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Demystifying Private Credit Investing

A new wave of opportunity seems set to flow into private credit markets, which could enhance risk-adjusted returns and diversify portfolios. What's driving this potential, and how should investors think about integrating private credit into their existing portfolios?

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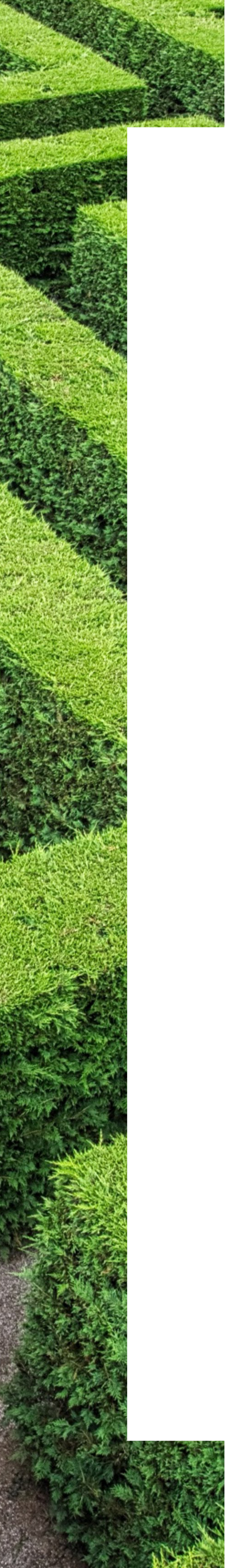
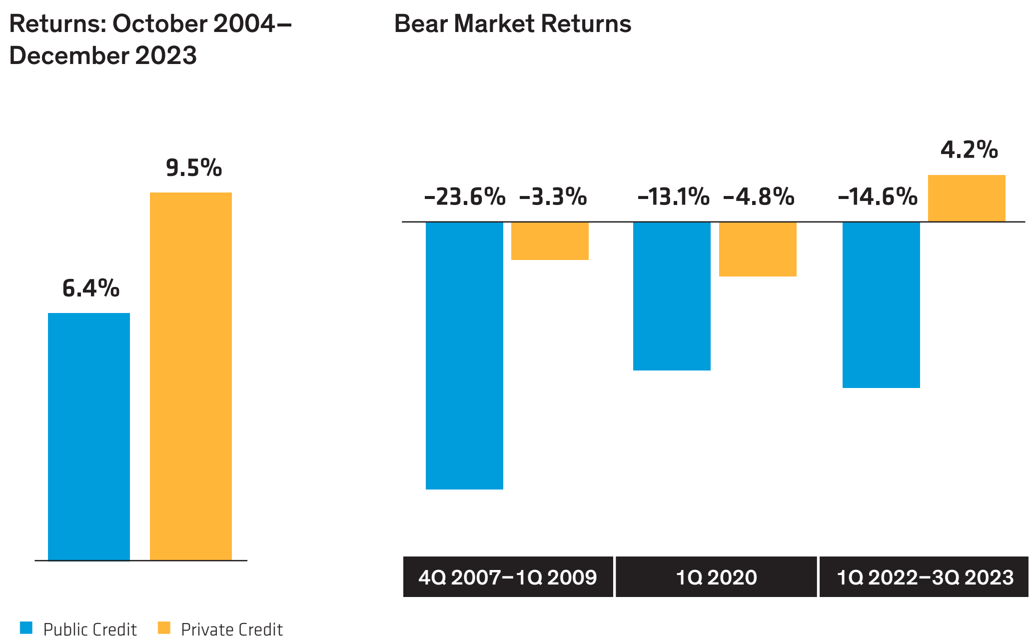


Many descriptions of the opportunity in private credit start with the premise that the traditional 60/40 stock/bond strategy, an investing staple for decades, is—to put it bluntly—dead. To paraphrase Mark Twain, we think its death has been greatly exaggerated.

Sure, traditional investing does face challenges from higher structural inflation, lower economic-growth expectations and long-term demographic trends. Given these headwinds, and where rates and valuations stand, the 60/40 is likely to deliver more modest returns than usual. It still has something left in the tank, though, and we believe it's a sound starting point for portfolio construction.

However, we also think that a critical piece is either missing or underrepresented in many portfolios today. It's one that has the potential to enhance income, diversification and risk-adjusted returns—the private-credit dimension. Historically, private credit has handily outperformed public credit over the past two decades (*Display 1*), while also defending much better during bear markets.

DISPLAY 1: PRIVATE CREDIT—A CLOSER LOOK AT RISK AND RETURN



Past performance does not guarantee future results.

