Alternative yield strategies in private credit portfolios

The private credit market has been an attractive source of return for yield-oriented investors willing to trade lower liquidity for higher absolute performance. However, excess fundraising in that market has depressed returns and increased risk. Fortunately, private markets offer an emerging set of differentiated strategies, also providing investors with the dual utility of attractive risk-adjusted returns.

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Due to private markets' innovative nature, these strategies focus on markets where capital is still limited and, by exploiting these pockets of inefficiency, provide investors with compelling risk-adjusted returns in addition to unique correlation features. Although an estimate of total market size is difficult to obtain, given the scarcity of data relating to these strategies, our database has captured over 200 sponsors with more than $ 90 billion of total fund size targeting alternative yield strategies dating back to 2013. For perspective, this represents roughly the same amount of capital raised in the mezzanine debt market over this period.

Nowadays, an emerging set of differentiated strategies exists (collectively 'alternative yield strategies') – each generally uncorrelated to each other or to other external, cyclical factors. The categories are as follows:

- Intangible Assets Strategies generate returns from contractual payments based on the use or sales of products derived from the ownership of the intellectual property that underlies those products.
- Specialized Asset-Based Lending forms the deepest part of the alternative yield market. These strategies offer current cash yield and a low credit risk profile given security interest in the underlying assets.
- Niche credit strategies are exemplified by sector-focused lending funds targeting specialized, underserved markets.
- Risk Transfer encapsulates various strategies, including acquiring and managing (re)insurers run-off portfolios, providing underwriting capital to insurance syndicates, purchasing existing life insurance policies, litigation credit or bank regulatory capital relief.

The current low interest rate environment has driven investors into increasingly risky assets in search of yield. Private credit – long at the forefront of financial product innovation – offers an emerging set of differentiated strategies that offer compelling return potential and provide investors with an additional tool to manage risk at a point in the cycle when risk management is needed most.

By building a diversified portfolio of best-in-class private credit managers using the alternative yield strategies, investors are offered exposure to the outsized risk-adjusted returns generated within these inefficient markets, while benefiting from the steady cash yield and diversification benefits of income streams with low or no correlation to business, credit or market cycles. Furthermore, the unique inter-fund correlation attributes of these strategies may minimize total portfolio volatility (risk), and, in doing so, create a stable cash flow stream that is attractive both in terms of the yield it produces and the diversification benefits it affords. ■