For Investment Professionals only

M&G Investments

A new perspective

Diversified private debt portfolios for insurers

Optimising private asset allocations

Faced with unique and diverse challenges, insurance investors have looked to increase their exposure to less liquid markets, such as private debt, over recent years. Private debt is often well-suited to an insurer's balance sheet and we believe that a diversified private debt portfolio, managed with specific risk constraints (duration, solvency capital requirements (SCR), internal rating etc), could and should form part of most insurers' asset allocation. This sort of well-constructed private debt portfolio, tailored to the insurer's unique circumstances, may balance a range of requirements, but primarily help meet a higher investment return objective over the long term – without having to increase portfolio risk. In particular, this paper focuses on shorter-dated private debt opportunities, many of which could be suitable for insurers with shorter-dated liabilities.

Private debt offers a broad and diverse opportunity set that continues to evolve and mature, so investors need to ensure that they are making the most of their allocations over time. We would suggest that previous frameworks and structures employed by insurers, which tend to focus on certain sub-types of private debt in a siloed approach, can create barriers to effective investment going forward and inadvertently narrow the opportunity set – thereby reducing the potential for diversification and increasing capital deployment time.

Alternatively, taking a flexible approach to investing in the private debt market should help insurance investors harness the full potential of the market, both now and as it evolves. Established private debt managers that have the ability to identify and assess the best available opportunities from across the full private debt spectrum, can help to ensure portfolios are optimised based on an insurer's individual preferences and risk appetite.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note that this is not a guide to future performance.

Quick take: Key principles for investment in private debt:

- Treat private assets more like public fixed income allocations, ie adopt duration and (internal) rating targets and set sector and individual name limits, but don't allocate individually in small amounts to lots of different sectors of the private debt market.
- Take a flexible, unconstrained, bottom-up approach to asset selection, allowing private debt managers to access value from across the entire investable universe as it presents itself.
- These can help to:
  - Reduce the governance requirement to sign-off on distinct financing structures, which takes up time and resource
  - Broaden the available investment universe and give potential benefits in terms of diversification and speed of deployment
  - Give managers the ability to dial up and dial down sectoral exposures to maximise the potential of allocations and optimise according to individual preferences and risk appetite
  - Allow managers to dynamically allocate to areas of the market which may be offering good relative value and allow insurance companies to benefit from market dislocations and opportunities
  - Reduce the potential risk arising from having fixed allocations to areas of the market which could become increasingly expensive.

We understand that insurance investors looking to make meaningful allocations to private debt will need to get comfortable with the potential risks of investing. Asset managers who can provide a robust internal ratings methodology can help insurers with their risk assessment, while also satisfying internal governance and Prudent Person Priciple requirements.

The case for a strategic allocation to private debt

Private markets in Europe have come a long way in the past decade or so. Private debt, or private credit as it is also often referred to, continues to attract strong demand from institutional investors globally who have essentially gone looking for what they cannot find in public markets, whether that's return enhancement, risk diversification, increased structural protections including financial and non-financial covenants, or regulatory capital efficiency.

Investors often associate private debt with 'mid-market' direct lending, given the popularity of that investment strategy since the global financial crisis (GFC). However, interest in other types of private debt has also steadily grown over the same timeframe. As these markets have become more established, investors who have put in the time, effort and governance to get comfortable with private debt and better understand the risks, have built larger and more complex portfolios.

Why allocate to private debt?

