The challenges of balancing 'alternative credit' and liquidity

Investing in illiquid credit securities has risen sharply since 2008. However, there are several issues around liquidity when making long-term investments in this area.

By *Martin Reeves*

Since the Great Financial Crisis, more leveraged credit has been created than ever before. Is this an unintended consequence of the global move to reduce risk across capital markets? For those of us working in the industry in 2008, one of the main challenges the market faced was managing illiquid securities. Cut to 2022, and these are exactly the securities that dominate the world of leveraged credit.

In a mature financial system, the availability of a wide-ranging set of borrowing solutions is a positive. From a systemic perspective, the disintermediation of the banks and the reduction of financing costs are positives if we seek a growing economy.

However, history shows that asset classes that enjoy periods of rapid growth will eventually be tested. Some of the many problems of 2008 emerged from the rapid rise of an alphabet soup of structured products that were highly rated, but whose underlying fundamental cashflows were opaque. It has proven to be a mistake to assume liquidity is correlated to higher credit quality.

Bonds versus loans

The challenge of loans and direct lending is the ease – or otherwise – of buying and selling those claims. In UCITS' terms, the lack of certain settlement dates and uncertainty of an available market make them hard to include in publicly quoted pooled funds.

Meanwhile, the high yield bond market has been

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overtaken by leveraged loans and in the last decade a material amount of direct lending has emerged. There is limited data on this market, but some estimates have concluded that in the US it is already approaching the size of the domestic high yield bond market.

One of the drivers of this growth has been the increase in single B rated issuance, previously the purview of high yield bonds. This has led to fewer companies using bonds. At the same time, the credit quality of high yield bonds has risen with more BB issuance and the quality of loans has deteriorated with more single B issuance.

Given the lack of liquidity one can argue that private lenders need to do more due diligence and stress testing given they are generally locked in until redemption. Loans and direct lending have a place in most diversified portfolios. The challenge is to hold enough to take advantage of low price volatility while still balancing the lack of readily available liquidity.

What happens when the music stops?

History shows that some will be caught out by the missing liquidity. This is not always due to problems with the fundamentals of the credit, but might be caused by issues elsewhere in multi-asset portfolios. Normally, when a strategy suffers a drawdown and the more liquid securities are sold first, this increases the proportion of illiquid securities beyond what was intended. Some illiquid alternatives can withstand quite a lot of strain and credit testing, but this does not mean they can be sold to raise cash.

The question is whether this creates systemic risk. The disintermediation of the banks as a result of the growth in alternative credit should be appealing. The challenge that we anticipate is when impairment rises for loans and direct lending when there is a coincidental rise in the demand for liquidity.

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High yield bonds have been proven to survive crises and default cycles. CLOs and leveraged loans got through 2009 owing to strong fundamentals going in: this worked well for clients who were not forced sellers. All three parts of the leveraged credit world – rated bonds, loans and private credit – are likely to experience similar default rates, but only one of these will be able to provide daily liquidity.

In illiquid markets, investors must understand that they are locking away their capital for a period. So liquidity planning is critical, and that’s where liquid credit comes in. Loans and direct lending of this size have also not been tested by a major financial crisis, whereas liquid credit has more of a track record. The casualties along the way serve as a reminder to investors when they look back that illiquid securities have their place in a portfolio, but during periods of stress they will not provide the same liquidity as high yield bonds. ■

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SUMMARY

Since the Great Financial Crisis, more leveraged credit has been created than ever before.

The high yield bond market has been overtaken by leveraged loans and in the last decade a material amount of direct lending has emerged.

Given the lack of liquidity one can argue that private lenders need to do more due diligence and stress testing given they are generally locked in until redemption.

In illiquid markets, investors must understand that they are locking away their capital for a period. Liquidity planning is critical.

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