Improving Portfolio Risk/Return by Adding Private Credit

Over the past ten years, arguably no asset class has seen more growth than private credit. When added to the typical 60/40 equity/fixed income portfolio, private credit offers the potential to enhance performance, improve stability of returns, increase portfolio diversification, and provide downside protection.

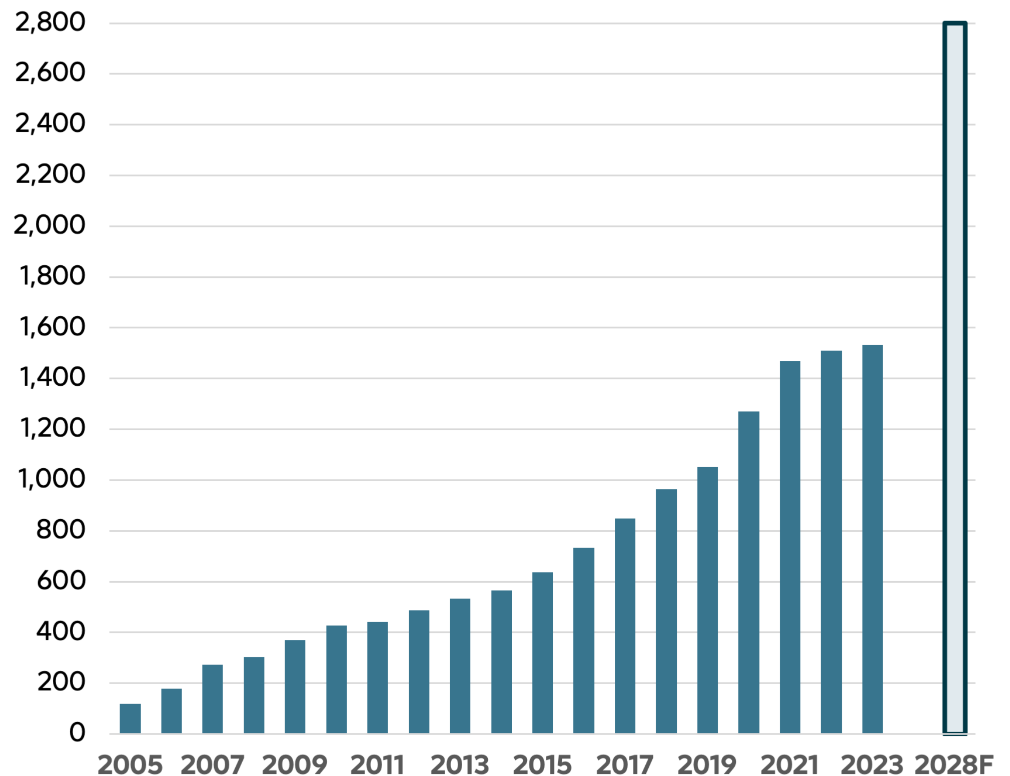
While a number of factors have driven significant growth in the private credit market over the last few years, institutional investors have been investing in the asset class for decades. We believe there is opportunity for individual investors to take advantage of this attractive opportunity as well.

IN PARTNERSHIP WITH *SLC MANAGEMENT*

What is private credit?

The private credit market consists of a broad range of debt financing solutions. These solutions include corporate loans such as direct lending and mezzanine loans, special situations or distressed investments in underperforming companies, specialty finance products such as net-asset-value (or "NAV") loans, and real estate and infrastructure credit. Different private credit strategies can span a wide range of borrower types, from corporates to real assets, mature to start-up enterprises; and appear throughout the capital structure, from senior secured debt to structured equity.

The private credit market has grown from roughly $100 billion of assets under management in 2005 to over $1.7 trillion at June 2023, and is expected to surpass $2 trillion by 2028. The growth of this market has been fueled by two key drivers: (1) the reduced participation of banks in the middle market loan market, and (2) the growth in private equity and the associated need for financing those deals.



