Summary

- Pension funds require less liquidity across entire portfolios, meaning they can benefit from illiquidity premiums and higher yields.
- Private debt offers a diversifier and reduces overall credit risk.
- Misconceptions persist with regards to private debt's risk-return profile.
- Although illiquid, private debt can play a long-term role in a portfolio that is de-risking due to its contractual, fixed-term nature.
- Transparency remains an issue.

Private debt - a source of diversification

Private debt as an asset class remains an important part of portfolios, despite the government-induced liquidity crisis. Georgie Lee explores

Private debt has several attractive features that make it a suitable investment for pension funds. After banks stepped back from the space following the global financial crisis, access to the asset class opened up to institutional investors, and the market has grown exceptionally ever since, with Preqin recently estimating that private debt assets under management will grow at a compound annual growth rate of 10.8 per cent between 2021 and 2027, and reach an all-time high of $2.25 trillion in 2027.

As investors started to look further afield for required income after the crash, private debt assets emerged to meet the demand.

This growth has, in part, been driven by how well it lends itself to pension schemes' investment approach. As long-term savings, pension funds require less liquidity. This means they can benefit from illiquidity premiums and higher yields.

They are also often well-positioned to absorb illiquidity risk, although premiums will be useless to those funds further along their buyout journey plans.

Experts agree that a key attraction of private debt is diversification, which in-turn reduces overall credit risk. It also has relatively low correlation with traditional growth assets resulting in risk reduction benefits.

Misconceptions

According to Hymans Robertson senior investment research consultant, Penny Cochrane, a common misconception about the asset class among investors and trustees is the degree to which fund extension risk can delay returns back to investors. "Given many of the first vintages of funds are only now approaching maturity, and extensions being considered and implemented, actual experience is only building in this area," she says.

Cochrane points out, however, that private corporate debt, or 'direct lending', is now a fairly well-established asset for defined benefit pension scheme investors.

Nevertheless, Mercer European head of private debt, Joe Abrams, cautions that investors and trustees have yet to grasp the risk and return profile.

"What we find is that if you select the right asset manager and build your portfolio appropriately, the overall level of risk is at least no higher than other forms of liquid sub-investment grade credit, with a material yield pick-up," he says.

Within the private debt universe, direct lending is the largest strategy, according to the Preqin report, with its floating rates appealing to investors. Preqin forecasts direct lending AUM to hit $1.22 trillion in the next five years – more than double the 2021 figure. Its share of AUM will increase, as it continues to outpace the growth of the broader asset class, according to the report.

Private debt is not limited to direct lending, however. "The world of private debt is now very heterogeneous, with

different geographies and focus on different parts of the capital structure, as well as other sub-asset classes such as structured credit and specialty finance, which are themselves very diverse with different risk and return profiles," says Abrams, adding that the overall market for private debt is now comparable in size to the syndicated loans universe.

Benefits

Crucially, private debt provides investors with access to a broader range of companies beyond public markets. Direct corporate lending, for example, targets firms that are typically too small to access traditional capital markets, or those that require more complex financing solutions.

"Private market debt filled the need that many pension schemes had to continue to generate a return greater than corporate bonds but in a lower risk way than investing in equities," says Cochrane.

"Private market debt provided a solution to this need as it offered more attractive returns than publicly traded corporate bonds. It provided alternative sources of return, hence spreading risk, and provided a more stable source of return due to the floating rate plus a margin return target."

Returns on private market debt are typically floating rate, plus a fixed margin, Cochrane explains, which helps protect pension funds from any erosion of the real value of returns in a rising rate environment.

Investment is typically fixed term, with a pre-defined investment period and a relatively predictable run-off profile. This is attractive for maturing defined benefit schemes with a pressing need for cashflow to pay members' benefits.

According to BNP Paribas Asset Management, while private markets cover a broad spectrum of investment options (equity, infrastructure, real estate), debt has been the most consistent performer over the past decade, increasing fundraising every year since 2011.

A spokesperson tells *Pensions Age*: "For investors that can afford to lock their money away for longer periods of time, private debt has been trumping traditional fixed-rate income and government bond yields ever since. To date, this higher yield has not come with any significantly higher corresponding losses in terms of default.

"When interest rates fell to historical lows, this attractive risk-return profile became even more so. For institutional pension schemes looking to match long-term liabilities with secure income streams, it has become a key building block in an allocation strategy that rotates private debt with other fixed-income assets."

XPS Pensions Group head of credit research, Steven Hickey, explains that while illiquid growth assets have an increasingly limited role in pension scheme portfolios, as most schemes are on a de-risking path and are reducing exposure to growth assets, private debt is in a "fairly unique position" because "although illiquid, it can play a long-term role within a portfolio that is de-risking due to its contractual, fixed-term nature," he says.

Concern points

As with any private market segment, transparency is often cited as an issue for investors, with the market remaining fairly opaque due the absence of public reporting on performance. And closed-end funds also come with blind-pool risk, highlights Cochrane.

"There is no sight on investments that will be made during the fund life at the time of commitment as opposed to open-ended funds where investors have sight on assets in the portfolio at the point of investment," she says.

Private debt managers are also generally behind the market in terms of reporting on ESG and climate metrics in their portfolios, which is a challenge for pension funds that require such information for their own reporting obligations.

Emerging trends

With a growing number of funds coming to market and investing across multiple types of private debt assets, pension funds can now obtain wide exposure to the private debt asset universe in a way that is efficient from a governance perspective.

"The wall of capital directed into the space over the last few years and the growth in the number of firms offering private debt funds has meant that competition for deals is often high, and this has subsequently led to a loosening of standards overall," says Hickey. "It's important to have a manager that maintains discipline, does not reach for yield and is willing to walk away from a deal if the price doesn't reflect the risk being taken."

The Society of Pension Professionals chair, Natalie Winterfrost, acknowledges it is difficult to discuss private debt amid the liquidity crisis that has played out of late.

"As pension values, and the associated liabilities, plummeted on gilt yield rises, illiquid holdings have become an ever-large part of shrinking portfolios," says Winterfrost. "Pension schemes have used their public market assets to meet their collateral calls and now have to rebalance and restore more liquidity by managing sales of private market assets."

So, it remains to be seen whether allocations to illiquid assets fall in the months ahead.

Written by Georgie Lee, a freelance journalist

In association with

BNP PARIBAS ASSET MANAGEMENT