Private Debt

This is a financial promotion. Your capital is at risk, the value of investments may fall and rise and you may not get back the full amount you invested. Past performance is not indicative of future returns.

We recommend a 3% overweight to private debt relative to our strategic asset allocation. Having demonstrated resilience through the economic dislocation in 2020 we believe that private debt strategies now offer improved return potential with attractive downside protection. Alternative alternatives offer a comparable contractual return stream with limited correlation to the broader economic picture and can be complementary to a core allocation to private debt.

We maintain our 9% allocation to private debt. The risk and return characteristics of the asset class have improved, both on an absolute basis and relative to more liquid credit strategies. For clients who are not liquidity-constrained we view private debt as offering access to superior yield-based return streams with potential upside from call protection and equity participation through warrants. While we continue to find compelling investments in specialist lending and uncorrelated strategies, the dispersion in fundamental outcomes created by the COVID-19 crisis has also generated attractive opportunities in rescue lending and distressed private assets. We expect the continued economic impact of the crisis to create refinancing and restructuring opportunities over the next 12-18 months which will allow managers with available capital to benefit from improved pricing and better structural and legal protections. We plan to take advantage of these opportunities both via fund commitments and directly via an increased allocation to co-investments.

Asset Class Definition

We define private debt to encompass a range of lending strategies from traditional corporate direct lending to specialist lending strategies across a range of sectors. As of 2020, we have also explicitly added distressed debt strategies to our definition of private debt given a comparable risk-return profile and a similar need for proprietary sourcing, strong underwriting, legal expertise and workout capabilities. We also include the less liquid segments of the structured credit markets (e.g. CLOs, CMBS, RMBS). These strategies share certain characteristics: i) a high level of mainly cash-pay contractual income, ii) seniority in the capital structure and/or substantial equity subordination, and iii) legal protection in the form of covenants; all of which combine to offer superior downside protection in comparison to liquid alternatives.

We include alternative alternatives in our allocation to private debt, given their similar structural and contractual income characteristics. The low level of correlation of these alternative strategies to other asset classes is driven by exposure to non-market risks such as longevity (e.g. life settlements), pharmaceutical research (e.g. drug trials) and judicial determinations (e.g. litigation funding). Given their comparable return profile and considerable diversification benefits, these uncorrelated strategies compete for capital against private debt allocations and form a core part of our portfolio allocation.

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Role in the Portfolio

Private debt and alternative alternatives allocations have two primary purposes in our portfolios: i) generating contractual income with a premium to liquid credit markets; ii) offering diversification through exposure to issuers and return streams that cannot be accessed directly via public markets.

Relative to liquid credit markets, we also find greater downside protection in private debt given our focus on specialist strategies targeting bilaterally negotiated and highly structured loans with superior covenant protection. Alternative alternatives can offer a similar return profile with limited correlation to other asset classes, which can We expect private debt to be one of the highest returning asset classes in our portfolios, while offering the best downside protection of the private asset classes, benefitting from contractual income, legal protection in the form of covenants, and a priority claim on the underlying assets.

Golden Rules

As the scope of our private debt investments has increased, we have refined our investment process and developed our golden rules for investing in the asset class, which we summarise below.

1. **Target specialists in niche strategies:** focus on opportunities in under-banked sectors. Specialist providers of capital providing certainty of execution can command a premium due to lower levels of competition and higher degrees of complexity.
2. **Focus on downside protection:** identify and partner with disciplined investors who i) take senior positions in the capital structure, ii) lend at low LTVs and iii) maintain discipline on covenants and documentation. Partner with investors that can protect capital and have the necessary skillset to directly manage assets in the event of a restructuring.
3. **Allocate to alternative alternatives:** uncorrelated strategies can offer attractive diversification benefits and resilience in a market downturn. These strategies pose a unique diligence challenge and it is critical to be aligned with best-in-class managers.
4. **Generate alpha through customisation and direct investment:** seek structures which offer enhanced discretion, tax benefits, fee savings, and customised risk exposures. Partner with high quality managers on co-investments to benefit from more immediate deployment and greater transparency.

Market Overview

The economic impact of the pandemic presented the first material challenge to credit structures since the global financial crisis. Weaker operating performance and negative cash flow led to short-term liquidity issues and, in some cases, covenant breaches, particularly for issuers in the sectors most directly impacted by the pandemic. As the breadth of the pandemic impact became apparent, public credit markets began to price in a significant increase in defaults. However, rapid intervention from central banks and the introduction of government support programmes meant that the increase in default rates for publicly traded debt, while significant, did not reach the levels of the global financial crisis.