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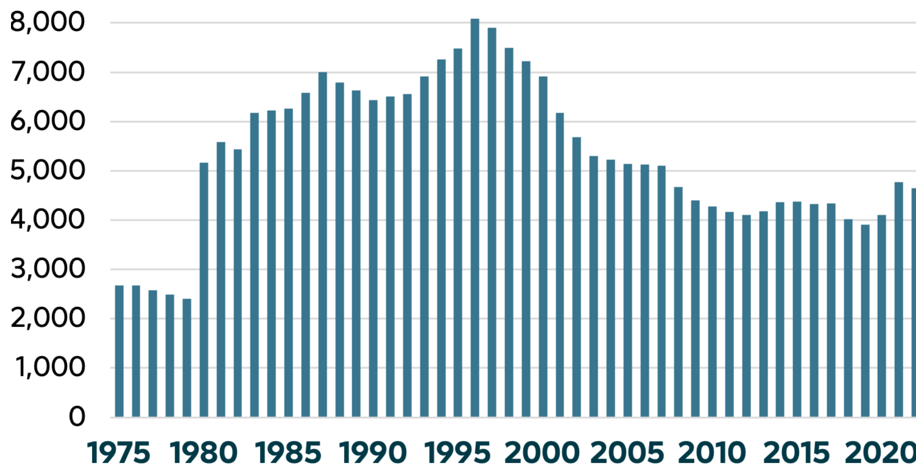
Prior to the Great Financial Crisis, banks were the primary lenders to mid-sized private businesses in the U.S., but as bank consolidation and regulation has increased, they have pulled back lending and have been replaced by non-bank lenders such as asset management firms and insurance companies. At the same time, the growth in private equity and the resulting need for private credit financing has driven increased demand for these loans.

Reduced Participation of Banks in the Loan Market

Source: S&P Capital IQ LCD

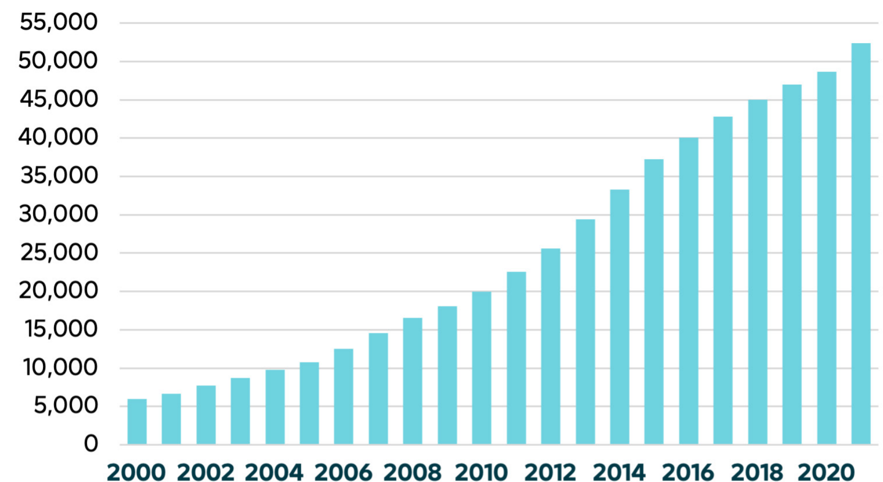
This key relationship between private equity and private debt has become one of the cornerstones of the non-bank financing market, particularly given the number of private companies in the United States has been growing for some time (as compared to a shrinking number of public U.S. companies). This robust network of private capital providers has been an important catalyst in helping private middle market companies grow.

