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Asset Mgmt Execs Warn of 'Accidents Ahead' with Private Credit

The hype around private credit is reaching peak levels – but some managers are questioning whether the asset class makes as much sense for investors in the current market environment .

By Bridget Hickey, Justin Mitchell | March 25, 2024

Private credit is having a moment. Years of low interest rates saw investors flock to the asset class to search for yield in a barren landscape for the public markets.

Managers have been scrambling to cash in on the strategy's higher fees by expanding their own capabilities or buying up smaller private credit shops. However, some asset management executives are questioning whether a bet on private credit makes sense for investors right now.

"The equation just doesn't add up for us," said James Smigiel, chief investment officer at SEI's investment management unit, where he oversees traditional and alternative investment offerings. SEI does not sell standalone private credit products, though it does offer exposure as part of a broader private asset strategy. In general, the firm prefers structured credit, Smigiel said.

Expected returns in the low-to-mid teens don't justify the liquidity constraints or the time it takes to get allocations fully invested, especially when other asset classes can offer similar return profiles, Smigiel said.

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>
> **Katie Koch**
> TCW

"What we have in private credit today is... a fairly substantial supply and demand imbalance – there's a lot of demand from the investor community and the amount of loans available in the marketplace have not kept up," he said.

That imbalance will lead to lower spreads – and lower returns, Smigiel added.

Other issues with the asset class include a lack of pricing transparency and limited diversification in the companies that investors can hold, he said.

Early investors in private credit, like endowments and foundations, have been rewarded for their exposure to the asset class.

However, "it just wouldn't surprise us to see even those client bases start to rotate out," Smigiel said. "Just because you have the illiquidity budget doesn't mean you have to burn it on something that really isn't offering you that attractive risk and return profile relative to what else you could be investing in."

Appetite for the asset class remains high but has dropped slightly, according to research from Nuveen.

Just over forty percent of investors plan to increase their allocation to private credit over the next two years compared to 47% the previous year, according to a survey of 800 global institutional investment decision-makers conducted between October and November.

Private credit managers have been marketing to corporate pensions, but the investment thesis for these asset owners doesn't usually add up, said Gary Veerman, head of liability-driven investment, or LDI, solutions at Capital Group. The firm does not have private credit capabilities.

Corporate pensions focused on LDI have two main kinds of risk they need to measure to meet their obligations – interest rate risk and credit spread risk – and the way they ordinarily measure that is with assets that mark to market, Veerman said.

Private credit assets, on the other hand, are not marked to market, and therefore could leave investors without a clear idea of whether they have adequate assets to match their liabilities.

"I would actually argue it compromises the integrity of the goal of the LDI portfolio," he said. "You're actually moving away from that primary objective on the hedging side."

Moreover, the asset class is still new, having debuted mostly in the aftermath of the 2008 global financial crisis, so investors have not seen how it reacts after a full market cycle, Veerman added.

In the new higher interest rate market environment, private and public pensions alike can get improved yields from 10-year Treasury bonds and investment-grade corporate debt, and these investments are nowhere near as risky, Veerman added.

Pensions need to ask themselves whether, in this environment, private credit really does "move the needle" on returns or provide actual diversification, Veerman said.

"Not only can they get healthier returns in these more traditional liquid asset classes that I think have been tested time and time again, ... [but] if you partner with the right manager, you want to be comfortable that not only does the asset allocation do what it's supposed to do in these periods of stress, [and] that you're not adding managers that add systematic risks that are already working against you," he said.

TCW, which has offered private credit strategies for 20 years, is also skeptical about the asset class. The firm's CEO, Katie Koch, predicts "accidents ahead" for private credit due to covenant-lite loans made over the last decade. These loans tend to place fewer restrictions on borrowers and result in more risk for lenders.

"Something that I have learned in my 20 years of investing is that we do all get to be geniuses when rates are zero and money is free," said Koch at the ALTSLA conference in mid-March. "We are going to see some things break because generally, bad loans are made during good times."

However, TCW continues to view the asset class as an "incredibly important" source of financing, Koch added.

The firm sees a "massive opportunity" in rescue lending – a private credit strategy providing financing to distressed companies – because private equity firms may struggle to back all their companies in a slower capital-raising environment.