There are multiple reasons why a strategic allocation to private debt makes sense for insurers. In our view, private debt offers ready access to a large and diverse opportunity set that could potentially provide:

- Predictable and long-term stable cashflows that match the characteristics of their projected liabilities
- Higher risk-adjusted returns versus public market equivalents, often referred to as 'illiquidity premium', while still maintaining credit quality
- Diversifying potential in an investment portfolio (from a risk and return perspective) given the lower correlation to public markets and macroeconomic drivers (counter-cyclicity). Private debt assets typically have different characteristics to public fixed income assets and could offer access to a broader range of exposures, sectors/industries or target outcomes
- Insulation of balance sheets from day-to-day fluctuations in publicly-traded bond and equity markets. The valuation of private and illiquid debt portfolios tends to be substantially less volatile than public market valuations (as underlying assets are often valued based on the present value of expected future cashflows)
- Enhanced risk mitigation through the ability of private lenders to:
    1. Offer borrowers multiple, and often bespoke, structuring possibilities to help mitigate risks;
    2. Create robust documentation including embedding (maintenance) covenants and other structural investor protections in deal-terms;
    3. Potentially maximise recoveries in the event that an investment does not perform as expected. Those with the in-house restructuring resource and expertise in place can play an active role in restructurings.

Mapping the opportunity set

The investable universe in private debt has become much broader and more diverse as a result of continued innovation within the asset class. Established private debt managers with the breadth of capabilities, expertise and resources have, in turn, responded to investor appetite for new sources of alpha by unlocking new opportunities for investment and by deploying capital across the capital structure to target different risk/return profiles.

Private debt comprises an array of opportunities spanning corporate lending, real assets, consumer finance and private securitisations. Institutional investors are able to gain access to asset classes and asset types which have the potential to deliver enhanced return profiles, including numerous opportunities that could attract a lower SCR and thus increase both the capital efficiency and profitability of an insurance company. Figure 1 highlights some of the key asset classes that can be used to build a diversified multi asset private debt portfolio – we have focused on the strategies currently of most interest to insurers. These asset classes can be blended and combined to suit very specific insurer requirements.

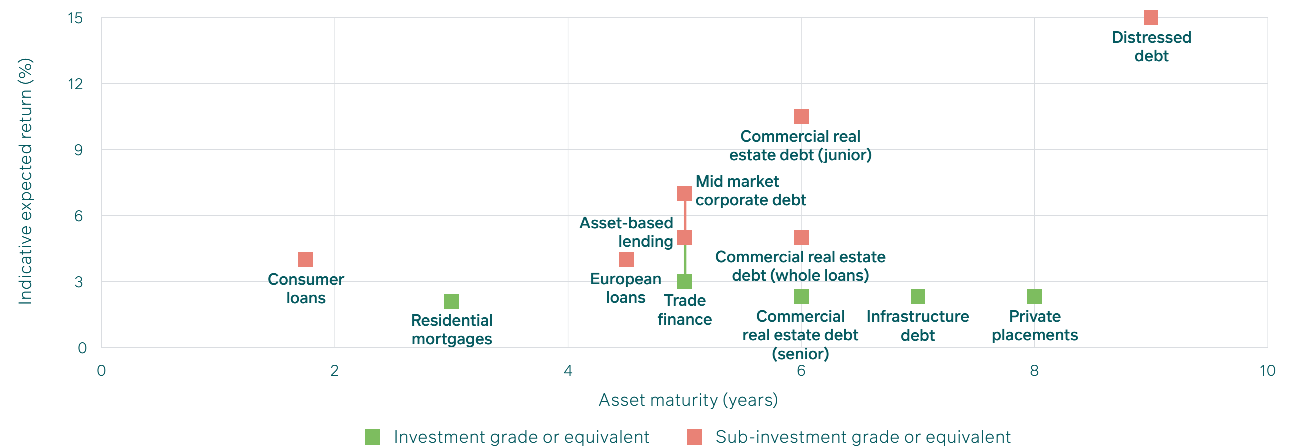
Figure 2 illustrates the investable universe and opportunity set in the private markets below 10 years of spread duration.