Number of U.S. listed companies



Source: World Bank, World Federation of Exchanges database

Number of private backed companies



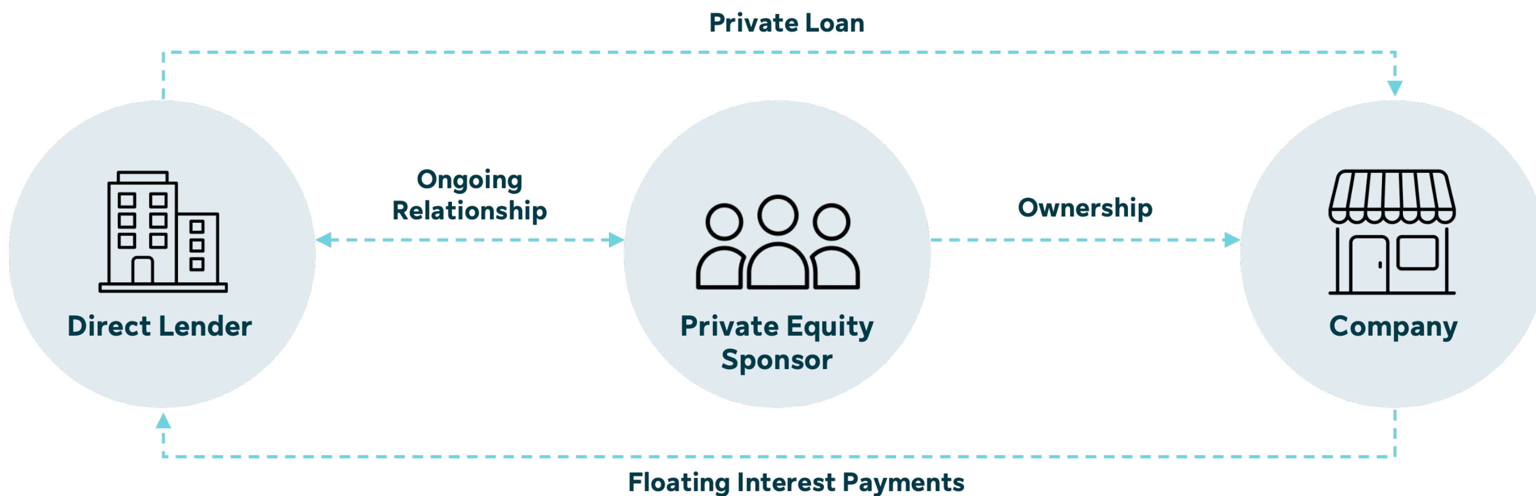
Source: PitchBook: Quantitative Perspectives US Market Insights Q3 2022

What is direct lending?

Within private credit, one of the largest segments is direct lending, which pertains to loans made by non-bank lenders to companies seeking capital. Direct lending is typically used to finance private equity-backed leveraged buyouts, growth initiatives, refinancings and recapitalizations.

Direct lending defined

Middle Market Direct Lending is large and growing, with potential advantages to lenders and borrowers.



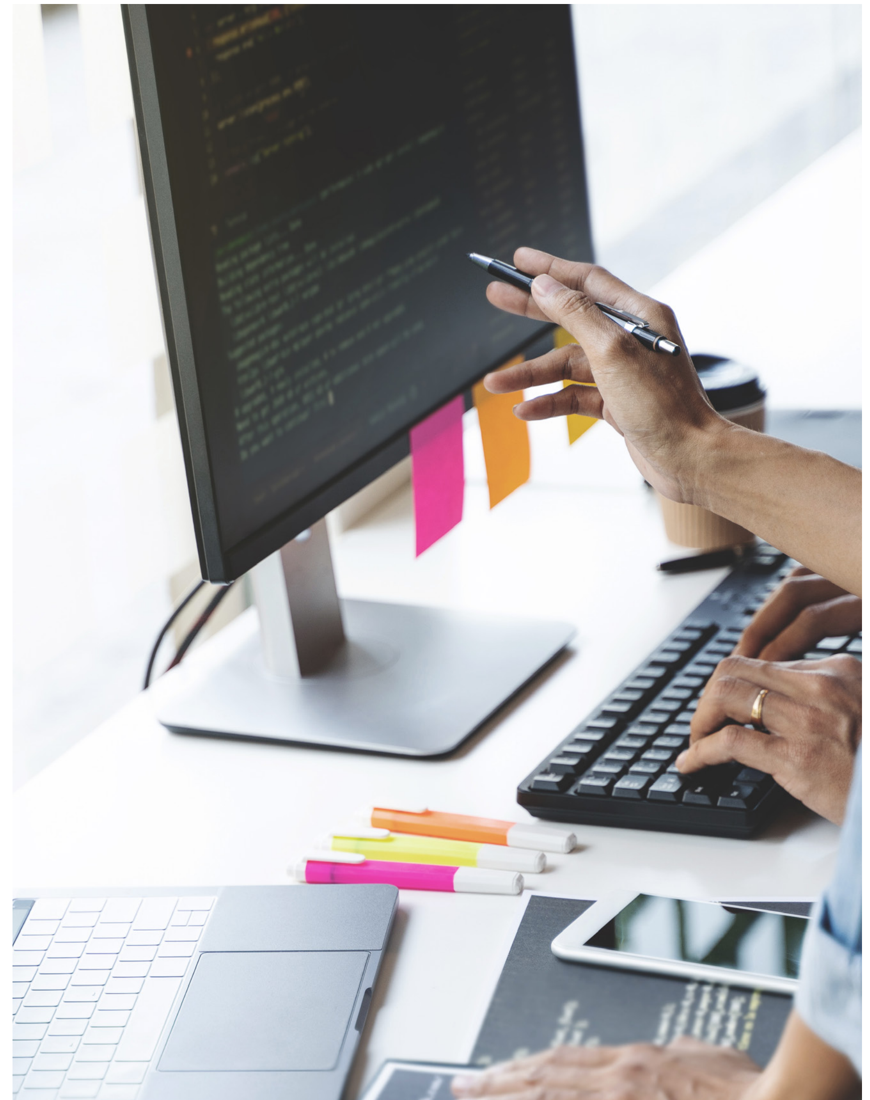
Definition	Opportunity	Key Characteristics	Borrower Benefits
• A strategy within private credit whereby non-banks **make loans directly** to private equity-backed companies	• **Leveraged buyouts**, growth capital, refinancings, and recapitalizations • The middle market consists of ˜**200,000 private companies** that represent 1/3 of private sector Gross Domestic Product (GDP), employing 48 million people[2]	• **Relationship-based** model • Limited number of parties • **Customized** documentation for specific risks of each transaction • **Enhanced** lender protections	• **Certainty** and **speed** of execution • Confidentiality / no ratings required • **Bespoke** capital solutions to meet specific needs • Ongoing growth **support** through add-ons and upsizes