High yield is represented by the Bloomberg US High Yield Index. Private credit reflective of the US middle market and includes senior secured, US-issued loans of less than $250 million.

As of December 31, 2023 | **Source**: Bloomberg, LCD, Morningstar, PitchBook Data, Inc., S&P and AllianceBernstein (AB)

What's behind private credit's strong showing? The answer is twofold. First, private market assets offer premiums to compensate investors for less liquidity—they may not be able to sell the security when they want. These premiums put yields higher than those of comparable public investments. Second, private lenders can negotiate loan terms directly with borrowers, incorporating requirements that provide added protection from defaults—along with generally higher recovery rates if defaults do happen.

The Private-Credit Market Origin Story

The headlines about banks stepping back from lending are often top of mind when private credit is mentioned today. This isn't a new process—it's actually been in motion for decades, driven by interest-rate environments, regulation and innovation. Leveraged loans are a good example: at one time, banks accounted for 70% of the market; today that share is less than one quarter.

Bank consolidation has also been at play, accelerating around the time of the 2008 global financial crisis (GFC) that centered on the banking sector. Policymakers answered the weakness in the banking system—and the systemic risk it created—with the Basel III regulatory framework in Europe and Dodd-Frank legislation in the US. These regulations effectively sought to transfer risk to market participants, and part of that regulation took specific aim at banks' financing of private equity–sponsored business. The result was a private-credit boom, with middle market direct lending flourishing.

The rise of direct lending gave investors greater access to a key segment of the US economy—the middle market. It's home to 200,000 companies, whose revenues range from $10 million to $1.1 billion; it accounts for one-third of US private-sector gross domestic product; and it employs 48 million workers. This is just one example of how private credit has capitalized on bank retrenchment to offer investors not only strong return potential but also diversification through exposure to new economic segments.

More than Direct Lending: Diverse Private Markets

The private credit market offers a wealth of investments that extend well beyond direct lending—there are as many as 30 subsectors, depending on how you choose to segment it. That may seem a little daunting to consider, which is why we think it helps to consider private credit in two complementary buckets: corporate-backed debt and asset-backed debt (*Display 2*).

DISPLAY 2: SIMPLIFYING THE WORLD OF PRIVATE CREDIT

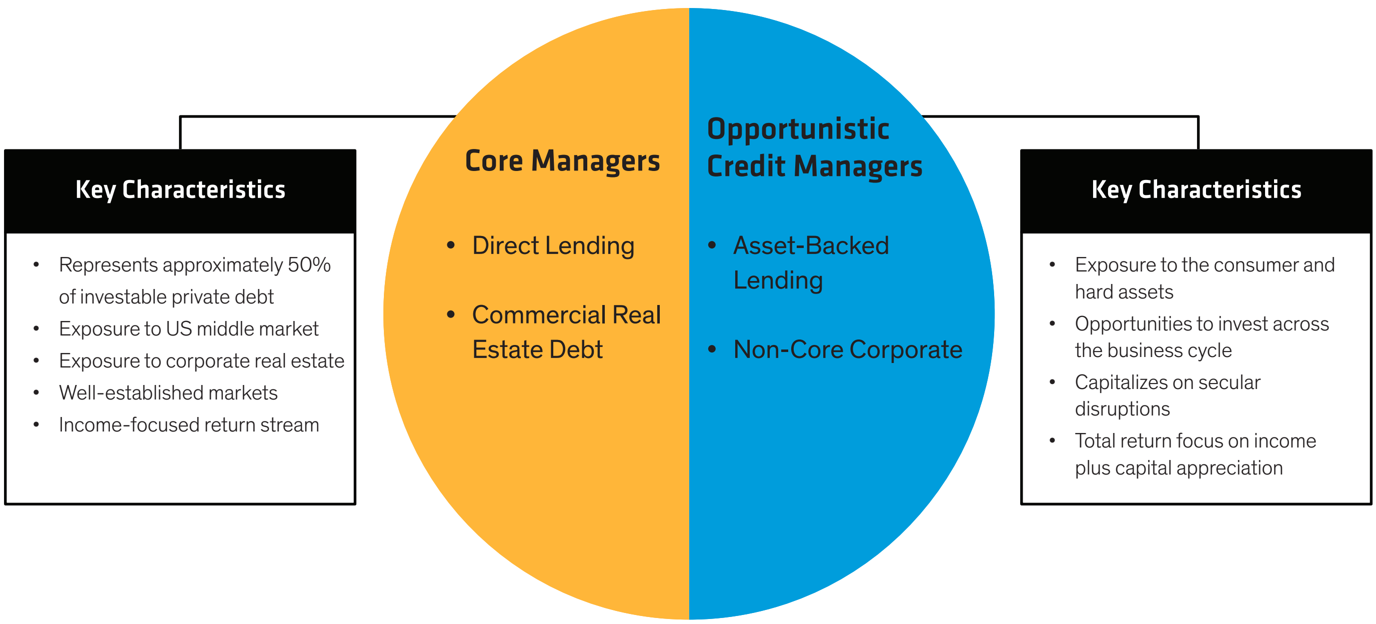
The Full Spectrum of Corporate and Asset-Backed Lending

