Insights
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Making Allocations to Private Credit vs. Leveraged Loans and High Yield

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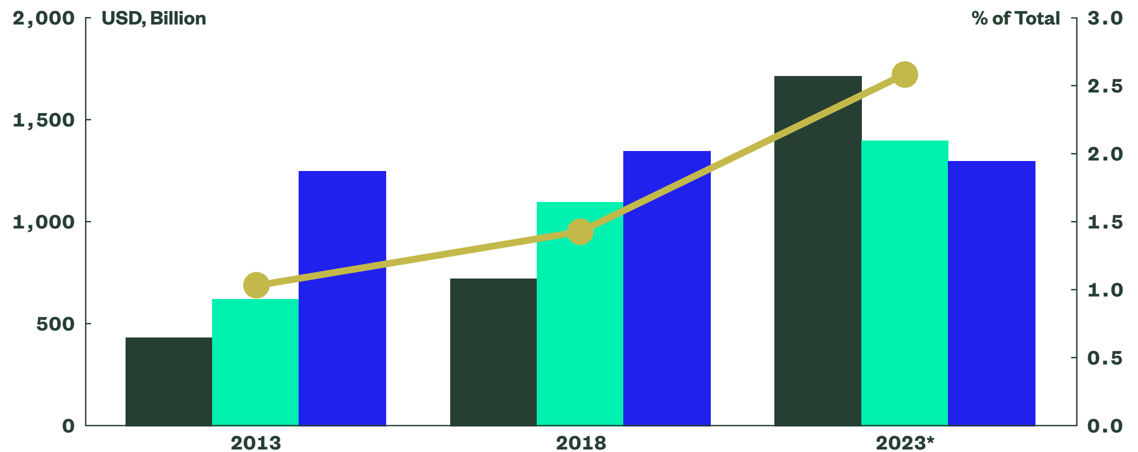
The growth of private credit assets under management in recent years has drawn increasing interest and scrutiny from investors. The scale of the expansion suggests a strong appetite among investors, but the lower liquidity and naturally opaque nature of private credit can make comparisons with public credit alternatives such as leveraged loans and high yield bonds difficult. While the three categories exhibit similar characteristics in the underlying exposures, there are notable differences and performance variations depending on the scenario. In this article, we focus on the characteristics, performance, and portfolio allocations to private credit relative to high yield bonds and leveraged loans, and consider how these should inform investors' allocation decisions.

Private credit typically forms part of the alternative investments allocation in investor portfolios, while high yield bonds and leveraged loans fall within general fixed income allocations. However, the high correlations between the total return performance of the three categories serve to highlight the similarities that exist in the underlying credit exposures, including credit sensitivity and cyclicality. Private credit has typically focused on small and mid-sized borrowers, while syndicated loans and high yield borrowers also tend to fall at the lower end of the credit spectrum. In private credit, the average size of the borrower has been growing, although lending to investment grade companies is still at a relatively early stage.

Evolution of Private Credit vs. Public Credit

Over the past ten years, private credit assets under management have grown at an annualized rate of approximately 16% to reach more than US$1.7 trillion at the end of Q2 2023, according to data from Preqin. This far exceeds the annualized growth of 5% p.a. seen in public credit markets. In absolute terms, private credit is still just a small fraction (2.6%) of total public credit markets (of US$66.3 trillion), albeit up from 1% a decade ago. However, the size of the private credit markets today is now comparable to that of both leveraged loan and US high yield markets.

Figure 1
Evolution of Private Credit, as a Percentage of Public Credit Markets



- Private Credit Assets Under Management
- Leveraged Loan Outstanding — USA
- High Yield Bonds Outstanding — USA
- Private Credit AUM as % of Public Credit (R.H.S)

Source: Bank of International Settlements (BIS), Preqin, SIFMA, International Monetary Fund. * As of June 2023.

Private credit strategies have proliferated from direct lending to distressed, mezzanine, venture, opportunistic and has also become more specialized by sector. Direct lending (which is still the largest and most conservative sub-segment) focuses on private asset managers making corporate loans typically to middle market companies (with annual revenues of between US$50 million to US$1 billion).

As an asset category, private credit direct lending grew strongly following the Dodd-Frank Act that introduced new regulations after the 2008 global financial crisis, which restricted commercial banks' lending to such companies. Underwriting guidelines by regulatory agencies, including the Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation (FDIC) for leveraged financing activities (including acceptable limits on leverage, credit concentration, systems, oversight and compliance) also provided impetus to the growth of private credit. A key draw for borrowers to private credit markets is the more efficient access to capital in customized terms as well as networking opportunities offered within the private markets industry. In contrast, the loan/bond syndication process in public markets is relatively complex and less customizable. Notably, a larger percentage of traditional leveraged loan borrowers (including for leveraged buyouts) are now turning to private credit markets instead of syndicated loan markets.

