AUGUST 24, 2022

InvestmentNews®

THE TRUSTED RESOURCE FOR FINANCIAL ADVISERS

INVESTMENTNEWS.COM

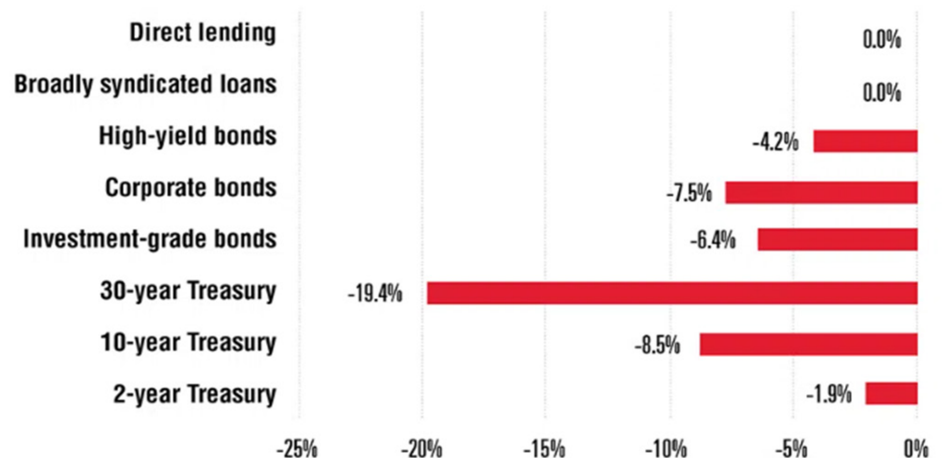
Income alternatives for individual investors

The inflation pressures that have emerged make it challenging to invest in fixed income, but there are possible solutions.

BY JACK SNYDER JR.

While financial professionals who look to traditional bonds as a steady source of current income for their clients have been forced to contend with meager yields for some time, the inflation pressures that emerged in the aftermath of the Covid-19 recession represent a new complication — and a novel one for many, given four decades of relative moderation.

Despite persistently lower yields relative to historical averages and elevated risks that characterize core fixed-income assets and unsecured below-investment-grade debt, we believe there are alternative solutions to be had. For example, assets like broadly syndicated loans and direct-lending investments (aka private credit or private debt) feature near-zero duration thanks to their floating-rate coupons, as well as relatively high income potential given limited liquidity and non-investment-grade status. Structures like interval funds can provide individual investors access to income strategies comprised of these less liquid and illiquid assets, with periodic redemption opportunities that have the potential to mitigate the illiquidity of the underlying holdings.



Note: Direct lending — Cliffwater Direct Lending Index; broadly syndicated loans — Credit Suisse Leveraged Loan Index; high-yield bonds — Bloomberg US Corporate High Yield Bond Index; corporate bonds — Bloomberg US Corporate Bond Index; investment-grade bonds — Bloomberg US Aggregate Bond Index.
Source: Bloomberg; data as of June 30.

RISING INTEREST RATES WEIGH ON FIXED-RATE BONDS

Coming out of the economic dislocations of Covid-19, high inflation prints thought to be transitory by many — including the Federal Reserve — have proved quite persistent. Inflation packs a one-two punch against traditional fixed-rate bonds, eroding the purchasing power of static coupon payments and often signaling higher interest rates, both of which weigh on market prices.

Treasury rates began to creep up in late 2021 and moved sharply higher in 2022 as it became evident the Fed was poised to hike its benchmark rate for the first time since 2018. The Fed ultimately raised rates in March in what may prove to be a lengthy tightening cycle.

Given their longer duration and lower yields, investment-grade issues have had a particularly rough time in this environment of early-1980s-style inflation and multiyear-high interest rates; the Bloomberg US Aggregate Index lost 10.3% in the first half of 2022.

