Park Square

Park Square Perspectives, Volume 4:

Credit is an “Asset-Pickers” Market

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Park Square Perspectives

Private credit has seen tremendous growth over the last decade, with many sophisticated institutional investors now allocating a significant portion of their portfolio to the asset class. While investors view the return profile as attractive, they are becoming more sanguine about the risks and more discerning as the asset class matures. They see many managers who lack long-term track records, appear to prioritise gathering assets over disciplined investing and who are beginning to encounter problems in their portfolios.

Moreover, in a broader investment world where passive investing is all the rage[1], academics have questioned whether private credit consistently generates alpha[2]. In our view, the asset class provides excellent opportunities to generate alpha and the observable benchmark is clear.

But the broad market is of very mixed quality, and therefore asset selection and manager selection are critical. We believe that credit is an “asset-pickers” market.

The challenges of benchmarking performance in credit

Loans are inherently a non-standard product, lacking the uniformity and consistency found in public equities or investment grade bonds that make for easy performance comparisons. They are offered in many different flavours of leverage, currency, sector, geography and documentary strength, not to mention different fund structures and vintages.

Recently, a trio of academics have tied themselves in knots trying to conjure a private credit benchmark from a combination of debt and equity markets[2]. While this approach may be appropriate for the riskiest elements of credit investing, it seems overkill for senior loans which are very similar to those in the broadly syndicated loan (“BSL”) market.

The most straightforward methodology is to use the US or European Leveraged Loan Indices which contain over one thousand loans and trade daily in a private marketplace with fairly good liquidity[3]. Depending on the segment of the private debt market one is targeting, an investor can add a spread premium to the LLI to compensate for illiquidity or other additional risks.

Supporting this idea of benchmarking private credit loans to the broader BSL market is the fact that the two markets have increasingly converged over the past several years. In fact, today middle-market direct lending can be increasingly divided into sub-segments of lower, middle and large-sized borrowers. The large end of this private debt market starts to blend seamlessly into the broader BSL market, with both markets competing to finance larger deals.

> *Unlike equity markets, you don’t succeed by backing the winners. In private credit, you win by avoiding the losers.*

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The drivers of performance in credit are very different from equity

Equity market performance is driven by winners, credit market performance is driven by avoiding losers. Unlike equities, where the upside can be limitless, credit investments offer a modest return, typically 1.35x your money in senior debt. No single winner in the credit market is likely to compensate you for losses.

In equity markets, owning the winners is critical and the impact of losers on the broad market is naturally reduced over time, as they drop out of the index when their market capitalisation becomes too small.

The S&P 500, for example, is heavily weighted to equity market winners consisting of large, established businesses that command premium valuations. Investors who fail to own equity winners (most recently Nvidia) will underperform the benchmark. Buying an equity index in a low-cost ETF is thus a sensible strategy which is challenging to outperform.

The broad credit market is of very mixed quality and selectivity is essential

By contrast, exposure to a broad credit index is a different story. The quality of a private credit deal depends on factors such as the defensiveness and stability of the borrower, total leverage, cashflow coverage, sponsor equity contribution and documentary protections.

In our experience, private credit is about picking the right opportunities. Think of it like buying a used car - you want one with low mileage, no rust, a full-service history and no hidden problems under the hood. In private credit you need to focus on high-quality companies and perform rigorous due diligence on the borrower and the documentation to ensure you make intelligent investments.

New companies frequently enter the leveraged loan market, and the vetting process can be inconsistent. Many credit investors such as CLOs (who are major buyers of leveraged loans) are technically driven and strongly incentivised to invest quickly in a very diversified way. These drivers arguably make these investors lack investment discipline.

As a result, there are a lot of unattractive borrowers in the LLI, and it is essential to avoid the "crud". In fact, there are entire sectors that we find unappealing and many companies we believe should not be leveraged at all. This is equally true in private credit and BSL markets. You simply are not compensated at original issuance for taking a risk by investing in the "crud". Selectivity is not just important – it's essential.

Of course, diversification has its place, but too much diversity reduces the overall quality of the portfolio as there are a limited number of good credits. Moreover, when you add in sectors which we believe just shouldn't be levered, this additional "diversification" actually adds risk to the portfolio.

At Park Square, we typically target somewhere between 30-60 companies per fund, depending on strategy, which is far fewer than the c.200 in a typical CLO or the c.1,500 in the leveraged loan market. This allows us to stay laser-focused on investing only in high-quality businesses with favourable structures.

Given this, private credit managers with highly diversified portfolios – or those following a passive 'buy the market' strategy – are likely to sacrifice quality and face higher default rates and lower returns, thereby eroding alpha. These are effectively "beta" managers, which may be the target of the recent NBRS academic paper. Unlike equity markets, where passive strategies such as ETFs are low-cost at c.4 basis points, passive credit strategies are comparatively expensive at c.50 basis points. Overall, active management in credit is even more important than in equities because the odds and the costs do not favour passive credit strategies.

