

Private Debt: Search for Transparency (Second of a Series)

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With the July 4th holiday weekend looming, readers of last week's column on shark tracking have asked how they can keep informed of Cabot's progress. That particular denizen of the deep was last heard from about two weeks ago off the coast of Bar Harbor, Maine. You can follow him at oceansearch.org (<https://www.oceansearch.org/tracker/?details=312>).

We continue this special series on surfacing features of private debt more observations from Cliffwater's CEO and CIO, Steve Nesbitt. His recently published "*Private Debt: Opportunities in Corporate Direct Lending*" [\[link\]](#)] covers the essentials of the asset class.

One interesting observation is on the scale of direct lending. Compared to \$10 trillion of corporate debt, equity financing of \$24 trillion, and \$2.1 trillion in loans held by commercial banks, the direct lending universe is much smaller. Nesbitt estimates it at \$400 billion.

Our own series on the size of the middle market [\[link\]](#) pegged the size of the middle market at between \$400-500 billion. Ares' 2018 study suggests a much larger number – \$910 billion – extrapolated in part from their own pipeline. Other sources estimate it a \$1 trillion.

Regardless it's still small relative to the more liquid public markets. Yet according to Nesbitt about 180 managers invest in the direct lending market. And that number is growing. As we noted last week, despite the popularity of midcap loans since the Great Recession, transparency to the asset class remains a headwind.

Thanks to the Cliffwater indices, CDLI and CDLI-S, this deficit is being addressed. In his book, Nesbitt also highlights the drivers of loan returns. Besides the spread component, individual gains and losses are critical to overall performance.

Unlike broadly syndicated loans, which are liquid and actively trade in the secondary market, middle market loan values don't swing depending on daily price moves. Instead, says Nesbitt, loan values are driven by realized and unrealized gains or losses.

"These gains and losses are determined by a quarterly fair value assessment of the loan's value. Yes, price changes in the broader markets are taken into account, but just as critical are expectations of individual borrower performance. It's for this reason that manager abilities are so important in direct lending. Losses are aligned with manager skill."

"Yield is beta," Nesbitt cautioned, "so don't let yield drive manager selection, which it so often seems to do. Instead focus on manager alpha which is measured by realized losses (defaults less recoveries)."

"We have two important findings about manager alpha. First, there is a wide dispersion in loss rates among direct lenders, with the first quartile exceeding the fourth quartile by two percentage points per year, on average."

The second finding is that loss rates are not as positively correlated with yield as you might expect. Managers, through their underwriting, can have a meaningful impact on total return beyond simple yield. We also find that manager alpha is persistent, meaning that manager selection is also critical to long term outcomes.”

Nesbitt illustrates the differentiation among manager loss rates in our [*Chart of the Week*](#), which reports cumulative loss rates among managers. Unlike stock managers, whose alphas (excess stock returns) tend to bunch closely to zero (or a small negative including fees), direct lender alpha appears to trend, making manager selection more valuable.

Statistically, Nesbitt says that stock manager alpha exhibits negative serial correlation while lender alpha exhibits positive serial correlation. In other words, poor stock manager performance is often reversible as styles recycle. Unlike direct lenders whose losses can’t be reversed and are more frequently perpetuated by pool sourcing and underwriting.