Middle market direct lending

The "middle market" segment of the direct lending market in the U.S. is largely focused on mid-sized companies with established business models and market positions with anywhere from $10 million to $1 billion in annual revenues. This segment consists of approximately 200,000 private companies that represent 1/3 of private sector Gross Domestic Product (GDP), employing 48 million people.[2]

Direct loans are primarily senior secured loans that are unrated, albeit generally considered to be below investment grade. Direct lenders are typically compensated through upfront fees and floating rate coupons, meaning payments are adjusted up or down based on changes in the underlying base rate, which is usually at the Secured Overnight Financing Rate (SOFR). However, unlike broadly syndicated bank loans, which are also floating rate instruments, direct loans have limited liquidity and are typically held to maturity or often times can be refinanced or repaid before the stated maturity date.

Historically, direct loans have on average delivered a return advantage over comparable tradeable assets. Some of this premium is compensation for the lower liquidity but it also stems from the greater degree of customization, structuring and underwriting required in private transactions, sometimes referred to as the "complexity premium".



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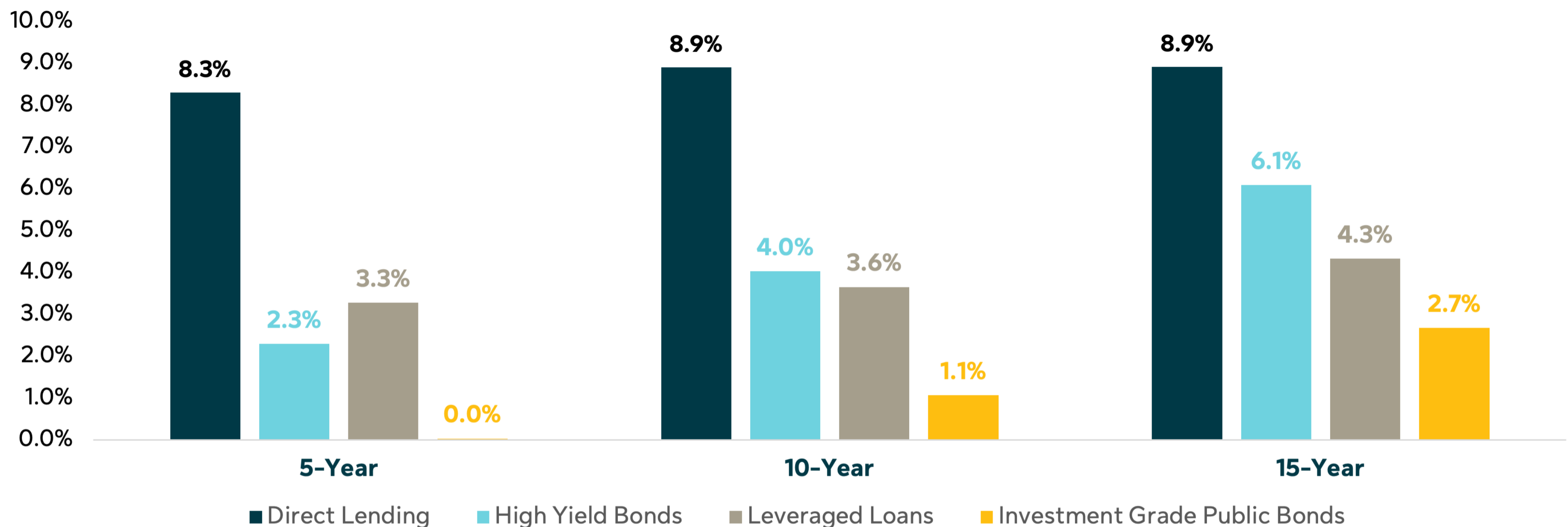
Income has been a key return driver of returns

