Multi-asset credit comes to the fore

MULTI-ASSET PRIVATE CREDIT

LAUREN MILLS

Investors are increasingly looking at multi-asset private credit mandates for diversification and stable risk-adjusted returns

KEY POINTS

- Private credit involves much more than corporate lending, encompassing a wide range of sub asset classes
- Some investors lack the infrastructure, expertise and access to a broad range of private credit categories, making outsourcing an option
- Liquidity risk is a problem, but practitioners say there is flexibility through strategic asset allocation

It may come as a surprise that many portfolio managers ventured into private credit long before the global financial crisis when the mainstream banks were still happy to lend.

Phil Waldeck, CEO of PGIM Portfolio Advisory, says his firm has been in the private credit business for more than 40 years.

"It's an established space," he says. "But it's changing and the multi-asset part of it is emerging. Also, there are so many iterations. And I think the art of private credit is defining what the combinations [are] that fit an investor's objectives."

He adds that often people think of private credit as a small market that does direct lending to companies.

Waldeck says: "It's also real estate debt, both investment grade and below investment grade. It's infrastructure debt, it's private placement. It's securitised products, and there are sponsored versions of private credit, as well as non-sponsored. So it's a pretty broad space."

Diversification and alpha

Peter Vincent, regional head of client investment solutions for EMEA at Franklin Templeton, says the benefit of a multi-asset private credit programme lies in its ability to provide diversification and dynamic alpha across various credit asset classes, which can lead to a more stable and potentially higher risk-adjusted return.

Vincent says: "Outsourcing the asset allocation in such programmes allows investors to benefit from the expertise of specialised managers who are adept at navigating the complexities of various credit instruments and market conditions to optimise returns."

He adds that skilled managers can handle the intricacies of credit investments, such as negotiating credit documents, establishing covenant protections, assessing liens and collateral, and navigating creditor committees. "This can be particularly advantageous for investors who may lack the time or expertise to manage such a diversified credit portfolio effectively."

'Outcomes, not products'

Louay Mikdashi, head of multi-sector private credit at Neuberger Berman, which manages multi-asset private credit mandates for institutional investors, including pension funds, says: "I think many investors often don't have the real-time ability to say, you know what, I'm going to be investing in direct lending right now for my next dollar while I'm going to be investing in asset-based lending in specialty finance and some of these other [multi-asset] areas. They don't necessarily have the infrastructure or the real-time knowledge to make that allocation."

In Mikdashi's experience many investors have moved away from being focused solely on the label of the asset class. "What they want is an outcome, not a product; they want income with a higher yield set and high yield with a lower correlation [to volatile market conditions]," he says.

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>
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He adds: "If you move from label-centric, to outcome-centric, you create a lot of that flexibility, particularly in private markets, because of all these inefficiencies to deliver on an outcome that you set forth. And that's the reason why the people are engaging with us on these strategies because, even though they are reasonably simple [and] on top of the capital structure, it's really hard to do unless you have the infrastructure and the price discovery to be able to do so."

In 2019, UK master trust NEST handed a multi-asset private credit mandate to BNP Paribas Asset Management (BNPP AM) with the remit to create an open-ended diversified private-credit fund, initially consisting of exposure to infrastructure debt, commercial real estate debt, European mid-market loans, UK small and medium-sized enterprises loans and US mid-market loans (see Profiles).

The fund offers active asset allocation in evergreen form, with principal repayments and interest reinvested to provide a total return for NEST's members.

Stephen O'Neil, NEST's head of private markets, says: "I think there is always a balance to be struck between having the operational efficiency of a blended solution and the expertise that comes with outsourcing the asset allocation across multi-assets.

"And typically, in my experience, a blended solution can come at a lower fee. It can be cheaper than the sum of its parts."

Option for DC schemes

Harriet Steel, partner and head of global clients at Pemberton, a European private credit manager backed by Legal & General, believes that multi-asset private credit mandates may become increasingly popular for defined contributions (DC) schemes.

She says: "[DC schemes] want to create better investment outcomes for their end beneficiaries and private credit is a very agile asset class that has the potential to create high returns. They are typically looking for a solid, stable, income-generating solution that delivers 9% to 10% over 10 years, in a diversified way and [private credit] represents around 5% of the overall defined contribution portfolio."

Steel says that the industry must debunk the notion that private credit is not a liquid asset class and show that there is a degree of liquidity flexibility.

Vincent says structuring multi-asset credit mandates involves defining the investment universe, setting strategic asset allocation targets and establishing tactical allocation guidelines.

He adds: "The structure is designed to capitalise on a broad range of credit opportunities while managing risk through diversification and active management." It typically includes a mix of high-yield bonds, emerging market debt, bank loans, private credit and structured credit assets, with the flexibility to adjust allocations in response to market conditions and investment opportunities. The mandates are often structured as separate accounts or dedicated fund structures, with commingled funds also growing in popularity.

Vincent says: "In a multi-asset private credit mandate, clients expect managers to actively select and manage investments across various credit instruments, monitor and adjust the portfolio in response to market changes, and achieve targeted

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returns. He explains that managers have to conduct credit analysis, structure credit agreements, execute strategic sector rotation, and maintain portfolio diversification to manage risk and capitalise on market inefficiencies.

Clients expect managers to have a deep understanding of various credit markets and to use this expertise to construct a portfolio that can navigate through different market cycles, says Vincent, adding: "Additionally, clients look for managers who can provide transparent reporting and clear communication about the strategies employed and the performance of the investments."

Liquidity risk

Liquidity risk in multi-asset credit mandates is a critical consideration, as it can affect the ability to meet redemption requests and impact returns.

Vincent says: "Managers must balance the trade-off between higher yields from less liquid assets and the need for sufficient liquidity to operate effectively. Effective liquidity management involves understanding the liquidity profile of investments relative to the potential liquidity needs of the mandate, ensuring that the portfolio can respond to market stress without adversely affecting investor returns."

O'Neil at NEST says that although the question of the availability of cash is a classic liquidity risk, the illiquidity of the underlying assets as well as subjective pricing in a volatile market must also be considered.

He says: "Even if you don't need to worry about cash, you still need to worry about the valuation mismatch and so we will always have a constraint on our repeated illiquidity appetite, driven by the confidence on member level valuations, more so than being able to take money in and pay money [out]."

Risk appetite

Vincent believes the popularity of multi-asset credit programmes should increase, "given their potential to facilitate a holistic exposure to complex credit markets".

He says: "Investors can gain internal efficiencies and potentially improve risk-adjusted returns by engaging multi-asset credit specialists to implement some or all of their credit exposure."

It requires significant resourcing, talent and expertise to navigate private credit markets, which not all investors have the capacity to do, and Vincent emphasises that private credit mandates can access a broader range of credit opportunities that may not be available in public markets.

"The decision to adopt such programmes depends on an investor's risk appetite, investment goals and internal resources and talent."