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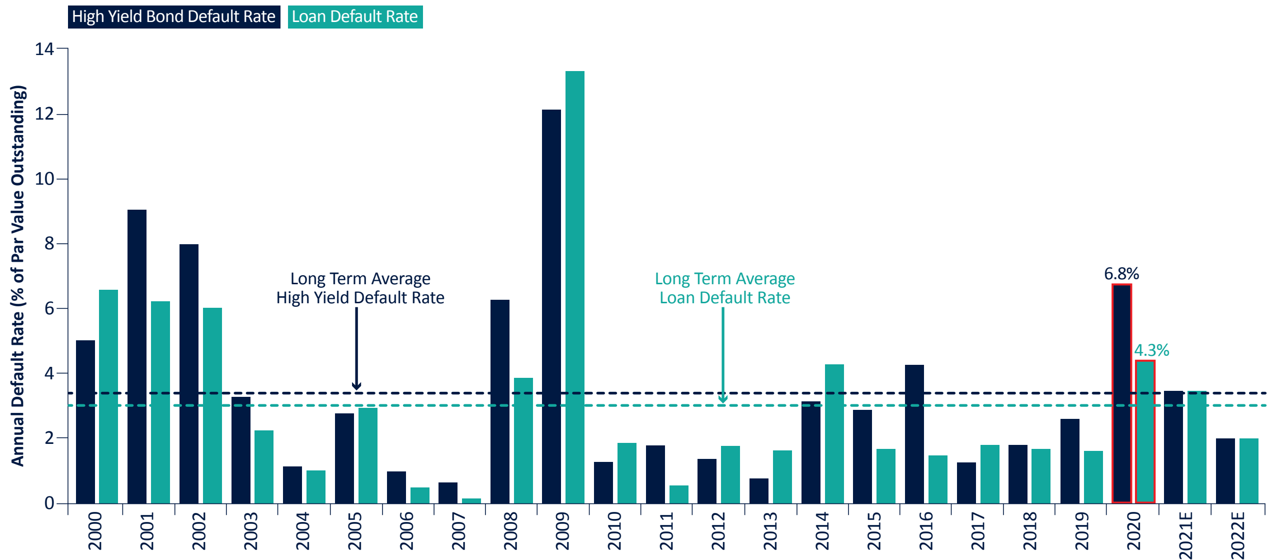
Exhibit 1

Default rates in high yield bonds and leverage loans more than doubled in 2020 but did not reach the levels seen during the global financial crisis

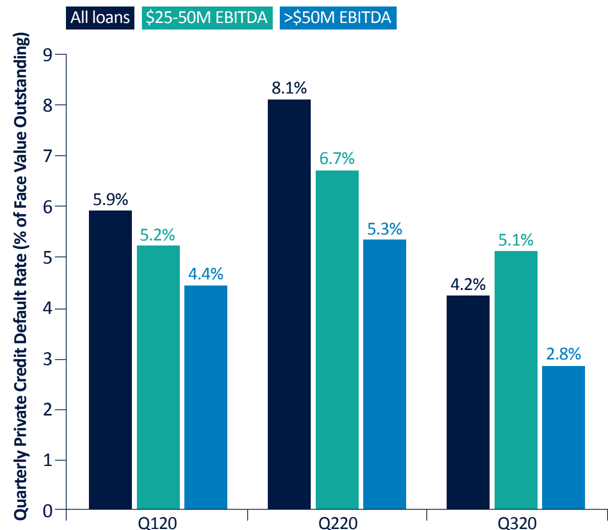


Source: *JP Morgan*

In private debt the default picture was more nuanced. In many cases private lenders were able to compel sponsors and business owners to inject additional capital into borrowers to provide a liquidity cushion to manage through the period of stress. However, there was also evidence of forbearance, with lenders extending loan terms, renegotiating covenants, and allowing borrowers to accrue (or PIK) interest, rather than making cash payments and depleting liquidity. The Proskauer Rose Private Credit Default Index[3] (shown in Exhibit 2) tracks senior and unitranche loans that have a payment, financial covenant or bankruptcy default or those that were amended in anticipation of a default. During the first and second quarters of 2020 the default rate shows that a material number of loans in the database were subject to some sort of default or amendment in anticipation of default, with smaller issuers disproportionately affected. While private credit default rates appear high, they reflect the flexibility of bilateral structures which allow for modification to allow issuers to work through shorter-term periods of stress without losing control of their assets.

