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50 YEARS OF INVESTMENT MANAGEMENT & RESEARCH

PRIVATE CREDIT

STILL A GOOD FIT IN A RISING-RATE WORLD

Insurance CIOs' enthusiasm for private credit may be waning now that the postcrisis yield drought appears to be subsiding. But we wouldn't write these investments off too quickly. Given their diversification and return-enhancing benefits, we believe private credit strategies still have a vital role to play in the well-balanced general-account portfolio, even as the rate environment normalizes.

Tightening US rate policy, improving global growth and fading deflation fears have lifted investors' hopes that the long period of ultralow interest rates may be nearing an end. With the prospect of bond yields returning to levels high enough to meet liability guarantees and profitability targets, some insurers may be reconsidering their appetite for illiquid private credit investments. After all, investing in this asset class[1] is no walk in the park. Private debt transactions are complex from sourcing to execution, requiring continual monitoring and added professional expertise.

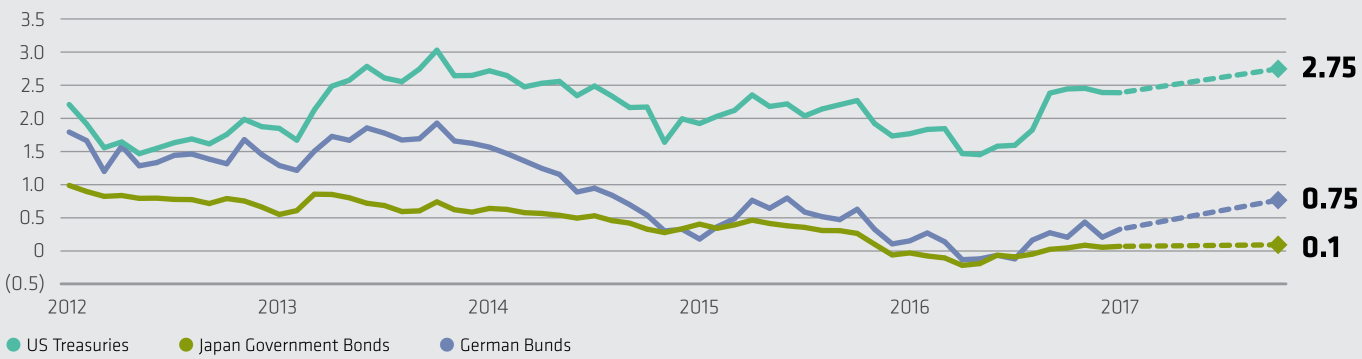
THE YIELD SHORTAGE IS FAR FROM OVER

But we see the situation differently. In our view, a strategic allocation to private credit should remain a top priority for insurance CIOs, for several reasons.

+ **Not So Fast.** While the days of rock-bottom rates may be over, investors aren't out of the low-yield woods just yet. We expect future global rate rises, led by the US Federal Reserve, to be slow and measured (*Display 1*). That means yields (and, indeed, returns across all asset classes) are likely to remain below historical averages for the foreseeable future. Insurers will still need to look beyond their traditional fixed-income solutions to meet long-term obligations.