In contrast, floating-rate fixed income assets have been a relative port in the storm, though concerns about the impact of tighter financial conditions on economic growth have weighed on total returns more recently. After a flattish first quarter, the S&P/LSTA Leveraged Loan Index is down 2.4% for the first five months of the year. The Cliffwater Direct Lending Index, which tracks the quarterly performance of middle-market loans, gained 1.8% in first quarter 2022.

Key to the outperformance of syndicated loans and private debt has been their floating-rate coupons and senior secured status. With coupons that reset on a periodic basis to maintain a fixed spread over a reference rate, both assets have very limited duration — and thus limited sensitivity to changes in interest rates, as shown in the chart below. Further, both are predominated by loans that are secured by the borrower's assets and cash flows, and are senior in its capital structure. This advantaged position historically has resulted in lower default rates and higher recovery rates compared to bonds, which are unsecured and subordinated. These structural features may be all the more important in light of the eco-

nomic uncertainty facing investors today.

Finally, syndicated loans and private credit typically offer higher yields than investment-grade bonds as compensation for the reduced liquidity of bank loans and near-zero liquidity of private credit. It's our view that 100% of an investor's fixed-income exposure doesn't need to be 100% liquid given the potential benefits that can be had in exchange for taking on some illiquidity risk. Recognizing this, investment managers have been hard at work developing alternative investment solutions appropriate for individual investors and their financial professionals.

INTERVAL FUND STRUCTURE OPENS DOOR TO RETAIL MARKET

Syndicated loans have been widely available in the retail space through mutual funds and exchange-traded funds, but access to private credit strategies historically has been limited to institutional investors through high-minimum private funds or separately managed accounts. More recently, however, investment managers have turned to the interval fund structure to provide individual investors with differentiated investment solutions that leverage the spectrum of unique risk-return profiles in the alternative credit markets.

Like an open-end mutual fund, an interval fund is a pooled investment vehicle that's available for purchase continuously at net asset value. Unlike mutual funds, however, interval funds don't provide shareholders with daily liquidity; instead, redemption windows open periodically at predetermined intervals (monthly, quarterly, semiannually or annually). This structure makes the interval fund wrapper particularly well-suited for strategies that invest in less-liquid assets like private credit in exchange for the higher coupons they often provide. For assets that do have some secondary market liquidity, like syndicated loans, it also frees the investment manager from the forced selling that may hamper performance in the daily redemptive space.

Though the Securities and Exchange Commission authorized interval funds in 1992, issuance didn't really take off until recently. The structure, which isn't limited to alternative credit, brought in about $19 billion in 2021 after raising assets at an annual rate closer to $9.5 billion from 2018 to 2020. Current interval fund assets under management stand at around $60 billion, and it wouldn't be surprising to see this figure climb, given forecasts that retail holdings of private credit products could grow nearly 13% by 2025.

A DIFFERENT APPROACH TO INCOME

In an environment characterized by persistently high inflation, rising interest rates, tightening financial conditions and an uncertain macroeconomic trajectory, the interest-rate sensitivity and slim yield cushions of core bond assets represent an unfavorably asymmetric risk-return profile for financial professionals seeking current income. There are alternatives, however.

Loans — both broadly syndicated and directly originated — typically offer higher yields than investment-grade debt as well as a floating-rate, senior secured structure that provides some cushion against the impact of rising rates and economic uncertainty. Though investors must bear additional liquidity risk in exchange, we think this is a trade-off that may deserve consideration. Given the role that fixed-income investments typically play in portfolios, 100% liquidity isn't a necessity, in our view, particularly in light of potential benefits that can be found in less-liquid corners of the credit markets.

Jack Snyder Jr. is national sales manager for the wirehouse and RIA channel and head of retail alternative sales for First Eagle Investments.

Broadly syndicated loans (BSLs) are the most common form of leveraged bank loans — i.e., loans supported by cash flows to finance mergers, acquisitions, and recapitalizations.

Direct lending is a form of corporate debt provision in which lenders other than banks make loans to companies without intermediaries such as an investment bank, a broker or a private equity firm.

