For professional clients only
February 2018
Investor Thinking

Investment opportunities across the credit continuum

- **Alternative forms of lending offer investors the potential to access a broad and diverse universe of opportunities/risk premia within credit and better risk-adjusted returns throughout the market cycle.**
- **Capturing the potential benefits of non-traditional lending instruments requires a deep understanding of private heterogeneous transactions, efficient sourcing and implementation, and thorough monitoring.**
- **Deeper corporate and non-corporate credit risk along with illiquidity, complexity and regulation surrounding these strategies, are some structural reasons that support the case for alternative lending.**

Introduction

The history of lending goes back to 1000 BCE and the temples of Babylon. Contemporaneous legal texts show that deposit accounts were a practice at that time. The existence of deposits led to the origination of loans – initially as simple as seed-grain for farmers – to be repaid after the harvest.[1] Although the instruments used to facilitate lending and trade activity have evolved, the basic purpose remains the same today – financing the economy.

In the modern financial system as well, funds flow from those who have a surplus (of liquidity, time etc.) to those who have a shortage or a need. In this paper, we describe the ability of lenders (i.e. investors) to similarly help finance the economy. We explain how in doing so, lenders are able to charge a premium based on the creditworthiness of borrowers, the efficiency and transparency of the underlying instruments or contracts used (e.g. from a capital charge consumption perspective), the availability of historical data, and the overall demand/supply equilibrium.

Why look towards alternative lending now?

Markets have long been supportive of traditional lending asset classes, such as sovereign and investment grade bonds, which have for a significant time served the return requirements of institutional investors and their core portfolios.

These markets are usually structured as over-the-counter (OTC) markets with banks acting as market makers or dealers (i.e. banks warehousing inventory) for those willing to provide financing. This structure has worked well for these simpler bond instruments, allowing lenders to focus on extracting value from carry, spread tightening, and default avoidance.

The large size of these markets offers substantial diversification potential. The different maturities on offer can be structured to provide a stable income/cash yield at regular intervals while well-functioning capital markets along with the large number of operators in the market help ensure liquidity.

As such traditional fixed income assets continue to play a key role in institutional investor portfolios towards, amongst other things, liability matching and capital preservation needs. Today, however, it is beneficial, if not necessary, to look beyond such traditional lending:

- **In the current low yielding environment**, looking beyond the basic credit instruments appears to be essential for investors searching for a higher yield given that spreads appear to be offering relatively little compensation for the risk of default, resulting in reduced carry. If interest rates were to rise, that could lead to capital losses wherever duration exists (e.g. fixed coupon instruments) and threatening the low default environment due to higher debt servicing costs.

- **Beyond reasons relating to today's market environment**, investors looking for potentially lower mark-to-market volatility[2], as well as diversification across return sources/risk premia could find alternative forms of lending also starting to play a significant role in their portfolios.

[1] "Banks of the World," by Roger Orsingher. Translated by D. S. Ault, Walker and Company, New York – Chapter I – Historical Survey of Banking Operations.
[2] Although some alternative asset classes such as CLO equity could be much more volatile than traditional credit.

What are the alternative forms of credit?

Viewing lending as an activity that finances the economy is helpful for understanding the breadth and depth of possible types of financing. Thus, beyond the traditional forms of credit, the spectrum of possible loans includes instruments to fund the building of roads, hospitals, schools, airports **(infrastructure debt)** or fund the acquisition, development or construction of commercial property **(commercial real estate debt)** or residential property **(residential mortgages)**. Alternative forms of credit can also be used to help insurance companies manage their risk **(e.g. insurance-linked securities)**, provide fast growing small and medium-size companies with refinancing opportunities directly with **direct lending** or indirectly with **bank capital relief solutions**, enable private equity companies to build up a portfolio of investments **(leveraged loans)** and even support individual consumers **(Dutch mortgages)**. In Figure 1 below we outline the broad opportunity set for lenders willing and able to move up the credit spectrum.