DISPLAY 1: GLOBAL RATES TO CONTINUE RISING, BUT AT A MEASURED PACE

10-Year Government Bond Yields: Actual and Forecast



As of March 31, 2017

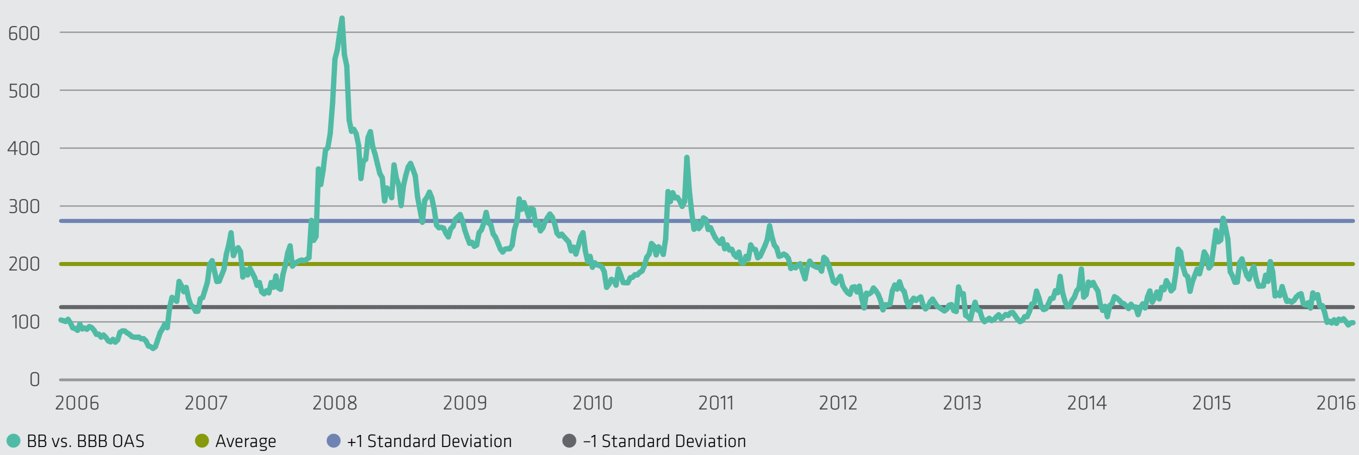
Historical analysis is not necessarily predictive of future results. Historical information is provided for illustrative purposes only and is subject to change.

Source: Bloomberg and AB

1 For this article, we define private credit broadly to encompass such sectors as direct lending to middle market enterprises, commercial real estate debt, mortgage-related securities, infrastructure debt and private placements.

- **Last Liquidity Premium Standing?** We think the "public versus private" liquidity-risk tradeoff is due for a rethink. At this late stage in the credit cycle, herding behavior is pervasive, spreads are extremely tight and balance sheets look stretched. As we see it, the liquidity premium in public credit markets has all but disappeared. And, with banks retreating from their role as dealers in public debt markets, liquidity may not be there when investors need it most. Private credit investments are less liquid, but they're also structured to compensate for that risk—and are less prone to crowding.
- **Solid Rising-Rate Defenses.** In general, private credit returns have a low correlation to changes in government bond yields, meaning they're less rate sensitive than many core fixed-income strategies. Also, direct loans to midsize companies or for commercial real estate are typically floating rate, allowing returns to rise as rates do. Investments backed by real physical assets, with cash flows linked to LIBOR-based indices, can provide an effective hedge in a rising-rate environment. Other sectors, such as residential mortgages, are fixed rate, but they typically pay a yield premium to cushion the impact of a rate rise.
- **Tougher Downside Protection.** Private credit strategies offer access to a broad opportunity set—spanning different market sectors, borrower types and geographic regions—that insurers may not otherwise be able to secure. These investments also typically have higher seniority, as well as stronger covenants and collateralization, compared with public credit securities of similar duration and quality.
- **Offset to Soaring FX Costs.** The yield pickup typically structured into private credit investments can help offset the foreign exchange hedging costs for non-US investors in US corporates, which have risen significantly over the past year.
- **Credit Disintermediation.** Given insurers' liability structures, insurers are well positioned to take advantage of the opportunities arising from the unwavering demand for alternative funding sources as banks shun riskier lending activities.

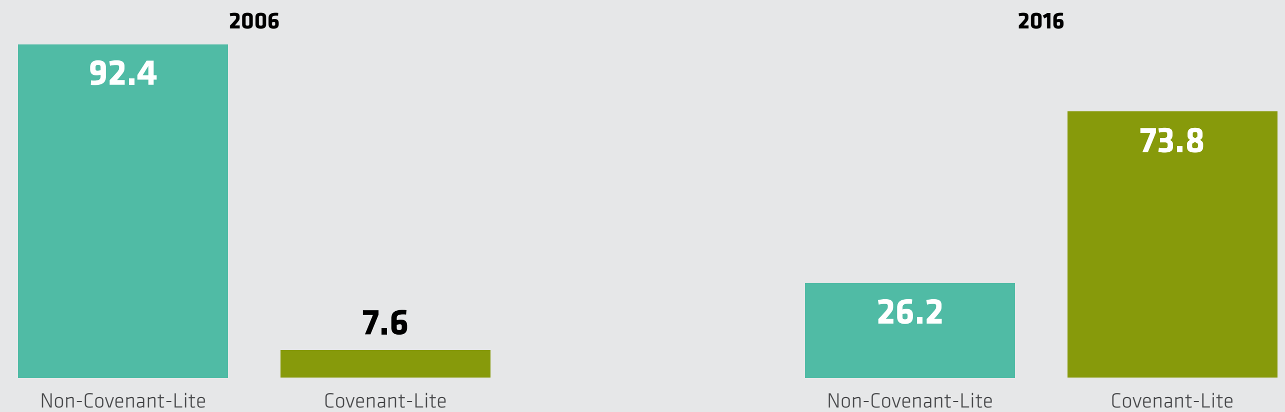
DISPLAY 2: SPREADS ARE EXTRAORDINARILY TIGHT TODAY
BB minus BBB Option-Adjusted Spreads (Basis Points)



