INVESTMENT MANAGEMENT UNIT

The private credit challenge.

Could your portfolio benefit from structured credit?

Private credit—also referred to as private debt—may not be the elixir for low interest rates that it once was. As dry powder has accumulated in private debt, investors may want to consider other options.

Structured credit is a compelling complement or alternative as it offers liquidity, transparency, potential downside protection, and a similar return profile.

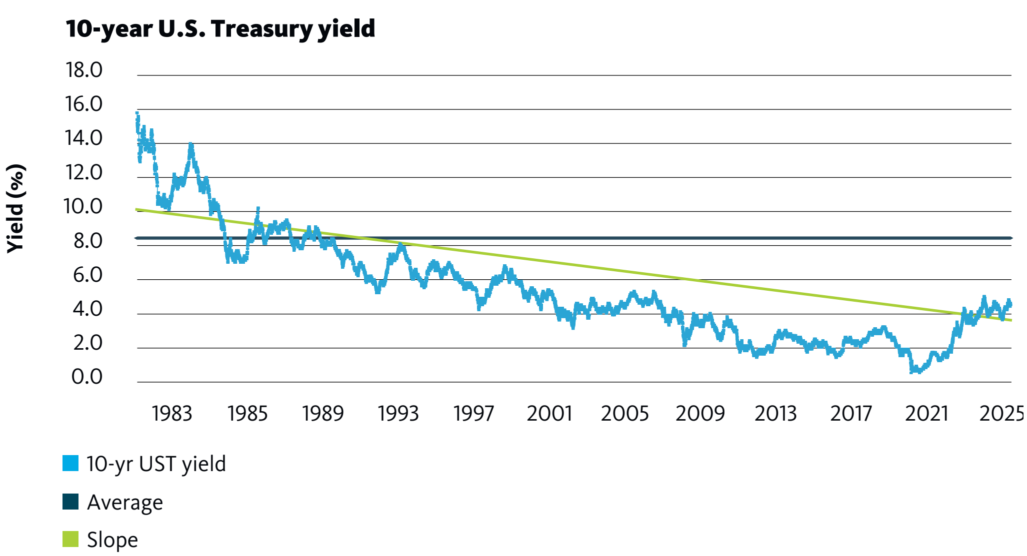
The changing private credit landscape.

A basic supply and demand problem. The interest rate environment has shifted over the past two years.

From September 1981 through mid-2020, capital markets enjoyed a 40-year downward trend in interest rates. Interest rates were so low that investors struggled to source yield for their portfolios. Now that the 10-year Treasury yield has broken above its 40-year trend (shown in the uptick in Exhibit 1), investors are rethinking their fixed-income exposure.

While the 10-year Treasury yield had hovered around 2% since 2013, assets allocated to private credit increased 14% per annum to $1.6 trillion today as investors sought and found yield in private credit.[1] A strong environment for buyouts resulted in a healthy supply of private borrowers to lend to, while liquidity-constrained banks retrenched, leaving more room for private credit to lend.