Figure 1: Ways to finance the economy

Gain exposure to…	Liquid	Mostly liquid	Mostly illiquid
…corporates (including SMEs)	Investment Grade Credit and High Yield	Collateralised Loan Obligations, Corporate Loans	Direct Lending, Trade Finance, Bank Capital Relief Solutions
…insurance companies		Insurance Linked Securities	
…consumers		Asset Backed Securities	Dutch Mortgages
…real assets			Commercial Real Estate Debt, Infrastructure Debt

Structural premia in alternative credit markets

Lenders can expect to earn a higher spread when investing in alternative credit for some fundamental reasons. However the lack of information surrounding these fundamentals along with a high cost of entry for some strategies could discourage lenders from entering the alternative credit market, which in turn is one aspect of the higher return available to those willing to participate in this market.

Besides the higher spread, alternative credit may help diversify a portfolio by opening up opportunities to a different pool of assets. The specific risk premia[3] that this opportunity set would give rise to will not only mean diversifying away from a traditional fixed income or equity portfolio but also within fixed income itself. In addition, the volatility of an investor's portfolio could be reduced as a direct result of this diversification benefit or through specific structuring features of the investment in an alternative credit strategy.

The structural reasons associated with specific risk premia, which result in higher expected spreads and diversification benefits are discussed overleaf. Also, Figure 2 below aims to capture the structural reasons mentioned on page 4 into five simple risk exposures to help provide an idea about the various avenues of risk premia.

> **"Viewing lending as an activity that finances the economy is helpful for understanding the breadth and depth of possible types of financing."**

Figure 2: Illustration of potential risk premium exposure[4]

	Corporate credit	Non-corporate credit	Illiquidity	Complexity[a]	Regulatory changes[b]
High Yield Credit	Risk premium exposure	No/reduced	No/reduced	No/reduced	No/reduced
Asset Backed Securities	No/reduced	Risk premium exposure	No/reduced	Depending	Risk premium exposure
Collateralised Loan Obligations	Risk premium exposure	No/reduced	Depending	Risk premium exposure	Risk premium exposure
Corporate Loans	Risk premium exposure	No/reduced	Depending	No/reduced	No/reduced
Direct Lending	Risk premium exposure	No/reduced	Risk premium exposure	Risk premium exposure	Risk premium exposure
Insurance Linked Securities	No/reduced	Risk premium exposure	Depending	Risk premium exposure	Risk premium exposure
Bank Capital Relief Solutions	Risk premium exposure	No/reduced	Risk premium exposure	Risk premium exposure	Risk premium exposure
Dutch Mortgages	No/reduced	Risk premium exposure	Risk premium exposure	Depending	Risk premium exposure
Trade Finance	Risk premium exposure	No/reduced	No/reduced	Risk premium exposure	Risk premium exposure
Commercial Real Estate Debt	Depending	Depending	Risk premium exposure	Risk premium exposure	Risk premium exposure
Infrastructure Debt	Depending	Depending	Risk premium exposure	Risk premium exposure	Risk premium exposure

Risk premium exposure

Risk premium exposure depending on the underlying security/structure/indentures

No/reduced risk premium exposure

Source: AXA Investment Managers. For illustrative purposes only.

[a] **Complexity:** Requiring access to key relationships in specialised industries, structuring with the help of other financial institutions (e.g. investment banks) or operationally demanding implementation and monitoring.
[b] **Regulatory changes:** In relation to balance sheet risk transfer in the wake of banking and insurance regulations such as Basel III, Solvency II, etc…

[3] Please note, risk premia are the potential rewards of risk taking. The rewards are not guaranteed. For example, illiquidity could result in not being able to sell your assets on time or regulaation could adversely affect the value of assets in the event it becomes more stringent without warning. [4] Relative to other assets in the table.

Structural drivers of specific risk premia

'Deeper' corporate credit risk: Only a small portion of corporates can afford bond issuance. Corporates that are shut out of the bond markets need to raise funds through loans. These are usually companies that are not big enough to raise money on the public markets or have bespoke structuring needs (for example unusual collateral, the need for a tailored funding package etc.). A diversification into bank capital relief solutions for example opens up investment opportunities in those corporates that are shut out of the public markets.

