Understanding the Differences Between Private and Public Credit

Newfleet
ASSET MANAGEMENT
A Virtus Investment Partner

In the past decade, the private credit market – debt that is negotiated outside of public markets – has grown tenfold as investors seek out higher-yielding alternative investments. Post-2008 regulatory changes to the financial system caused traditional lenders to pull back from lending to all but the largest companies, leaving a gap in the market that more loosely regulated and agile private lenders have stepped in to fill, often offering products with customizable structures that can streamline the deal's certainty of close within shorter timeframes.

Private credit thus encompasses a variety of solutions, including senior secured loans for larger corporate borrowers, loans backed against assets such as real estate or airplanes, and, historically, borrowers that are smaller in size and more highly leveraged than public credit borrowers.

Following are key examples showing how private and public debt typically diverge in yield, duration risk, credit risk, liquidity, and valuations.

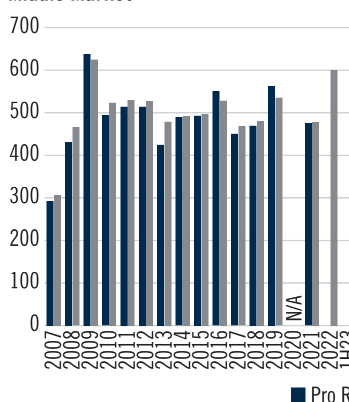
LIQUIDITY

Public Credit Publicly traded debt instruments are typically more liquid than private credit.

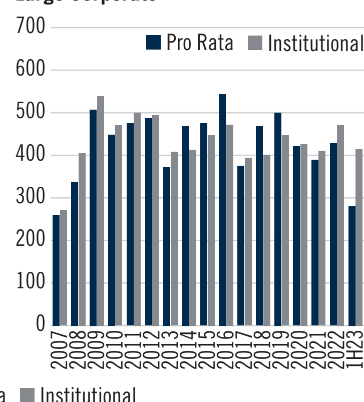
Private Credit Private credit is less liquid than public debt and usually comes with a significant illiquidity yield premium – i.e., an incremental return that compensates investors for locking their funds into assets that are not highly liquid.

PRO RATA AND INSTITUTIONAL SPREADS

Middle Market



Large Corporate



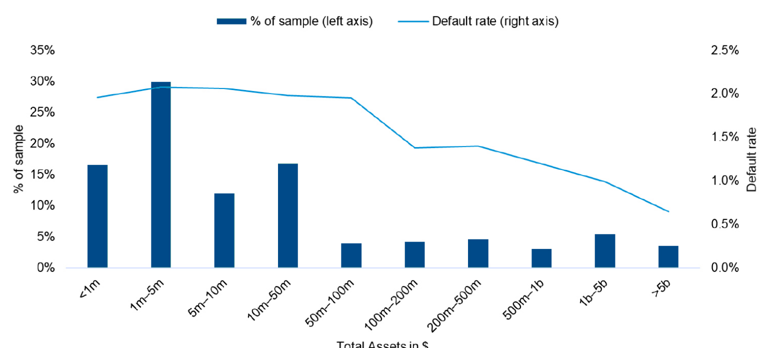
Source: Pitchbook LCD. Data as of June 30, 2023.

CREDIT RISK

Public Credit Larger publicly traded companies typically pose less of a credit risk than smaller middle market firms. Research from Moody's Analytics (see right) shows credit risk decreasing as companies increase in size.

Private Credit Direct lending, which still makes up the bulk of the private credit market, usually focuses on lending to small- to medium-sized businesses. Along with higher overall credit risk, private credit investors must typically factor in the borrower's financial health, the debt's seniority, valuations, and the quality of the protections underwritten into the credit.

DEFAULT RATE BY SIZE



Source: Moody's Analytics. As of December 31, 2021.

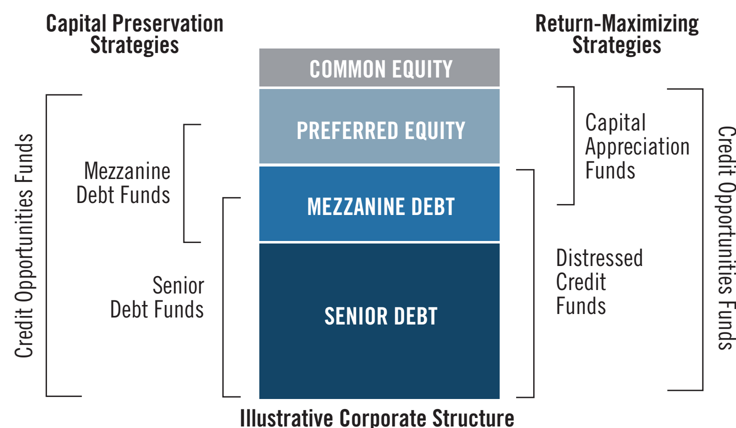
DURATION RISK

Public Credit	Public debt investors who want to lessen interest rate risk typically do so by reducing duration and yield.
Private Credit	Private credit instruments are typically tied to floating rate structures that may help investors reduce duration risk without sacrificing yield.

VALUATIONS

Public Credit	Publicly traded debt valuations are more transparent than those of private credit – the price of a bond or credit as reflected in the data is typically assumed to be the fair value.
Private Credit	Private credit valuations are less transparent because they are priced internally rather than using market-based pricing. Eschewing market-based pricing may increase the risk of inflated valuations, which may, in turn, lead to inflated fees if the fees are structured to pay a fixed percentage of AUM.

WHERE PRIVATE CREDIT STRATEGIES TYPICALLY PLAY IN THE CAPITAL STACK



Source: Cambridge Associates LLC.

As private credit encompasses a wide variety of strategies, it may also see a wider dispersion of returns. Private credit outcomes rely heavily on the quality of the lender's due diligence to minimize risk, the position of the debt in the capital structure, the type of collateral the manager is lending against, and their experience investing through multiple cycles. Investing in the right blend of private and public credit may offer investors an opportunity to enjoy the benefits of diversification in their fixed income portfolios and help mitigate exposure to significant losses.

To learn more about Newfleet Asset Management, please contact us at 877-332-8172 or visit newfleet.com.

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Bonds may offer a relatively stable level of income, although bond prices will fluctuate providing the potential for principal gain or loss. Intermediate-term, higher-quality bonds generally offer less risk than longer-term bonds and a lower rate of return. Generally, a portfolio's fixed income securities will decrease in value if interest rates rise and vice versa.

Bank loans may be unsecured or not fully collateralized, may be subject to restrictions on resale, may be less liquid, and may trade infrequently on the secondary market. Bank loans settle on a delayed basis; thus, sale proceeds may not be available to meet redemptions for a substantial period of time after the sale of the loan.

IMPORTANT RISK CONSIDERATIONS:
Credit & Interest: Debt instruments are subject to various risks, including credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt instruments may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities.
Market Volatility: The value of the securities in the portfolio may go up or down in response to the prospects of individual companies and/or general economic conditions. Local, regional, or global events such as war or military conflict, terrorism, pandemic, or recession could impact the portfolio, including hampering the ability of the portfolio's manager(s) to invest its assets as intended.

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