NON-TRADABLE CREDIT MARKETS: APPEALING REWARDS FOR LONG TERM INVESTORS

By Fons Lute

In an era of extremely low interest rates, investors are seeking returns in every possible corner of the fixed income market. Emerging markets debt - over the past years or two a troubled asset class - is getting en vogue again and other niche-like segments of the market are doing well.

From an ECB point of view this is exactly what investors should be doing. While the ECB is willing to buy most of the outstanding government bonds at stratospheric prices and starts chasing corporate bonds as well, the aim is to fuel the money supply by directing investors to the remaining markets. And that is what investors do – although one might argue that pension funds are held back from selling their 'govies' as these are essential liability hedging instruments that cannot easily be substituted by non-government securities.

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Who thinks that quantitative easing thus leads to the easy financing of corporate activity and housing is horribly wrong. Well-known corporate lenders enjoy abundant access to the loans they are looking for, but things are different for parties of lower repute. We are all aware of the discussions about how to propel SME lending or home mortgage finance. European banks seem hesitant to do as much in such areas as they did before the GFC.

While credit investments are 'hot' among investors and signals of crowding start to flash, there are sufficient opportunities for institutional investors to participate in lending activity to households and businesses. Instead of focusing on 'more of the same' in crowded public markets, there are enough reasons for investors to consider an allocation to non-tradable credit markets. Private debt instruments offer access to a broader range of lending activity than is available in the public markets. While loan admission policies and maturities may be similar at times when comparing public and private loans, credit margins tend to be higher in private markets and barriers to entry are substantial. The high hurdle of gaining exposure to private lending structures largely abandons the cyclical 'money-chasing-assets' feature of public debt markets. More specifically, non-tradable debt lacks the investor sentiment factor that drives much of the volatility in tradable debt markets. As a result, exposure to non-tradable credit markets will harvest credit risk premium similar to tradable markets but with less volatility. Stated

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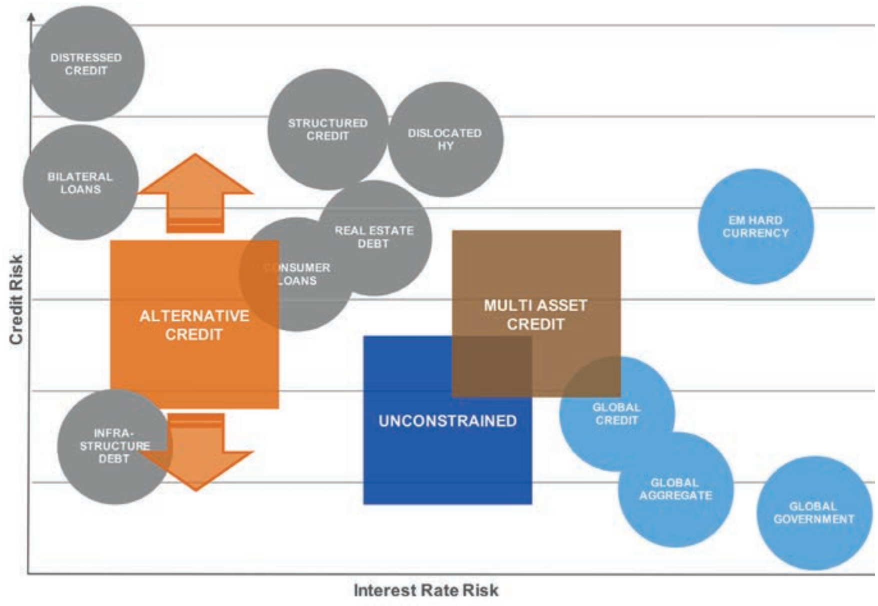
otherwise: the same level of default risk in non-tradable credit markets compares with higher valuation stability compared to its tradable counterparts. This leads to a higher expected Sharpe Ratio over time for a portfolio that includes private credit.

From a portfolio strategy point of view I consider the non-tradable credit market segments easier to assess than the tradable credit market segments. This consideration rests on the notion that it is investor sentiment that drives a substantial portion of the price volatility of listed securities. In my experience the Sentiment factor is the major 'swing factor' that time and again tends to detach market pricing (far) away from fundamental values. Without the profound influence of a Sentiment factor it is easier to determine the distance of current valuation to the fair value in the non-tradable credit markets. Non-tradable credit markets are not exposed to this excess volatility. This does not imply that non-traditional credit markets are free of dislocations. Reality has it that a leverage cycle exists which inevitably leads to occasional dislocations, both in traditional and in non-traditional credit markets. In non-tradable credits, income return is generally high and this allows investors to tune their exposure to their market view. When fears of overheating in private market lending arise, the investor can decide to invest the cash flows elsewhere in his portfolio or add it to his cash buffer and wait with investing until the market has returned to normalcy.

Investing in non-tradable credit alongside a listed credit portfolio will offer investors more issuer diversification than investing solely in public high yield bonds while offering a higher expected return. The private lending universe is broad and currently is very much a global rather than a regional marketplace. Accessible segments of the non-traditional credit market are in infrastructure, consumer

Figure 1: Fixed income market segments and portfolio choice



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loans, commercial real estate and corporate lending. Such markets can be accessed through specialized intermediaries that exist and many of whom have a wealth of experience in investing in these less well-known areas to the international fixed income markets. Investments can be allocated to the market segments of choice, offering ample discretion for investors to select the desirable combination of credit risk and interest rate sensitivity.

Working with the non-tradable credit specialists enables investors to take on a broader range of loans than they could possibly invest in by themselves. Credit specialists with thorough experience in lending practices are well placed to partially engage into the riskier segments of the markets.

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Their deal selection skill will allow the fund to achieve returns in excess of public high yield markets with lower write-down risk.

Global fixed income markets have more to offer investors than what is offered through publicly listed securities. Specialized intermediaries offer solid and structured ways for investing in private market instruments. Using these opportunities within their asset allocation strategy seems like a natural thing to do for long term investors in Europe, especially after the changes in bank capital regulation that urge European banks to change their lending behaviour. In low return fixed income markets a portfolio of blended non-tradable credit will offer attractive yields to investors. «

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