

Private Placement Debt Helps Pensions to Diversify

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Q What benefit can private placement debt bring to well-funded pension funds?

Based on our analysis upwards of 95 percent of the asset class is investment grade,¹ so private placement debt is a complement to the public fixed income component of pension fund portfolios. Incorporating the asset class into the portfolio can help bring diversification benefits as well. If you look at the set of names in a typical private debt portfolio, the overlap with public indices tends to be less than 5 percent. This is beneficial for pension funds, which often seek to improve diversification by limiting exposure to a single issuer.

Investors also benefit from the economics of private debt. There is an illiquidity premium built into the pricing of these assets and other sources of potential return enhancements throughout the lifetime of these deals. Debt covenants are structured so that these can be long-term investments; the intention is to manage them for the lifetime of the deal rather than quickly trade out of them.

These covenants are designed to provide downside risk protection on the assets. Unlike in the public market, where financial covenants are more limited, private debt covenants are the hallmark of the asset class and include meaningful safeguards around a company or project's performance with protections such as limitations on debt, minimum cashflow metrics and so forth.



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“Investment grade private placement debt affords pension funds greater scope for managing their fixed income portfolio.”

Q What do pension funds need to consider when allocating to private debt?

First and foremost, we believe sponsors and consultants should focus on the depth and reach of the private placement asset manager's platform, the leadership position of the manager in the industry, and the team that they have in place: do team members have the specialized sector expertise and experience through multiple market cycles to create the most diverse set of opportunities with appropriate risk adjusted returns to suit the pension funds' investment objectives? Returns should be thought about over the longer term, as these assets are not actively traded in a total return context.

The challenge of benchmarking is another important consideration. Pensions typically need total returns for benchmarking their investments. Bonds, unlike stocks, trade less frequently, and private placement bonds even less so. Typically, private placement bond values are estimated using bespoke pricing models, which are not standardized and can be calibrated against secondary market transactions, a basket of public bond comparables, or against public indices, for example. Because of the nature of the private placement asset class, these bond pricing models can be maintained by the asset originator or a third-party vendor. Therefore, we believe it is especially important in selecting the right investment manager to gain a thorough understanding of their valuation processes and consistency of approach.

Q One concern is liquidity: if the need arises to close out a fund, is an allocation to private debt problematic?

I think about the liquidity question in a few ways. First, we're not talking about allocating a majority of the portfolio to private placement debt. We're talking about a modest allocation, maybe in the region of 10-20 percent, as a complement to the public allocation of the fixed income portfolio. Liquidity becomes less of a concern in that case.

Where there are valid liquidity concerns, it is possible to incorporate certain features into investment structures in order to address the issue. For example, open-end commingled funds can be used to provide investors with the ability to redeem their asset allocation should they need to.

Moreover, an increased demand for the asset class from both pensions and insurers has created a fairly active secondary market for private placement debt, which makes it easier for investors to sell their positions if they need to.

On top of this, pension funds often terminate or reduce their plans with a pension risk transfer to the large insurers that know the private placement market well and are comfortable taking on such investments. So, in fact, there might not even be the need for pension funds to liquidate these assets at all. All in all, we have found that once we are able to engage in a dialogue with plan sponsors and consultants about the asset class and the types of structures they can use to access it, many of their concerns about liquidity go away.

Q Are private placement strategies a good fit for all pension funds?

We believe that a private placement allocation makes sense for a variety of plans, including smaller to mid-sized plans, larger ones and those at or near full-funded status. The diversification benefits, attractive relative value and downside volatility dampening aspect inherent in private placements is a benefit to any size plan. There are, however, different types of structures we would recommend in order to access these assets, depending on plan size. Smaller or midsize plans may benefit from an allocation to a comingled private placement fund vehicle to achieve sufficient diversification. Larger plans will be able to allocate mandates of sufficient size via a separately managed account to achieve a diversified private placement portfolio. Fully-funded plans who are reducing equity exposure and increasing fixed income can benefit from the hedging and diversification benefits of an allocation to privates.

Private placement strategies can be further tailored depending on where a pension fund is in its glide path: whether it is looking for a longer-duration portfolio mix or whether it seeks more intermediate asset liability matching. Investments can also be tailored according to credit tilt. For example, one pension fund might prefer a strategy that targets mid-to-low triple-B investments, while the strategy of another pension fund might be skewed toward higher quality investments.

Strategies can also be adjusted based on certain sectors. Perhaps a pension fund desires more exposure to infrastructure debt or to hard assets, for example.

The private placement market is highly customizable and, with the different pools of capital available, it is possible to create opportunities across the maturity and credit spectrums.

What does the future of the asset class look like?

Interest in private placements has quickly picked up momentum over the past couple of years, and we are having many more conversations about the asset class with pension funds and the consultant community. Private placement debt is a bit of a newer asset class for pension plan sponsors, but the asset class itself has been around for more than a century, and the education process is well underway. As allocators become more familiar with it, understanding its potential benefits, and allocate to it, many more opportunities will emerge.

The shift of pension funds towards fully funded status will likely continue to drive interest in private placements. As the funding position improves, pension funds typically want to reduce their riskier

equity allocation and replace it with assets that hedge liabilities and protect funded status. Private placements meaningfully expand the fixed income opportunity set and, as bonds become increasingly important, we believe private placement debt will play a growing role for pensions.

Endnote:

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² At estimated fair value. Includes MetLife general account and separate account assets and unaffiliated/third party assets.

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