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Private credit soars 77% as asset class continues to heat up

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Gregg Disdale said private credit often is less volatile than fixed income and can pay regular income.

Private credit has been on a tear with the largest U.S. pension plans, and that trend is showing little signs of stopping anytime soon.

Private credit portfolios of defined benefit plans among the largest 200 U.S. plan sponsors surveyed by Pensions & Investments increased 77.3% to $89 billion in the 12 months ended Sept. 30.

While that increase slowed from the nearly doubling, 93.1% increase in the year-earlier period, it also reflects a 453% increase from 2018, when P&I first included private credit in its annual survey.

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Asset owners are continuing to add or bulk up exposure to private credit in their portfolios. After the Sept. 30 end of P&I's survey period, the two largest pension funds in the U.S. — the $496.8 billion California Public Employees' Retirement System, Sacramento, and the $313.9 billion California State Teachers' Retirement System, West Sacramento — added private credit allocations.

On Nov. 15, CalPERS created a new 5% private debt target allocation, while also boosting private equity by 5 percentage points to 13%, increasing real assets by 2 percentage points to 15% and adding 5% leverage to its asset allocation.

"The return premium associated with these private asset classes makes them important building blocks for constructing portfolios capable of meeting CalPERS' return objectives," according to a November staff report.

CalPERS officials plan to bring its private debt management in-house, noted Theresa Taylor, currently CalPERS board president but who was investment committee chairwoman at its November meeting.

CalPERS and private credit

Even without a private debt allocation, CalPERS tops P&I's list of the largest investors in private credit with assets up to $10.8 billion from only $604 million a year earlier.

Before adopting the separate private debt target allocation, CalPERS had been investing in private debt strategies as part of its private equity allocation. Since 2020, CalPERS also has been boosting its private credit exposure by increasing assets invested in opportunistic strategies, a bucket limited to 5% of plan assets that is not part of its overall asset allocation, and skewed those strategies toward credit investments. As of Sept. 30, CalPERS had $3.2 billion invested in opportunistic strategies, up from $500 million a year earlier, CalPERS investment reports show.

CalPERS' neighbor across the Sacramento River, CalSTRS, revised its fixed-income policy in September, adding an overall 5% target allocation to private credit as part of its 13% fixed-income allocation. A staff memo for CalSTRS' Sept. 1 meeting noted that private credit has gained "a foothold in many institutional investors' portfolios" because it generates cash flow with a higher risk-adjusted return than public debt. Private credit also reduces the correlation of fixed income to public equity and public debt, the memo said. CalSTRS did not report any private credit investments on its survey.

The private credit portfolio of the $72.7 billion Los Angeles County Employees Retirement Association, Pasadena, Calif., which plan officials refer to as illiquid credit, had a significant increase during the survey period with assets up 116.3% to $1.8 billion as of Sept. 30.

In May, the LACERA board approved a new asset allocation that increased its allocation to illiquid assets to 32% from 19%, including a 4-percentage-point boost to its illiquid credit target to 7%. This

illiquid credit increase is being funded by a 5-percentage-point reduction in liquid credit to 4%.

LACERA's strategy is to maintain a slight overallocation to liquid credit and, over time, use the capital to fund its illiquid credit commitments, said CIO Jonathan Grabel in an interview.

37.6% increase at Florida

Officials at the Florida State Board of Administration, Tallahassee, which oversaw a $199 billion defined benefit plan as of Sept. 30, attributed the 37.6% increase to $5 billion in private credit partly to valuation increases of the relatively small portfolio.

"Obviously, the percentage growth is high due to a relatively small base," said Dennis MacKee, FSBA spokesman, in an email. "Part of the increase was due to appreciation, but most was due to aggressively committing and deploying capital during the pandemic when spreads were wide."

Even before the pandemic, asset owners have been shifting more of their asset allocation toward private credit because of the low yields of more traditional fixed income, said Faraz Shooshani, San Francisco-based managing director, senior private markets consultant at Verus Advisory Inc. It can take five years for an asset owner's portfolio to experience the full impact of an asset allocation decision, he said. Verus has seen early evidence that private credit is delivering the income, yield and returns that investors expect, but they have to be sure to get the portfolio structure and management selection right.

These days, Mr. Shooshani said that investors are being cautious because the markets have been fairly hot. There is concern that private credit portfolios could be impacted by the denominator effect which is when a decline in public markets lead to an increase in the percentage of alternative investments in investors' portfolios.

Illiquidity premium

Gregg Disdale, London-based head of alternative credit at Willis Towers Watson PLC, said that private credit continues to be popular among asset owners in the U.S. and elsewhere. In many parts of the private credit market, there is still an illiquidity premium, he said. Also making the asset class attractive to some investors is that private credit often pays regular income and is less volatile than fixed income, he said.

The possibility of interest rate increases is making investors more interested in private credit, which tends to have a floating rate, Mr. Disdale said.

That is not to say there are no risks, Mr. Disdale said. While defaults have been "exceptionally low," should interest rise it may put pressure on borrowers, potentially resulting in an increase in loan defaults, he said.

"But unless there is a meaningful pickup in defaults" it should be a good environment for private debt, Mr. Disdale said.

Law firm Proskauer Rose LLP, New York, on Jan. 27 released the findings of its most recent Private Credit Default index, showing a 1.04% overall default rate for the fourth quarter, representing a drop in defaults from 1.5% in the third quarter and 2.4% in the first quarter of 2021. Defaults have generally been going down since a peak of 8.1% in the second quarter of 2020, Proskauer data shows.

Private credit strategies such as direct lending have been "exceptionally popular" with spreads between private and U.S. Treasury bonds narrower now than in 2010, Mr. Disdale said. What's more, the opportunity set is growing. Borrowers are looking to use private credit over more traditional loans due to the flexibility of private loans and because private lenders are willing to lend a higher amount, he said.

At the same time, private credit investment pace has rebounded "very strongly" from the fourth quarter 2020 through 2021, Mr. Disdale said. Investment activity is expected to continue in 2022, he said.