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May 2022 • privatedebtinvestor.com

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Private debt's six biggest challenges

Leading asset class professionals explain their concerns (and offer reasons why things may not be all that bad)

In the turbulent world we see around us in 2022, it's clear there are plenty of concerns and anxieties for all of us. But what are the major worries of private debt investors as they survey the investment landscape? That's the question we asked six leading asset class professionals – and, in the following pages, you will find their highly insightful responses.

Interestingly, there was no overlap between choices, as every individual volunteered their own unique challenge. The six topics were as follows: uncertainty (Deborah Zurkow, Allianz GI); liquidity (Dan Zwirn, Arena Investors); competition (Chris York and Greg Mason, Ares Management); ESG (Sabrina Fox, European Leveraged Finance Association); valuations (Ingo Wichelhaus, Mount Street Group); and transparency (Nelson Chu, Percent).

Read on to find out more about why these challenges were chosen, along with thoughts on what the asset class can do to avoid being knocked off course by them. ■

Liquidity

How liquidity 'exacerbates the stress'

With record amounts of money chasing compressed returns, investors have higher risk tolerance (eg, longer duration, weaker covenants, higher subordination/debt multiples, etc). Today, with markets priced to perfection, inflation voiding the going-forward "Fed put" and geopolitical issues adding complexity – is there anything else to worry about? Unfortunately, yes: liquidity.

Liquidity is a disregarded topic, and typically conflated with time horizon (the misconception is that short-term risk can be ignored by long-term investors). It is often assumed to match the "package" it comes in. But as the 2016 experience in UK commercial property funds showed, one cannot give real estate daily liquidity simply by selling it in a mutual fund. Asset-liability mismatches in fixed income are pervasive, and, should a real downturn come, liquidity will exacerbate the stress.

Rewind to the 2002 WorldCom fraud, which wreaked havoc on the public and private markets, with the debt also widely held in CLOs and CDOs. At $30 billion, it was a large issuance for the time, but pales compared with today.

While many take comfort in post-WorldCom changes (such as step-up clauses for downgrades), others underappreciate the post-Volker Rule world (where dealers hold scant inventory), eligibility rules (where downgrades will cause sell-offs of losing positions), and investor psychology (where sell-offs always lead to more selling). The International Monetary Fund studied covid-19 sell-off dynamics and noted that to cover redemptions, funds were forced

Dan Zwirn
CEO and CIO of New York-based fund manager Arena Investors

to shed cash and US Treasury securities first, increasing concentration in illiquid assets, and only with "unprecedented central bank policy support" were they able to avoid widespread fund closures.

'Not our problem'

Asset managers note this, but say, "It's not our problem." A simple web search brings up papers from the largest managers citing their "high-priority" relationships with the broker/dealers; that they maintain ample liquidity (verified by risk management departments); technological advances (eg, electronic trading) offsetting lower inventories; and, at the extreme, some even dismiss the issue completely, arguing liquidity squeezes present tactical opportunities.

Regulators similarly turn a blind eye – US Federal Reserve-led studies note "only limited evidence of a

> *"Some even dismiss the issue completely, arguing that liquidity squeezes present tactical opportunities"*

deterioration in [bond] market liquidity" and that in March 2020, while dealers absorbed "no additional inventory despite considerable selling pressure", the data was merely "interesting" and that "much work remains to be done".

Why does this matter for private markets? Beyond the contagion factor, illiquid investments are priced at a spread to 'liquid' assets. As the illiquidity in spreads typically outweighs the credit risk component in periods of turmoil, one can only assume large scale losses. In underperformance, private investments will experience myriad issues. These include managers (with no prospect of earning incentive fees) having the ability to extend fund realisation periods (charging management fees, sometimes based on their own marks); managers amplifying "amend, extend, pretend" practices (unable to force a crystallisation due to long durations and loose covenants, and typically lacking workout capabilities anyway); or situations where sponsors are at odds with lenders (and begin torching otherwise "friendly relationships").

Whatever your liquidity needs, you should ensure you are not a victim of circumstance. Start by ensuring managers are not using leverage imprudently (with non-recourse financing arrangements), check governance in asset valuation policies, and revisit alignment (noting the current trend where owners of the most illiquid credit managers are selling their stakes at record levels). Perhaps add tail-risk hedges, making investments with "downward convexity", or reducing outright exposures through direct sales and/or secondaries. ■