Through February 28, 2017
Average and standard deviation since 2009
Source: Bloomberg Barclays

DISPLAY 3: COVENANT-LITE LOANS ARE BACK IN VOGUE

Covenant-Lite Issuance as Percent of Total Institutional Volume



As of December 31, 2016
Source: Bank of America Merrill Lynch, *High-Yield Credit Chartbook*, March 31, 2017

CAUTION: AGING CREDIT CYCLE

A healthy US economy and the new US presidential administration's pro-growth proposals have made investors more confident that global economic growth can gain traction after years of sluggishness. Corporate profit growth also looks poised for a rebound. These conditions suggest that the credit cycle has longer to run.

Even so, caution signs are blinking. Valuations look stretched: the spread differential between BBB-rated and BB-rated bonds is as tight as it's been for the past decade (*Display 2*).

At the same time, credit quality has deteriorated. In the postcrisis cheap-money era, corporate balance sheets have become more leveraged and interest coverage has declined.

"Covenant-lite" loans—loan agreements without the usual protective covenants for lenders—are back in vogue. They are much more prevalent among large-cap companies than midsize ones (*Display 3*), because large firms tend to have better access to high-yield debt financing. And capital structures are becoming more aggressive. These trends, in particular, seem to signal the late innings of a credit cycle.

Given this backdrop, we believe private credit—with its stronger terms and downside-risk protection—makes sense. Private credit structures enable investors to work out deals as a part of a restricted group of lenders and to actively engage with the borrower's management if there's a default or distress situation. This hands-on engagement helps reduce the risk of a negative return surprise.

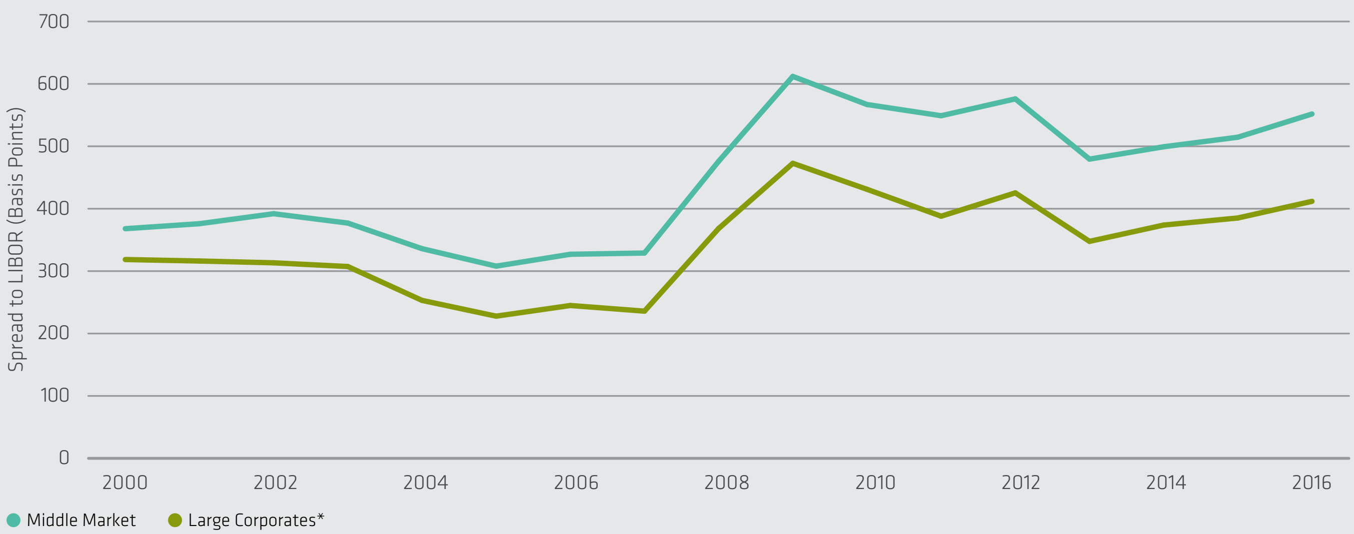
BEWARE THE LIQUIDITY ILLUSION

Are investors getting paid enough for liquidity risk? It's an important question when assessing the risk/return tradeoffs and allocations between traditional, publicly traded fixed-income strategies and their less liquid counterparts. In our view, the answer is less straightforward than it may seem.

