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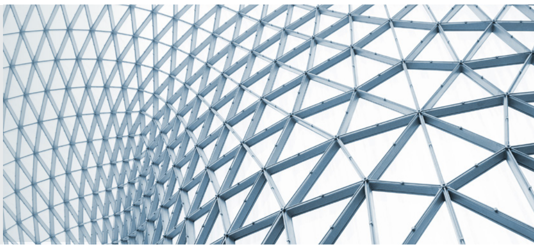

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Private debt and liquidity finally meet

DC members and smaller DB schemes get long-awaited access to illiquid assets

Key Takeaways:

- The challenges of investing in private debt for smaller DB schemes and DC schemes can be overcome. Two affiliates of Natixis Investment Managers have joined forces to build a strategy which provides cost effective exposure to private debt for investors with a long term investment horizon.
- Half of the assets are allocated to European private debt, while the other half are invested in a liquid multi-asset credit portfolio, creating considerably more liquidity than a pure private debt fund.
- For members of DC schemes who choose low-risk default strategies, and for smaller DB schemes, the strategy can enhance returns from fixed income allocations while keeping volatility low.

Many investors are cut off from illiquid debt, depriving them of access to a growing and attractive asset class and benefitting from an illiquidity premium which could boost their fixed income returns.

Illiquid debt is well represented in the portfolios of many defined benefit pension funds and larger institutions, but DC pension scheme members and members of smaller DB schemes are frustrated by their inability to access illiquid assets.

Despite the desire of DC scheme managers and smaller DB schemes to offer illiquid investments to their members and clients, few workable solutions has been forthcoming until now.

Murtaza Merchant
Partner, Head of Fund Optimisation
MV Credit

Alex Thompson
Vice President, Investment Director
Loomis, Sayles & Company

Why private debt is off the menu for many investors

The private debt market has expanded rapidly over the last decade and now represents a sizeable and growing part of the fixed income universe.

However, it is difficult for many investors to access for 5 key reasons.

First, illiquid and often closed-end fund structures do not meet regulatory requirements for many investor types, including the DC market.

Second, the large minimum commitments demanded by managers of illiquid assets reduce portfolio diversification for smaller investors.

Third, fees for private assets are relatively high and usually contain a sizeable performance fee.

Fourth, it is a complex asset class to analyse, and often beyond the due diligence budget of the mass market and smaller institutions alike. This imposes governance costs.

Last, and definitely not least, many investors worry about locking up their money for long periods, even when they have a long-term investment horizon.

“Some investors tell us they want private debt in their portfolios, but they also want some liquidity,” says Murtaza Merchant, Head of Fund Optimisation at MV Credit. “Their desire for liquidity may be more driven by comfort than by need.”

Innovative strategy combines private debt and liquid multi asset credit

The challenges of investing in private debt for smaller investors and DC schemes can, however, be overcome. Two affiliates of Natixis Investment Managers have combined forces to create a strategy which provides exposure to private debt through an open-ended strategy with daily subscriptions and redemptions.

The innovative strategy brings together MV Credit, an expert in European private credit and Loomis Sayles, a global investment firm with active fixed income, equity, multi-asset and alternatives capabilities. Ultimately, half of the assets in the strategy are allocated to European private debt and managed by MV Credit, while the other half are invested in a liquid multi-asset credit portfolio managed by the Loomis Sayles Alpha Strategies team

The yield-enhancing, private debt half of the portfolio invests primarily in senior loans which typically finance upper mid-market private equity backed deals. Senior loans in the private debt space typically yield more than investment grade bonds. The private debt portfolio allocates a small proportion of its assets to subordinated debt, where yields are higher than for senior loans.

For its private loans, MV Credit focuses on non-cyclical, stable sectors offering strong visibility on revenues and ideally with low capex and flexible cost structures. This corresponds most often with investments in healthcare, software, B2B services and IT services. The diversified loan portfolio operates across different geographies and is designed to be robust through economic cycles.

The Loomis Sayles portfolio focuses on corporate credit (both investment grade and high yield), bank loans, securitized assets and emerging market debt.

Both investment teams retain their respective investment philosophies and investment processes.

Efficient deployment of investors' capital

Unlike allocations to pure play private debt strategies, the MV Credit/Loomis Sayles strategy puts investors' capital to work immediately.

Initially, investor money is allocated to the liquid Loomis Sayles portfolio, where it can be deployed rapidly. "The Loomis Sayles multi-asset credit portfolio has a global opportunity set and cash can be put to work relatively quickly such that investors can start earning yield almost immediately," says Alex Thompson, Investment Director at Loomis Sayles.

In the meantime, MV Credit identifies private market investment opportunities to enhance strategy returns. As these opportunities materialize, Loomis Sayles tactically liquidates some holdings and the proceeds are used to buy private debt managed by MV Credit.

The process is repeated over the next 12-18 months until all of an investor's assets reach the target 50:50 allocation.

Provision of liquidity

The result is a strategy which has considerably more liquidity than pureplay private debt funds. "We have a 20-year plus track record of investing in private credit markets and capturing illiquidity and complexity premiums in the market," says Murtaza Merchant. "We can now offer that to new types of investors, who have not had that access into private debt in a meaningful and cost effective way".

These first steps will be supported by what Merchant describes as "responsible and limited liquidity". That is, the strategy has a daily NAV and daily trading, but cannot in all circumstances provide total liquidity.

While the strategy offers daily liquidity, it is intended to form a constituent part of a much larger pool of liquid assets, such as equities. Investors will only truly benefit from the private debt exposure if they adopt a long term investment time horizon. That being said, subscription and redemption requests are met by Loomis Sayles in the first instance.

"The Loomis Sayles portfolio management team aims to provide not only attractive risk adjusted returns but also act as the principal source of liquidity for the fund. Close communication with the team at MV Credit is imperative to successful management of the strategy," says Thompson.

Resilience to market volatility

Since private credit has a low correlation to traditional asset classes, the strategy has proven resilient to market volatility. So it does not suffer the same level of drawdown as publicly-traded bonds during times of market panic.

At the same time, the strategy has a better redemption profile than private debt funds that are entirely invested in illiquid assets. Initial redemption requests are met by selling assets in the liquid Loomis Sayles portfolio, while maintaining the private debt portfolio.

The liquidity provisions have been designed to minimise pressure to liquidate the private debt assets. In addition, the strategy includes mechanisms (e.g. gating) to ensure that all investors are treated fairly, especially under adverse market conditions.

"This is very important", says Merchant, "We want to meet liquidity requirements whilst avoiding having to force sell illiquid private debt assets and also ensure fair treatment for all investors".

Focus on DC default funds and smaller DB schemes

The strategy is a good fit for DC scheme default funds, where investors seek market-beating risk-adjusted returns, but do not necessarily want or need to know the technical aspects of strategies.

For similar reasons, it is suitable for smaller DB schemes that don't have the budget for selection and management of relationships with private debt managers. It is easily accessible to smaller institutions via recognised pension platforms.

The strategy has an attractive management fee and no performance fee, making it affordable to most pension schemes. It also has a conservative risk profile aimed at newer investors to private debt assets.

The low-risk 50:50 strategy aims to return 5%-6% gross over a full market cycle.

Demand for access to private debt is finally met

For investors who want some liquidity, but don't need total liquidity, who want to increase fixed-income returns without taking a significant extra risk, this strategy represents something of a breakthrough.

For inexperienced members of DC schemes who choose low-risk default strategies, and for smaller DB schemes, the strategy can enhance returns in fixed income allocations while keeping volatility low.

Demand from consultants and pension scheme managers for universal and low-cost access to private debt has finally been met.

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