Private credit managers tend to favor senior secured debt that is among the most insulated from company losses. (UBS)

Should investors fear losses in private credit?

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Some investors fear private credit will see a rise in defaults and losses in 2024, as prior rate hikes weigh on company cash flows. But we think the asset class can weather trickier times, thanks to private managers' ability to choose the most resilient creditors.

We think near-term challenges warrant careful investing. Yet the long-term case for private credit as a diversifier and potential improver of a portfolio's risk-return characteristics remains intact, subject to awareness of the risks.

Some investors fear higher defaults and losses in private credit in 2024.

- Lagged effects of interest rate rises have led investors to worry that private credit assets may experience more defaults or losses.
- Rising default rates in the US syndicated loans market have led some private credit managers to use payment-in-kind interest to mitigate losses.

But manager focus on the most resilient creditors can reduce risks for investors.

- Private credit managers tend to favor senior secured debt that is among the most insulated from company losses.
- New loans offer attractive yields. The median private credit transaction in October originated at an all-in spread (additional yield over benchmark interest rates) of 600bps and a yield-to-maturity of 11.8% on an unlevered basis, according to JPMorgan.
- Many managers are focused on lending to sectors that are less sensitive to growth, generate more cash flow, and need less capital investment—cybersoftware is just one example.

So, we think long-term opportunities in private credit outweigh near-term challenges.

- We continue to see a place for private credit and direct lending strategies as a strategic source of income in well-diversified portfolios.
- Investors should consider the risks inherent to private markets before investing, including illiquidity, long lockup periods, leverage, and overconcentration.

Did you know?

- Newly originated private loan data show financial sponsors are using less debt than in 2021, while putting in more equity relative to debt in leveraged buyout transactions than at any time since 1997.
- Many private loans are provided to deals sponsored by private equity houses. The latter offer operational expertise (like global provisioning to lower portfolio companies' costs of buying materials), additional due diligence, and considerable equity to reduce debtors' risks and provide a cushion in shakier economic conditions.

Investment view

We believe existing private credit investors in well-diversified funds, run by experienced managers, should be suitably compensated in terms of yields, investor protection, and stricter terms on new loans to offset potential losses elsewhere. We continue to see a place for private credit and direct lending strategies as a strategic source of income, diversifier of returns, and potential improver of a well-diversified portfolio's long-term risk-return characteristics, subject to awareness and management of the risks.

Main contributors - Matthew Carter, Karim Cherif, Christopher Swann, Antoinette Zuidweg

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Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

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In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- 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.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
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- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer's "home" currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.