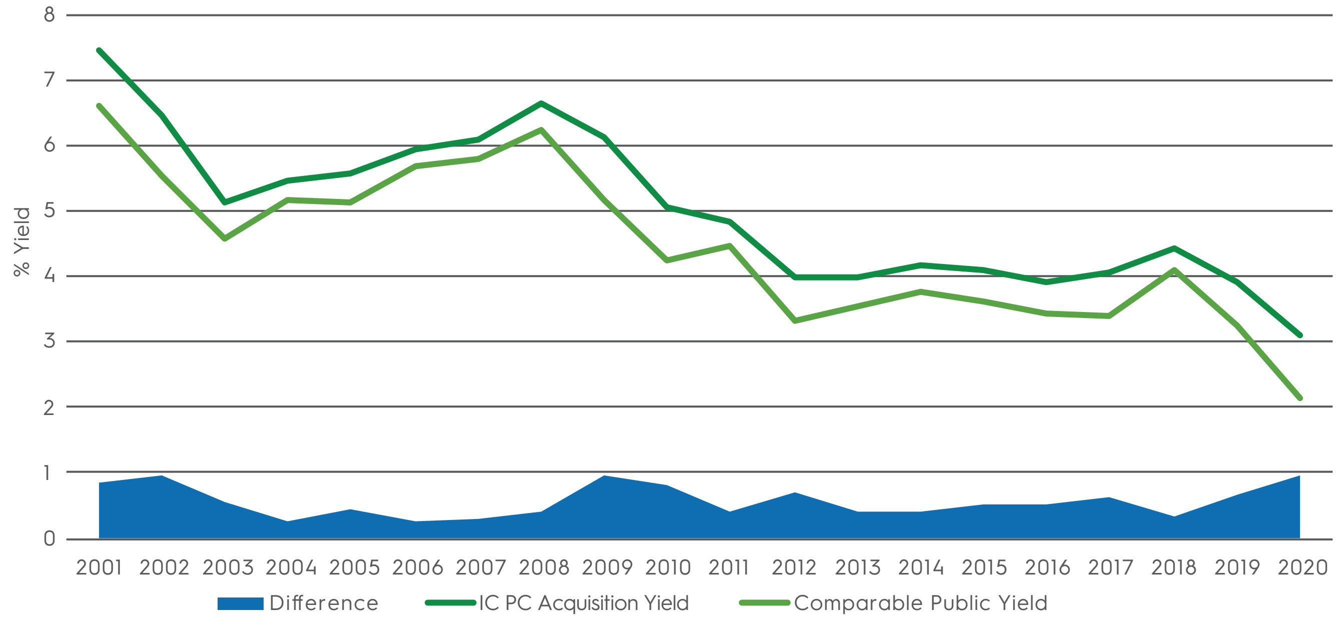
A complementary source for additional yield: Investment Grade Private Credit

- **Although institutional investors' allocation to publicly traded investment grade (IG) bonds is essential for liquidity and stability, yields today are historically low.** The typical corporate pension fund, for example, with a fixed income allocation of close to 50%[1] and long-term performance goals averaging 6.5%,[1] faces a wide return gap to be filled.[2]
- **A portfolio of mid-sized allocations to IG private credit could generate a substantial yield premium of 0.4% to 1.0% over core fixed income, with similar or even improved credit risk** (see Figure 1, below.) Such a "sweet spot" portfolio delivers broad diversification while also enabling participation in the most attractive large deals.
- **IG private credit drawdown protections are stronger than those of public bonds'.** Private credit is not subject to the forced selling – and resulting sharp price decline – that can result when public bond ratings fall below a rating of BBB. In addition, IG private credit terms generally provide strong covenant protections, which could provide downside protection to investors from financial and event risk.
- **Skillful, experienced investors with a well-developed deal network can build customized IG private credit portfolios that could improve portfolio outcomes** for institutions with surplus liquidity, both on an absolute and risk-adjusted basis. Asset managers with a financial institution parent have a real advantage in this "sweet spot" market segment.

1. Wadia, Zorast; Perry, Alan and Clark, Charles. "2020 Corporate Pension Funding Study." Milliman White Paper, April 2020, **https://www.milliman.com/-/media/milliman/pdfs/articles/2020-pension-funding-study.ashx**.

2. As at January 8, 2021, the yield on the Bloomberg Barclays US Aggregate Bond Index was only 1.21% and the yield on the Bloomberg Barclays US Corporate Triple-B-rated Index was 2.14%. Source: **https://www.wsj.com/market-data/bonds/benchmarks**.

