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Letter from Down Under (Second of Two Parts)

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In our various overseas meetings over the past six months with institutional investors in the Middle East, Japan, UK, Germany, Belgium, Switzerland, Singapore and, most recently, Australia, consistent themes arise. The virtues of private credit are generally well appreciated, particularly in light of recent interest rates that have lifted all-in returns to historic highs.

But each region comes at their views of the asset class from different perspectives depending on how developed it is relative to public strategies. In MENA and APAC banks dominate lending, while the EU and UK have seen more disintermediation to private debt over the past decade.

But the story of institutional investing in Australia is superannuation funds. These public pension vehicles – almost fifty in number, with fourteen major ones *[Chart of the Week]*– have generally replaced what in the US would be state retirement funds. The majority of the largest superannuation funds have exposure to direct lending, including AustralianSuper, CBUS Super, HESTA and ART.

Much of that is allocated to European debt and is centered around commercial real estate, leveraged loans, subordinated notes and securitization facilities. Also, as in Europe, there's been a heightened awareness of ESG as both positive and negative screens for investments.

Relative to other asset classes, private debt is a small share, roughly 5% in a typical portfolio. Public equities represent around 53% of the total with 19% fixed income and 16% property and infrastructure. The balance is comprised of private equity, hedge funds, and cash.

Private debt's allocation is expected to grow to 20% over the next decade. A study last August from Mercer's chief investment officer in Australia predicted more appetite for private debt, as those "funds tend to have a buy-and-hold approach, meaning lower volatility than equivalent public market debt." And that "its illiquid nature tends to equate to higher yields."

Fund managers in Melbourne and Sydney are looking ahead. How will highly leveraged borrowers deal with shrinking interest coverage and higher defaults? If funds or borrowers are looking to extend or tighten terms, isn't that the sign of the beginning of a down-cycle? Which managers have the best chance of making it through a potential downturn unscathed?

Nevertheless experienced credit investors we spoke with like the current credit crop. "We had pulled back from private debt because we didn't like the value proposition," one told us. "Yields didn't seem to match the risk. Now it's better."

Another wondered how far improved all-in yields would go. "Is this as good as it gets?"

Amid challenging macro conditions – US-China, Ukraine-Russia, tech, and deglobalization – what one Sydney investor called a "poly-crisis," the steadiness of private debt performance has been noteworthy. "Our goal is to invest, set and forget," a fund head reported. "Private debt helps."