Fast and Furious (Second of Two Parts)

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The 60/40 allocation model for investing has taken some hits since the Fed began raising rates over two years ago. 2022 saw a sea of red ink for liquid strategies – both the "60" and the "40" – with improved returns last year and so far in 2024.

Sophisticated institutional investors long ago adopted the modified 60/40 which includes an allocation for alternatives. Is it 40/40/20? Every situation is different. But illiquid assets now have a permanent place in many portfolios thanks to their valuation and price stability through a variety of economic and market cycles.

Private credit has become a core to an alts allocation. When rates rise, it's a natural hedge to fixed income exposure. When rates fall, it retains a consistent premium to public credit. Amid rate volatility, it produces a steady income stream with minimal disruption from headline risks.

Unlike the fast and furious movers in public equities, private credit issuers are non-traded entities. Their valuations, hence "prices," stand or fall based on the performance of the businesses. And because direct lenders (the core practitioners in middle market debt partnering with private equity owners) buy-and-hold their loans, the asset class is a heavily managed one.

As we discussed in our Best Practices in Private Credit series, portfolio construction is everything. With little way out short of refinancings or company sales, how these loans perform will reflect directly on investor returns, not how they trade. This puts the onus on portfolio managers to select not just the highest-quality issuers, but the most stable industries.

Notice we don't say "fastest growing." Revenue growth is a nice-to-have, but not essential, component in private credit investing. Slow growth, even occasional slow negative growth, is manageable. Fast growth is not necessarily a plus, providing a helpful contrast to the tech-heavy stock markets. A good equity story is not necessarily a good credit story, and vice versa.

For diversified private capital platforms offering junior capital and equity investments as well as senior debt, this provides an opportunity to differentiate opportunities without casting one or another aside. And while certain sectors provide better upside, middle market private equity firms tend to operate in niche markets. Healthy returns can be realized via consolidation of regional players in slower growth arenas. Also from technological scale and improvements.

Private credit managers focus on industry as well as borrower concentration. This is true in sub-sectors of larger industry classifications such as healthcare and business services. They tend to be generalists with certain areas of expertise. This is different from large CLO platforms with teams of analysts covering aerospace, transportation, gaming, etc.

Finally, risk/reward in private credit is not asymmetric; limited upside is accepted along with limited downside. There are no big winners, since you only expect to back get your principal and interest. It's a horse race where, as one friend puts it, all you have to do is finish the race.