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The credit market is driven by technicals and subject to dislocation

Selectivity goes beyond choosing the right credits – it is also about patience. As Warren Buffett wisely noted "whether we're talking about socks or stocks, the time to buy quality merchandise is when it's on sale". This principle applies directly to the BSL market, where periods of economic stress or geopolitical tensions can cause dislocations, leading to temporary mispricing.

CLOs play a significant role in market dynamics. When new CLO formation slows, demand for loans decreases, driving prices down. Additionally, forced selling by CLOs – triggered by rating downgrades or covenant breaches – can flood the market with loans, exacerbating price declines. This is particularly true in Europe, where capital markets are less developed than in the US, and where liquidity is thinner.

Such dislocations – whether caused by external shocks or CLO technicals – can create compelling buying opportunities. Investors who are patient and selective can acquire fundamentally strong credits at attractive discounts in the secondary market, potentially improving a portfolio's risk return profile.

Our approach to generating alpha

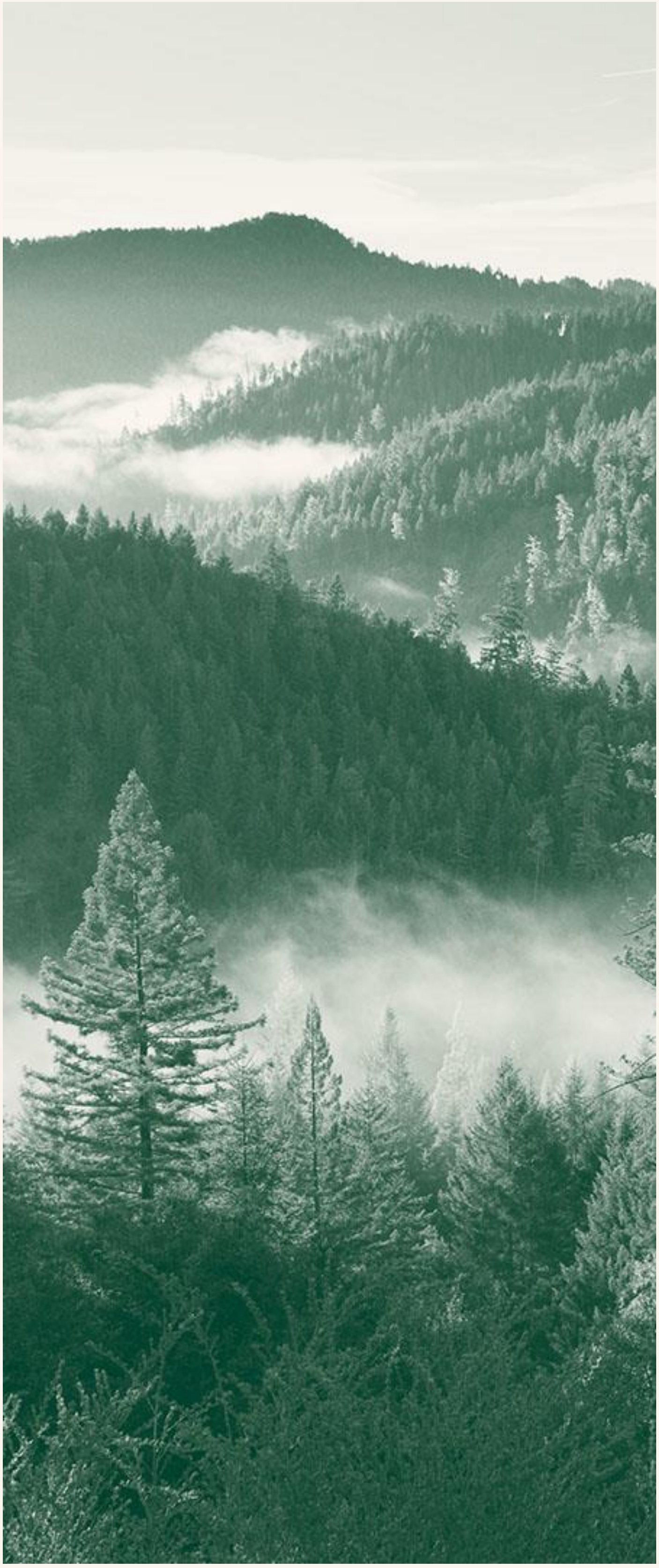
At Park Square, high-conviction credit picking is in our bones. Our philosophy centres on investing in high-quality, market leading, stable, and predictable businesses that make great credits. Many companies and sectors will never make the cut. Once we are satisfied with the creditworthiness of the company, we create favourable structures, negotiate strong loan documentation and secure premium economics.

After a company joins our portfolio, we adopt a rigorous and proactive approach to portfolio management. If a deal shows signs of turning sour, we aren't afraid to exit early to protect our investors' capital.

We believe this approach is the best path to consistently outperform the market, underscoring that private credit really is an "asset-pickers" market.

Notes:

1. McAlpine, "The Rise of Passive Investing in Today's Market", *Morningstar*, 6 June 2024
2. Erel, Flanagan and Weisbach, "Risk-Adjusting the Returns to Private Debt Funds", *National Bureau of Economic Research*, March 2024
3. Morningstar LSTA US Leveraged Loan TR USD, *Morningstar,* 31 August 2024



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