Investors' desire for income at all costs has compressed the risk premiums for larger, more liquid governments and corporates. These effects can be seen in the growing premium gap between privately originated middle market loans and broadly syndicated large-cap loans since 2008. Middle market loans have historically offered a higher premium than large-cap corporates, but the gap reached 140 basis points by the end of 2016—much higher than the 15-year average of 107 basis points (*Display 4*).

DISPLAY 4: PREMIUM GAP BETWEEN MID- AND LARGE-CAP CORPORATES HAS WIDENED

Average New-Issue Spread of Senior Loans



Through December 31, 2016

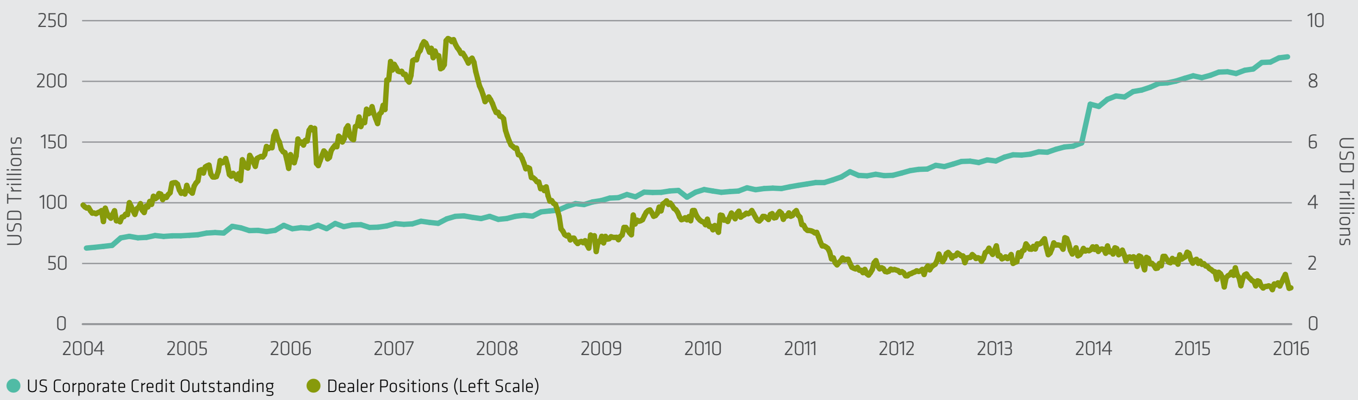
Past performance is not necessarily indicative of future results.

***** Large corporate senior loans are defined by S&P as loans greater than $500 million.

Source: Standard & Poor's (S&P)

DISPLAY 5: BANKS HAVE RETREATED FROM THEIR ROLE AS DEALERS

Growth of Market vs. Dealer Balance Sheets



Through July 31, 2016

Historical analysis is not necessarily predictive of future results. Historical information is provided for illustrative purposes only and is subject to change.

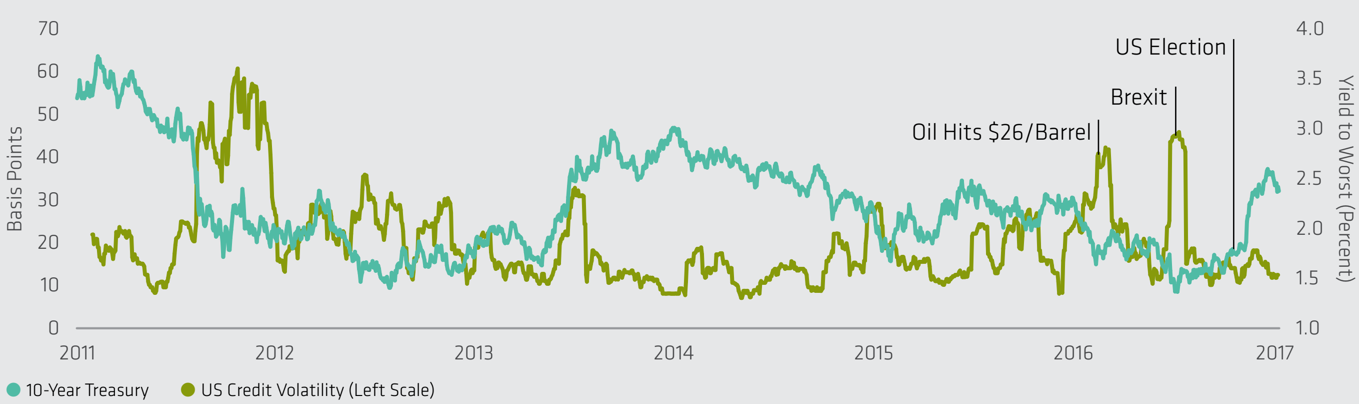
Source: Financial Industry Regulatory Authority