Corporate Debt		Asset-Backed Debt
• Corporate Cash Flows	**Backed By**	• Cash Flow–Producing Assets
• Direct Lending	**Core Sector**	• Commercial Real Estate
• Direct Mezzanine Debt • Distressed Debt • Special Situations	**Key Opportunistic Sector**	• Residential Real Estate • Specialty Finance • Hard Assets and Infrastructure
• Corporate Bonds	**Public Market Equivalent**	• Securitized Debt

For illustrative purposes only.

As of June 30, 2024 | **Source:** AB

DISPLAY 3: SIMPLIFYING THE ALLOCATION USING CORE AND OPPORTUNISTIC PRIVATE CREDIT



For illustrative purposes only.

As of June 30, 2024 | **Source:** AB

Corporate debt is secured by company cash flows, and its returns tend to be income driven. Investors collect the coupon and accept a loss rate. Asset-backed debt is secured by cash flow–producing assets whose underlying payments are less tied to the corporate business cycle—offering investors a level of economic diversification. Direct lending is a good example of corporate-backed private credit, while commercial real estate debt is a well-known representative of asset-backed private credit.

Other avenues for investors in the corporate debt category are mezzanine debt—which puts investors further down in the capital structure, with less protection in exchange for more yield—and distressed debt, from companies in or near bankruptcy. With the asset-backed debt side, investors can also tap into residential real estate mortgages and consumer debt—credit cards, auto loans and the like.

The Core-Opportunistic Framework

For investors looking to build a portfolio of these private opportunities from scratch, we think a straightforward core-opportunistic construction may fit the bill (*Display 3*).

To design the core component, investors should identify a good, senior-secured direct-lending manager and a good commercial real estate–debt manager. Combined, these two building blocks represent more than half of the investable private debt market. They also provide exposure to the expansive and dynamic middle market and corporate real estate. Both markets are well established and deliver income-focused return streams.

On the opportunistic side, it makes sense to find an opportunistic multi-sector manager with the capabilities to access exposures in the important consumer sector and in hard assets—generally, tangible assets with intrinsic value. Opportunistic strategies give managers the flexibility to pursue potential across the business cycle, capitalize on secular disruptions, and invest in distressed and dislocated corporate debt and mezzanine debt. Opportunistic investing also tends to be more total-return oriented, with income and capital appreciation from assets often bought at a discount.

We think this approach provides investors with a simple way to think about building a private-credit allocation to access its potential—both now and in the years ahead.

A New Chapter in the Bank Retrenchment Story

For two decades, the private credit wave has been driven by GFC-induced stress in the banking system and the regulations enacted to address those issues. From our perspective, a similar chapter may be unfolding today, with many banks facing an income-statement problem.

While US bank-deposit flows have increased lately, they're still well below the levels of a couple years ago. Banks also face a mismatch between the high short-term rates paid on deposits and the lower interest rates on their loan portfolios. This issue has suppressed bank lending and created stresses that are particularly intense for smaller institutions.

Just as in earlier chapters of the banking story, new regulation looms—labeled Basel III Endgame in the US and Basel IV in Europe—the final leg of post-GFC regulation that powered up private credit markets. In this chapter, the focus isn't on direct corporate lending but on other items residing on banks' balance sheets—consumer loans, industrial and commercial loans, residential real estate and commercial real estate. The net result will boost the capital banks must hold against their loan portfolios, possibly by as much as 19% in the US and 24% in Europe.

To avoid having to raise new capital, banks can sell securities deemed riskier under the new rules. They can reduce lending, which they've already been doing. And they can consolidate, a process already under way, with weaker banks being gobbled up by or joining forces with those in better financial condition. Banks can also "originate to distribute," making loans and then selling them to investors instead of keeping them on their balance sheets.

