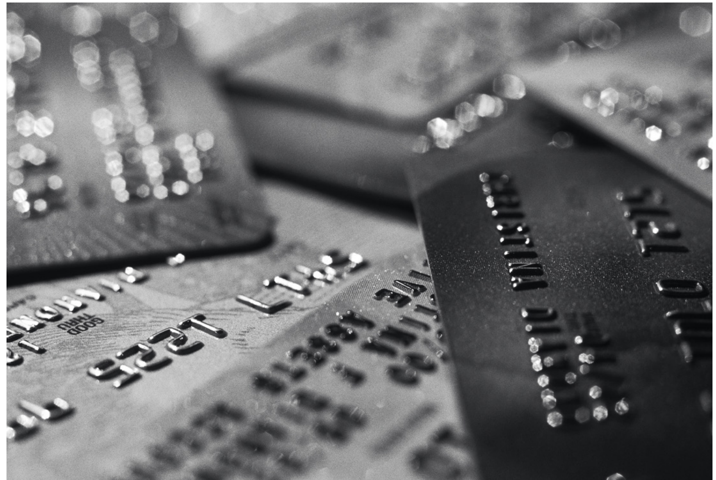
Private Credit: The Great Diversifier

By Mick Solimene
MONROE CAPITAL

Among institutional investors, private credit was the fastest growing asset class across all "alternative" categories last year. While many were drawn to consistent yields in an era of low rates, as inflationary threats escalate and central banks now tighten monetary policy, it's the diversification attributes and safety of the asset class now fueling interest. For RIAs serving HNW clients, many of the same characteristics that appeal to institutions are just as relevant to individual investors seeking a refuge.



While the enthusiasm powering the markets started to dissipate in January, it wasn't until mid-June that stocks officially entered bear-market territory. Inflation, supply-chain constraints, and a higher cost of capital are the most acute headwinds, but the war in Ukraine and geopolitical tensions elsewhere, represent wildcards that amplify existing threats or pose new risks more difficult to quantify.

Against this backdrop the distinguishing features of private credit become even more pronounced. The diversification attributes, alone, remain important, but as investors embrace a defensive posture, the quality of returns and historic stability of the asset class offers peace of mind unattainable in other areas of fixed income. The biggest draw, however, may be the alpha available through active management that reacts to or capitalizes on market shifts as they occur.

'Acyclical' Diversification

The diversification qualities of private assets are generally well understood. Investors benefitted from this during the onset of the pandemic, when private market exposures provided a ballast that blunted the volatility in public securities. Fast forward to today, and the floating-rate terms of most credits will help investors guard against aggressive Fed action anticipated over the next 18 months.

Alpha Through Active Management

A rising tide has lifted all boats, but the influence of active management can't be understated. This dynamic distinguishes private credit from public fixed income. In the case of the latter, traditional instruments will lock in prices for durations ranging from five to 30 years; private debt managers, alternatively, have contractual repricing opportunities to achieve desired risk-adjusted returns as the market changes.

Depending on the specific credit, managers have the ability to support issuers through issues that might arise during periods of economic uncertainty by modifying loan terms and requirements to maximize enterprise value. Active management also includes constructing purposefully defensive portfolios or enhancing diversity across obligors, sectors, and sponsored and non-sponsored deals.

Heading into the second half of 2022, similar dynamics are at play. Manager selection will be critical, favoring those with experience navigating periods of economic uncertainty; longer-tenured, specialized teams; and lenders with a track record of delivering alpha across the cycle. ■

Mick Solimene is a Managing Director and Portfolio Manager for Monroe Capital's HNW portfolios.

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