Private Credit – Why Now? (Second of a Series)

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Last Tuesday the winner of the largest Powerball jackpot winner in history – $2.04 billion – was announced (but not yet identified) by the California Lottery. A gas station in Altadena, just north of Pasadena, sold the ticket (10-33-41-47-56). The lucky recipient can elect a lump sum of $1 billion or be paid in installments over thirty years. I'll take the cash, your honor.

It's rare (actually, one-in-292.2 million) when timing in portfolio management works to that kind of perfection. Studies have shown that most investors pull money out of markets precisely when they should be putting more in. Fear is a powerful motivator.

A recent WSJ article highlighted the challenges retirees are facing with just such circumstances. As we've noted previously public equities and fixed income have been correlated like no other time. This has resulted in an extraordinary downdraft in all liquid asset prices. "Everything on the statement is blood red," said one investor.

The 60/40 allocation model is reinforcing negative asset performance rather than mitigate it. As our Chart of the Week shows, bonds typically provide income producing cushions during bear stock markets. Until now. Not since 1801 have Treasurys taken such a hit in values. Liquid strategies are proving to be no safe havens.

Part of the attraction of alternatives is their lack of correlation to equities and bonds. Yet at this moment some high-yield bond and loan trades appear compelling. Why not take advantage of these one-time opportunities? It's one thing for experienced CLO managers to sift through heavily discounted secondary deals. But it's very different if you don't understand the risks.

Another key attribute of private credit is its ability to generate consistent returns over long periods of time. Since the GFC institutional investors, particularly those with stakeholders such as pensioners who seek guaranteed income, appreciate the stability of private credit returns.

For most of the past decade – largely a zero risk-free rate environment – senior direct debt has comfortably yielded 6-7%. Amid today's volatile world, with capital a precious commodity, high-yield projects appear. But once the Fed begins to taper (and eventually concludes) rate hikes, markets will return to more normality and those opportunities will fade.

Buying private credit now, or adding to an existing position, further insulates portfolios against future price shocks. If the electricity goes out in a winter storm you can get the fireplace going and break out the woolen blankets. But buying a generator, if you don't already own one, is a pretty good alternative.