Exhibit 1: Yields are on the up and up

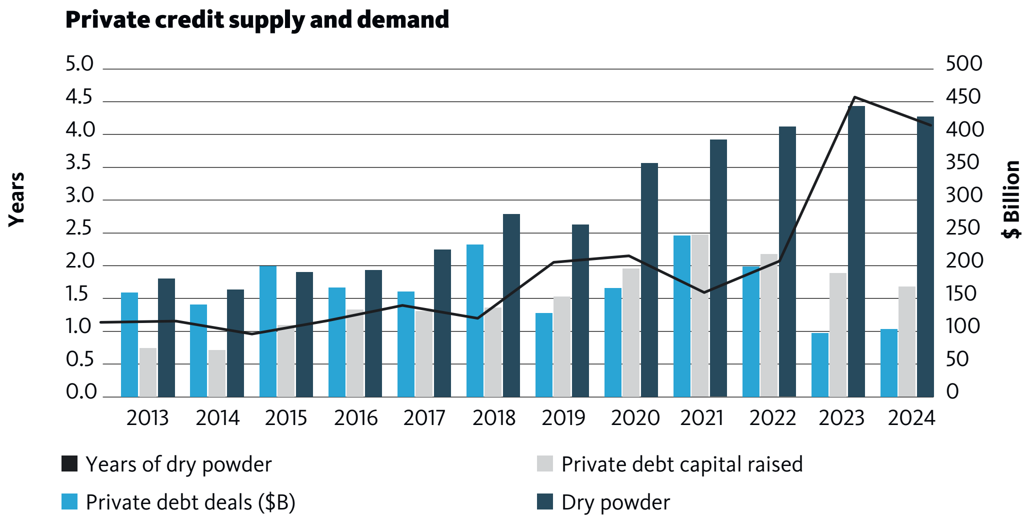


Source: Macrotrends. Data as of February 2025.

[1] Kat Hidalgo, "Private Market Investors Plan Bigger Stake in Private Credit," Bloomberg, December 10, 2023.

However, in 2023, as buyouts slowed, the increase in dry powder (capital committed to private credit funds) accelerated. Back in 2021, there were 1,496 private loans issued valued at $248 billion. In 2024, the number of privately issued loans totaled at 909 for $104 billion in value, marking the third consecutive year substantially below 2021 levels. At the same time, dry powder remains elevated at $431 billion as investor demand materially outstripped private loan issuance/supply. The ratio of dry powder to deal value in 2024 suggested it would take 4.1 years to deploy committed capital at the current rate of deal execution, only slightly below the year-ago level of 4.6. For comparison, this same ratio averaged 1.5 in the prior 10 years.[2]

Exhibit 2: Too much capital chasing too few goods (loans)



Source: Preqin, SEI. As of December 2024.

Despite demand for private credit materially outstripping the supply of private credit issuance, investors allocated another $190 billion to private credit managers in 2023 and $169 billion in 2024, and that continues today. Recall that in economics, prices go up when demand exceeds supply, and in credit, when prices go up, yields and spreads contract. In the case of private credit, the pricing mechanism is a combination of the spread over the risk-free rate as well as the lender's underwriting standards. Tighter spreads and looser underwriting standards are resulting in a competitive race to the bottom. If private credit managers did maintain strong lending standards and 'price' discipline, it would take even longer for investors to achieve target exposure levels. Institutional investors tell us that despite sizable commitments to private credit funds, they have not received capital calls fast enough to achieve their private credit exposure targets.

[2] Preqin and SEI research.

Understanding the alternatives.

Structured credit versus private debt. As with any fixed-income instrument, collateralized loan obligations (CLOs) and private credit are subject to several risks.

This includes but is not limited to credit risk, prepayment risk, and reinvestment risk (please see the important information section for further discussion of CLO risks). Nevertheless, anyone considering a new private credit allocation may want to consider a structured credit strategy that invests in CLOs, either instead of or as a complement to private credit. Structured credit behaves similarly—like private credit, floating rates are the norm in structured credit which helps protect investors in a rising rate environment—but has several decisive advantages relative to private credit.

Better liquidity

Unlike private credit, structured credit trades in a relatively liquid secondary market. An allocation to a structured credit manager means minimal latency to achieving target exposure levels. In contrast, an allocation to a private credit fund and its drawdown structure means it may take years before an investor meets their target exposure. As Exhibit 2 suggests, there is enough dry powder to cover four-years' worth of private debt deals, so a fresh allocation would join a very large stockpile. Allocators looking to put their precious assets to work right away may favor structured credit's availability.

Private credit is wholly owned, generally not syndicated, and trades by appointment, if at all. There is no formal secondary market, so unwinding an investment means finding a buyer, paying a transaction fee, and taking a liquidity haircut. The secondary market for CLOs is deep and liquid with minimal transaction costs.

