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RPM Ep 36 transcript

Michael Venne: [00:00:03] One of the most interesting developments over the years has been the growth and evolution of private debt, though many still equate it with direct lending, that is, loans made to private companies predominantly in the middle market. The fact is, private debt is a rich and varied asset class spanning corporates, real estate and infrastructure, and also spans the risk return spectrum from core direct lending to distressed opportunistic lending and specialty finance. And increasingly, private debt is being seen for what it is: a solution for myriad investor objectives. Now, prior to the pandemic, private debt was largely regarded as a bond replacement strategy capable of generating superior yields during the era of low and zero interest rate policies. Fast forward a few years, and yields on the ten-year treasury are hovering near 5%. But at the same time, the role that private debt can play in an LPs portfolio is also changed. In addition to being seen as a substitute for fixed income, we're beginning to think of private debt as a diversifier capable of generating equity like returns over the long run. Now, all this is to say that building an allocation to private debt is no longer as simple as swapping bonds for loans. It requires careful planning and analysis and data backed assumptions to build one's assets strategically, as well as to fine tune one's portfolio in the near term using tactical adjustments. Joining me today to discuss some of the finer points of building a private debt portfolio is Christian Frei, Stepstones head of risk and a partner in our Zurich office. Christian, welcome back to RPM.

Christian Frei: [00:01:40] Hi, Michael, thanks for giving me another opportunity to talk about our work here at RPM.

MV: [00:01:46] Yeah, I think this makes three episodes now. You're our favorite guest it seems.

CF: [00:01:51] Might be, I haven't counted them.

MV: [00:01:53] All right, so Chris, let's tuck in. We're talking about something that you focus on: strategic asset allocation or SAA. But before we dig any deeper, I want to discuss our recent partnership with GIC. We partnered with them on a paper about private debt portfolio construction. I've received a lot of questions about the genesis of that project, as I'm sure you have as well. Tell us, how did that project come about?

CF: [00:02:17] So GIC does have an experienced team that's responsible for asset allocation. And so they were working internally on a framework to help them decide how and how much they should allocate to private debt. And they have approached us for contributing in a couple of ways. On the one side on the taxonomy, so how to think about the different components in private debt, the sub strategies and other input that they were looking for is the parameters that go into computing and asset allocation, mostly risk and return, but also the supporting data that we have to support these assumptions. And then last but not least, they were also looking to us to tell them about, you know, how current market conditions look and where there might be shorter-term opportunities for portfolios. And then they had before they went about that project, they were looking at what's available in the literature out there, and they didn't really find a lot. And so they felt like it might be interesting also for other LPs to learn, and that we could share the experience we have with them. For us on our side, we've been working with a couple of LPs on similar projects, but, you know, that idea of actually putting it down in a paper was really the catalyst to, you know, sit down, spend the time and put it into a digestible format in that paper.

MV: [00:03:50] Now, we've been talking about asset allocation (SAA) for a long time now. I know you and I have worked on a paper in the past. How does this recent paper different from our earlier work?

CF: [00:04:03] So the short answer is, you know, the earlier paper or papers dealt with asset allocation across equity and debt and across all asset classes, while what we're looking at here is just a private debt, and by focusing just on private debt, you know, we were able to take or we are taking a much more granular view in terms of strategy breakdown. So, for example, you know, we modeled the different segments or market segments of direct lending separately. But also, we look at the different specialty finance strategies separately. We also use risk metrics and return metrics that are a bit more applicable to specifically private debt. But despite these differences, we're still discussing the same core competencies that we consider key for successfully implementing a private markets program. So specifically, we express our conviction that deriving an asset allocation is only one of the many process steps that one needs to master to implement the private markets program, and other steps that we touch are, you know, doing realistic pacing, analysis, you know, ensuring efficient capital deployment, you know, having access to good cheapies and then as well, you know, monitoring and risk management.

MV: [00:05:29] So, Christian, that's really fascinating. And I'd be curious if at some point in the future, we take a similar tact and do SAA papers on all of the private markets' asset classes. So going back as far as 7 to 10 years, when discussing the rationale for private debt and its place in a portfolio, we often discuss that as a replacement strategy now that market conditions are significantly different. Is that still the case?

CF: [00:05:56] I think in some way, one can still think of the allocation in terms of a replacement, in the sense that if you add an asset class to an allocation it replaces or crowds out other allocations. But what's certainly the case is that for most investors, with probably a few exceptions, only a few years back, private debt was just one of many alternative assets in a portfolio. And as alternative lenders stepped into the void left by banks and the asset class grew and investor got more familiar with private debt and its risk and return characteristics, they started to more and more view it as a strategic component of the portfolio. But also, you know, many investors probably associated, as you said, private debt, mainly with corporate direct lending. But private debt really includes all collateral types, from infrastructure to real estate, all the way to specialty finance. And so, as allocations in portfolios grow and as you know, the broad or considering the broad spectrum of collateral types that it spans, the need for a systematic approach to allocation decisions clearly increased. And I think that really reached most of LPs by now.

MV: [00:07:15] So, Christian, we're really getting to the heart of the matter here. And that's the portfolio construction. A lot has been written about the demise of the traditional 60/40 portfolio. And in our paper, we offer a case study for how investors might think about supplanting a portion of their traditional portfolio with private debt assets. Can you walk us through that?