Figure 1 Private debt investment opportunities for insurers

Corporate lending	Real assets	Consumer finance
European leveraged loans	Infrastructure debt	Residential mortgages
NIG mid-market corporate lending (direct lending, asset-based lending)	Senior commercial real estate debt	Consumer loans
IG mid-market corporate lending (trade finance)	Junior commercial real estate debt	
Private placements	Whole loan commercial real estate debt	
Distressed debt and special situations		

Source: M&G, as at August 2021. IG = Investment grade, NIG = Non-investment grade. Information is subject to change and is not a guarantee of future results.

Figure 2 The private debt investable universe – focus on shorter-dated liabilities

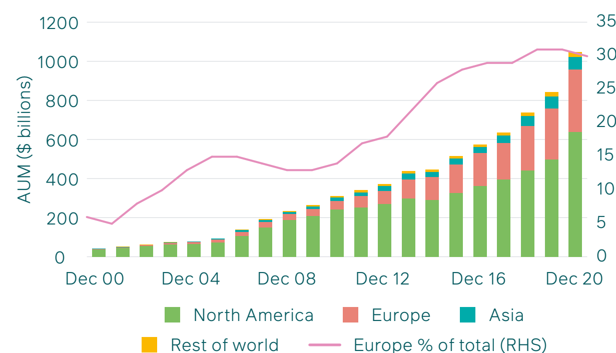


Source: M&G, as at August 2021. The source of the information is M&G experience of trading in the market. Information is subject to change and is not a guarantee of future results.

Large, scalable market with long-term growth potential

Private debt has been a growing part of institutional portfolios for several decades for the reasons we have already outlined. Available data on the asset class indicates that assets under management (AUM) has likely crossed the US$1 trillion threshold, despite the pandemic disrupting origination and investment activity during parts of 2020. According to the latest figures (converted from US dollars to euros) from data provider Preqin, which provides the most comprehensive view of the market, private debt AUM rose to €850 billion as of December 2020, tripling in size relative to €286 billion in AUM recorded for 2011. Dry powder levels — the amount raised for private debt strategies but not invested — has also increased exponentially in recent years, reaching €310 billion in August 2021.

Figure 3 Private debt AUM by geographic focus, 2000-2020



Source: Preqin Pro, as at 31 December 2020. Information is subject to change and is not a guarantee of future results.

All signs point to further growth ahead. Preqin has forecasted private debt AUM to reach €1.25 trillion by 2025, increasing at a compound annual growth rate (CAGR) of 11.4% — the second highest of any alternative asset class, after private equity. Increased demand from borrowers for alternative sources of funding has also been a central tenet of the growth in private debt and will continue to be part of its ongoing development.

Many companies are opting to stay private for longer periods of time compared to a decade ago before deciding to go public – spending their fastest-growing years under private ownership and tapping into large pools of private growth capital to build to sufficient size and scale for an IPO.

There is a great need for many insurance companies to put capital to work. Industry consensus suggests that around 10% of insurer investment portfolios will be allocated to private markets in the next five years. While this is a significant amount of as-yet uninvested assets looking for private market opportunities, we believe there is no shortage assets requiring private credit financing solutions, enabling significant capital to be deployed. Insurers and asset managers alike will nevertheless need to be able to withstand this weight of incoming capital and deploy in a sensible, scalable and timely manner.

Private debt set to enter its next phase of growth?

Many of the factors that supported the growth, development and evolution of private debt in Europe in the years since the GFC, including those that have supported lending outside of the banking sector, continue to do so. Multi-year banking and financial regulatory reform is still in the early stages of implementation and borrowers' demand for more flexible sources of capital has only grown.

Policymakers too are going some way to encourage the ongoing development of private debt in Europe, with recognition that non-bank lending plays a valuable role connecting capital markets with the real economy – many have already pointed to the crucial role private debt could play in a post-pandemic recovery.

As the asset class enters its next phase of growth, we think investors are on the verge of a huge opportunity.