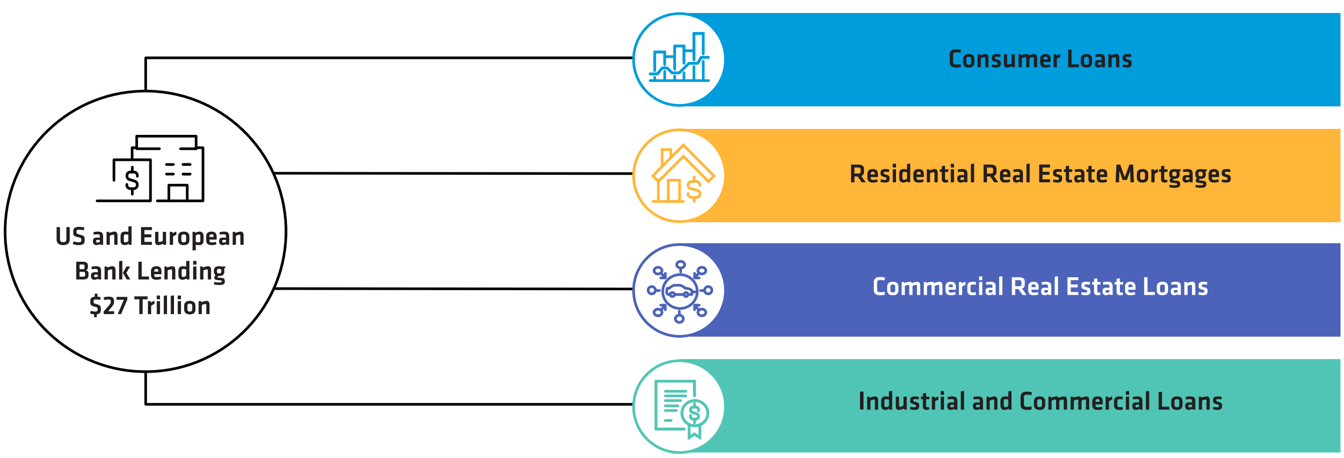
The Next Big Opportunity for Private Credit

Deleveraging, consolidation and originate to distribute will likely define the next wave of private credit potential, with investors both buying loans from banks and lending to those needing capital to make new loans. The final regulations are maybe two years away from coming into effect, with the aftermath likely to play out for years as banks adjust to a new reality.

What could the scope of the coming opportunity be? The combined bank-lending market in the US and Europe is an eye-opening $27 trillion (*Display 4*). Not all those assets will leave, but even a modest share would bring a sizable flow into private markets. We're starting to see this migration in the consumer loan segments and residential real estate, enabling investors to tap into the consumer sector, which is 70%–80% of the US economy and generally underrepresented in allocations.

DISPLAY 4: ASSETS ARE EXPECTED TO MOVE OUT OF THE US BANKING INDUSTRY

Nonbank Lenders Have an Opportunity to Capture Outflows in Key Areas



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As of January 31, 2024 | **Source:** European Central Bank, Federal Reserve and AB

Of course, access to opportunity doesn't ensure success. There are economic cycles to navigate, which can bring credit stress and potential defaults in down times, and as with public markets, individual segments will go in and out of favor. That puts a premium on experience in identifying, executing on and managing private credit investments.

Where to Make Room: The Portfolio-Sourcing Decision

For those seeking to tap into private credit opportunities, a proliferation of new investment vehicles is providing avenues for individuals to access these segments—effectively democratizing private markets.

Then there's the question of how to source private credit exposure from an existing portfolio allocation. There are several ways to do this. The simplest may be to carve exposure out of an existing credit allocation, which could bolster income and diversification while reducing drawdown risk.

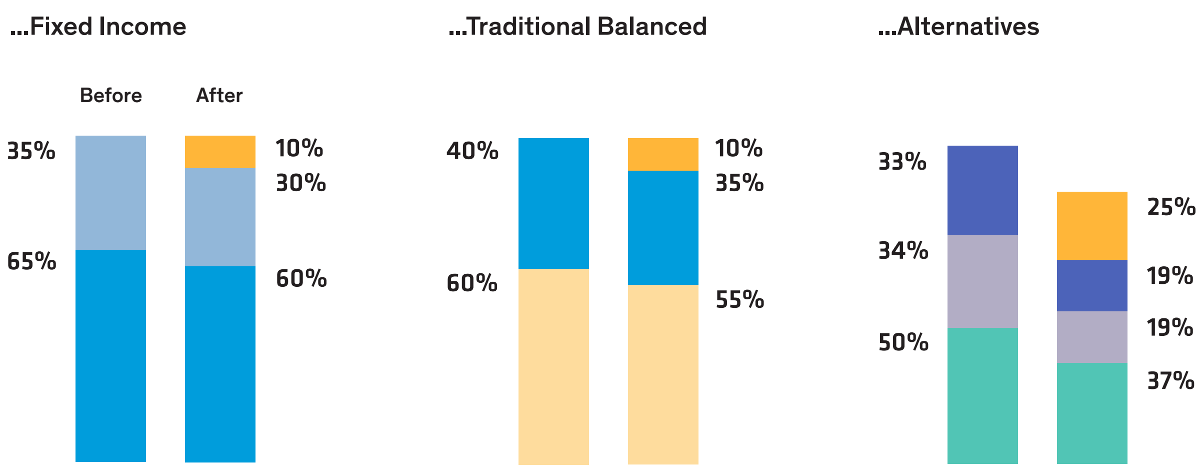
Because private credit has low duration, a modest credit beta and strong return characteristics, a slightly more creative allocator can find additional ways to source exposure (*Display 5*).

