

Could private debt replace hedge funds in investor portfolios?

Roger Woolman of SS&C Advent discusses a new trend among allocators



W

ith such attractions on offer as substantial risk-adjusted returns, reliable income streams, low correlation to other asset classes, principal protection relatively assured, and so on, it's little wonder investors are piling into the private debt market.

Contrast that with the hedge fund industry, where investors have redeemed approximately \$64bn this year through August, amid concerns about the cost-adjusted returns on offer. So could private debt funds continue to gain on, and potentially supplant, hedge funds in investors' alternatives toolbox?

Private debt on the rise

Private debt fundraising has exceeded \$100bn for the past four years, with seven-year trailing fundraising up 9% per annum since 2013 – faster than private equity and closed-end real estate growth, according to McKinsey.

Preqin figures show private debt assets under management have tripled in a decade, hitting \$769bn as of June 2018. And they continue to grow. A third of investors surveyed by Preqin planned to increase their allocation through 2019, while the



Roger Woolman
SS&C Advent

Roger Woolman joined SS&C Advent in 2011 and currently holds the position of director, funds and alternatives. He is responsible for the management and oversight of SS&C Advent's funds and alternatives business segments for the Emea & Apac regions. Woolman is a Fellow of the Institute of Chartered Accountants in England and Wales and has over 25 years of experience in the investment funds world, and has worked in Grand Cayman, Dublin and London.

Alternative Credit Council (ACC) predicts the sector will top \$1trn by 2020. Pension funds, with their long investment horizons and demand for stable returns, have become particularly active allocators.

The investment flows reflect widespread investor satisfaction with performance. More than 90% of respondents to Preqin's H1 2019 outlook felt private debt met or exceeded expectations in 2018. Fuelled by strong and expanding borrower demand, the returns are appealing, with almost half the surveyed investors targeting an annual absolute return of 8% to 12%.

Over the same period, more than half the hedge fund investors canvassed said they were disappointed with portfolio performance, while only about a third believe performance will be better in 2019. Concerns mean 21% of investors intend to reduce their allocations to hedge funds over the longer term – the

highest figure for any of the alternative asset classes.

What to watch for with private debt

Not that the private debt markets are all upside. Headline returns may be attractive, but they come with trade-offs for fund managers and their investors.

Growing competition

The influx of capital and launch of new funds is intensifying market competition. Smaller firms and new lenders are finding it more difficult to raise money, while funds have to fight harder for a limited number of deals. Private credit managers may be forced towards lower-quality transactions in response, with poorer terms (i.e. more flexibility on loan covenants and pricing) and/or reduced returns.

Borrower risk

As we near the end of the current credit cycle, with the prospect of tougher economic conditions and (at some point) higher interest rates for borrowers ahead, robust risk management capabilities will become ever more vital to guard against defaults. But more relaxed covenants

could be storing up trouble for when harder times come.

As the ACC report observes, experience in dealing with borrowers in stressed or default situations will determine how successfully managers can weather changes in the economic and credit cycle.

Illiquidity

To avoid a potential mismatch between assets and liabilities, private debt funds often require a hold-to-maturity approach, with the fund life spanning fund raising, investment, the holding of positions and profit taking. The best yielding offerings in particular may tie up capital for several years.

Complex service demands

Along with delivering performance, fund managers must also satisfy stringent servicing demands.

Institutional investors now account for over 70% of the capital committed to private debt funds. And they bring tough due diligence and ongoing servicing expectations with them, including calls for:

- Tailored fee arrangements
- Enhanced transparency, including clear, frequent and often customised reporting
- Watertight compliance capabilities
- Technology and cyber-security resilience
- Robust business continuity and disaster recovery procedures.

Administering private debt – with its complex accounting and reporting obligations – is no easy task either. Since private debt can be more flexible and bespoke than typical bank loans or public debt instruments, specific operational expertise and technology capabilities are needed to manage the risks and service investors. Common complications/pain points include:

- **Combining debt and equity:** private debt is often rolled up with equity-type arrangements. In such cases, the equity and debt must be tied together from an accounting and reporting perspective.
- **Complex structures:** along with public and private companies, borrowers commonly take the

form of special purpose vehicles (SPVs). These bring heightened governance, exposure monitoring and transparent reporting requirements.

- **Hybrid funds:** private debt offerings tend to be structured within closed-end funds. The ability to account for hybrid fund structures, and look through those structures to follow the cash is essential.
- **Accounting standards:** under the IFRS 9 standard, financial instruments have to be correctly classified and measured, depending on whether the assets are held for trading or lending purposes.

Heightened deal competition is also leading to more flexible credit agreements for borrowers, and a compression in spreads. To counter the impact, fund managers will have to better manage the risks and improve their operating efficiencies to prevent a squeeze on profitability.

Along with delivering performance, fund managers must also satisfy stringent servicing demands

Success depends on systematising

To continue to grow, and avoid a painful fallout when the next downturn hits, private debt funds will need to follow the same path towards institutional-quality investment and operating robustness that the hedge fund industry has already undertaken.

Scalable, repeatable, resilient (and, where possible, automated) processes are vital. And the biggest step towards achieving that is a fit-for-purpose systems infrastructure.

Yet spreadsheets – with the operational and financial risks they bring – remain common in the private debt world. With templated spreadsheets, problems or errors that inevitably creep in become ingrained, as they are reused and disseminated across the organisation. Flexible rounding rules for calculating interest in a spreadsheet similarly

compound financial errors, adding risk and potential cost.

Errors and control failings raise regulatory and compliance red flags too. Investors and regulators expect robust risk management, accurate and timely reporting, and auditable transaction processes. None of that is viable in a spreadsheet-oriented environment that depends on manual inputs and workarounds.

Efficiency and scalability issues are another consideration. Building or reconfiguring a spreadsheet every time a new loan or piece of business is brought on eats up time and resources. Whenever private debt positions have to be commingled with other assets, or other accounting systems, staff will need to manually import those positions into the general ledger. This lack of operating scalability will become untenable as fund manager deal volumes expand.

Automate to accumulate

A robust, sophisticated system has therefore become a must-have for specialised private credit managers and any multi-asset class funds that incorporate private debt.

A flexible solution with the functionality to accommodate loan administration and accounting, and that can track and report on the debt, enables firms to efficiently monitor and manage their risks. Automating the downstream processes will streamline operating costs and deliver valuable scalability.

And a controlled, auditable environment will allow fund managers to meet their compliance responsibilities, ensuring they can satisfy investors' due diligence expectations and improve their chances of attracting allocations.

The appealing fundamentals of private debt suggest it has the potential to become a mainstay of the alternative asset class. While it may never overtake the hedge fund sector, the returns, income streams and diversification benefits on offer make private debt a compelling addition to investors' portfolios. Fund managers should ensure they are suitably equipped to take advantage. **HFM**

To download a copy of our white paper on private debt, visit the SS&C Advent website.