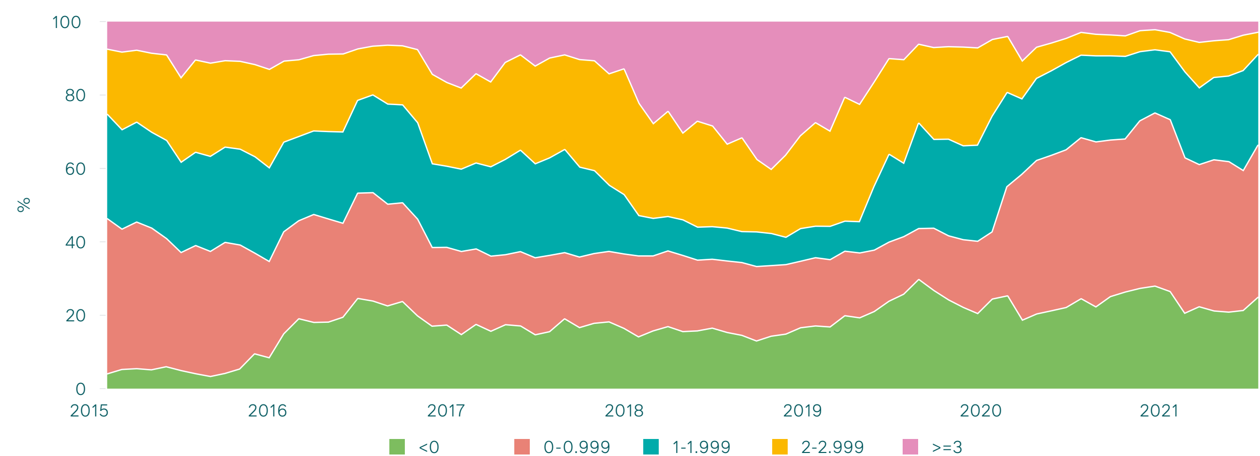
A source of stable, long-term yield

For insurers, private debt is becoming an increasingly important component in the search for stable yield, particularly for those looking to reduce balance sheet risk and income volatility.

Bonds have long been considered the mainstay of reliable income streams, but years of declining bond yields in-line with very low interest rates have made it harder for investors to reliably generate attractive levels of income in order to meet their objectives over the long term. Although inflation concerns have reared their ugly head in recent months, in turn triggering a sell-off in global bond markets, public bond spreads remain tight and yields are near historically low levels.

The volatility and disruption to the real economy during the past year or so has also created demand for assets that can reliably deliver stable income in more challenging and uncertain environments. In this respect, traditional investments comprising mainly fixed income assets (government and investment-grade corporate bonds), have been found wanting as trading in these 'liquid' markets became more difficult at the height of the COVID-19 crisis and spreads widened materially. Many private debt asset classes, in comparison, while not immune arguably proved to be relatively resilient amid wider market volatility.

Figure 4 Share of the US$67 trillion global bond markets by their yields



Source: Bloomberg ICE BofA Global Broad Market Index (GBMI), as at 31 July 2021. % distribution of full market value according to yield-to-worst. Information is subject to change and is not a guarantee of future results.

Diversification of risk

In addition to being a source of yield, adding private debt is widely considered to provide risk diversification, especially for portfolios comprised mainly of widely-traded (corporate) bonds. The benefit of diversification can be potentially enhanced by an allocation approach that allows investment across multiple asset classes within private debt – spanning real assets and consumer risk as well as private corporate lending (see next section, 'Building diversified private debt portfolios for insurers'). The performance of many private asset classes are uncorrelated with public markets such as equities and bonds, for example the return correlation of European leveraged loans to public market comparators (versus high yield bonds over a five-year horizon) has tended to be between 0.5 and 0.6[1]. For other private asset classes, impairment-based methodology may be applied when appraising performance of these assets and this helps to reduce mark-to-market volatility.

Private assets can also provide issuer diversification given the majority of private issuers are not active in public markets. For example, there is limited crossover between loan and high yield bond issuers in Europe, and 'mid-market' corporate direct lending tends to involve lending to private businesses with EBITDA typically in the range of €10-40 million, according to our definition – too small to access the public capital markets.

