looking at the absolute returns, but within the wider context of balance sheet management.

There are several sub-asset classes within Alternative Credit that offer high quality, predictable cash flows and low historical losses. These would be good candidates to incorporate in the matching portfolio. Although these loans add some illiquidity into a portfolio, this need not impair investors' overall ability to meet their ongoing liquidity or rebalancing needs. Pension funds and insurers traditionally have a fair amount of government debt on their balance sheets. Even in extreme scenarios, it is very unlikely that funds will ever require the full extent of this liquidity potential. Many pension funds even tend to have significant surplus liquidity, for which they are overpaying because they are competing with central and commercial banks to buy government debt and investment grade bonds, which creates high prices, low yields and impairs the liquidity of these assets.

An asset class for all seasons

Investors should remember that forecasting global growth is as uncertain a practice as predicting the weather. They can assess current conditions and anticipate future developments but it always makes sense to have a raincoat or sunscreen to hand.

And when it comes to allocating portfolios, Alternative Credit provides an invaluable option, offering suitable investment opportunities irrespective of whether global economic growth remains rangebound, breaks out above its ceiling or reverses into recession.

Investors must determine their objectives and constraints, their economic growth projections and how they want to anticipate future developments within their asset allocation.

But as they chart their courses they need to remember that floating interest rates and direct exposure to a growing economy are chief among the strengths of Alternative Credit. By considering it together with traditional asset classes, they can find suitable strategies offering an attractive yield pick-up and characteristics that are particularly beneficial in, for example, a rising rate environment. Alternative Credit is a particularly apposite strategy for those investors who need to match their portfolios with longer-dated liabilities.

By using the right navigation tools, investors can sail in calmer waters, benefitting from the upside and suffering less from the downside as they chart their courses ahead.

Go to **www.nnip.com/int/shake-up** for more information

NN investment partners

This communication is intended for MiFID professional investors only. This communication has been prepared solely for the purpose of information and does not constitute an offer, in particular a prospectus or any invitation to treat, buy or sell any security or to participate in any trading strategy or the provision of investment services. While particular attention has been paid to the contents of this communication, no guarantee, warranty or representation, express or implied, is given to the accuracy, correctness or completeness thereof. Any information given in this communication may be subject to change or update without notice. Neither NN Investment Partners B.V., NN Investment Partners Holdings N.V. nor any other company or unit belonging to the NN Group, nor any of its directors or employees can be held directly or indirectly liable or responsible with respect to this communication. Use of the information contained in this communication is at your own risk. This communication and information contained herein must not be copied, reproduced, distributed or passed to any person other than the recipient without NN Investment Partners B.V.'s prior written consent. Investment sustains risk. Please note that the value of any investment may rise or fall and that past performance is not indicative of future results and should in no event be deemed as such. This communication is not directed at and must not be acted upon by US Persons as defined in Rule 902 of Regulation S of the United States Securities Act of 1933, and is not intended and may not be used to solicit sales of investments or subscription of securities in countries where this is prohibited by the relevant authorities or legislation. Any claims arising out of or in connection with the terms and conditions of this disclaimer are governed by Dutch law.