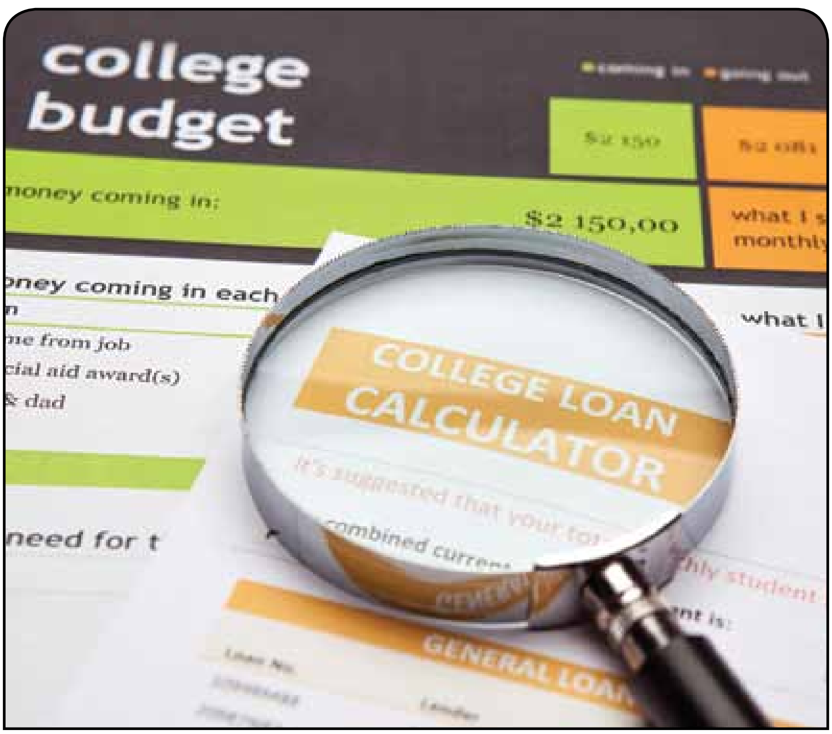
Rethinking Fixed Income:

How Private Debt Provides Investment-grade Quality, With Premium Yield

By: Bruce MacKinnon & Louis Bélanger

The search for yield continues. The persistence of low interest rates has given institutional investors the daunting task of finding yields to match their commitments previously pledged, during a time of higher bond market returns. The need for long-dated bonds to match liabilities has led to huge growth in demand relative to supply, exacerbating an already muted outlook for returns. With no real change in the risk appetite of investors, there is a need to 'rethink fixed income' and consider a wider range of investment options that could help boost returns.

Where can investors find investment-grade equivalent securities and earn higher yields without sacrificing credit quality? One area may be hidden within the universe of private debt.



Debunking The High Risk Myth

When investors think of private debt, they often associate the asset class with higher risk investments such as high yield bonds, mezzanine lending, and subordinated debt.

The largest part of the private debt universe however, is focused on higher quality loans. *Chart 1* highlights the broad spectrum of the private debt space and, importantly, illustrates the relatively large size of the investment-grade equivalent space within the spectrum (see *Chart 2*).

These higher quality loans have many attractive attributes typically lacking in the public debt market. Investment-grade private debt is:

- typically secured against an asset
- includes detailed, timely reporting requirements
- has a risk-based covenant package
- has a repayment schedule tailored to suit the specific credit profile of the underlying investment, resulting in lower refinancing risk

What's more, private debt investments are based on an active, ongoing investment management relationship, whereby the private debt team maintains direct contact with borrowers throughout the life of the loan and actively engages in monitoring performance as required. In the public bond market, this relationship is usually managed by a third party. These qualities have been noted, particularly by the American Society of Actuaries, who recently concluded that private debt outperforms public bonds on a risk/return basis.[1]

Why Investment Grade?

Investment grade private debt offers concrete enhancements to an investor's fixed income portfolio. The key benefit comes from higher yields earned to compensate for illiquidity and the highly tailored nature of the investment structures (see *Chart 3*). The premium yields, as well as some of the key risk-based benefits of the investment grade private debt market, are outlined below (see *Chart 4*):

- **Illiquidity premium**

Private debt investments are generally viewed as illiquid. Investors receive a significantly higher yield over comparable publicly rated bonds for recognizing that private debt investments are intended to be held to maturity. Most institutional investors today are 'long' liquidity and are, therefore, holding assets that provide liquidity beyond their liability needs. This provides an opportunity to carve out an unneeded piece of liquidity and swap it for a higher yielding substitute.

▶ **Tailored transaction premium**

This 'uniqueness' premium is derived from the unique or complex borrowing needs of borrowers. Whereas public bonds are most often unsecured corporate or government obligations with few covenant protections, private debt deals are generally customized with favourable covenant and security packages to address the unique requirements and underlying credit of borrowers. This increased level of customization translates into a higher interest rate for similar levels of risk.

▶ **Diversification**

In the context of Canada's highly concentrated public bond market, investment grade private debt offers an attractive fixed income substitute. By adding an allocation to high quality private debt, an investor can gain market sector and geographic diversification: an attractive enhancement to a traditional investment-grade portfolio.