Like most fixed income asset classes, a key driver of long-term total return performance for direct lending has been income. Industry data shows that for the past 20 years the average annual total return has been 9.4% (gross of fees).

Factors responsible for this historic yield premium include: (1) the illiquidity premium, (2) structuring complexity, and (3) the value to borrowers of speed, customization, privacy, and certainty of execution, especially in volatile markets.



Source: Cliffwater Direct Lending Index (Direct Lending), Bloomberg US Corporate High Yield Index (High Yield Bonds), Morningstar LSTA US Leveraged Loan Index (Leveraged Loans), Bloomberg US Aggregate Index (IG Public Bonds). **Past performance does not guarantee future results.** It is not possible to invest directly in an index. Data as of 12/31/2022.

Amongst the most appealing attributes of private credit in today's uncertain economic and geopolitical environment are the negotiated downside protection features, such as covenants. Covenants are conditional terms in lending agreements beyond simply paying back the loans – they're often included in an effort to ensure borrowers' financial performance remains sound and management continues to be responsible when making corporate decisions. Pledged collateral is another typical downside feature. Borrowers pledge assets or property to lenders, which is forfeited to the lender in the event of default. Private credit deals include extensive due diligence with direct dialogue between the borrower and the lender, leading to greater access to information for the lender and oftentimes results in better credit terms, more influence on the debt structure, and more control of potential workout processes.

Lower correlation, lower volatility

Private credit, with its floating rates and customized terms, has been less correlated to investment grade and high yield bonds, potentially improving overall portfolio diversification and lowering volatility when added to a diversified portfolio. As illustrated in the graph below, the total return generated by direct lending has exceeded that of other credit products, with lower volatility.

Trailing 10Y Total Return

14.0%
12.0%
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%

Public Equities

Direct Lending

Investment Grade Public Bonds

0.0% 2.0% 4.0% 6.0% 8.0% 10.0% 12.0% 14.0% 16.0%

Historical Volatility

Source: Representative indexes: Aladdin - Bloomberg US Aggregate Bond Index (IG Public Bonds), S&P 500 Index (Public Equities), Cliffwater Direct Lending Index (Direct Lending). Data as of 9/30/23.
Past performance does not guarantee future results. It is not possible to invest directly in an index.

Manager skill is important. Direct lending demands highly specialized analysis and expertise and requires experienced teams in order to source and manage loans. The direct relationship allows greater communication, which during business stress can potentially lead to more cooperation and better outcomes to preserve value, and the additional customization and underwriting required can likely help generate higher yields for investors.