FIGURE 1: IG PRIVATE CREDIT HISTORICALLY YIELDS MORE THAN PUBLICLY TRADED BONDS



Source: Securian Asset Management, Inc., Factset and Merrill Lynch U.S. Corporate Master Index. As of 12/31/2020. Data spans from 12/31/2001 to 12/31/2020. IG PC Acquisition yield represents the weighted average acquisition yield of all securities purchased by Securian AM during each calendar year. Comparable Public Yield is the weighted average yield of all comparable public bonds to each security purchased by Securian AM in duration and sector (FIN, IND and UTIL). The public comparables were derived using Factset daily matrices beginning 09/01/2018, and Merrill Lynch U.S. Corporate Master Index spread matrix derived for the periods prior to 09/01/2018. For each year through 2008, this data includes all private placement securities and certain 144a structured securities purchased by Securian AM. The 144a securities were included because each security had a combination of one or more of the following characteristics that made them more similar to private placements rather than public bonds, lack of registration rights, collateral, covenants, non-DTC eligibility and/or amortization. Beginning in 2009, private placement securities include securities that are private placements only.

Institutional investors are looking for higher yields from their fixed income portfolios

Fixed income investments are a large — and often the largest — asset class allocation in most institutional portfolios. For example, the Milliman 2020 Corporate Pension Funding Study shows that the fixed income allocation of the 100 largest corporate defined benefit pension plans in the United States averaged 49.1% of plan assets.[1] A sizable allocation to core fixed income is generally a necessity for institutional investors that need liquidity and diversification.

The Milliman study also noted that corporate defined benefit plans had an average expected rate of return of 6.5% for funding purposes.[3] With publicly traded bond returns currently in roughly the 1% to 2% range,[2†] these plans require double-digit returns from their remaining assets to achieve their funding goals - a difficult achievement to sustain over time, and one which generally requires taking on increased risk.

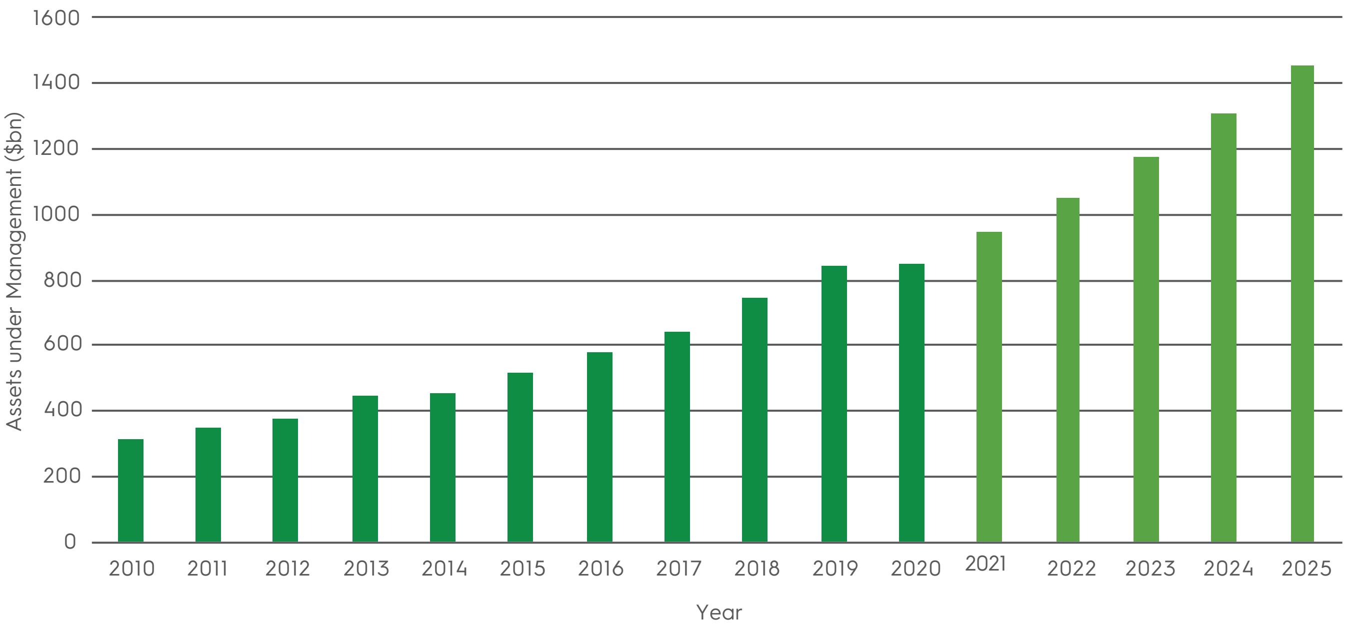
Similarly, endowment funds must pay out approximately 5% of their average market value each year and lower yields will likely make it more difficult to reach that target.