[1] Based on pre-pandemic monthly correlations between loans and high yield bond returns (hedged to Euros) over 5 years. Source: S&P LCD European Leveraged Loan index, ICE BoFAML European, Global, US High Yield bond indices.

Furthermore, real asset debt and consumer finance tend to have very different underlying risks and performance drivers. Real assets derive security from property or infrastructure assets, which ultimately drives returns and loan recoveries.

Consumer finance is an asset class that has been historically difficult to access directly, so exposure here can provide diversification since insurers tend to have low/no allocations to residential mortgages and consumer loans. Being bank loans in nature, residential mortgage and consumer loan spreads are not driven by financial market dynamics and have exhibited low historical correlation with equivalent corporate bonds.

Illiquidity and complexity as sources of extra return

In debt markets there are three ways to potentially increase your return: 1) increase your credit risk by investing in assets with a lower credit rating; 2) increase your duration risk by investing in longer-dated assets; and 3) invest in assets which offer an illiquidity premium. The latter option is the only one which isn't associated with a higher capital charge for European insurers.

The required compensation for illiquidity will differ for different types of investors, but insurers can often comfortably accommodate a degree of illiquidity due the nature of their liabilities. Private debt is generally considered to be illiquid or less liquid relative to public market comparators (where these exist). While it's possible to sell assets, there is typically no liquid secondary market, thus making trading more difficult. The exception is the secondary leveraged loan market which exhibits decent two-way flow. However, as private markets grow and develop further, this could start to change.

As well as an illiquidity premium, there is often a complexity premium associated with private debt, with analysis of the transaction and structure more important than for corporate credit. In some of the smaller, less established parts of the market, the frequency of deals tends to be lower and the analysis undertaken on each transaction is more bespoke in nature. This often permits managers to garner greater compensation from these smaller-scale investments compared to larger, more widely-syndicated transactions.

Building diversified private debt portfolios for insurers

As a consequence of the regulatory environment, the constraints placed on insurers can impact the way they invest, both in terms of the types of assets they require to meet their objectives, and how they build portfolios. When looking to build 'Solvency II-friendly' private debt portfolios for insurance clients, it is important to understand the characteristics of the potential "building blocks". Some investors assume that the range of opportunities (duration, coupon type, rating) in each asset type is the same as for public debt, and that is far from the case.

Figure 5, on the next page, offers an overview of the treatment of key private debt asset classes under the Solvency II framework.

Importantly, having the ability to create investment solutions that are flexible, diversified and customisable is a key advantage, in our view, when investing in private debt, and could help to align the mandate with a constantly changing opportunity set in order to make the most of allocations over time.

The building blocks

Figure 5 What asset classes and assets could comprise an insurer's private debt portfolio?