Exhibit 2

Amendments, extensions, and defaults in private credit peaked in Q2 20 as issuers sought to restructure their liabilities to manage through the pandemic



Source: *Proskauer Rose*

[3] The Proskauer Rose Private Credit Default Index includes 642 active loans in the US, representing approximately $121.5B in original principal amount as of September 30, 2020. The index includes loans that have a payment, financial covenant or bankruptcy default, loans that are otherwise in default if the default is expected to continue for more than 30 days and loans that were amended in anticipation of a default. Default statistics represent defaults during that quarter.

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Private Debt Asset Class Performance

While there was evidence of loan restructurings, extensions and renegotiations, realised losses in private debt in 2020 remained low. The Cliff water Direct Lending index showed realised losses of only -2.4% for the first three quarters of 2020. Unrealised markdowns to reflect potential capital impairment accounted for a further -2.4% in losses, but interest income meant that broad private debt strategies were able to show positive, albeit muted, returns for the first three quarters of 2020 of +1.7%(Exhibit 3). The benefit of covenants which compel borrowers to address near term issues (either through capital injection or improved terms for the lender) and the bilateral nature of the transactions offered significant protection and the ability to look through the immediate stress period towards normalisation.

Private debt indices, as reflected in Exhibit 4, delivered muted but positive returns for the first three quarters of 2020. The Cliff water Direct Lending Index returned +1.7% in the first 9 months and is a good proxy for middle-market lending, tracking the unlevered gross return of over 6,000 direct loans held by US BDCs (business development companies). The overall State Street Private Debt index fell -1.8% for the first 9 months of 2020, which reflects the underperformance of distressed strategies (-4.5%) relative to mezzanine (+1.3%) and special lending (+2.6%) strategies. Over the last 5 years, the State Street Private Debt indices have generally returned 6-9% per annum.

Exhibit 4

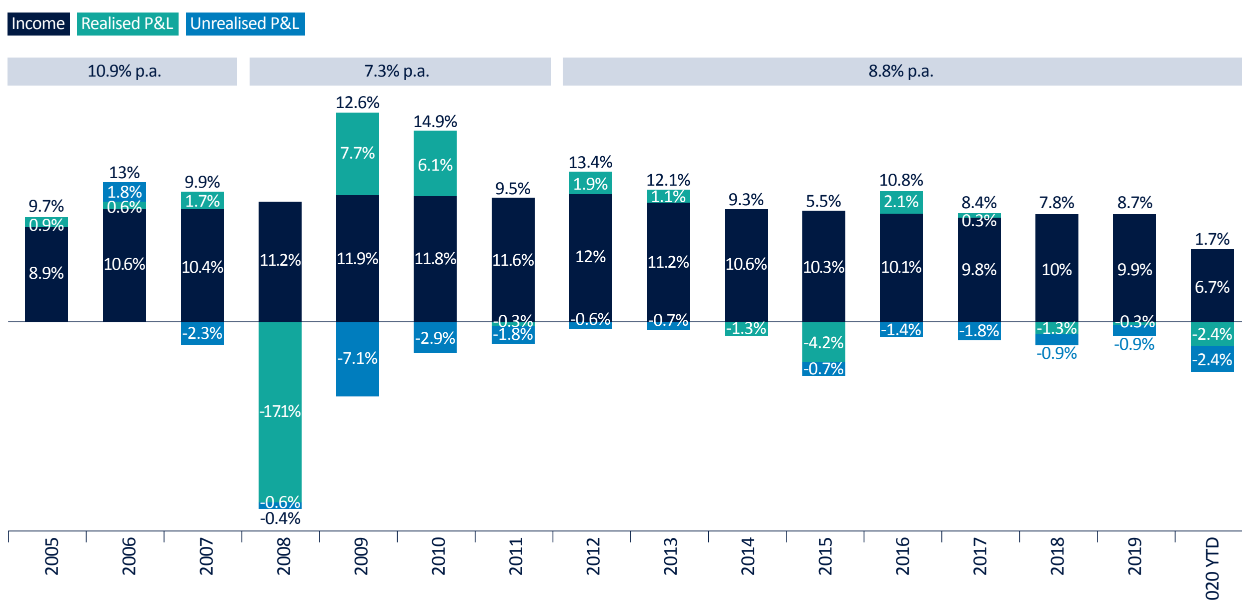
Traditional private debt returns have been muted in 2020, reflecting NAV markdowns taken on loans to issuers in challenged and COVID-19-affected sectors