3. Sielman, Rebecca. "2020 Public Pension Funding Study." Milliman White Paper, December 2020.

Investment grade private credit could provide a useful yield pickup over public bonds

As shown in Figure 1, investment grade private credit has historically delivered 0.4% to 1.0% higher yields than publicly traded bonds — at comparable levels of credit risk. Institutional investors seeking these higher yields have been migrating into private credit (both investment grade and other forms), which is expected to grow about 11% per annum for the next four years (Figure 2, below).[4]

FIGURE 2: PRIVATE DEBT ASSETS ARE GROWING



Source: Preqin, Future of Alternatives 2025 as of 10/01/2020. 2020 figure is annualized based on data to October. 2021-2025 are Preqin's forecasted figures.

The investment grade private credit yield advantage

The IG private credit yield advantage stems from two key sources:

- lower liquidity, and
- customized structuring, often of more complex transactions.

Because IG private credit is not publicly traded, it is less liquid than public bonds (although a secondary market does exist). In return for this reduced liquidity, investors require a higher yield. Given the lower liquidity, most institutional investors use IG private credit as a complement to their liquid core fixed income portfolio, not as a substitute, and typically hold their positions to maturity. An IG private credit portfolio constructed with a custom duration maximizes the liability-matching requirements of some institutional investors, such as life insurance companies and pension plans.

4. Preqin, Future of Alternatives 2025.

Negotiated private credit covenants are also additive to the total return. IG private credit contains covenant packages and/or security that help limit downside risk, allowing institutional investors to hold the assets to maturity. Such covenants may include seniority in the capital structure, limits on leverage, restrictions on asset sales and requirements to maintain minimum coverage ratios. Issuers of IG private credit appear willing to accept such covenants in exchange for access to long-term capital tailored to meet their needs. Covenant packages generate additional income through waiver or amendment fees, increased interest, and prepayment fees. In our experience, such additional income has averaged approximately 30 additional bps per annum.[5] The underlying covenants and security offered in IG private credit also offer downside protection, as discussed below.

IG private credit risk can be strictly contained

Investment grade private credit risk is tightly managed at both the individual bond level and the portfolio level.

Strict underwriting is essential to ensure strong protection. An experienced team, including credit analysts and dedicated legal staff, is necessary to ascertain the creditworthiness of each issuer; to correctly price the credit and its unique provisions; and to properly structure the bond covenants. Covenants provide protection via "early warning" steps such as limiting leverage and protection from event risk.

A well-constructed portfolio of IG private credit could result in very low loss rates. As there is no standard benchmark index for IG private credit, a strong portfolio can be built based on portfolio needs and underwriting requirements. In our own experience at Securian AM, our IG private credit loss rate since 2003 has averaged only 2 bps per year — essentially equivalent to the loss rate on AA-rated public bonds (Figure 3).[6]

FIGURE 3: EXPERT INVESTMENT GRADE PRIVATE CREDIT UNDERWRITING PRODUCES SIMILAR LOSS EXPERIENCE TO AA- RATED PUBLIC BONDS

S&P Corporate Credit Rating	Weighted Average Default Rate (%) (1981-2019)
AAA	0.00
AA	0.02
A	0.05
BBB	0.16
BB	0.61
B	3.33
CCC/C	27.08

Securian Asset Management Investment Grade Private Debt average annual loss 0.02%

Source: "Default, Transition, and Recovery: 2019 Annual Global Corporate Default and Rating Transition Study," S&P Global Ratings, April 29, 2020, https://www.spglobal.com/ratings/en/research/articles/200429-default-transition-andrecovery-2019-annual-global-corporate-default-and-rating-transition-study-11444862. Securian Asset Management, Inc., average annual loss data as of December 31, 2020.

5. Source: Securian Asset Management, Inc.

6. "Default, Transition, and Recovery: 2019 Annual Global Corporate Default and Rating Transition Study," S&P Global Ratings, April 29, 2020, https://www.spglobal.com/ratings/en/research/articles/200429-default-transition-and-recovery-2019-annual-global-corporate-default-and-rating-transition-study-11444862.

In the event that a default occurs, private credit holders typically receive higher recoveries than public bondholders. This stronger outcome is due both to private credits' contractual seniority in the issuer capital structure as well as the strong covenants in IG private credit.

A well-diversified IG private credit portfolio provides additional risk protection. Investment grade private credit issuers come from all major industries, both domestic and foreign, allowing an institutional investor to build a well-diversified portfolio. Many issuers do not issue public bonds, so a private credit portfolio also diversifies an institution's overall fixed income portfolio. An IG private credit portfolio can also be diversified by tenor and other structural factors.

Private credit managers are not constrained by index allocation weights. Unlike corporate bond indices, which give indexers the perverse incentive to raise exposure to the largest — and usually most levered and risky — issuers, IG private credit managers need not measure their portfolios against any benchmark sectors or borrower weights. IG private credit managers are free to build their version of an optimal portfolio to meet an investor's needs.

