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***IN FOCUS***

# What DB pension schemes can gain from private credit

April 2021

Low yields in public assets can make it difficult for defined benefit (DB) pension schemes to balance excess return requirements with risk tolerance. Private credit asset classes can offer a way to balance risk and return requirements within – or alongside – a multi-asset growth approach. Private credit can also be an attractive component of cashflow driven investment (CDI) solutions, given maturity profiles and risk characteristics.

Here, two of our investment specialists outline why they believe private credit can play a role within a DB pension scheme's strategy.

- Clement Yong, Multi-Asset Fund Manager, explains how private credit can fit into a multi-asset approach
- Jon Exley, Solutions Manager, talks through the benefits that a private credit allocation can bring to a CDI solution.

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## Private credit for multi-asset investors

As multi-asset investors, a wide range of assets is crucial to generating returns and managing risk. When it comes to generating returns, equities have been a stalwart in that regard. Equities represent a major part of multi-asset portfolios, and especially those with a growth target. Credit is also another asset that has become increasingly important in such portfolios.

In the first quarter of 2020, Covid-19 stopped the world in its tracks. Many equity and credit markets sold off materially on expectations that economic activity would come to a halt. However, it was not long before major central banks and policymakers around the world stepped in; injecting economies with unprecedented stimulus. In the US, cheques were literally deposited into citizens' accounts. The Federal Reserve (Fed) slashed interest rates to unprecedented lows. Not only that, the central bank effectively provided a backstop for public corporate debt (specifically investment grade debt) as it pledged to buy such debt on the secondary market.

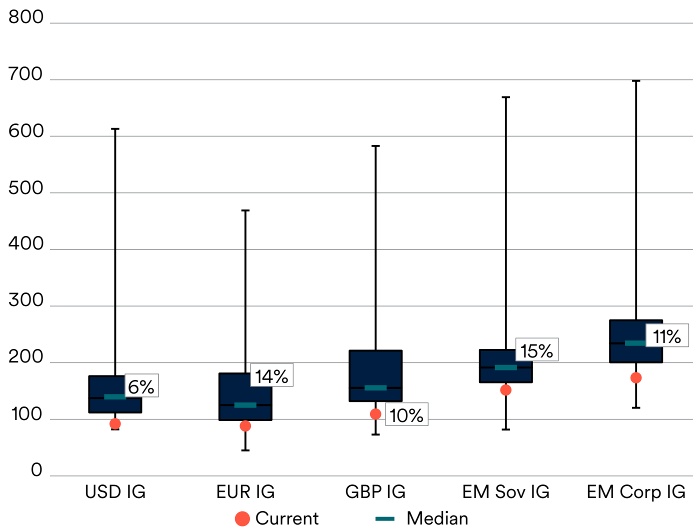
This was a crucial development not only for credit investors but also for multi-asset investors. As corporate debt trades at a spread over government debt, the addition of a liquidity backstop made for a heady mix for investors. Multi-asset investors could afford to rotate from government debt into credit in the hunt for yield.

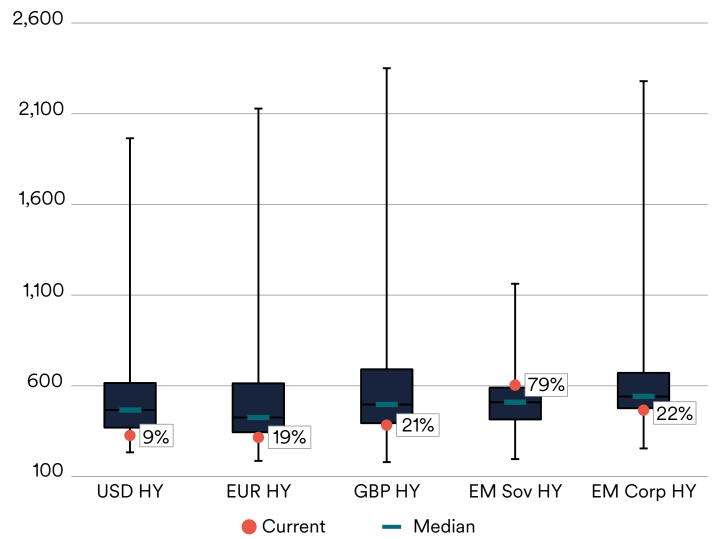
However, while spreads were north of 250 basis points (bps) at that time, they quickly evaporated. Spreads have tightened considerably since then, now trading just under 100bps. We have specifically referred to US investment grade debt as an example, but the tightening of spreads is true for most major credit markets. The chart below depicts the range of spreads across a selection of credit markets. The green dots indicate the percentile at which current spreads trade. It almost goes without saying that spreads in public credit are very tight.

