

## Markets Insight

# Investors in credit are backing hammers that see only nails

The systematic underpricing of loans will inevitably blow holes in balance sheets

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After a decade of low rates and investors calling for higher yields, unprecedented amounts of capital have flowed into private markets to fund loans and other specialised credit assets. We are now in an environment that is commonly referred to as “late in the cycle”, where investors are concerned about making bad investments at a time of multi-decade lows in spreads over Treasuries.

But while this has led some to scrutinise the quality and pricing of investments, there has been virtually no self-discipline in the markets from issuers, fund investors, fund managers or rating agencies. Issuance and fundraising have maintained a blistering pace even as credit quality and protections have deteriorated.

In addition, there continues to be an unprecedented amount of capital flowing into increasingly specialised vehicles that offer investors access to narrow investment opportunities – and almost no debate about the tremendous amount of moral hazard that exists (and continues to grow) in private credit. This is curious. Even a cursory review of the myriad credit-related financial disasters of the past 300 years have featured moral hazard as their root cause.

The label “private credit” is, itself, hazardous in so far as it indicates the adoption of these

investments as an institutional asset class. As someone who has been active in such investments for 25 years (long before they were deemed to represent an alternative “class” of assets), I was surprised to see the market evolve along the lines of the long-only asset management business – that is, specialised offerings such as middle-market US corporate loans, marketed in similar ways to mid-cap US equities. In addition, we have seen the arrival of managers who offer a broad array of options, inviting investors to make their own investment allocation decisions from the “cheap seats”.

It is ironic that the traditionally siloed nature of banks and insurance companies – which fostered the creation of the alternatives investment industry – has re-emerged. Investors are being sold mandates that are exposed to price-taking in narrow areas of specialised finance. A European Real Estate Mezzanine Fund, for example, has every reason not to raise its hands and say, “Enough! Current pricing makes no sense and I need to return your capital”. After all, companies have salaries and rents to pay and, like the residential mortgage originators before the 2008-09 crisis, may tell themselves and their investors, “This time it’s different”.

Today, if you are a private credit manager hoping to

raise assets, you have to offer what sells – for example, North American clean energy or European infrastructure debt. That is opposed to the traditional approach, whereby an asset owner would partner with a fund manager as a meticulous and careful steward of capital.

By creating what sells (versus what makes a good investment), investors are backing hammers that see only nails. Once capital is committed, there is every incentive to put that money to work within that narrow mandate – no matter what headwinds the strategy might encounter during the commitment period.

We are certain of one thing: every permutation of industry, geography and product that we have ever seen is only occasionally compelling. We just do not know when it will become so. As an investor, you need the ability to freely and dispassionately assess whether any individual area presents an attractive opportunity. Investors should have no a priori commitments regarding any given area.

An investor could start by asking the following questions. To the extent a particular opportunity looks attractive, am I sourcing managers who also have expertise across industries, products or geographies, so that they can also find opportunities when

that specific trade no longer looks as good? Is the duration of the commitment in line with the length of that opportunity? Further, is the structure of assets and liabilities matched, so that the liquidity terms fit the underlying assets?

And finally, is the seniority of the debt and the value of an issuer’s assets enough that I can absorb losses in the underlying collateral before realising losses or getting wiped out? Does the projected return compensate for the risk I am taking?

While we cannot predict when the next downturn will take hold, we do know for certain that fixed income positions ultimately have maturity dates and covenants that create a day of reckoning.

Nowhere are markets more, in Warren Buffett’s paraphrasing of Ben Graham, a weighing machine versus a voting machine. In the short term, the ravenous hunger for yield may push pricing ever tighter, and issuers will continue to be able to roll over or refinance their debts. However, the systematic underpricing of credit will inevitably blow holes in the balance sheets of those who accumulate it.

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