Private credit can be a valuable component of a diversified investment portfolio for investors who can manage its risks. (Shutterstock)

Private credit for portfolio diversification

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Private credit can offer investors diversification opportunities beyond public stocks and bonds. While private credit can provide additional income compared to other asset classes, the segment comes with unique risks that investors should consider.

Private credit markets provide a way for investors to lend money directly to non-public companies.

We continue to see a place for private credit and view direct lending strategies as a strategic source of income and diversifier of returns. The rise in companies deciding to stay private for longer rather than enter the public markets has increased the appetite for private credit financing. Nonetheless, considering the improved lending conditions in the US, we believe spreads could tighten as private credit investors and US banks compete for deals.

Despite the increased competition, new loans in the private credit market look resilient. The median private credit deal in 2023 priced at an all-in spread (the extra yield for investors over government bonds) of 600 basis points and at an all-in, unlevered yield of about 12%, according to JPMorgan data. In January 2024, the loans came with stronger investor protections including stricter documentation and prudent levels of borrowing, with median net leverage (a measure of debt to earnings) of 4.5x (a decrease from 4.9x in 2023). We believe direct lending volumes should reaccelerate in 2024, driven by increasing M&A and refinancing activity, as the rate outlook stabilizes.

Diversification is key in private credit investing. By spreading investments across various regions, sectors, issuers, companies and vintages, investors can mitigate risks and capitalize on different growth opportunities. Most importantly, high-quality management is crucial for navigating this complex market. With careful selection of managers and spreading investments across several strategies, we believe private credit can be a valuable component of a diversified investment portfolio, offering long-term income and the potential for mid- to high-single-digit returns each year.

Borrower distress and default risks exist. Risks exist, particularly on loans for companies with potentially weaker finances. We believe default rates have peaked, and our base case of a US economic soft landing is supportive of default rates stabilizing around low-to-mid-single digit levels. But a soft landing also means slower growth. And the lagged effects of higher interest rates could still fuel over-levered borrower distress and defaults. Additionally, history suggests that during economic downturns private loans tend to be more stable with fewer defaults than subordinated debt (a type of debt that is the last to be repaid), particularly for private loans that are typically senior on the capital structure (first claim on cash flow and collateral in case of a default). During the pandemic, private loan default rates peaked at 5% to 7% while US high yield bonds default rates were 10%.

Compared to public market investing, investing in private markets comes with a number of additional risks. For example:

- Private Credit offers a liquidity premium given the investor lock-up.
- Fees on private market investments may be higher than in public markets.
- The cash flows generated from these investments can be unpredictable.
- Investors give up some control over their investment in exchange for potentially higher returns.
- There may be limited information on performance compared to listed investments.
- Investors may commit money without knowing exactly what they're investing in (blind pool risk).
- Some private market strategies may use borrowed money (leverage), which can increase risk.

For more details on CIO's private markets views, please see our ***Private markets: Quarterly private markets update*** *(18 Mar 2024)*

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- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-U.S. securities and illiquid investments.
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