The luxury of a 'spread cushion' over government debt is all but gone.

Schroders capital

**Figure 1: Liquidity and low rates continue to underpin tight spreads**



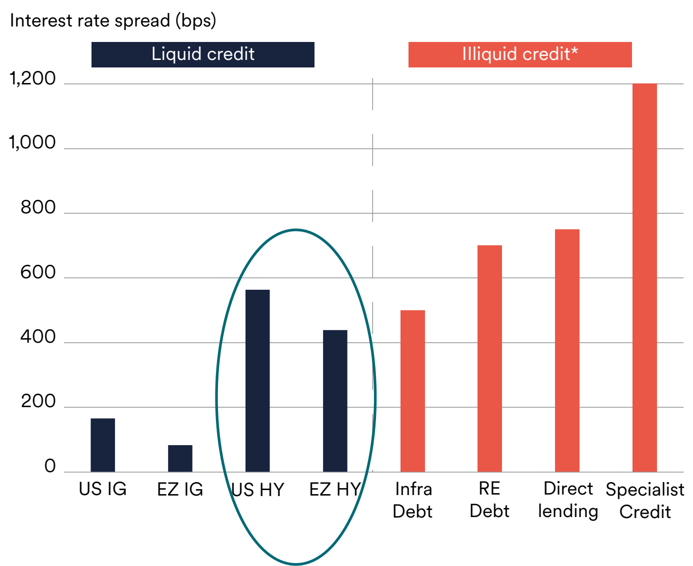

Source: Bloomberg, BofA ICE, J.P. Morgan. As of 4 March 2021.

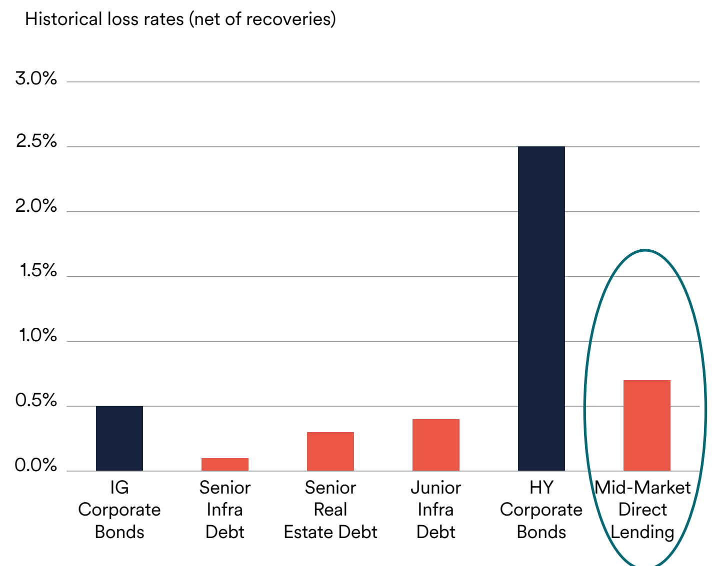
To get any sort of spread cushion in public credit, investors will be pushed into riskier areas such as high yield. However, bar the high yield segment of emerging markets, spreads in high yield are also at historical tights. In an environment where there is still plenty of central bank-induced liquidity sloshing around in the system, this is unsurprising. We must casting our nets further still.