A CLO, once formed, generally has a reinvestment period of four years when the CLO manager can rotate in and out of loan portfolio holdings opportunistically. They can use principal and interest payments to purchase higher-quality loans that may have fallen too far with market stress or sell loans in the secondary market when excess capital chases prices too high. Examples of this were prevalent in 2024 as holders of CLO notes were frequently able to sell on the secondary market at premiums to par, something that does not happen with private loans. Secondary market volatility can provide better portfolio optimization opportunities for structured credit managers than for managers of private credit funds with little to no secondary market.

Increased transparency

Put simply, investors favor transparency. The vast majority of the CLO market is comprised of broadly syndicated loans (BSL) and many of these companies issue financials that are made available to the public. These companies all have credit ratings from the likes of respected ratings firms, i.e., Moody's and S&P Global. Moreover, rating agencies provide ratings for the various CLO tranches. Private credit tends to lend to smaller companies and investors are beholden to what the manager chooses to share about the private borrower. Conversely, a structured credit investment supplies superior transparency by way of its credit rating and public financials.

Underwriting consistency

Some private credit managers arguably conduct better underwriting compared to banks who make money on volumes—get the deal on the tape and sell it off to someone else like they did with sub-prime residential mortgage-backed securities (RMBS). There is much more dispersion in private credit underwriting quality. While the best funds do generally reliable underwriting, underwriting standards and covenants have loosened as more private credit managers compete with banks (on the upper end) and each other for deals. In the last five years, 1,400 private debt funds have been raised versus 600 funds raised over the five-year period ending in 2013.[3] The flood of entrants invited a mentality of "raise as much capital and deploy it as fast as possible." The pace of deploying capital has slowed and the stockpile of capital is growing. As banks begin to lend again and compete with the slew of new private credit entrants, it could lead to more defaults and fewer investor-friendly deals in a "race to the bottom" according to a report from Moody's Investor Services in October 2023.[4] Investors need to keenly vet private credit managers to find those that demonstrate consistently high underwriting standards.

Downside structural risk mitigation

Private credit managers call capital loan by loan. Often, in the upper-middle market where the multi-billion-dollar funds play due to their size, many loans are structured as uni-tranche deals.[5] These uni-tranche deals are newer, have not been fully tested by the bankruptcy courts, and may prove to be less investor-friendly after the dust settles. Further, a portfolio of directly originated loans has no structural subordination, meaning that if any loan in the private credit portfolio defaults, the investor returns will be negatively impacted.

In structured credit, securitization adds a layer of structural risk mitigation. First, a CLO is a collection of hundreds of bank loans across many industries, so there is a high level of diversification. These are not the collateralized debt obligation (CDO) at the center of the 2008 global financial crisis (GFC), which were concentrated in only one industry exposure, sub-prime residential real estate. Rather, CLOs represent much broader sector exposure. Second, a CLO has multiple tranches, so investors can curate their investment to fit their risk-reward profile. Third, for higher-rated tranches, investors are buffered from the idiosyncratic risk of a single loan defaulting as those losses are first absorbed by the equity and junior tranches. During periods of market stress when default rates are elevated, higher-rated tranches are paid coupons and principal in full before lower tranches are paid. Investors in higher-rated tranches are structurally protected from a baseline level of defaults.