Duration is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates.

Floating Interest Rate is one that changes periodically: the rate of interest moves up and down, or "floats," reflecting economic or financial market conditions.

S&P/LSTA Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads and interest payments.

Cliffwater Direct Lending Index, or **CDLI**, is an asset-weighted index of over 8,000 directly originated middle market loans totaling $223 billion as of March 31, 2022. The CDLI assists investors to better understand asset class characteristics and to benchmark manager performance.

Credit Suisse Leveraged Loan Indices are designed to mirror the investable universe of the U.S. dollar, euro, pound and Swiss franc-denominated leveraged loan markets.

Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

Bloomberg Barclays US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market.

Bloomberg Barclays US Aggregate Bond Index, or "Agg" (for aggregate), is a broad-based fixed-income index used by bond traders, mutual funds, and ETFs as a benchmark to measure their relative performance.

Indices are unmanaged. Once cannot invest directly in an index.

Thirty-year treasury is a debt obligation backed by the U.S. Treasury that matures after 30 years. Thirty-year treasury bonds are among the world's most widely followed fixed-income assets. Thirty-year treasury yields fluctuate based upon market demand and the general outlook for the economy.

10-year Treasury note is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.

2 Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 2 years. The 2 year treasury yield is included on the shorter end of the yield curve and is important when looking at the overall US economy.
An **exchange-traded fund** (**ETF**) is a basket of securities that tracks an underlying index. **ETFs** can contain investments such as stocks and bonds.

Important Risks:

Past performance is not indicative of future results.

The opinions expressed are not necessarily those of the firm and are subject to change based on market and other conditions. **These materials are provided for informational purposes only.** These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice. Any statistics contained herein have been obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed. The views expressed herein may change at any time subsequent to the date of issue hereof. The information provided is not to be construed as a recommendation or an offer to buy or sell or the solicitation of an offer to buy or sell any security. The portfolio is actively managed and holdings can change at any time. Current and future portfolio holdings are subject to risk. The information in this piece is not intended to provide and should not be relied on for accounting, legal, and tax advice

All investments involve the risk of loss of principal.

Alternative investments can be speculative and are not suitable for all investors. Investing in alternative investments is only intended for experienced and sophisticated investors who are willing and able to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks include:

- Loss of all or a substantial portion of the investment;
- Lack of liquidity in that there may be no secondary market or interest in the strategy and none is expected to develop;
- Volatility of returns;
- Interest rate risk;
- Restrictions on transferring interests in a private investment strategy;
- Potential lack of diversification and resulting higher risk due to concentration within one of more sectors, industries, countries or regions;
- Absence of information regarding valuations and pricing;
- Complex tax structures and delays in tax reporting;
- Less regulation and higher fees than mutual funds;
- Use of leverage which magnifies the potential for gain or loss on amounts invested and is generally considered a speculative investment technique and increases the risks associated with investing in the strategy;
- Carried interest which may cause the strategy to make more speculative, higher risk investments that would be the case in absence of such arrangements; and
- Below investment-grade loans which may default and adversely affect returns.

FEF Distributors, LLC (Member SIPC) distributes certain First Eagle products; it does not provide services to investors. As such, when FEF Distributors, LLC presents a strategy or product to an investor, FEF Distributors, LLC does not determine whether the investment is in the best interests of, or is suitable for, the investor. Investors should exercise their own judgment and/or consult with a financial professional prior to investing in any First Eagle strategy or product.

First Eagle Investments is the brand name for First Eagle Investment Management, LLC and its subsidiary investment advisers. First Eagle Alternative Credit is the brand name for those subsidiary investment advisers engaged in the alternative credit business.

©2022 First Eagle Investment Management, LLC. All rights reserved.

(#S0107553) Reprinted with permission from InvestmentNews. © 2022 Bonhill Group plc. All rights reserved.
For more information about reprints and licensing visit www.parsintl.com.