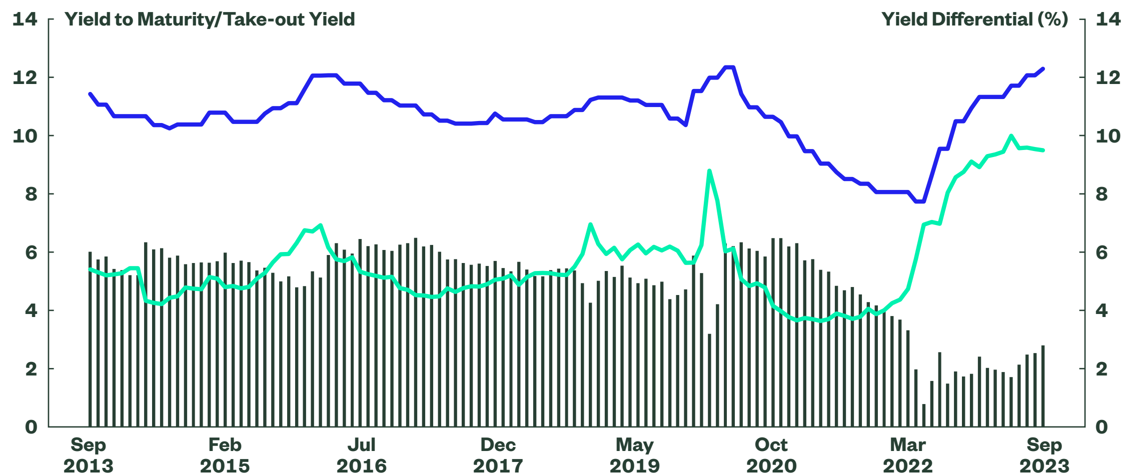
Comparison of Key Characteristics and Recent Performance

From an asset allocator's perspective, both private credit and leveraged loans provide access to a floating-rate income source linked to short-term interest rates such as SOFR, as opposed to high yield bonds that provide fixed rate coupons. Most private credit direct lending is generally for maturities of five-to-seven years; this is similar to leveraged loans, although in most cases these are refinanced well in advance of the actual maturity date. In comparison, US high yield bond markets have an average maturity of around 4.9 years, with a modified duration of 3.5 years. Since the inception of private credit direct lending in 2005, the credit loss ratio has been 1.03%, which is closely in line with that of leveraged loans (0.92%), but lower than high yield bonds (1.49%). It is worth noting that the risk, return, and other characteristics within private credit sub-strategies such as distressed, mezzanine and venture can vary significantly compared to the direct lending category that we focus on in this paper.

Because private credit fund structures are illiquid (i.e. not listed on an exchange or generally traded on secondary markets), this has resulted in private credit investors typically demanding a larger 'Illiquidity Premium' to assume the risk. Over the past decade, private credit has offered an estimated average yield premium of 5% over leveraged loans and 3.8% versus high yield bonds. However, a significant rise in public bond market yields in recent years, coupled with strong inflows into private credit, has resulted in the yield premium shrinking to 2.3% and 2.8%, respectively, in September 2023 (the latest available data across the three categories — see Figures 2 and 3). Private credit presented a three-year take-out yield of 11.76% (Cliffwater Direct Lending Index as of September 2023) as opposed to a 9.5% yield to maturity offered by the Morningstar LSTA US Leveraged Loan 100 Index and an 8.9% yield to worst offered by the ICE BofA US High Yield Index.