Institution	Q3 YTD 2020	1 Year	3 Year	5 Year	Since Inception
Cliffwater Direct Lending Index (Gross)	7.0%	7.9%	8.8%	8.3%	9.6% (2004)
State Street Private Debt Combined IRR USD (Net)	-1.8%	1.8%	4.6%	6.5%	9.8% (1992)
State Street Private Debt Distressed IRR USD (Net)	-4.5%	-1.3%	2.7%	5.5%	9.9% (1997)
State Street Private Debt –Mezzanine IRR USD (Net)	1.3%	4.0%	7.6%	8.9%	10.5% (1993)
State Street Private Debt – Special Lending IRR USD (Net)	2.6%	6.7%	5.7%	6.3%	7.0% (2014)

Source: *Cliffwater and State Street.*

Exhibit 3

Realised losses in private debt in 2020 were -2.4%, with a further -2.4% in unrealised losses to reflect NAV markdowns[4]



Source: *Cliffwater*

[4] 2020 YTD data shown through to 30 September 2020.
Trailing 12-month returns as measured by the Cliffwater Direct Lending Index (CDLI). Returns are unlevered and gross of fees. CDLI seeks to measure the unlevered, gross of fees performance of U.S. middle market corporate loans, as represented by the underlying assets of Business Development Companies ("BDCs"), including both exchange-traded and unlisted BDCs, subject to certain Eligibility Criteria. The CDLI is an asset-weighted index that is calculated on a quarterly basis using financial statements and other information contained in the U.S. Securities and Exchange Commission ("SEC") filings of all eligible BDCs. Returns below 1% are not labelled. Annual numbers may not sum to the total annual figure as a result of calculating the annual performance of Unrealised P&L, realised P&L and Income independently.

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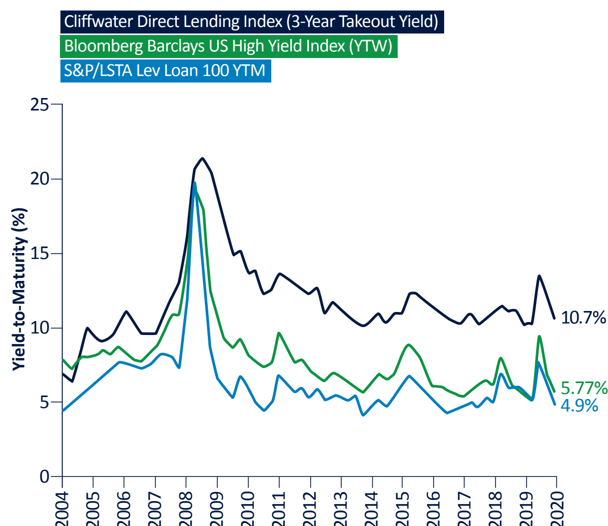
Market Valuations

Liquid credit markets normalised quickly in 2020 on the back of central bank support, trading back to (and even through) the levels at which they started the year, despite higher default rates. Conversely, private lenders have seen an improved opportunity set and enhanced terms, through a combination of more attractive pricing, fewer EBITDA adjustments, improved covenant packages and increased equity subordination. This improvement reflects a recognition by issuers that access to liquidity is not guaranteed in a more challenged operating environment, so they are prepared to pay a premium for certainty of execution. Additionally, while private debt managers still have significant dry powder available to them ($209 billion according to Preqin[5]), many are occupied managing existing positions with significant exposure to sectors adversely affected by COVID-19.

Using the Cliffwater Direct Lending Index as a proxy, middle market lending is now offering an illiquidity premium of 5.8% per annum relative to syndicated leveraged loans (see Exhibit 5, below), which has significantly increased from the 4.4% we reported in Insights 2020. This is an attractive pick-up in yield for senior debt in structures which are now benefiting from improved credit protection. Despite the dislocation early in the year, both liquid indices ended Q3 20 at tighter levels than they closed Q3 19, with the US high yield index 12 bps tighter and the leveraged loan index 97 bps tighter, while private debt yields were 41 bps wider over the same period.

