INVESTMENT

What is alternative in credit?

Alison Swonnell looks at the expansion of the credit sector and particularly the growth of private-debt investment

WRITTEN BY ALISON SWONNELL DIRECTOR OF FUND OPERATIONS, LCM PARTNERS

LCM Partners was honoured to win European Pensions' Alternatives Manager of the Year award for 2017. As a credit manager we expect to be the 'boring' part of a pension fund's allocation and, to be frank, after almost 20 years investing in consumer and SME receivables we were quite happy with that description. But in today's world of uncertainty, 'boring' is now officially 'interesting', even within the alternatives spectrum, and of course we could not agree more.

In recent years credit has had one of the largest asset class shake ups: whilst equity is still 'stock', real estate still 'bricks and mortar', and absolute return may or may not be absolute (or even return) depending on your manager selection, credit is definitely no longer represented just by fixed-income funds. The spectrum of credit investing for institutional investors has widened more than for any other asset class. This is in part due to the fallout of the financial crisis 10 years ago, which firmly put the spotlight on data transparency down to the loan level. With a proper understanding of the risk/return expectation of underlying credits new investment possibilities emerged.

The opening up of new markets and the evolution of asset classes within the private-debt arena means that today we have direct lending, mezzanine, consumer, special sits, distressed and many other forms of associated jargon to choose from. However, one unifying factor of many of these products is that they provide wholesale access to the underlying loans and their income. Receiving higher returns by stripping out the costs related to intermediary banks or financial structures, whilst accessing the same underlying investments directly, has created an interesting juxtaposition: with rates at an all-time low, credit becomes the alternative and alternative credit becomes the mainstream.

One thing that is clear is that providing access to credit in wholesale form can only be advantageous for institutional investors. Put simply, private debt is non-publicly traded debt. It has the same intrinsic values of publicly-traded debt, but it comes in its wholesale, reduced cost, form. What was once the preserve of prop desks at investment banks is now accessible to pension funds via holdings in alternative investment funds. Furthermore, whereas private-market funds used to define the search for alpha through private equity or the more speculative ends of the real estate or infrastructure markets, alternative funds can now play a valuable role in making actuarial progress against pension scheme liabilities. Pension schemes have broadened what they are looking for and the search for yield now officially encompasses alternative credit.

The credits themselves may range from corporate debt (companies of all shapes and sizes) down to consumer debt (individuals) and anything in between. However, the universal advantage to all forms of credit is the level of running cash generation from the assets. This partly mitigates one of the downsides of investing in private debt, which is usually offered in closed-ended structures: the underlying assets are liquid, and whilst the fund structures may not be tradeable, the predictable cashflows can help pension funds match their liabilities and naturally amortise their exposures. For example, investing in consumer and SME loan portfolios allows LCM Partners to return all capital typically within 36 – 48 months; the investments start

returning cash from day one after purchase.

So if most private-debt strategies are buying assets similar to those contained in fixed-income funds is the illiquidity premium of investing in private-debt structures justified? Unsurprisingly we would argue 'yes', and indeed we think the case is compelling.

The comparable levels of volatility in the table above highlights the point that the indices are composed of funds investing in similar underlying assets, meaning that their risk characteristics are quite evenly matched. So why are the returns so much higher when the investable assets are the same? Buying whole loans directly in a wholesale format versus wrapped credits in a retail/ intermediated format, like a securitisation, strips out many of the layers of cost. These costs can be significant and arguably provide no additional benefit or protection to an institutional investor and certainly offer less transparency. This means that there are greater cashflows available to send back to the investor, delivering higher IRRs and money multiples.

Performance table	Return	Volatility	Sharpe Ratio
LCM Partners	12.8%	2.6%	4.9
Barclays US High Yield	4.5%	6.3%	0.7
Barclays Europe High Yield	4.7%	3.6%	1.4
Barclays US ABS	1.7%	1.3%	1.5
Barclays Europe ABS	0.3%	2.3%	0.2
S&P Leveraged Loan 100	2.5%	3.7%	0.7

Returns data end June 2014-end June 2017 *Source: LCM Partners*

Another advantage, which may be less obvious, is that the investment manager who buys the portfolio of whole loans also has complete control over the performance of the underlying receivables. Stripping out layers of cost also strips out layers of administration, leaving the purchaser (owner) and the borrower (obligor). The simplicity of this relationship enables the owner to be directly involved in portfolio management in a way that a desktop trader who is a number of steps removed from the obligor can never be. In LCM's case we manage the portfolio and our sister servicing company, Link Financial, has the direct relationship with the customer, administering all aspects of the loans and payments. LCM Partners therefore has line of sight over portfolio performance down to the lowest level of granularity. Loan by loan level, static pool data built up over nearly 20 years also enables a level of precision in underwriting that ABS and high-yield funds cannot mirror. We are able track all cashflows in real time on a daily basis against the original business plan made at the point of investment.

For trustees considering investing in private debt there are clearly many benefits, not least the diversity of the alternatives credit spectrum and the growth in the number of investment managers building track records in this space. However, with the diversity also comes the idiosyncrasies of the products and the operations, the detailed understanding of which, we would argue, is one of the greatest risks that trustee boards must overcome when analysing alternative credits. Analysing what is being bought and stress-testing performance requires trustees to identify managers who are both transparent and data rich. The first point being attitudinal, i.e. finding a manager who is willing to share the detail behind the returns, and the second point being related to longevity i.e. track record. Attitudinal considerations are usually relatively easy to overcome, particularly with so many managers in fundraising mode. Length of track record, however, particularly in a sector that for many investment managers is still emerging, is more difficult and binary – you either have a track record that goes back many years buying these wholesale credits or you don't. Equipped with this data, pension schemes can be more confident in their fund selection process and in their ability to identify alternative-credit managers who can perform across all economic cycles.

To conclude, consistency of performance and preservation of capital, more often associated with fixed-income funds, combined with superior returns and strong yields has made private debt one of the fastest growing areas of institutional investor demand globally. The investment case is compelling and investment managers are finding ever more alternatives to generate returns from credit. As an investment manager who has been active in this sector for a long time, one of our common challenges is in explaining to those who are used to investing in fixed-income funds, the similarity of the risk profile juxtaposed against much higher returns – we admit it is a nice problem to have and it is what makes this not such a 'boring' alternative after all. ■

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