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Why Portfolio Construction Matters (Second of a Series)

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“What’s the key portfolio strategy managers should employ for success?”

“Diversify!” That’s how one top PM answered our question. There are many levels and measures of diversity. You don’t want to be stuck with large exposures in any one industry, no matter how resilient it may seem.

Healthcare, 20% of the US economy, is a broad category with multiple sub-sectors. But as investors discovered in 2020 (and during various times in the past decade), issues such as regulatory overhang associated reimbursement risk can be tricky to navigate or predict.

The good news is that the middle market tends to be “nichey.” The best portfolio companies are leaders in smaller, specialized arenas. That makes them hard to categorize in traditional industry groups. Where, for example, would you put a commercial landscaping company? Is it business services? Housing? Hair salons?

Outsized commitments can create challenges if they become problem loans. Even small losses can negatively impact returns. Yet we see lenders taking larger holds, especially in unitranche financings. We’ll see if that changes ahead of a slowing economy.

In a risk-off world, credit managers with up-and-down the balance sheet solutions can position further up the capital structure to more senior, secured, floating rate debt.

A further element of diversification is based on Ebitda dispersion. Definitionally, the traditional middle market covers $10-50 million, but can also move into the $50-100 million range with covenants. That provides a nice size mix to take advantage of different spreads and credit agreement terms. It also helps to balance out by company size.

Finally, diversifying by leverage attachment points creates a healthier risk profile. Senior debt managers can over time adjust debt-to-equity ratios with a mix of regular way senior, stretch senior and unitranche. This also creates attractive weighted average spreads.

What’s our PM’s top secret to sound portfolio management? “Discipline!” Stick to strategies that have worked over time and match your investing culture. Don’t drift into areas where your team has no expertise, no matter how tempting the yields or volume may be.

Next week: We look at how private credit managers use private equity to diversify portfolios.