Exhibit 5

The premium offered by private lending over traded credit alternatives has increased as liquid markets have traded tighter, and terms for private lenders have improved



***Source:** Cliffwater, Bloomberg*

In Insights 2020 we emphasised the importance of focussing on specialist lenders in less cyclically-exposed strategies, allocating to alternative alternatives to benefit from their uncorrelated return characteristics, explicitly limiting exposure to commoditised middle-market lending and using customised structures which allowed us to take advantage of dislocations. By maintaining this discipline in our approach and by opportunistically increasing our exposure to distressed strategies in 2020, our private debt

[5] Preqin Quarterly Update: Private Debt Q3 2020 https://www.preqin.com/insights/research/quarterly-updates/preqin-quarterly-update-private-debt-q3-2020

[6] Net returns are based on Partners Capital core fee class (0.5% annual management fee and 5.0% performance fee). Past performance is not a reliable indicator and is no guarantee of future results. Please see important Disclaimers at the end of this material.

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Investment Strategy

Our investment objective is to partner with who we believe to be the best private debt and alternative alternatives managers to deliver a 10%+ total return through the cycle with: i) contractual income yield ii) substantial downside resilience and iii) low correlation to public equity and credit markets. As in previous years, our strategy is comprised of allocations to the following four sub-strategies:

1. Corporate lending strategies, which is focused on senior-secured and opportunistic lending, but which also includes middle market direct lending, mezzanine lending and CLOs (collateralised loan obligations);
2. Sector specialists and niche lending strategies with a focus on healthcare and technology, though we are also exploring sectors such as professional sports and telecom infrastructure;
3. Real estate lending strategies, which includes lending against real estate assets and CMBS (collateralised mortgage backed securities); and
4. Alternative alternatives, which have little correlation to corporate earnings or the real estate market.

For 2021 we continue to bias our commitments towards sector specialists, niche lending and alternative alternatives, where we see the best risk-adjusted returns. However, we also expect to skew our 2021 allocations to partners and situations with the following characteristics:

1. Opportunistic and nimble managers: In 2020, we made commitments to opportunistic managers who were able to capitalise on both stressed/distressed debt and rescue lending opportunities, reflecting the considerable opportunity set generated by the impact of the pandemic. Looking forward to 2021 we will continue to prioritise managers that can take advantage of dislocations across all of our four sub-strategies. However, we tend to favour managers who can pivot opportunistically in the event of dislocation towards secondary markets, rather than dedicated distressed debt strategies.

2. ESG and DEI: We are increasing our focus on strategies with strong ESG credentials and those with a positive impact, and we will continue to engage with our existing managers to drive ESG integration in their investment processes and business operations. Within our own manager selection process, we are engaging in several initiatives to expand our research pipeline to access more funds owned and managed by women and under-represented minorities.

3. Bespoke structures and co-investments: We are also increasing our focus on bespoke structures and co-investments which offer increased customisation, control, and lower fees.

We remain focused on building diversified private debt and alternative alternatives portfolios that are resilient in a range of economic environments. Private debt, by nature of its senior position in the capital structure, floating rate pricing and relatively shorter duration, should benefit from an inflationary environment with rising rates. Conversely, in the event of a more prolonged recovery from the pandemic, our skew to less cyclical sectors such as healthcare and technology should continue to benefit from the secular trends that underpin our bias to these sectors.

Hypothetical return expectations do not represent actual trading and are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance.

Distressed Opportunities

We view distressed investing as highly cyclical and typically only make commitments to distressed strategies when warranted by the opportunity set. As such, we do not have a target allocation to distressed, but will allocate opportunistically to distressed opportunities within our other sub-strategies. Given our concerns about the over-extension of the cycle and the increasing amount of leverage on corporate balance sheets we had prepared for a new distressed cycle via a commitment to a patient capital vehicle which would only draw capital in the event of a downturn.

Our existing private debt managers deployed capital into a broad range of securities during the market dislocation, including CMBS, high yield bonds and leveraged loans. In private markets they made commitments to rescue financings in both corporate and real estate situations as well as some innovative fund financing transactions. In our dedicated SMAs for structured credit we were able to deploy additional capital in high grade CLO debt to take advantage of the dislocation.

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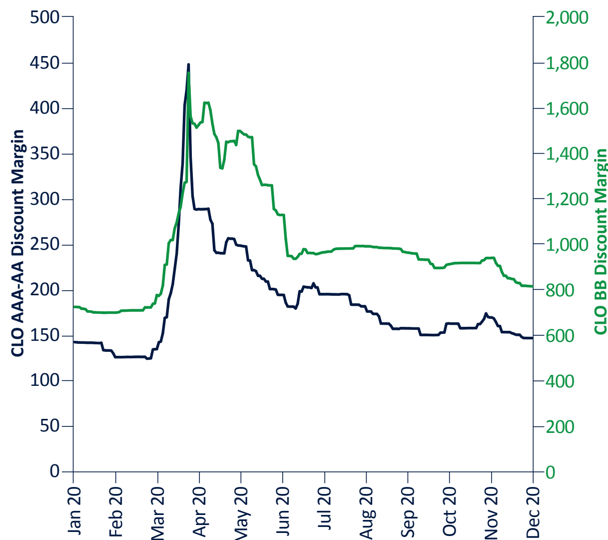
Exhibit 6

Our CLO managers purchased AAA/AA CLO debt in March 2020 as spreads reached wide levels to take advantage of the dislocation in higher quality assets.