▶ **Potential risk reduction**

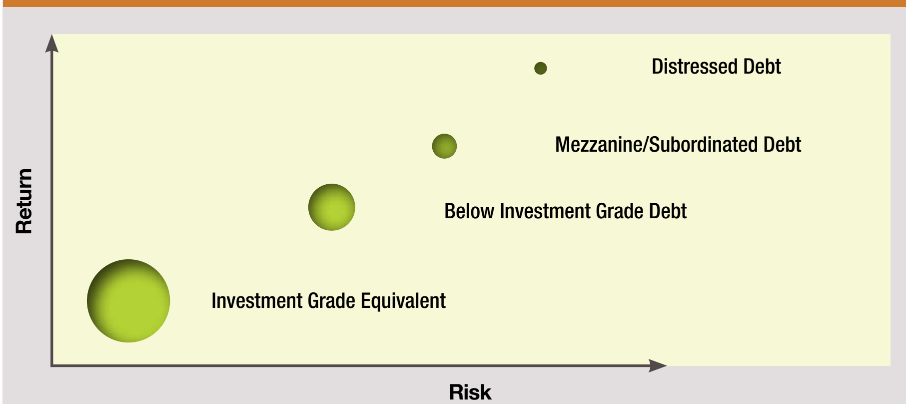
Many private debt securities have payment streams that are a mix of interest and principal repayment. This means the majority of the debt is paid back sequentially over the life of the loan, minimizing the refinancing risk found in a typical mortgage or bullet structure of traditional publicly-traded fixed income investments. This benefit has also been observed by the Office of the Superintendent of Financial Institutions (OSFI) which, based on its regulatory capital rules for life insurance companies, implicitly views private debt as less risky than mortgage investments.[2]

▶ **Niche relationships**

A key barrier to entering the private debt market is the expertise required to source, structure, and monitor these investments. Successful private debt origination platforms not only have experts with direct relationships with borrowers and intermediaries in specialized asset classes, but also have the credit processes and infrastructure necessary to monitor transactions over the investment horizon. A focus on key relationships in targeted sectors is likely to result in transaction opportunities that offer the ability to

Chart 1

The Private Debt Investment Spectrum



For illustrative purposes only.

Chart 2

A Broad Range Of Investment-grade Equivalent Options

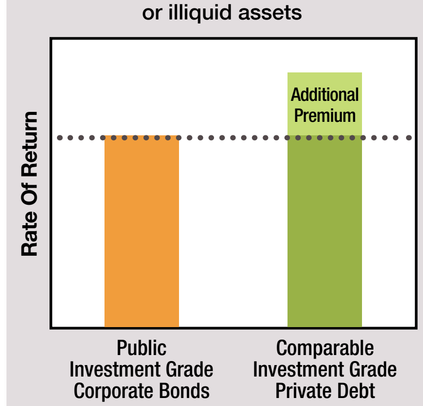
Credit Rating	Infrastructure	Power	Corporates & HUMS[1]	CLT's & Mortgage Bonds	Asset Backed Loans
AAA					
AA					
A+		Hydro	Unsecured Corporates	Credit Tenant Leases	Collateralized Loon Pools
A	Social Infrastructure	Gas	Hospitals		
A-	Transportation		Utiltities		
BBB+	Mobility	Solar	Schools		
BBB		Wind	Municipalities	Mortgage Bonds	Structured Credit
BBB-			Secured Mid Market		
BB	Direct Project Sponsor Loans				
B		Jr. Project Loans			

[1] HUMS = Hospitals, Utilities, Municipalities, Schools. [2] Credit Tenant Leases.

Chart 3

The Private Debt Premium

Private debt investors are typically compensated with additional yield premiums for distinctly structured or illiquid assets



For illustrative purposes only.
Source: TD Asset Management

Chart 4

A Source Of Alpha In A Wide Range Of Strategies

Private debt can add value and play a key role in many different investment strategies and portfolios. Some examples include:

- **Part of a Liability Driven Investment (LDI) Strategy:** The long-term nature and the cash flow profile of these investments make them an appropriate match for insurance and pension liabilities.
- **The 'Plus' portion of 'Core Plus' bond portfolios:** Private debt can act as the 'plus' component of a core fixed income portfolio that helps expand the investment universe beyond the traditional Canadian public bond investment grade universe, potentially enhancing yield and increasing diversification.
- **Insurance portfolios to address capital constraints:** From a regulatory capital point of view, investment grade private debt transactions are lower risk and, therefore, less capital intensive than other asset classes such as mortgages and preferred shares. As a result, private debt may provide enhanced yield with a better risk adjusted return relative to traditional mortgages and public fixed income securities.
- **Endowments:** Private debt investments can offer high quality, stable cash flows that are well suited for endowments with minimal annual payouts. Unlike greenfield infrastructure equity investments, they are 'current pay" and do not exhibit a negative j-curve, where fees are higher than income for many years.

negotiate preferred covenant and security packages. This, combined with an independent, comprehensive, and repeatable credit process, can materially reduce risk in a diversified private debt portfolio.

With real interest rates not anticipated to rise anytime soon, the yield on a typical public, investment-grade fixed income allocation may not cut it for the long term. Adding an allocation to high quality private debt can potentially provide investors with the yield enhancement they need, without sacrificing credit quality, making private debt an attractive complement to a traditional investment-grade portfolio.

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1. Society of Actuaries:"2003-12 Credit Risk Loss Experience Study: Private Placement Bonds" (January 2016).
2. Superintendent of Financial Institutions: Minimum Continuing Capital and Surplus Requirements as published by the Office of the Superintendent of Financial Institutions (OSFI) (November 2014).