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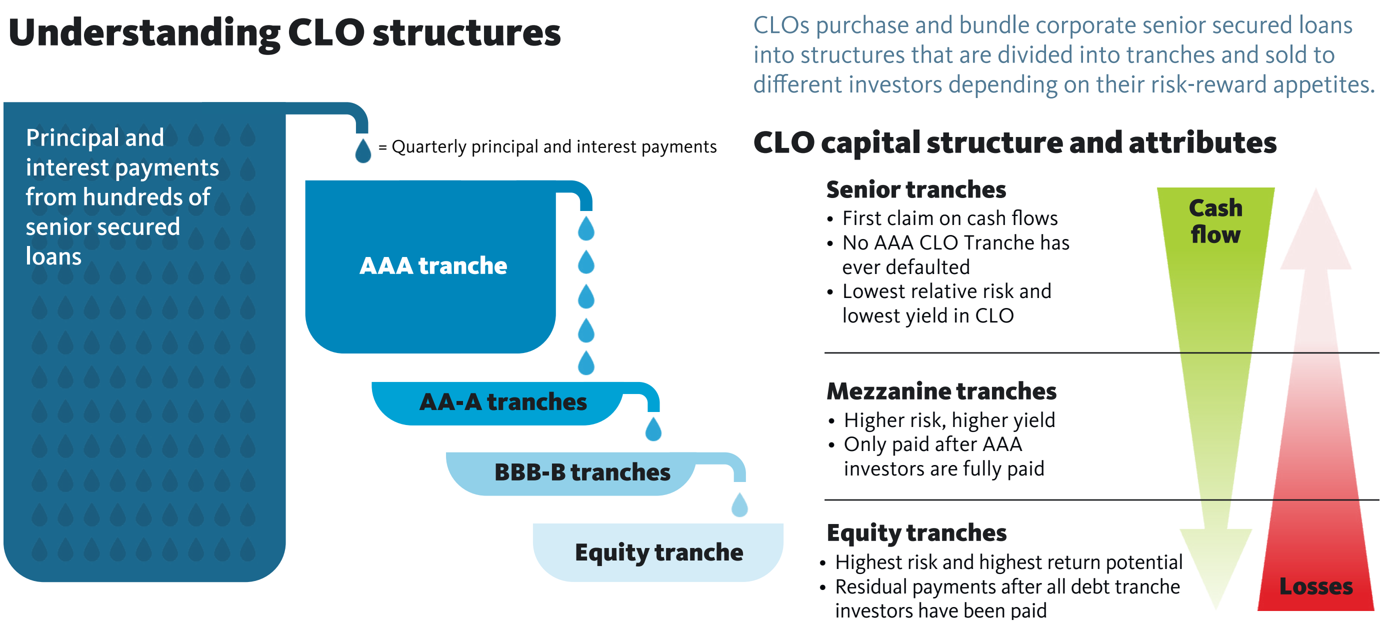
[3] Preqin and SEI research.

[4] Paula Seligson, "Private Credit Lenders Giving Up Protections to Win Bigger Deals," Bloomberg, October 26, 2023.

[5] A hybrid loan structure that combines senior and subordinated debt into one debt instrument. The borrower of this type of loan pays a blended interest rate that falls between the rate of the senior debt and subordinated debt.

In fact, over the last 30 years (1993-2022), only 1.3% of BBB-rated U.S. CLO tranches suffered any impairments, and just 3.6% of BBs had any impairments.[6] The equity tranche is the most volatile, but an active fund manager can pick and choose when to invest in the equity tranche based on market pricing (e.g., Is the market providing sufficient reward for the risk assumed?). Exhibit 3 illustrates how CLOs are structured—specifically, how each layer or "tranche" offers a different risk-reward profile.

Exhibit 3: Layers of protection



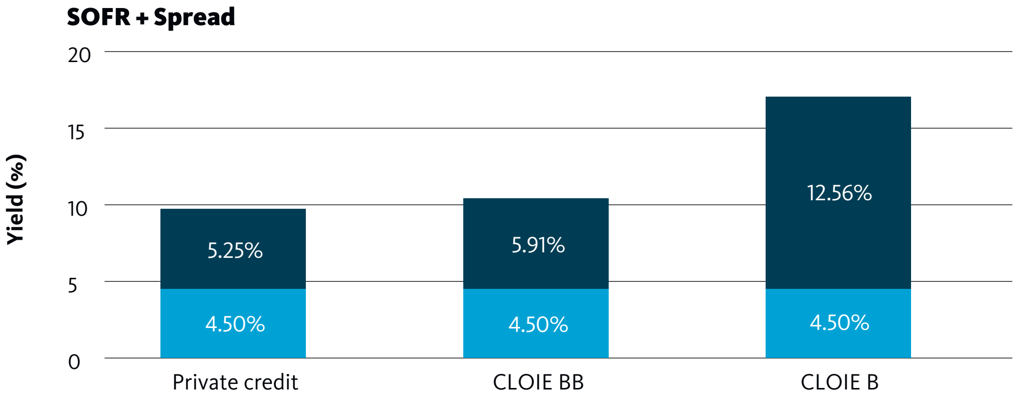
As of December 31, 2024.
Source: SEI research, S&P.

