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

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Coney Island was the scene last Thursday of Nathan's Annual July Fourth hot dog eating contest. For the 12th time in 13 years the men's champion was Joey "Jaws" Chestnut. He downed 71 franks and buns – not his personal best, but far ahead of the second-place finisher (50). The top woman, Miki Sudo (31), also was a repeat winner.

"I don't know how they went down," said one amazed onlooker of Mr. Chestnut's effort. "He crushed it."

Not everyone relishes filling up on foot-longs, but observers may compare it to the relentess appetite for yield in the credit markets. That search drives the need for the same transparency in direct loans as is inherent in asset classes with which they compare most closely; namely, broadly syndicated loans and high yield bonds.

This lack of clear data and liquidity brings an expectation of higher returns, the so-called illiquidity premium. But even accounting for this difference, direct loans provide strong relative returns.

The Cliffwater Direct Lending Index (CDLI) captures a good profile of direct loans from BDC portfolios. Comparing returns with other asset classes, Cliffwater's CEO and CIO Steve Nesbitt notes that private equity is the best performer, at 14.1% in the period from September 2004 to December 2017.

Direct lending came in second with an annualized return of 9.7%, which outperformed commercial real estate (8.8%), high-yield bonds (7.6%) and leveraged loans (4.8%).

As our *Chart of the Week* highlights, other credit classes have higher returns than direct loans. However, non-sponsored loans, loans to smaller middle market borrowers, and second-liens all have higher risk premiums associated with those yields.

To measure relative risk, institutional investors look at the concept of maximum drawdown. As outlined in his primer on direct lending [link], Steve Nesbitt outlines how this measure – the cumulative value decline from peak to trough – compares across the asset spectrum.

At the safer end, Treasurys lost little value during the worst of the Great Financial Crisis. The Russell 3000, on the other hand, suffered almost a 50% drop from September 2007 to March 2009. The problem, of course, is that holding Treasury or related securities isn't much of a yield solution. Hence the interest in direct loans by investors since the GFC.

Volatility for direct loans is less than for other investments. The maximum drawdown for direct loans was 8% over a similar period a decade ago. Much better than stocks, but also better than real estate, which had a 24% drawdown, according to Nesbitt's calculations.

Nesbitt says history illustrates another benefit of the asset class. “To help offset losses incurred by a decline in loan values,” he said, “direct loans provide a high current yield.”

“Another key finding about direct loans during the GFC relates to fair value accounting. It was estimated in the downturn that unrealized losses were 14%, yet the actual losses were only 10%. So not only the asset class, but the methodology was stress-tested.”