Credit risk	Strategy building block	Overview	Risk module	Estimated solvency capital requirement (SCR)	Target return*	Estimated return on capital (RoC)
Investment grade equivalent	European and UK residential mortgages	Whole loan investments of residential mortgages. Potentially compelling risk-adjusted returns and highly attractive capital treatment (counterparty risk module).	Counterparty default risk	0-5%	Mid-swaps + 1.75-2.25%	35%+
	Senior real estate debt	Senior-ranking commercial real estate debt which is backed by collateral, which should allow a 50% reduction in SCR.	Spread risk	15% 7.5% with collateral benefit	Libor + 3% (pre-crisis)	20% 40% with collateral benefit
	Senior infrastructure debt	Long-dated debt benefiting from qualifying infrastructure status under Solvency II.	Spread risk	12-20%	Gilts/Mid-swaps + 1.5-2.5%	7.5-20%
	European and UK long-lease property	An attractive way of matching long-dated insurance liabilities. Treated as property risk.	Property risk	25% (standalone) c.20% (post-diversification)	c.3%	12-15%
	European private placements	Private lending to IG companies that do not typically have public corporate bond issues. Offers investment diversification, enhanced structures. Well-priced transactions can be sourced on an opportunistic basis.	Spread risk	c.15% (depends on asset duration)	Libor + 2-2.5%	13-17%
IG NIG crossover risk	Mid-market corporate lending	Mid-market corporate loans can be structured as traditional cashflow lending or asset-based lending (ABL) transactions, and the universe can include trade financing deals. The mid-market corporate lending universe offers investors a continuum of target risk/return metrics depending on their preference.	Spread risk	c.15% (depends on asset duration)	Libor + 3-7%	20-50%
	UK consumer loans	Whole-loan portfolios of consumer loans acquired from banks. Compelling returns versus equivalently-rated corporate bonds.	Spread risk	15%	Mid-swaps + 3.5-4.5%	25-30%
Non-investment grade equivalent	European senior loans (conservative approach)	Conservative, senior loan-only approach based on fundamental credit analysis. Attractive running yield of Libor + 4%. Liquidity benefits versus other private assets, given an active secondary market for loans.	Spread risk	25-30%	Libor + 3-4%	10-15%
	Distressed debt / special situations	Equity-like returns with capital consumption more akin to that of high yield debt. Diversity of asset type means restructuring does not suffer from market cyclicality.	Spread risk and equity risk	20-25%	12-15%	50-75%

Source: M&G, as at August 2021. Indicative only. *Target return estimates are gross of fees and the source of the information is M&G experience of trading in the market. Estimated return on capital is a function of the estimated solvency capital requirement calculated using a prescribed standard formula approach under Solvency II and the target return estimates. Information is subject to change and is not a guarantee of future results.

Optimising the portfolio from a regulatory capital perspective

Experience has taught us that building private asset portfolios under Solvency II involves at least two key considerations. As experienced managers working in partnership with our insurance clients, we look to effectively and efficiently optimise allocations:

1. from an economic risk/return basis;
2. with respect to key insurance metrics, such as SCR budget, return on capital, duration target.

Credit risk

Private markets assets are typically unrated by external credit assessment institutions (ECAI) under the Solvency II standard formula. The spread risk charges on unrated bonds and loans are lower than those of sub-investment grade issuers with comparable durations, so unrated private debt tends to be quite capital efficient. However, without a public rating, there is no standardised measure of risk for each asset. Managers that can provide a robust 'internal' ratings methodology, that is fit for use by an insurer, can add a lot of value in this regard.

The Prudent Person Principle states that firms may only invest in assets of which they are able to identify, measure, monitor and manage the risks which are being taken. An internal rating methodology offers a crucial framework that can be assessed, and assets can be monitored against that methodology.

This in turn allows insurers to satisfy internal governance and Prudent Person Principle requirements, which demand that they demonstrate sufficient knowledge of the different asset classes that could comprise the investment mandate (typically a defined list), and further enables them to outsource the management of holistic portfolios that are invested within the approved framework without the need to assess all investments on an asset-by-asset basis. This approach also offers scope to potentially incorporate new asset classes as part of the mandate at a future date.

Credit analysis

Fundamental credit research and analysis is critical to all stages of the investment process and ongoing management of the portfolio. Full evaluation of the credit and risk profile of an investment can sort the good, quality businesses (with a reason to exist) from those which may offer less compelling fundamentals or less favourable terms to lenders for the same risk. This is not only important to help maximise return for a given level of risk in a portfolio, but also to ensure the right investments are selected at the right time.

Risk mitigation can be potentially further enhanced through the ability of private lenders to secure structural protections from borrowers such as improved covenants; and through the asset manager having in-house restructuring resource and expertise in place in order to help to maximise recovery value in the event that an investment does not perform as expected.