In a liquidity fuelled environment, it makes sense to also consider the more illiquid, or private spectrum of credit. It is important to note here that private credit comes with its own risks and it is certainly not necessarily a "safer" asset. The clue is in its name, in terms of the main differences in risk compared to its liquid/public counterparts. In a nutshell, private credit means that the debt will be locked in for longer and there is a lack of secondary market. This means that there needs to be a huge amount of confidence in the underlying investment, and trust in the underlying manager if it is delegated, for any committed capital in this space.

Comparing private versus public debt, it will come as no surprise that the spread that can be achieved in the private space is more attractive than public debt. More surprisingly however, private credit has also fared far better historically in terms of default losses, a crucial consideration within credit.

**Figure 2: Private debt vs. public credit (1) – Higher spread, lower loss rate**




Source: Bloomberg, Cambridge Associates, Schroders, June 2020.
*Illiquid credit returns expectations from a group of private credit managers currently fundraising in the market.

There are a few possible explanations for this.

### Private credit can be more neatly tailored

The implication here is that control over the investment is therefore higher. Taking direct loans as an example, specifically the mid-market segment, investors have a much larger say in the structuring of debt. Investors are usually able to choose in which part of the capital structure they would like to invest. Very often covenants are almost a given.

Compare this with public markets where this is essentially non-existent – the market there is more "what you see is what you get". It is worth noting also that not all loans (or by extension, private credit) are created equal – the bank loan market, even though technically a private one, offers less room for customisation as the size of the deals there tend to be bigger and banks hold many of bargaining chips in this sector.

**Figure 3: Illustrative loan comparisons**

| | Middle market loans (direct lending) | Bank loans (broadly syndicated loans) | Public market debt (high yield) |
|---|---|---|---|
| **Company Size (EBITDA)** | USD 10m to USD 75m | USD 75m + | Usually listed companies |
| **Covenants** | Significant/tight | Limited/loose | None |
| **Lender model** | Originator | Trading desk buyer | Market buyers |
| **Lender influence on structure** | High | Limited | Very low |
| **Investment process** | One month | Less than two weeks | A few days |
| **Credit monitoring** | High (monthly data, management & GP access) | Limited (quarterly data and public information) | Publicly available data |
| **Secondary market liquidity** | None | Limited | Generally liquid |

Source: SPP Capital Partners, Schroders, 2020.

### Private credit as a complementary diversifier

The "real asset" nature of underlying debt in private credit deals - such as infrastructure and real estate – means defaults are typically lower. Infrastructure – think roads, telecommunication networks, schools – tends to be less sensitive to the economic cycle. These assets are essential to the public. Some parts of real estate are definitely linked to the economy, retail is a prime example, but this is where the capital gains component of asset will be more affected rather than the rental income component. As both infrastructure and real estate are secured assets in nature, in the event of a default the ring-fenced assets can be sold and proceeds used to repay the lender.

All this points towards an attractive correlation to assets typically found in a multi-asset portfolio. The correlation of private credit to assets such as equities is positive, but tends to be low. This is important. Equities are still an important driver of returns in a multi-asset growth portfolio. Private credit is therefore a complementary diversifier of returns.