Figure 2
Yield Premium of Private Credit Direct Lending vs. Leveraged Loans

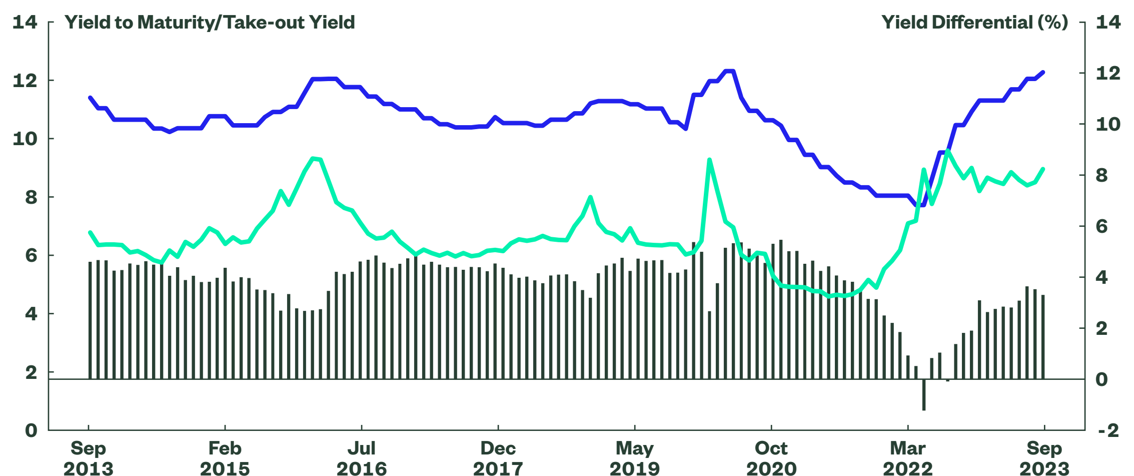
- Estimated Yield Premium — Private Credit vs. Leveraged Loans
- Leveraged Loan Yield (Morningstar LSTA US 100 Index)
- Private Credit Est. (Cliffwater Direct Lending Index)



Source: Cliffwater, Morningstar, State Street Global Advisors. Data as of September 2023. Yield premium is estimated as the difference between the three-year Take-out Yield of the Cliffwater Direct Lending Index and Yield to Maturity of Morningstar LSTA Leveraged Loan 100 Index.

Figure 3
Yield Premium of Private Credit Direct Lending vs. High Yield Bonds

- Estimated Yield Premium — Private Credit vs. High Yield Bonds
- High Yield Bonds (BofA US High Yield Index)
- Private Credit Est. (Cliffwater Direct Lending Index)



Source: Cliffwater, Bank of America, State Street Global Advisors. Data as of September 2023. Yield premium is estimated as the difference between the three-year Take-out Yield of the Cliffwater Direct Lending Index and Yield to Maturity of the ICE BofA US High Yield Index (modified duration of 3.6 years).

Recent Performance and Performance Across the Credit Cycle

Against a backdrop of public market yields hovering near historical lows until early 2022, private credit (direct lending) delivered attractive excess returns versus leveraged loans and high yield bonds over the three and five year periods to September 2023, compared to the historical average (see Figure 4). These excess returns were noticeably higher relative to high yield bonds which faced significant headwinds due to rising benchmark yields and the impact of duration. However, the aforementioned decline in the yield premium commanded by private credit has contributed to a narrowing of the performance gap between the three categories over the past year. We note now that the future return prospects for all three categories have improved due to the increase in benchmark rates.

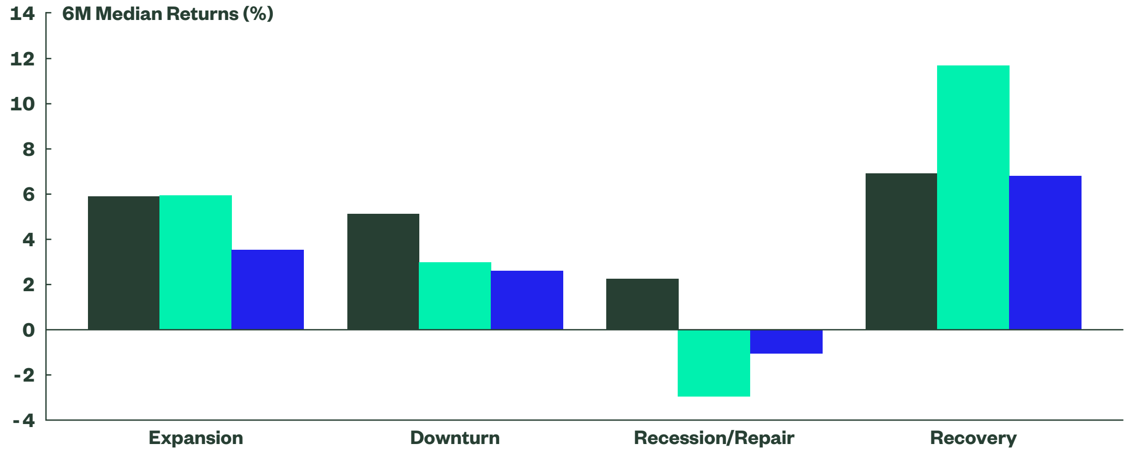
Figure 4
Comparison of Total Return Performance (Sep 2004–Sep 2023)

Source: Private Credit total return performance measured by the Cliffwater Direct Lending Index total return, US high yield measured by the ICE BofA US High Yield Index, Leveraged Loans by Morningstar LSTA US Leveraged Loan Index. Data as of September 2023. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Returns greater than one year are annualized. **Past performance is not a reliable indicator of future performance.**

Performance Through Key Stages of the Credit Cycle

An important factor for investors to consider is the relative performance of the three categories during the key stages of the credit cycle: expansion, downturn, recession, and recovery. In our assessment of this, given the challenges in identifying where we are in the credit cycle, we base our analysis on the movements in the Federal Reserve Bank of New York's Corporate Bond Market Distress Index, which provides a comprehensive, unified measure of the functioning of the corporate bond markets. Regimes are identified based on the current position of the index and the trend in the index's direction on a quarterly basis.

