Lead Left Interview – Stephen Nesbitt (Part 2)

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This week we continue our conversation with Stephen Nesbitt, Chief Executive Officer of Cliffwater LLC. Cliffwater is one of the largest alternatives advisory firms, assisting clients globally in their allocations to hedge funds, private equity and real assets. ***Second of two parts –*** ***View part one***

The Lead Left: What's the outlook for fixed income in this rising rate environment?

Stephen Nesbitt: In very simple terms, as we look at the world it's been a bull market for bonds for more than thirty years. If you look at the level of interest rates, the risk-free rate, that trend is probably over. You won't make big bucks by being long on rates.

Second, if you look at public equities, who knows where the stock market is going? It certainly looks fairly valued at the moment. With stocks, you should be able to get inflation plus 5%. So that gets you 7%, but with a lot of volatility. Up until now, the government has been a risk mitigator. We're not sure that's going to be the case going into the future.

TLL: Contrast that to direct lending or private credit opportunities?

SN: Private credit spreads have gone up and down over the last 35 years, correlated with the business cycle. We've been in the 7th or 8th inning of a recovery phase for the past five years now. But lending embodies on one of the most important elements for returns, which is alpha.

Generating alpha is about having the right manager. There are good and bad ones. The better managers have better underwriting skills and sourcing capabilities. In direct lending, you're not taking rate risk; and duration doesn't affect us. You're also not betting on equity gains, as you would be with warrants associated with mezzanine. As an investor we expect to pick up spread and manager alpha.

Finally, liquidity is an important difference between direct lending and broadly syndicated loans. Most direct lending assets are private, so investors get a 1.5% incremental return as a liquidity premium.

TLL: That's a good point to turn to our Chart of the Week. Compare for us direct lending returns with high yield.

SN: You can see there the spread between the two asset classes, both the size and volatility of the spread. We attribute the size of the spread to two things. First, the 1.5% liquidity premium. The second is the size effect. With larger deals, all the underwriting work can be done off a Bloomberg. That's true of high yield as well. For direct lending, there's a direct contract between the borrower and the lender. These are private securities. The monitoring and lack of tradability for alternative private deals means less volatility. We measure that premium quarterly. Being able to negotiate directly with the company can be worth a lot, often 2-3% more. That higher spread cannot be arbed from a trading platform.

The chart shows our performance index plus the yield calculations of the underlying unleveraged assets. The yield, in this case, equals the current interest income divided by the total amount of NAV.

TLL: Don't the yields of BDC assets reflect higher risk than average senior middle market loan?

SN: BDCs are just a vehicle. We're interested in the underlying assets, the performance of the "engine." Our index captures the assets driving all BDCs, both public and private. It doesn't measure manager performance; just the asset. Some managers operate in more senior securities, some junior, some both. Direct lending yield can differ as much as 5% depending on where you operate. Our index captures all of them as one.

Some managers may opt to leverage their vehicles depending on investor preference. When we report yield, we report everything together. The lower the yield, the more senior the securities.

TLL: Steve, how do you account for credit losses?

SN: There's a long history, including Moody's and S&P data, of high yield and broadly syndicated default rates and losses. Yields are pretty transparent. The interesting question is: higher yields on loans are great, but what about higher losses? The data we collect gives us an ability to calculate credit losses period to period. We report realized and unrealized losses compared to more traded credit.

Our finding is that direct lending has roughly the same loss rates as broadly syndicated loans and less than high yield. We've captured all the data from 2004, including before the Great Recession. Over this 12-year period we found loan losses average 1% per year, while high yield is 1.5%. So for direct lending, you take the 10% Index yield minus 1% losses gets you 9%. If you assume fees of 1-2% that leaves you with a net yield of 7%. Compare that to the 7% return we established earlier for equities with a fraction of the volatility.

TLL: Compare that to high yield.

SN: With high yield, the Index return of 6% minus 1.5% losses gives you a net 4.5%. Assuming 0.5% fees and expenses, nets a 4% return. Compare that to the 7% for loans, and you're realizing a spread of 3% in favor of loans.

Now compare direct lending to broadly syndicated loans. The latter has a current yield of 5% with 1% losses, giving you a 4% return. Subtract the same 0.5% for fees and expenses results in a 3.5% net yield.

Now some direct lending managers are better than others. If you can achieve 25-50bp of losses, instead of 1% annually, that could be worth and additional 0.5% of yield. That pushes you closer to a 7.5%, or even 8% net return.

Contact: Stephen Nesbitt
snesbitt@cliffwater.com