**Figure 4: Estimated correlation vs. other comparable credit and equities, September 2008 to September 2020 (in GBP)**

| | Infrastructure debt | Private debt | Real estate debt | High yield | Leveraged loans | Equities |
|---|---|---|---|---|---|---|
| **Infrastructure debt** | 1.0000 | | | | | |
| **Private debt** | 0.3636 | 1.0000 | | | | |
| **Real estate debt** | 0.5960 | 0.7245 | 1.0000 | | | |
| **High yield** | 0.4428 | 0.4463 | 0.1535 | 1.0000 | | |
| **Leveraged loans** | 0.2966 | 0.7665 | 0.5602 | 0.5117 | 1.0000 | |
| **Equities** | 0.2970 | 0.6404 | 0.2240 | 0.7718 | 0.5979 | 1.0000 |

Source: Schroders. Indices used for correlation table are as follows: Infrastructure Debt – Investment Grade European Utilities Index. Real Estate Debt – US Commercial Mortgage Backed Securities. Private Debt – Burgiss Private Debt Database. High Yield – Global High Yield. Leveraged Loans – US Leveraged Loans Index. Equities – MSCI ACWI.

## Private credit within a CDI solution

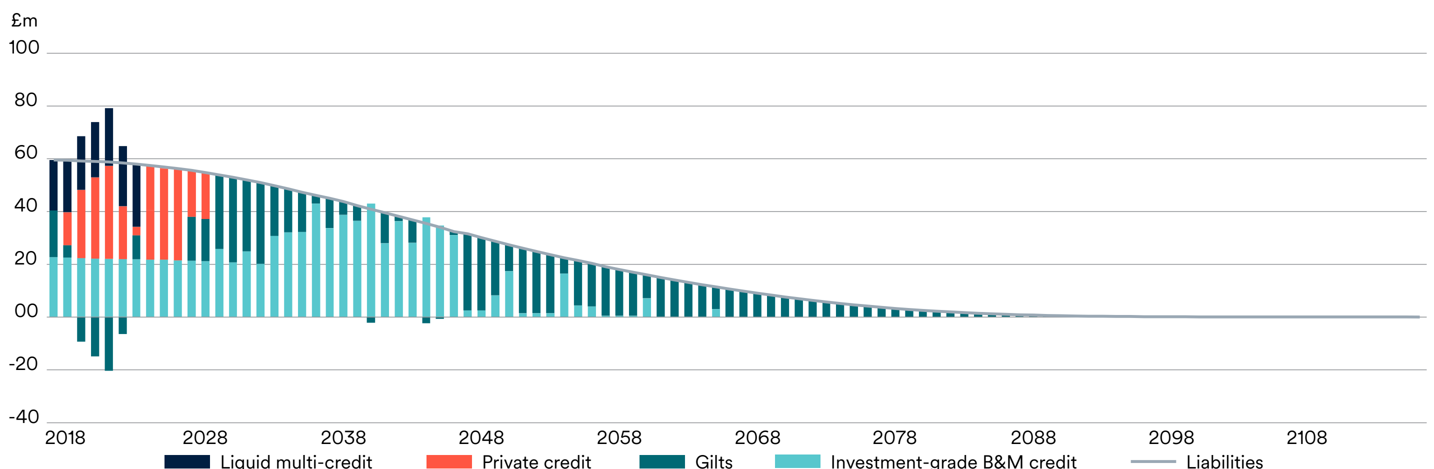
Historically, most pension schemes have constructed their investment portfolios using higher-risk "growth" assets such as equities to close their funding gap with the remaining assets invested in "matching" gilts. In doing so, they are effectively relying on a combination of dividend income and equity sales at unpredictable prices to deliver some of the cashflows needed to meet their future liabilities.

A cashflow driven investment (CDI) approach can, however, provide an alternative way of fully funding liabilities with more certainty of outcome than a traditional growth and matching approach. It does this by allocating to fixed income assets that can provide greater certainty of delivering required cashflows, ideally without any requirement for significant future disinvestments in unknown future market conditions.

These CDI solutions can use a wide range of other fixed income assets that also provide contractual cashflows. This is where we see different forms of private credit as attractive building blocks for a CDI solution.

A typical CDI solution - combining a range of these so-called 'contractual assets' - is illustrated below in Figure 5.

**Figure 5: How a CDI strategy might help match a typical scheme's liabilities**




Source: Schroders. For illustrative purposes only.