Source from a Public Bond Portfolio: We've argued that a credit barbell is the most efficient bond allocation—for example, a public credit barbell with 35% in high yield and 65% in core bonds. Carving 5% from each component funds a 10% private credit allocation that has the potential to increase annualized returns, reduce volatility and drawdown risk, and boost income.

Source from a Traditional Balanced Portfolio: Private credit can also be sourced from a traditional stock/bond portfolio, such as a 60/40 strategy. Taking 5% each from stocks and bonds to fund private credit may enhance returns, reduce risk and produce a better overall outcome.

Source from an Alternatives Portfolio: Another option is to enhance an existing alternatives portfolio. For example, private credit may replace some of the allocation to strategies such as hedge funds, private real estate and private equity within a broader alternatives strategy. This approach, too, has enhanced return and risk metrics.

DISPLAY 5: SOURCING PRIVATE CREDIT EXPOSURE FROM…



	Fixed Income Before	Fixed Income After	Traditional Balanced Before	Traditional Balanced After	Alternatives Before	Alternatives After
Expected Return	4.4%	4.8%	5.8%	6.1%	7.1%	7.4%
Expected Volatility	7.3%	6.5%	10.8%	10.0%	12.6%	7.8%
Prob. of 20% Drawdown	2.2%	2.1%	13.5%	11.3%	28.8%	17.3%
Exp. Income (Annualized)	6.4%	6.5%	3.4%	4.0%	0.5%	2.8%

Core Bonds · Public Credit · Private Credit · Global Equity · Private Equity · Private Real Estate · Hedge Funds

Current forecasts do not guarantee future results.

Core bonds are represented by the Bloomberg US Aggregate Bond Total Return Index, global equities by the MSCI World Gross Index, and public credit by the ICE BofA US High Yield Index. Private credit, hedge funds, private equity and private real estate data are provided by AB. Probability of a 20% loss is the probability of peak-to-trough losses, which may include a multiyear period of difficult markets. Simulated or hypothetical performance results have certain inherent limitations. Unlike the results shown in an actual performance record, these results do not represent actual trading. Results include estimates of trading costs and market impact; however, because these trades have not actually been executed, results may have under- or overcompensated for these costs. Simulated or hypothetical trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve returns or a volatility profile similar to those being shown. | As of June 30, 2024 | **Source:** Bloomberg, ICE Data Indices, MSCI and AB

Next Steps: Thinking Through a Private Credit Allocation

Investors may be wondering how to approach the private credit opportunity. We think it's sensible to follow a set of concrete steps along the path from consideration to implementation.

1

Assess Opportunity

We hope that this paper has provided an effective overview of the growing opportunity in private credit. But you may want to conduct additional due diligence on your own to get more comfortable with it.

2

Design Allocation

A core-opportunistic combination may be a good starting point, but what allocation to each building block makes sense for your portfolio? Which private credit strategies will be within each building block? And which managers are best-equipped to guide them?

3

Determine Sourcing

If a private credit allocation seems right for you, think about how you'll make room in your portfolio. Will it come from your public fixed-income allocation, your overall stock/bond mix or from your existing alternatives exposure?

Looking at the Big Picture

A new round of banking sector regulation is poised to create a new wave of potential in private credit markets in the years ahead. Investors looking to capture it have an opportunity to enhance portfolio income and returns while bolstering diversification through access to segments of the US economy that have been absent from or underrepresented in many allocations.

For investors whose profile is suitable for private credit investing, two to three targeted investments in core and opportunistic strategies may produce a well-diversified private allocation. This exposure can be sourced from a number of areas: public fixed income, a traditional balanced strategy or an existing alternatives allocation, with vehicles tailored to specific private credit segments.

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