Non-corporate credit risk: Not only does investing beyond traditional credit help to access corporates that are shut out of the bond markets but also away from such corporate credit risk. For example asset backed securities and Dutch mortgages provide exposure to the credit risk stemming from individuals. Catastrophe bonds (a form of ILS) on the other hand provide exposure to the risk of natural calamities. Infrastructure debt helps diversify exposure towards loans supporting projects that provide essential services such as transportation, utilities, power generation and communication.

Illiquidity: For investors willing and able to invest in assets with limited or no secondary market, illiquidity is a source of return that could be exploited. Commercial real estate debt and infrastructure debt are examples of credit assets for which borrowers are willing to pay a premium rate of return, to lenders willing to lock in their money for a longer period of time. However, asset classes such as insurance linked securities (ILS) can be liquid or less liquid depending on format of the investment. Catastrophe bonds are the most well-known and liquid format of ILS but at the less liquid end of the spectrum are for example reinsurance sidecars which allow investors to participate 'side-by-side' with the reinsurer, sharing profits and losses of the reinsurer's book of business.

Complexity: Some lending arrangements (for example CLOs, direct lending, bank capital relief solutions), require expert knowledge, access to key relationships in specialised industries or a need to be structured with the involvement of other financial institutions (e.g. investment banks). Unique and exclusive return opportunities are available to investors that have the resources and expertise to understand the underlying assets, structure these transactions and manage the operational complexity of implementation and monitoring. Also asset-backed securities, depending on the way in which they are structured (allocation of cash flow to different investors, indentures to protect the cash flows, responsibility of the collateral sellers/servicers etc.), could either have a relatively simple or complicated structure – affecting the risk premium.

Regulatory changes: In the wake of stringent Basel III rules, banks are increasingly incentivised to transfer part of their balance sheet risk to other institutional investors at very attractive premia. This gives unconstrained investors the opportunity to capture returns by purchasing bank assets or entering into private bank capital solution transactions with deleveraging banks or to build partnerships on direct lending with banks. Banks are also pulling back from some of their traditional lending activities, notably in the commercial real estate and trade finance spaces, and this gap is increasingly being filled by institutional investors.

To reduce some of their own balance sheet risk, insurers often re-package insurance risks to transfer a portion of the risk to investors. Investors agree to pay some of an insurer's claims in case of an event whilst collecting a premium for agreeing to do so. Catastrophe bonds are one example of such insurance-linked securities.

In both cases above (banks or insurance companies transferring risk) the pricing of the transaction enables investors to capture part of the reduction in regulatory cost that the insurer/bank would have had to integrate otherwise.

Other reasons that may support investors' interest for lending to alternative credit markets

Mispricing/Restructuring: Although this could be true for any asset class, it is helpful to identify this aspect of return generation here, as traditionally default avoidance has been a major focus for credit investing. In the alternative credit world, value can also be extracted from restructuring assets in default or distressed assets. For instance, by carefully identifying assets that are distressed for short-term reasons, pockets of value that are otherwise inaccessible could be identified. Investors can then expect to see values recover from distressed levels as soon as the short-term dislocation dissipates.

At the more liquid end of the spectrum, credit market mispricings can arise owing to inefficiencies caused by constrained investors (for example CLO debt investments are heavily penalised with capital charges for insurance companies). Excess return can be generated by identifying mispriced securities through rigorous fundamental analysis and implementing trades (long/short or relative value) to benefit from the expected normalisation of market dislocations.

Floating vs. fixed rate: The floating rate nature of some types of loans is helpful in a rising rate environment. As mentioned earlier rising interest rates would hold back returns wherever duration exists. Floating-rate instruments could be used to hedge against this scenario. On the other hand, not all loans are floating rate and investors might prefer fixed rate loans for the purpose of liability matching and these can also be found in the alternative credit universe – for example, Dutch mortgages.

Seniority/collateral: Recovery rates in the senior-secured loan universe have historically been greater than those seen in the high yield bond universe (for example 67% for senior secured corporate loans versus 41.2% for high yield bonds) due to the higher seniority in the capital structure and the covenants provided by the corporates for loans[5]. Similarly, Dutch mortgage loans and commercial real estate debt have collateral backing them – an aspect that is unavailable in the traditional bond universe.