IG private credit doesn't face the "fallen angel" forced selling issue

When IG public bonds are downgraded below a BBB rating, forced selling can cause immediate sharp mark-to-market valuation declines. The investment guidelines for most publicly traded bond portfolios, such as those for index funds, require the investment manager to sell a bond whenever the issuer fails to maintain a required minimum credit rating. In the case of publicly traded bonds that fall below investment grade — the so-called "fallen angels" — such forced selling to opportunistic high-yield bond managers often causes the market price of the bond to fall dramatically.

Institutional investors holding these fallen angels can incur significant losses upon the next mark to market. In one recent study, the performance drag between fallen angels and investment grade bonds in the first half of 2020 was as much as 1300 bps.[7]

By contrast, IG private credit is not subject to forced selling. In addition, as a private asset class, IG private credit is generally marked to market monthly rather than daily, resulting in much smoother changes in valuation.

The "sweet spot" for investment grade private credit transactions

An investment manager willing to invest $40-$100 million in an IG private credit transaction on behalf of its clients is in the "sweet spot." A manager can assemble a well-diversified portfolio via such mid-sized investments, where the manager can take all of a mid-sized bond opportunity or can participate meaningfully as one of a number of investors in a much larger transaction. The manager can also take advantage of smaller opportunities that attract fewer lenders, thus potentially obtaining even better terms for its clients.

Access to new investments is a key requirement for building well-diversified IG private credit portfolios. A manager making mid-sized allocations is large enough to be called by investment bankers seeking lenders for their corporate clients, by private equity managers seeking financing for their portfolio companies, and by peers offering exclusive access to club deals. An established network of investment bankers, private equity managers and peers, along with a solid reputation for efficient and fair practices, is essential to move from potentially being called to definitely being invited to a seat at the table for a new private bond issue.

7. Scozzafava, Bernie. "Despite Some Fallen Angels, Corporate Bond Investors Have Heaven on Their Minds." Parametric August 3, 2020, **https://www.parametricportfolio.com/blog/despite-some-fallen-angels.**

IG private credit managers with a financial institution parent have a real advantage. For example, at Securian AM our IG private credit clients invest alongside Securian Financial Group, Inc., benefitting from our parent's consistent presence in the market and its favored access to attractive transactions. This also ensures a strong alignment of interests with our clients.

Investing in the "sweet spot" allows customized portfolios to meet specific client needs because of the large number of opportunities managers can access when they make placements in the mid-range. For example, a portfolio for pension funds with long-term liabilities can be assembled to have longer duration, while a shorter duration portfolio can be customized for property and casualty insurers whose liabilities tend to be much shorter.

Institutional investors with liquidity needs can still benefit from a complementary allocation to IG private credit

Institutional investors can generally set aside a portion of their portfolios for less liquid investments. With the possible exception of a pension plan or other institution that is being liquidated, most institutional investors do not require 100% liquidity. After covering their liquidity needs with an allocation to core fixed income, it may make sense for them to benefit from the illiquidity premium included in IG private credit yields through a complementary allocation.

The lower liquidity of IG private credit is partially offset by the higher income it generates. Institutions needing a long-term reliable stream of current income may therefore be well-served by holding IG private credit to maturity. We have seen life insurers use this approach for many years.

For these reasons, we recommend IG private credit be viewed as a "buy and hold" mandate even though there is an active secondary market for well-covenanted issues.

A well-managed IG private credit allocation could add value to most institutional portfolios

Buying and holding investment grade private credit to maturity could provide a reliable income stream that can complement a core fixed income portfolio and help meet almost every institution's needs:

- IG private credit offers higher yields than similar public bonds, with lower credit risk
- Strong covenants provide additional downside protection
- A complementary IG private credit allocation diversifies an institution's fixed income portfolio
- A complementary IG private credit portfolio can be tailored to meet each institution's specific needs

Most institutional investors can reap these benefits by working with a skilled, experienced IG private credit investment management organization that includes solid underwriting and legal talents and access to a well-developed deal sourcing network.

About Securian Asset Management, Inc.

As part of a financially stable mutual company, we focus on the long-term and seek to execute consistently for our clients. Our asset management business has been built with a risk and liability management focus, coming from our long, successful history investing for our parent company's general account. We stay true to our purpose, our values and our roots, while being innovative and nimble to help prepare our clients to meet their investment objectives from a position of strength.

Sources: Securian Asset Management, Inc, Bloomberg, Factset, Merrill Lynch U.S. Corporate Master Index, Milliman, Wall Street Journal, Preqin, S&P Global Ratings, Parametric, Bloomberg.

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