## The design of a CDI solution

An important and often overlooked source of investment flexibility in CDI solution design, is that it is not necessary for asset cashflow timings to exactly match those of the liabilities. If a CDI solution is combined with liability driven investment (LDI) hedging, cashflow "gaps" can be filled in. This is shown in figure 5.

However;

A. A broad cashflow match achieved with the CDI assets will reduce the amount of LDI hedging (and associated assets) required.

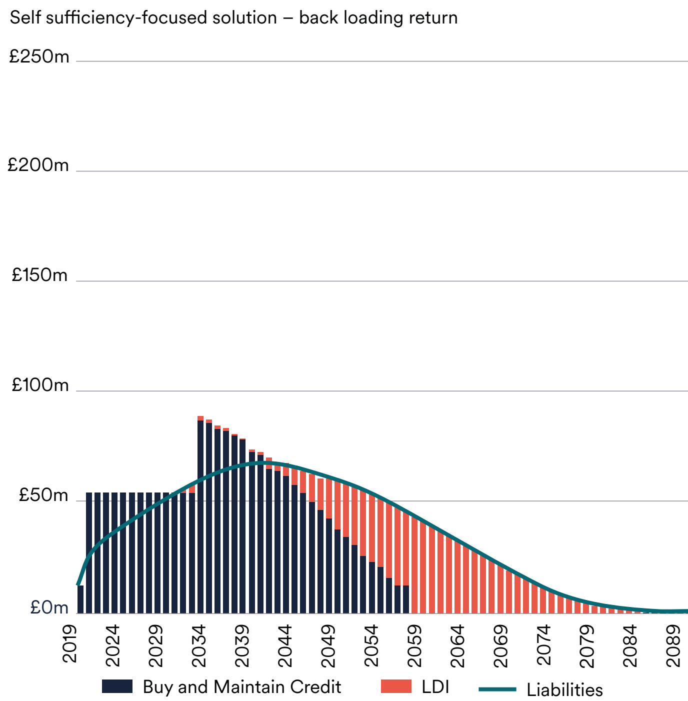
B. To the extent that there is a mismatch in cashflow timing, it is better to receive any excess asset cashflows earlier in the life of the liability cashflows.  This is illustrated by the excess cashflows in Figure 5. This will reduce the leverage of the LDI portfolio over time.

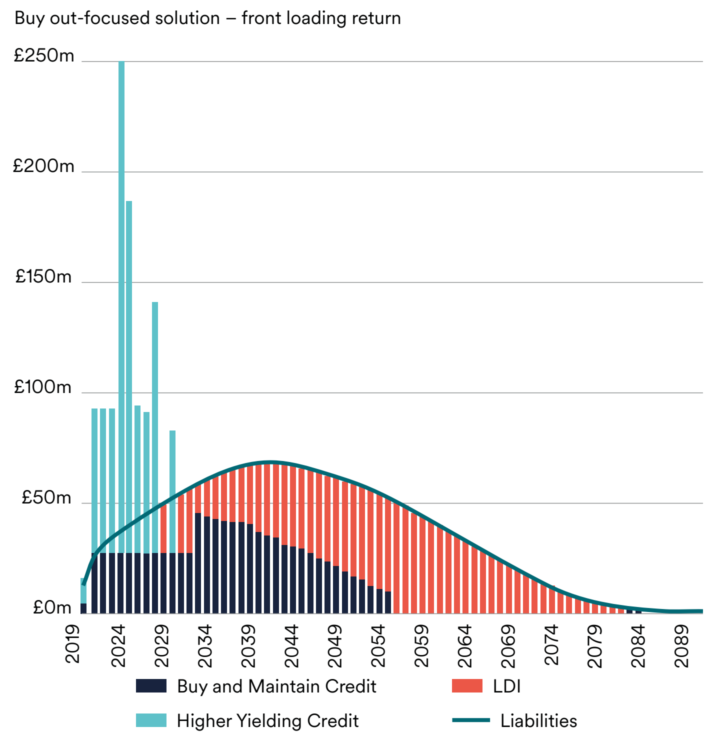
In particular, solutions can be "front loaded" to provide excess returns from contractual cashflow assets in the earlier years (see Figure 6). These can then be reinvested in gilts to meet later cashflows as part of the integrated LDI process. Although this front loading of asset cashflows means that more LDI hedging is required, from a covenant risk perspective, it is often the optimal approach.