Figure 5
Typical Returns Across the Credit Cycle (Sep 2004–Sep 2023)



Source: State Street Global Advisors, Cliffwater (CDLI), Bank of America (H0A0), Morningstar (SPBDAL) as of September 30, 2023. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. **Past performance is not a reliable indicator of future performance.**

In the expansionary phase of the credit cycle, typically marked by benign credit conditions, we usually see very little performance dispersion between the three categories. However, when heading into a credit downturn, the performance divergence increases as leveraged loans and high yield bonds typically factor in a deterioration in the credit cycle more swiftly than private credit markets.

In the recessionary phase of the cycle, we generally find a deterioration in absolute performance of all three categories as credit losses rise. In the 2008 global financial crisis, we saw the credit loss in the US High Yield Index rising to 6.59% (with default rates over 10% and a recovery rate of 36%). Leveraged loans suffered a credit loss of 4.99% in the same period (with a 12.8% default rate but a better recovery rate of 61%). Private credit direct lending experienced a credit loss of 6.9%, similar to that of high yield bonds but it delivered better performance due to higher starting yield premiums.

Moving out of a recession and into a recovery phase, the fixed rate nature of coupons has helped drive strong high yield bond outperformance as such phases are typically characterized by a rally in government bonds and narrowing credit spreads due to improvements in credit fundamentals. Notably, private credit has tended to lag by the greatest amount during such a phase as high yield bonds and leveraged loans price in a recovery more quickly than private credit markets.

Portfolio Implications of Three Asset Categories

From a portfolio perspective, high yield is the most liquid of the three categories, followed by leveraged loans, both of which are priced on a daily basis. Private credit is typically valued on a quarterly basis, with slower valuation adjustments compared to publicly traded high yield and leveraged loans. These valuation frequency differences can lead to high yield and leveraged loans exhibiting relatively higher volatility levels as measured by standard deviations of quarterly returns. Of note, private credit investments are often structured as closed-end investment vehicles with a finite lifespan and typically do not allow redemptions after the fundraising period. Open-ended, or evergreen, structures are gradually being introduced but these usually have redemption thresholds and gate protections, making them more strategic in nature and unsuited to tactical allocation adjustments. From a portfolio liquidity perspective, we believe the three categories can complement each other and can be used to optimize investor allocations. Since the timing of private credit capital calls are uncertain (and some capital calls can take multiple quarters or years), investors can utilize the better liquidity profile and easier access of high yield bonds or leveraged loans to gain interim sub-investment grade exposure for the committed but as-yet-uncalled capital while being mindful of tactical risks in the segment.

The Bottom Line

Since large yield premiums in private credit no longer remain the dominant factor in allocations, investors have to balance the better liquidity, efficiency, and flexibility (suitability for tactical allocations) offered by leveraged loans and high yield versus the customized exposures and strategic nature of private credit to make sub-investment grade allocation decisions.

While the yield premium offered by private credit helps enhance portfolio returns, these have shrunk significantly in recent years and the asset category lacks the liquidity and flexibility to opportunistically deploy capital from a tactical asset allocation viewpoint, especially during phases of high market dislocations. The dispersion among the performance of private credit managers is very wide, highlighting how important manager selection and due diligence is to generating expected returns. Furthermore, the proliferation of private credit strategies and specializations means investors need to fine-tune their portfolio exposures when making strategic asset allocation decisions.

In contrast, high yield bonds and leveraged loans present investors with the liquidity and flexibility needed to make tactical asset allocation changes, and can be used effectively and quickly to adjust overall exposure to sub-investment grade credit sectors. This is especially important during periods of significant market dislocations. The higher interest rates today and normalized risk premiums suggest improving total return prospects for both of these categories mean they warrant consideration for strategic asset allocations alongside private credit. An indexed approach to high yield bonds and leveraged loans can also be used to gain broad exposures to these sub-investment grade categories and efficiently harness reliable risk and return outcomes of these credit sectors.

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* Pensions & Investments Research Center, as of December 31, 2022.
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