High Yield Bonds and Private Credit (Second of Two Parts)

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“Time to go to cash,” we announced one night at the dinner table. It was early June. The Dow had nearly climbed back to its February 12 peak. The moment seemed ripe for a personal portfolio move. “What does *that* mean?” our six-year old daughter asked. “It means Daddy wants to put our money in a mattress,” her mother replied.

Granted, interest rates were in the lowest decibel range. But loss of principal was more on our mind than yield. More pressing matters – like whether to give our ten-year old a cell phone for her elementary school graduation (we did) – intervened, and the reallocation opportunity was lost. Last week equities swooned on fears of a second COVID wave.

Being held hostage to headlines is one of the big worries associated with liquid assets. Yes, you can ride the momentum wave up on good news, but bad news sends the roller coaster right back down. Even credit related assets, as we’ve described in our bond series [link], can be hijacked by technicals such as fund flows and Fed moves.

For almost a decade before the Great Recession, leveraged loans and public equities showed little correlation – around 20%. Loans and high-yield were somewhat more correlated at 60%. By June 2009, correlation increased dramatically, to 40% and 80%, respectively, per LSTA/S&P LCD data.

When the world plunged off the precipice after Lehman, asset values fell in unison, with investors seeing no safe harbor. That dynamic was sustained for years, in part due to the globalization of asset management, in part the velocity of volatility.

The search for an antidote led to private credit. There the assets were owned privately, didn’t trade, and were valued on fundamentals. Direct lending portfolios behaved as expected through the GFC, with defaults and recoveries better than liquid loans.

As our *Chart of the Week* shows, middle market debt was modestly correlated to junk bonds and leveraged loans over the past decade, even less correlated to equities, and uncorrelated to investment grade bonds. While the current crisis is still early days, private credit flow is driven, not by technicals, but by PE dry powder and investor appetite.

Valuations of middle market loans is a topic for another day, but unlike BSL prices they don’t swing with market moves. While correlation is a key factor in comparing asset classes, investors look closely at fundamental attributes such as risk, returns, and consistent performance. That makes MMLs increasingly prized in a diversified investment portfolio.

As COVID-19 marches through the country, the markets and the economy, offering a measure of stability against the backdrop of relentless volatility, and premium returns over time, are good things.