The portfolio is subject to more risk (or higher illiquidity in the case of private credit) at a time when the trustees of the scheme inevitably have more visibility over the strength of their sponsoring company's covenant. In addition, there may be a wider and more attractive range of investment opportunities at short to medium dated maturities compared with longer maturities.

This type of front loaded strategy can also work well for a scheme that is aiming to negotiate a buy-out with an insurance company that is willing to take over the liabilities. Getting to that stage will depend on improving buy out funding over time. This may occur naturally as the fund matures, or as more of the liabilities are settled through transfer values, in addition to enhanced returns from the front-loading itself.

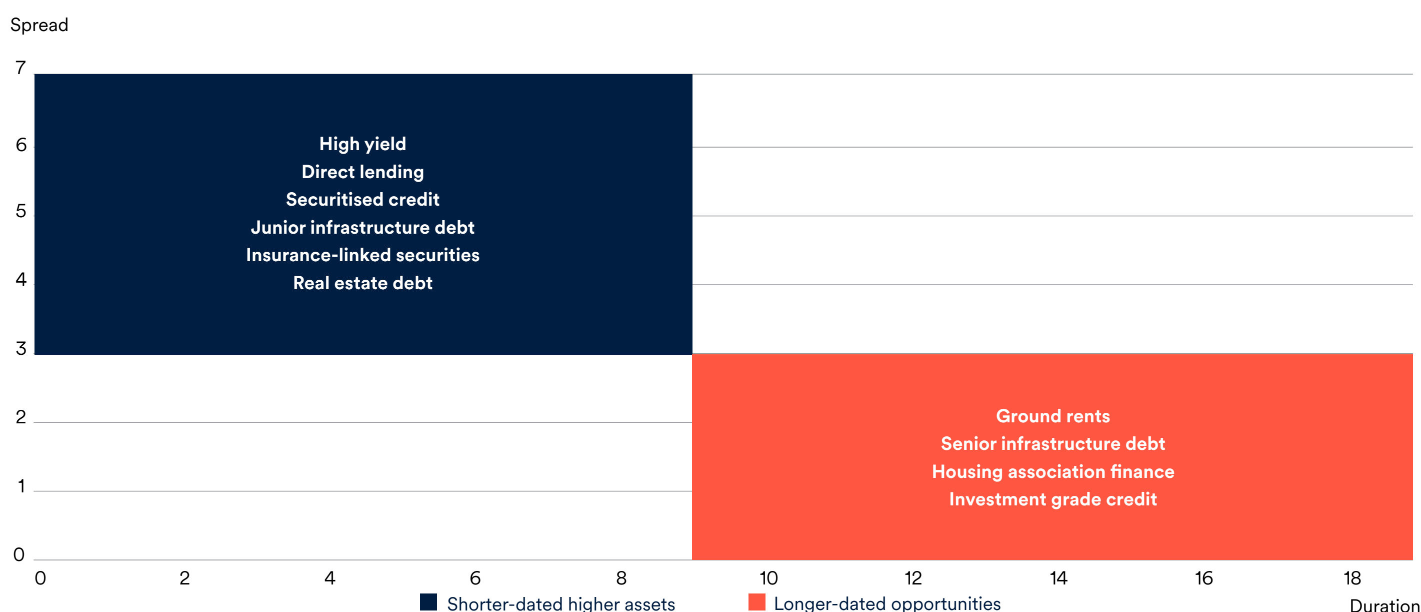
**Figure 6: Return generation can be timed to meet funding targets**




Source: Schroders. For illustrative purpose only. There can be no guarantees these returns will be achieved. Scheme is assumed to be 100% funded on TPs of Gilts + 60bps. Equivalent Gilts flat funding is 87.1%.