CF: [00:07:38] Yeah, sure. We should not forget that ultimately, private debt is a fixed income asset with credit risk. And so, you know, for many investors it will be about substituting parts of the fixed income allocation with a private debt allocation. The discussion about relative attractiveness of a debt versus equity is also an interesting one, and it's probably particularly interesting in current times, but that would go beyond the scope of our podcast today. But going back to your question about supplanting a portion of the traditional portfolio, to do so, it's obviously not sufficient just to look at an absolute return. As you point out, with treasuries around 5%, duration has become attractive for many investors that had not considered it attractive up to now. And considering that some private debt assets are floating, and others do possess duration, one needs to separate the duration component of the return from the spread component of returns. And similarly, you know, risks are different across strategies, as you already highlighted. And clearly the tendency is that higher spreads will come with higher risk. To demonstrate what the benefits of a private debt allocation in a traditional portfolio could be, we prefer to look at two

generic cases. The first generic case is when we demonstrate what the return pickup can be, or what the return pickup can be achieved, if one substitutes part of the fixed income portfolio with a private debt allocation that has the same risk. In the second case, we then evaluate the reduction of portfolio risk if one substitutes with a private debt portfolio of equal return expectations. So one has two extreme cases that can give some insight as to how also combinations of the two objectives might do.

MV: [00:10:06] That's really interesting. And again, I'd encourage our listeners to download the paper so that they can see the exact percentages that we estimated in our models. So, Chris, when I was flipping through the paper at first, you know, specifically with respect to the risk return diagrams, they look like standard risk return diagrams as we know them. But taking a closer look, I realized that we're not using volatility as the risk measure. Is that accurate?

CF: [00:10:37] Yeah that's a very good observation. To work with volatilities in a portfolio construction one needs time series of time weighted returns from where volatilities can be computed. And such time series are not available for most of the private debt strategies that we cover. So that's one of the reasons. The other reason is that we need the risk measure that that makes it possible to study the integration of private debt allocations into a liquid credit portfolio. That is a risk measure that is applicable for traded and non-traded assets. And if one takes volatility, one faces the challenge that the price discovery process for traded credit and private credit is different. In the case of private debt, valuations are adjusted in anticipation of increased realized losses. For traded credit prices, of course, do the same. However, they tend to react much more strongly to anticipated losses. And they do so, you know, much earlier. And so, to avoid being caught in the discussion about which of these two volatility measures is better or how to bring them, you know, on equal footing, we decided to settle with a concept that we call stress losses as a risk measure. And stress losses we define, as you know, peak losses exceeding long-term expected losses or long-term average losses over the period of 12 months. And this is a risk measure that can be estimated for credit independently of whether it's traded or not.

MV: [00:12:34] So this is really interesting to me. And I think it ties back to an earlier point we made about evolution. So as an asset class has matured and evolved, so too is our thinking about it evolved to the point where now we've developing or using risk measures that we may not have considered at a previous point in time. I mean, it is just part of the natural cycle, the natural occurrence of things. I'm curious about how, you know, our use of different risk measures than the traditional measure of volatility affects the data that we collect. Can you take us behind the scenes to discuss the data that undergirds these models?

CF: [00:13:20] Yeah, sure. Despite the increased appetite by investors for private debt, there's still very little data publicly available and specifically asset level data. So for most of the modeling, we rely on data collected by us from our GP relationships. And we collect this data and analyze the data as we conduct due diligence on GPs and update track records. Over time, the data set has grown to about 20,000 credits with over 100 data points per transaction. And so that's the repository we mainly use for all these different modeling exercises we are doing.

MV: [00:14:11] So 2 million plus specific points about credit transactions. So Christian let's shift from the strategic to the tactical. A private debt team has been producing a lot of quality research lately, much of which is related to short-term changes in credit markets. Now, as we all know by now, constructing a portfolio is a long-term endeavor with commitments to funds that cannot be adjusted to capitalize on short run opportunities. Can you talk to us a little bit about how credit investors can position themselves to pounce on near-term opportunities, and then how to plan for these opportunities when they're constructing a long-term SAA?

CF: [00:14:56] Yeah. So the question about implementing tactical or short-term opportunities is one that many of us get regularly. And our answer typically stresses that it is still important of having a strategic plan from where to improvise on, because otherwise one might easily get lost and at the end, making tactical decisions is all about relative value decisions. It's about observing changes in relative value, which then informs the investor on deviations or how to deviate from that long term plan and shift commitments on the shorter notice from one allocation to another. And I'm stressing the relative value because one might, you know, for example, see spreads widen in one area of the private debt universe and conclude that, well, yes, there is an opportunity. However, if one looked at the full spectrum of the private debt universe, one might realize that, you know, spreads, widened everywhere, and that the relative increase in spreads might be somewhere else. And so it's important to have a holistic coverage of spreads and spread changes over time. Another aspect that we think is important for capturing shorter term opportunities in credit is that one has to have established relationships with GPs that can source these opportunities, but also to have the necessary structures in place that can hold securities or investments associated with these opportunities. Because otherwise, if this is not in place, the opportunity might be gone before the first investment can even be funded.

MV: [00:16:57] Christian, thank you again so much for joining me today. Be well and looking forward to seeing you soon.

CF: [00:17:03] Well, thanks again for giving me the opportunity to talk about our research here.

MV: [00:17:11] Thank you for listening. For more color on today's conversation, head to stepstonegroup.com where you can find a copy of the paper Christian and I discussed, along with the rest of our Thought Leadership library. RPM is available on Apple, Spotify, Stitcher, and other podcast platforms.