CASE STUDY

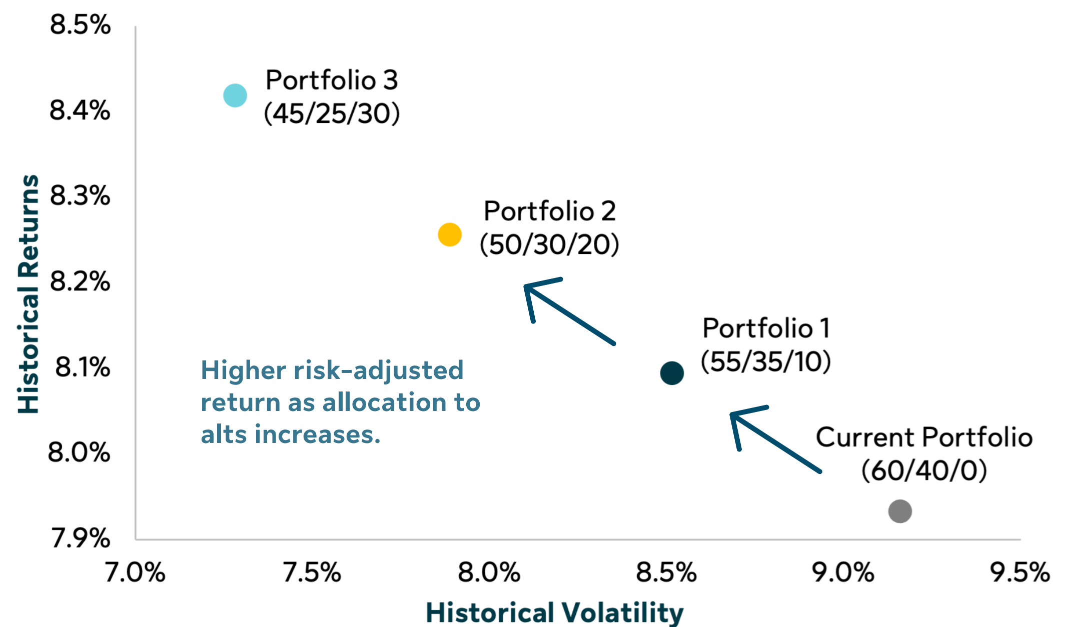
Adding Private Credit to a 60/40 Equity/Bond portfolio can improve returns while reducing overall volatility

To illustrate the benefit of adding private credit to a traditional 60/40 equity/bond portfolio, the following case study shows the impact on overall portfolio risk and return at different allocations to private credit.

- In **Portfolio 1**, we reduce the allocation to bonds and equities by 5% each and initiate a 10% allocation to private credit.
- In **Portfolio 2**, we reduce the allocation to bonds and equities by 10% each and increase to a 20% allocation to private credit.

As we increase the allocation to private credit, the overall historical return of the portfolio increases due to the attractive return profile. In addition, because of the relatively low correlation of private credit to public equities and bonds, the portfolio's overall volatility is reduced as well.

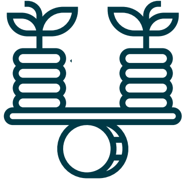
The opportunity that exists today for individual investors to potentially improve portfolio return while reducing overall volatility is compelling. And as the private credit market continue to grow, access to these investments is becoming easier for individuals given the wide variety of vehicles available.



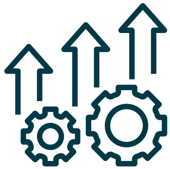
	Equities	Bonds	Private Credit
Starting Portfolio	60.0%	40.0%	0.0%
Portfolio 1	55.0%	35.0%	10.0%
Portfolio 2	50.0%	30.0%	20.0%
Portfolio 3	45.0%	25.0%	30.0%

Source: Equities: S&P 500 Index, Bonds: Bloomberg US Aggregate Bond Index, Private Credit: Cliffwater Direct Lending Index from year end 2013 to year end 2023 (10 Years). **Past performance does not guarantee future results.**

Key takeaways



Direct lending has been a popular asset class with institutional investors for decades, that opportunity is now **increasingly available to individual investors.**



Investors are often rewarded with higher yields than in tradeable markets, driven by the illiquidity premium they earn for being in a less-liquid asset class as well as the additional value that borrowers derive from the customization and speed and certainty of execution available in the private markets.

Direct loans in particular have a **long history of delivering consistent returns primarily driven by income.** The direct relationship between borrower and lender allows greater communication, which during business stress can lead to more cooperation and better outcomes to potentially preserve value.

When added to a traditional asset mix, investors may see **improved outcomes from both a risk and return perspective.**

About the SLC Management group of companies

SLC Management is a global institutional asset manager of Sun Life that offers institutional investors traditional, alternative and yield-oriented investment solutions across public and private fixed income markets, as well as global real estate equity and debt and infrastructure. We help our clients optimize their asset allocation profile and meet their long-term income and capital appreciation objectives by leveraging our insights and deep capabilities in fixed income, alternatives and real assets through our specialty managers including SLC Fixed Income, BGO, Crescent Capital Group, and InfraRed Capital Partners. Through Advisors Asset Management, our independent U.S. retail distribution firm, we can extend our alternatives solutions to high net worth investors.