> **"By carefully identifying assets that are distressed for short-term reasons, pockets of value that are otherwise inaccessible could be identified."**

[5] Source: JP Morgan, Default Monitor, High Yield and Leveraged Loan Research, 2 January 2018. 19-year long term average for the loans and 25-year annual average for the bonds.

> “Capturing the potential benefits of financing the economy via non-traditional lending instruments requires a deep understanding of heterogeneous private transactions.”

How to invest in alternative lending instruments

Capturing the potential benefits of financing the economy via non-traditional lending instruments requires **a deep understanding** of heterogeneous private transactions.

For example:

- the covenant package of a private transaction to fund a fast growing medium-sized manufacturing firm in Germany differs significantly in complexity from a similar loan to fund a refinancing transaction for a major brand high street retailer in central London.
- in the case of commercial real estate debt, the property valuation and cash flow modelling aspects such as a tenant’s ability to deliver on their business plan, capital expenditure analysis or environmental due diligence reports (that assess the likelihood of flooding, landslides etc.), site visits, will be very different for a central London office block versus that of a beach resort in Spain.
- The credit assessment of a callable high-yield bond issued by a company that has substantial leverage at the operating company level (and most vulnerable assets at the holding company level) will be very different from one with a simpler structure and leverage and relevant assets at the operating company level.

Secondly, the unique nature of every borrower, type and length of a project, covenant package, senior versus subordinate status, operating or holding company status of borrower, bespoke indentures and subsidiary guarantees, amongst other things, make it important to carry out case-by-case analysis on investments. The various characteristics and risks to consider give rise to less liquid markets with limited access to them. This raises the question of **efficient sourcing and implementation**. As such, apart from being comfortable with the drivers of return of this category of investments, investors should ensure they have the ability to source deals efficiently, the experience to evaluate the available investments and the ability to negotiate the terms of each transaction properly.

Finally, these investments also need **frequent and thorough monitoring** over time as information specific to the characteristics of individual transactions could cause structural changes to valuations and default probabilities. As an example, a collateralised loan obligation (CLO) BBB tranche valuation could be affected by its collateral pool, the strength of any bespoke indentures behind the underlying loan agreements, the efficiency of the CLO manager servicing the debt and the vintage of the tranche. Equally, contagion from more liquid credit markets could create market volatility and therefore entry point opportunities (for a portfolio that is continuously being monitored) if price was to disconnect from fundamentals.

Risk

From a risk perspective, the relative position of the different asset classes will depend on the market context and specific client situations such as the regulatory background, investment structuration, valuation framework, liquidity requirements and risk measurement obligations relevant to the portfolio.

General economic and market conditions such as interest rates, mortgage prepayment rates, availability of credit, inflation rates, economic uncertainty and changes in laws could affect the value of alternative credit assets. As a result some widely recognised risk factors such as, market, credit, performance and liquidity risk as well as other risk factors more specific to each asset class are important to assess and monitor.

Conclusion

The existence of a gap between the supply and demand due to bank retrenchment in large parts of the alternative credit market is telling of the fact that this is an opportunity that is yet to be fully exploited.

As investors continue their search for yield, better understanding these strategies and the available implementation options early on, could help with well-organised and informed execution.

If they could have travelled ahead in time, the lenders of Babylon might find operating in today's long-established OTC bond markets rather complicated. Likewise, investing in alternative credit might seem esoteric or even difficult today but some time and effort in understanding these strategies and getting comfortable with the required implementation routes, could prove very beneficial.

> **“Alternative forms of lending offer investors the potential to access a broad and diverse universe of opportunities/risk premia within credit and better risk-adjusted returns throughout the market cycle.**

Design & Production: Internal Design Agency (IDA) | 21295/2018 | Produced using stock that is FSC certified.

AXA INVESTMENT MANAGERS

Issued in the UK by AXA Investment Managers UK Limited, which is authorised and regulated by the Financial Conduct Authority in the UK. Registered in England and Wales No: 01431068. Registered Office: 7 Newgate Street, London EC1A 7NX.In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.