Managing ESG risks and opportunities

For private assets, it is not possible to apply a one-size-fits-all approach to analysing environmental, social and governance (ESG) factors given the unique attributes and risks (which can be idiosyncratic in nature) of the diverse range of sub-asset classes and assets that comprise the investable universe.

Private debt's emphasis on long-term credit quality nevertheless lends well to incorporating ESG considerations, given the fact that borrowers and lenders work very closely together. This close nexus can allow for meaningful dialogue with borrowers to pro-actively engage on material ESG issues, giving private lenders an edge relative to public bondholders, in this respect. As well as access to borrowers, for a strong, systematic engagement programme, it's important to have sufficient resources to do the engagement, the lobbying and the risk assessment in-house, to do it both qualitatively and quantitatively.

Working in partnership with our insurance clients

Objective: UK general insurer with limited exposure to the private markets, operating a partial internal model under the Solvency II framework and looking to increase portfolio yield without increasing risk by accessing European private debt markets.

Segregated mandate aim: To construct a deliberately flexible portfolio of private debt assets with broadly similar average duration and risk/rating to the existing corporate bond portfolio, and to obtain an illiquidity premium over public markets.

Scope of investable universe: Commercial real estate debt, infrastructure debt, European leveraged loans, mid-market corporate lending, residential mortgages and other idiosyncratic opportunities.

In brief: Segregated mandate requirements:

- Returns: Overall SONIA + 3% return target[2]. Minimum return over equivalent corporates of 0.5% (on average)
- Risk and Ratings: Over 50% of the assets with investment grade equivalent risk (internal rating). Average BBB rating (internal rating)
- Maturity: Under 10 years, average maturity: < 5 years
- Geographic focus: Global, FX risk hedging to be applied
- SCR limits: 15% spread risk SCR limit.

How can managers most effectively deploy capital?

We believe there are several ways to enhance the deployment potential of a private debt mandate, yet doing this effectively and efficiently requires the flexibility to focus on the most interesting opportunities and to continue to avoid overpriced sectors over time.

Seeking the right balance

As a manager looking to fulfil a specific mandate, being able to deploy capital relatively quickly is preferable, in order to meet client expectations within a reasonable timeframe, so having scalable opportunities is important. However, the private debt market is one where the most attractive assets are often of an opportunistic nature. Hence having a wide mandate in terms of asset types is very important, and having constraints in terms of internal ratings helps create a balanced operating framework. Understanding a client's appetite for assets and scale over time is also important as governance, as we understand that investment in new asset classes requires a large governance budget.

[2] As stated in the IMA.

Go where the (relative) value is

We believe it is essential to pay the right price for the right assets. Pricing and relative value across individual private debt markets can ebb and flow due to a variety of factors, and the illiquidity premium (or conversely structural protections) may diminish as markets become commoditised or niche areas become crowded. Often, there may only be a short-term window where the best pricing is available.

This is why we believe a flexible, risk-based approach, where managers can access value as it presents itself, rather than rigidly following a process of filling a pre-determined asset allocation, can achieve better outcomes.

Summing up

We believe that the typical approach employed by insurance investors when allocating to private debt – progressively identifying sub-types of private debt, completing governance on these over an extended period, and then filling a pre-determined allocation – may result in sub-par portfolios, particularly where the sub-asset class is "popular". However, by looking at private debt allocations from a new perspective, ie increased flexibility for the manager to source assets across the full range of opportunities, but with specific insurance-led constraints on internal ratings etc, we think that insurers would be well-positioned to harness the full potential of this dynamic and evolving asset class in order to meet their needs and objectives over time.

Private debt investment typically offers a yield pick up over publicly-traded corporate debt, together with better structural protections, while providing diversification. The main risk that asset managers can help insurers avoid is creating investment portfolios that achieve the illiquidity and complexity without the additional return.

Working with managers who can access the widest possible range of private debt opportunities is crucial. Both to build portfolios in a timely way, and also to help ensure potential risk-adjusted returns are achieved. ☐

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