We'd also argue that public credit markets aren't as liquid as investors may think. While the amount of US corporate credit outstanding has grown steadily since the global financial crisis, dealers' balance sheets have not (*Display 5*), and these conditions are unlikely to improve anytime soon. This trend has reduced turnover in the corporate bond market and has led to higher trading costs during periods of market stress.

Public credit markets could also witness higher mark-to-market volatility than their private market peers, made worse by the growing popularity of passive index-tracking and exchange-traded bond funds, which favor larger, easier-to-trade liquid instruments. In the hunt for yield, investors have been herding into the same opportunities, altering the relationships between valuations and fundamentals. As we saw during the credit sell-off more than a year ago, opportunities arising from sudden bursts of credit market volatility have tended to vanish as quickly as they appear (*Display 6*).

DISPLAY 6: OPPORTUNITIES FROM SUDDEN BURSTS OF CREDIT VOLATILITY HARDER TO CAPTURE

US Credit Rolling Volatility vs. 10-Year US Treasury Yields



Through December 31, 2016

Source: Bloomberg Barclays

Some insurance-industry regulatory frameworks, such as Solvency II, are establishing stiffer capital requirements for riskier, more volatile assets. Insurance companies need to take these recent structural changes into account when deciding their overall allocation and their approach to investing in the global credit markets.

Because private credit markets aren't subject to much, if any, secondary market activity, the valuation process tends to be based more on the assessment of credit quality than on technical factors such as flow. Such considerations align well with the objectives of insurers with longer investment horizons.

BUILT-IN DEFENSES TO RISING RATES

Because many private credit investments are underwritten as floating-rate instruments, they generate higher income and mark-to-market benefits in rising-rate environments. Those features should be particularly appealing to property and casualty insurers, which typically have a limited appetite for duration on the liability side.

Life insurers, particularly those with high fixed-guaranteed legacy businesses, have traditionally preferred fixed-rate instruments, which offer a better match for their liabilities. As rates normalize, a barbell strategy, combining long-dated yet liquid government bonds with floating-rate private credit instruments, should deliver both the duration and yield enhancement insurers expect.

AN OFFSET TO SPIRALING HEDGING COSTS

Insurance companies in Europe and in Asia have been putting more money into US corporate bonds over the past few years as domestic interest rates have plunged to record lows.

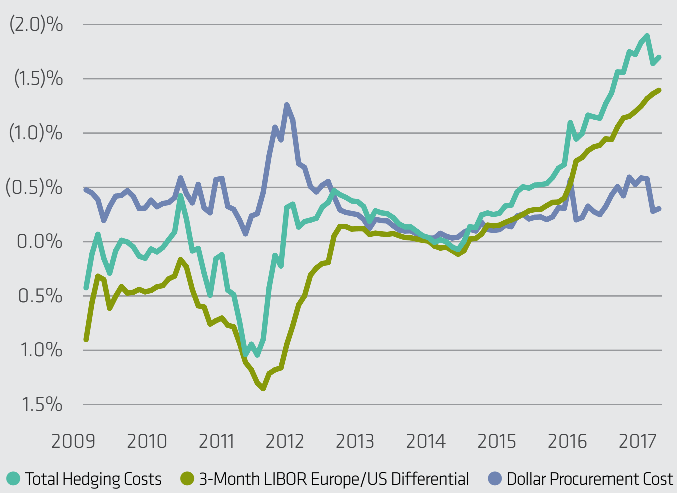
The strong demand this generates for US dollars, coupled with the widening differentials between US rates on one hand and Japanese or European rates on the other, has dramatically increased hedging costs for investors who didn't use longer-term hedging instruments such as cross-currency swaps to hedge their foreign currency exposure (*Display 7*).