As of December 31, 2023, SLC Management has assets under management of **US$283 billion/C$374 billion.** As of December 31, 2023, the brokerage and advised business at AAM represents approximately US$41.4 billion in assets. (Assets under supervision represent US$5.4 billion in UIT assets. The firm has US$32.1 billion in assets under administration that represents the non-proprietary assets for which AAM provides various levels of service, but not management. The firm's US$3.9 billion in assets under management represents AAM's proprietary separately managed account, mutual fund and ETF assets.) For more information, visit **www.slcmanagement.com**.

For more information visit **www.aamlive.com** or contact a financial professional to discuss potential opportunities in today's environment.

Disclosure

SOURCES:

[1] National Center for the Middle Market, 2024.
[2] Year-End 2023 Middle Market Indicator, middlemarketcenter.org

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RISKS: Alternative investments offer the potential for diversification, higher returns, and protection against inflation, however they come with their own set of risks and challenges.

Past performance is not a guarantee of future results. All investments are subject to risk, including the loss of the principal amount invested. There is no guarantee of downside protection and losses may occur, including the loss of the entire principal amount invested.

Diversification will not guarantee profitability or protection against loss.

Alternative investments may lack transparency as to share price, valuation and portfolio holdings. Complex tax structures often result in delayed tax reporting. Compared to mutual funds, private funds are subject to less regulation and often charge higher fees.

Bonds that are rated below investment grade are sometimes referred to as "high yield bonds" or "junk bonds." Below investment grade securities have predominantly speculative characteristics with respect to the issuer's capacity to pay interest and repay principal. They may also be illiquid and difficult to value.

An investor may not have access to their investment for an extended period of time.

Market risk is prevalent since many of the companies invested in are unproven, which can lead to significant losses. Default risk is also higher with less established companies. Additional risks include limited operating history, uncertain distributions, inconsistent valuation of a portfolio, changing interest rates, leveraging of assets, reliance on the investment advisor, potential conflicts of interest, payment of substantial fees to the investment advisor and the dealer manager, potential illiquidity, and liquidation at more or less than the original amount invested. Performance may be volatile, and the NAV may fluctuate.

DEFINITIONS:

Gross Domestic Product (GDP) is the monetary value of all finished goods and services made within a country during a specific period. GDP provides an economic snapshot of a country, used to estimate the size of an economy and growth rate.

Correlation is a statistical measure of how two variables move in relation to each other with coefficients ranging from +1 to -1. A correlation coefficient of +1 implies that as one variable moves, the other will move in exact lockstep. Alternatively, a correlation coefficient of -1 implies that if one variable moves, the other moves in the same amount in the opposite direction. If the correlation is 0, the movements of the variables are completely random.

The **Bloomberg US Aggregate Bond Index** is an unmanaged, broad-based index composed of US dollar denominated, investment grade, fixed rate taxable bonds with at least $250 million par amount outstanding and at least one year to final maturity.

S&P 500 Index is an unmanaged market capitalization weighted index used to measure 500 companies chosen for market size, liquidity and industry grouping, among other factors.
The Morningstar LSTA US Leveraged Loan 100 Index is designed to measure the performance of the 100 largest facilities in the US leveraged loan market. Index constituents are market-value weighted, subject to a single loan facility weight cap of 2%.

Cliffwater Direct Lending Index (CDLI) seeks to measure the unlevered, gross of fees performance of U.S. middle market corporate loans, as represented by the underlying assets of Business Development Companies ("BDCs"), including both exchange-traded and unlisted BDCs, subject to certain Eligibility Criteria. The CDLI is an asset-weighted index that is calculated on a quarterly basis using financial statements and other information contained in the U.S. Securities and Exchange Commission ("SEC") filings of all eligible BDCs.

National Council of Real Estate Investment Fiduciaries (NCREIF) Fund Index – Open End Diversified Core Equity is a capitalization-weighted index of gross-of-fee investment returns of 38 open-end commingled funds marketed as a being a diversified core investment strategy, primarily investing in private equity real estate.

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