[6] Pratik K. Gupta, Chris Flanagan, and Victoria Xu, "What is worth? BB don't hurt me," BofA Global Research, BofA Securities, January 19, 2024.

Similar return potential

We have discussed the downside risk mitigations, better liquidity, and transparency benefits of structured credit. What's more, we believe the potential returns from an actively managed portfolio of CLO debt and equity are on par with those of private credit. Yields at the end of December 2024 for new private credit loans, as reported by JP Morgan, averaged secured overnight financing rate (SOFR 4.5%) + 5.25% or about 9.75%. The CLO BB tranche of the JP Morgan CLOIE index at the end of December 2024 had an average coupon of SOFR + 5.91% or 10.41% and the CLO B coupons were SOFR + 12.56% or 17.06%. Just as yields look similar across these assets, historical returns do as well.

Exhibit 4: Mirror, mirror



Source: SEI Research, JP Morgan. Private credit is the average coupon of deals tracked by JP Morgan since January 2022. CLOIE yields are as of 12/31/24.

Private credit appears to be less volatile, but that is due to a lack of daily mark-to-market. In reality, the CLO and CDLI indexes demonstrate an 86% correlation and behave very similarly. The volatility of the CLO index is more of a measure of the price of liquidity. For liquidity suppliers (buyers during periods of stress) the supply-demand imbalance creates an interesting contractual upside. Unlike stocks, fixed-income instruments are contractual obligations. For CLOs, defaults need to rise above GFC levels for senior tranches to lose what they are contractually owed. In return for assuming the risk that default rates remain below levels reached during the GFC, senior tranche CLO investors can earn yields that exceed investment policy statement return objectives. CLO securitization not only helps to diversify idiosyncratic risk, but senior tranches also earn attractive yields despite a structure that mitigates a historically high level of defaults.

Structured credit now, or private credit in five years?

As investors ourselves, we certainly understand the appeal of private credit for institutional investors when done carefully and when taking into consideration each manager's unique value proposition.

Still, an investment in structured credit carries much of the same appeal as investments in private credit, but without the burden of five years of dry powder commitments sitting in cash waiting to be called. With that said, the question becomes: Do you want to invest in private credit half a decade from now, or invest in structured credit today?

Have questions or want to learn more about structured credit?

Few in the industry compare to us. Visit us online or scan the QR code to contact us for more information on our alternative investment capabilities.

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There are risks involved with investing, including loss of principal. Collateralized loan obligations (CLOs) and other structured finance securities may present risks similar to those of the other types of debt obligations and, in fact, such risks may be of greater significance in the case of CLO and other structured finance securities. In addition to the general risks associated with investing in debt securities, CLO securities carry additional risks, including: (1) the possibility that distributions from collateral assets will not be adequate to make interest or other payments; (2) the quality of the collateral may decline in value or default; (3) CLO equity and junior debt tranches will likely be subordinate in right of payment to other senior classes of CLO debt; and (4) the complex structure of a particular security may not be fully understood at the time of investment and may produce disputes with the issuer or unexpected investment results.

CLOs are subject to liquidity risk. CLOs may invest in securities that are subject to legal or other restrictions on transfer or for which no liquid market exists. The market for certain investments may become illiquid due to specific adverse changes in the conditions of a particular issuer or under adverse market or economic conditions independent of the issuer. The market prices, if any, for such securities tend to be volatile and the Fund and CLO managers may not be able to sell them when it desires to do so or to realize what it perceives to be their fair value in the event of a sale. CLO portfolios tend to have a certain amount of overlap across underlying obligors.

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