While the Fed is clearly on a path to higher rates, both the European Central Bank and the Bank of Japan continue to hold fire. This situation suggests that the interest-rate gaps between the US and Europe or Japan will grow. That scenario would reduce non-US investors' already diminished benefits from investing in US corporates. Spreads would need to be far higher to compensate for the increase in FX hedging costs. Once again, private credit investments, which typically earn higher yields than more liquid traditional bonds without adding credit risk, can offer a good solution.

DISPLAY 7: FX HEDGING COSTS HAVE SOARED LATELY

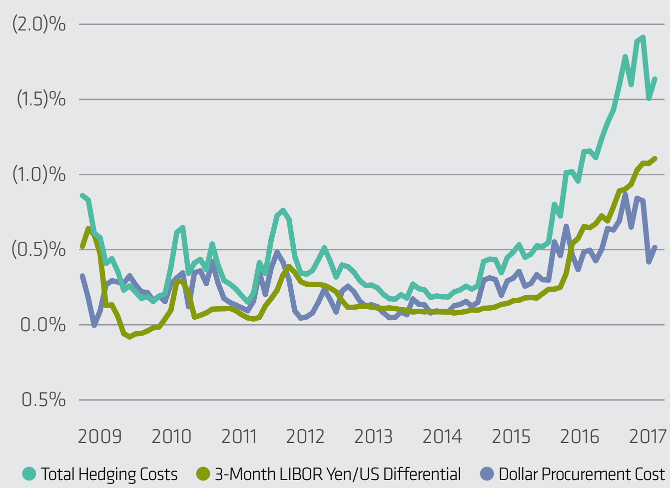
COST OF HEDGING A USD BOND INTO EUROS

Inverted scale: a negative (positive) number means a cost (gain)



COST OF HEDGING A USD BOND INTO YEN

Inverted scale: a negative (positive) number means a cost (gain)



Through February 28, 2017

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Costs computed as the sum of the interest rate (three-month LIBOR) differential and the dollar procurement cost; annualized

Source: Bloomberg and AB

CREDIT DISINTERMEDIATION IS HERE TO STAY

Whatever the rate environment, we expect the demand for alternative providers of financing to continue to grow—creating attractive investment opportunities for well-capitalized insurers.

Irreversible structural changes explain why this trend has lasted. Disintermediation has been under way since the 1990s, but it took off in the wake of the global financial crisis, when banks were forced to dramatically reduce their balance sheets and withdraw from certain riskier lending activities. Alternative providers of capital—insurance companies, asset managers, pension funds and specialty finance firms—have stepped in to fill the breach.

The US market is the epicenter of the bank disintermediation trend, but Europe is catching up fast. We expect European banks' share of corporate financing to decline further as these economies continue to improve and as new regulations drive banks to further delever their balance sheets. The disintermediation of European credit markets should also get a push from the ongoing implementation of Europe's Solvency II insurance-industry regulations. Insurers may now claim some capital relief under this framework, thanks to the collateralization or higher seniority of their investments in borrowers' capital structure.

Some market watchers are questioning whether the new US presidential administration's proposals to dismantle Dodd-Frank regulations will fuel a resurgence of bank corporate lending in the US. Our take is that US policymakers are more focused on simplifying bank regulations than on reducing capital requirements. In that case, changes are more likely to affect areas such as consumer financing than corporate lending.

It's just as important that banks no longer have the infrastructure and resources they need to efficiently service these types of lending activities. Even if capital rules were unwound in the future, banks would have to rebuild this business from scratch. So, while bank lending activity is likely to increase as rates rise, we don't see these institutions recapturing anything close to their former share.

CONCLUSION: PRIVATE CREDIT EXPOSURE AS A PERMANENT ALLOCATION

A gradual rise in interest rates may signal the start of a normalization in the prices of financial assets. But it will take time to fix the disconnect between fundamental credit metrics and valuations in the public market, given investors' continued appetite for yield and income. In that context, building a permanent exposure to private credit in the asset allocation of insurers brings not only a much-needed yield boost but also a better risk-adjusted return than remaining exposed to more crowded and volatile segments of the public markets.

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