PRIVATE DEBT CAN PROVIDE EXCESS RISK-ADJUSTED YIELDS COMPARED TO CORPORATE CREDIT IN THE PUBLIC MARKET, AS WELL AS DIVERSIFICATION BECAUSE THE PRIVATE MARKET HAS TYPES OF DEBT—FOR EXAMPLE, PROJECT FINANCE AND MID-MARKET DEBT—THAT AREN'T ACCESSIBLE THROUGH THE PUBLIC MARKET.

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CANDACE SHAW
Senior Managing Director and Portfolio Manager Private Fixed Income, Sun Life Institutional Investments (Canada) Inc., a Sun Life Investment Management company

PRIVATE DEBT MARKETS HAVE EVOLVED OVER THE PAST FEW YEARS AND CREDIT ANALYSIS HAS IMPROVED SIGNIFICANTLY, SO PRIVATE DEBT INVESTORS CAN HAVE THE ASSURANCE OF HIGH CREDIT QUALITY.

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PHILIP (PHIL) GILLIN
Executive Vice-President and Portfolio Manager, Bentall Kennedy Canada and Sun Life Investment Management

THE PERFORMERS

× CANADA'S INFLUENTIAL THOUGHT LEADERS ×

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Private Debt, such as corporate loans, securitizations and commercial mortgages, to name a few, is unexplored territory for many investors, but Phil Gillin and Candace Shaw believe that, done right, investing in this asset class provides unique opportunities to boost risk-adjusted returns, enhance fixed-income diversification and more.

What can institutional investors gain by enhancing their plans' exposure to private debt?

CANDACE SHAW: Private debt can provide excess risk-adjusted yields compared to corporate credit in the public market, as well as diversification because the private market has types of debt—for example, project finance and mid-market debt—that aren't accessible through the public market. Customized covenants support the credit quality of some loans and, when you're higher in the corporate structure, your loss given default is potentially lower. Also, you can customize cash flows and reduce refinancing risk at maturity by structuring private debt to amortize over the term of the loan.

PHIL GILLIN: I'd add that private debt markets have evolved over the past few years and credit analysis has improved significantly, so private debt investors can have the assurance of high credit quality. There are also idiosyncratic aspects of private debt instruments that can enhance yield with equivalent or less risk than in the public market. For example, Canada Mortgage and Housing Corporation (CMHC) loans may be secured by a multi-family rental apartment building, but they also benefit from a Government of Canada guarantee of principal and interest, and provide a yield premium of 90 to 110 basis points over Government of Canada bonds.

Where are you currently finding the most attractive opportunities in private debt?

PG: We're active in high-yield, with a recently launched fund focused on second mortgages, mezzanine loans and B-position loans in the construction lending space, and see opportunities there to realize potentially superior returns on well-structured loans, particularly in Alberta and British Columbia.

CS: In the asset classes I manage, we're finding most of our opportunities outside Canada this year. In the mid-market space, loans outside Canada tend to be investment-grade and senior-secured and still deliver 450 basis points over the London interbank offered rate. In the project finance and infrastructure space, larger spreads tend to be available particularly in Europe but also in the United States.

What market and economic forces are likely to impact private debt in the short-term and long-term?

CS: The low-for-long interest rate environment we've been experiencing since the financial crisis is driving people in a search for yield, and attracting more investors to private debt. This rising demand is increasing competition and causing spreads to narrow significantly.

PG: Private debt is an increasingly competitive marketplace; however, some newer players don't have the necessary expertise, background and underwriting discipline for this complex asset class. Another cloud on the horizon is that a healthy credit market requires a robust economy and, in Canada particularly, there is apprehension about how changing dynamics in the energy and commodity sectors will affect economic growth.

CS: Regarding longer term, governments around the world, including both the Trudeau and Trump governments, have recognized the need for investment in infrastructure. A focus on improving and expanding infrastructure is a potential future opportunity.

What risks should plan sponsors keep in mind when investing in private debt?

PG: These are complex assets and you have to do your homework. In public equity markets, analysts thoroughly research companies. In public fixed-rate markets, rating agencies analyze and rate securities. In private asset classes, you don't have the benefit of that publicly available information, so you need to work harder to understand the credit you're getting, the assets you're buying, and whether the risks match your risk tolerances.

CS: Investing in this asset class shouldn't be a short-term tactical play. There is less liquidity in private debt than in publicly traded markets and, because the market isn't as open and transparent, you may get higher or lower than the mark-to-market when you sell. It's really important to be supported by expertise, experience and a network that can source deals.

How can plan sponsors manage private debt's lower liquidity?

CS: Look at your fund's size and the cash flows you require for disbursements, and size your investment in private debt appropriately. Then think of it as something that's not going to be touched for five or 10 years. Open-ended funds usually require at least several months' notice for you to take your cash out; however, payouts are subject to the manager's discretion so there may be long delays to get your cash out.

PG: Candace and I are both advocates of private debt as an investment opportunity, but we certainly wouldn't recommend anybody put 100 per cent of a fixed-income portfolio into private debt. We see it as a diversification and yield-enhancement play within a broader strategy around fixed income.

How can smaller plan sponsors access private debt?

CS: It is more difficult for sure than for bigger players. At Sun Life Institutional Investments (Canada) Inc., we accept minimum investments of $5 million from institutional investors. And if you are part of Sun Life's broader Group Retirement Services business, our investment-only accounts accept even smaller amounts from institutional investors. A pooled fund is probably the best route into this because you get diversification up front.

PG: Sponsors can invest through a fund, but must be careful to get the right match in terms of the manager. There is quite a range with different styles and you want one whose investment style and risk tolerance are congruent with yours, especially because there's less liquidity in the asset class and if you pick the wrong partner it can be difficult to extricate yourself.

WHAT'S YOUR IDEAL VACATION?

PG: *Running, cycling and seeing historic sites.*

CS: *Exploring other countries without a fixed schedule.*

WHAT'S THE FIRST WEBSITE YOU CHECK EVERY MORNING?

CS: *The Weather Network.*

PG: *I'm old school, so for me it's a hard copy of* The Globe and Mail.

WHAT'S YOUR FAVOURITE TIME OF DAY?

PG: *About 5 a.m. After I read the paper, I go to the gym.*

CS: *Monday to Friday, it's mornings when I have great expectations for the day. On weekends, it's around dusk when I come home from the day, sit back and relax.*

Sun Life INVESTMENT MANAGEMENT