**Figure 7: Examples of assets available for building CDI solutions**




Source: Schroders, June 2018. For illustrative purposes only.

## Spread x duration

CDI solutions are generally designed for relatively well funded schemes that don't quite have enough assets to meet all of their liabilities with gilts alone. An important point on CDI as a consequence of this shortfall, is that a scheme's CDI portfolio must deliver enough credit return (or spread), above gilt yields, to close it.

The key mathematical measure in CDI solution design, which determines sufficiency to achieve this goal, is the spread on the assets over government bonds, net of expected defaults, multiplied by the asset duration. In other words, this is the additional spread expected to be earned on the assets multiplied by the average time period over which it is earned. This "spread x duration" value basically needs to equate with the shortfall. It provides a way of calculating the effective return contributions from a range of assets with different terms and spreads and makes direct comparisons much easier.

In general, we tend to see a separation between higher spread, shorter duration, lower credit quality vs. lower spread, and longer duration, higher credit quality assets. This is illustrated in Figure 7.

While higher credit quality is preferable in general, a CDI investor's long-term objectives will shape the assets included in the CDI solution. Self-sufficiency objectives lead to a high quality, long duration, lower spread solution – known as a "back-loaded" solution. On the other hand, if buy-out is a near term objective, the solution will favour lower quality, shorter duration assets with higher spread in order to close deficits sooner; a front-loaded solution. As you can see from Figure 7, this is where we see various private credit asset classes, such as infrastructure debt, direct lending and real estate debt, as favourable options when looking to frontload your CDI solution.

## The role of private credit in a CDI solution:

Within this context, we believe that private credit ranks highly as a CDI asset for a number of key reasons:

1. **Yield pick-up**
   As described in the context of a multi-asset portfolio, the initial reason that many investors are attracted to private credit is the ability to earn a yield pickup over traditional fixed income instruments. Whereas investment grade corporate bonds have been offering credit spreads of 1.0–1.5%, it has been possible to earn 2.0% or more in senior infrastructure and real estate debt (both of which share characteristics with bonds of investment grade rating). Similarly, while credit spreads on high yield bonds have been 4.0–5.0%, junior infrastructure debt offers on average 4.5% and senior mid-market (corporate) senior direct lending in the US and Europe between 6.0% and 8.0%.
2. **Risk characteristics**
   Again, as mentioned earlier, private credit asset classes also provide the potential for greater certainty of returns due to lower credit loss rates than other credit asset classes. This is an extremely important characteristic in a CDI portfolio given the ultimate aim is to target greater certainty of return.
3. **Maturity profile**
   The typical maturities of these asset classes (4–10 years) provide a meaningful duration over which this spread is earned whilst falling within the 'sweet spot' of maturities that expire within the term over which many schemes are seeking to earn excess returns before they seek to de-risk or prepare for buy-out by an insurance company as the plan matures.
4. **Attractive net "spread x duration" characteristics**
   Combining the significant spread pick up available in private credit asset classes with their typical shorter duration leads to attractive net spread x duration metrics which lends itself to being an attractive option when looking to front-load a CDI solution.

# Conclusion

**We believe that investing in private credit asset classes can offer a number of benefits to schemes at different stages of their lifecycle. Whether a scheme is still looking to include it as part of their multi-asset growth solution or use it as part of their de-risking journey into a CDI solution, private credit can be valuable. Private credit exhibits a number of potential advantages including attractive levels of risk adjusted returns, diversification versus traditional asset classes and an attractive maturity profile.**

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