Source: *Barclays*

Our expectation is that the default opportunity in this cycle will be focussed in private markets, given the implicit central bank backstop available to issuers in public markets. While borrowers were able to put in short-term liquidity solutions in Q2 2020, many did not anticipate the more prolonged impact of the pandemic and were funded for 12-18 months with an assumption that there would be a normalisation to 2019 profitability in 2021. As additional liquidity and periods of debt forbearance are exhausted, as the time to a normalisation in profitability is extended, and as government support schemes are withdrawn, the likelihood of covenant pressure rises, as does the chance of further restructurings and refinancings. We are therefore positioned with managers that we think will be able to participate in rescue financings for both real estate and corporate issuers.

Corporate Lending Opportunities

Our commitments to corporate middle-market direct lending have been minimal for several years. We view middle-market direct lending as increasingly commoditised as the large amount of capital available for these strategies leads to competition on terms between lenders and ultimately a less attractive risk/return profile. The flow of capital into direct lending strategies slowed in 2020 but they remain the largest sector of the private debt market, offering less differentiated returns, limited covenant protection and fewer opportunities for alpha generation than we can find in more specialist strategies. In corporate lending we are now more focussed on opportunities in capital solutions and rescue lending that offer the potential for premium pricing due to participating in transactions that require speed of execution, the ability to manage complexity and the capacity to offer more innovative structuring.

Structured credit remains an opportunistic allocation in our private debt portfolios, as we remain mindful of the mark-to-market risk of the asset class, albeit partly mitigated by high cash yields. As discussed above, we took advantage of increased dispersion and volatility in the CLO market in March and April, acquiring senior debt at attractive valuations, but we also suffered some mark-to-market losses on CLO equity allocations during the initial sell-off. Our CLO equity positions ended the year with a positive return, reflecting the substantial rebound in leveraged loan pricing in the second half. Despite the mark-to-market challenges during the year, cash flows to our equity positions were not interrupted as CLO structures continued to exhibit resilience despite a higher loan default rate.

Sector Specialists and Niche Lending Strategies

We continue to target allocations to sector specialists and niche strategies where lenders with proprietary sourcing networks and the ability to underwrite more complex sectors can structure transactions with premium pricing, equity participation, and better-than-market covenant packages. Our focus on less cyclical sectors such as healthcare and technology proved beneficial in 2020 as both sectors proved resilient and were relatively unaffected by the impact of the pandemic. Still, some managers reported mark downs in NAV in 2020 reflecting the uncertainty in operating conditions created by the pandemic.

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We are increasingly seeing investment opportunities related to professional sports with the disruption arising from COVID-19 depressing valuations and offering attractive entry points for managers who have sourcing networks and execution ability in this sector. The fundamentals of the sector are attractive, with multiple sources of value: a growing market for live sports media content, collateral in the form of real estate, ticket sales and parachute payments and the potential for favorable exit opportunities as the outlook normalises post-COVID.

In niche and specialist lending we aim to consolidate existing relationships and identify and partner within the next generation of specialist lending managers. We are also broadening our focus to sectors with similarly non-cyclical characteristics to healthcare and technology, such as telecom infrastructure. We view specialist lending as offering substantial potential for co-investments, given the proprietary nature of the transactions, and will be levering both existing and new relationships to build out our pipeline of co-investments.

Real estate lending strategies

Real estate lending strategies form a core part of our private debt allocation, offering diversification to our corporate lending exposures. Our expectation is that the real estate lending opportunity will be different in 2021 from prior years due to the considerable disruption the pandemic has brought to normal working practices and the knock-on effect this will have on commercial property valuations.

We expect the continuation of these dynamics in 2021 to present opportunities for lenders who can maintain their discipline and step into challenged transactions with new capital or restructuring capabilities. In 2020 our portfolios benefited from an opportunistic manager who was able to acquire secondary CMBS at attractive prices during the dislocation in H1 20.

Alternative alternatives (30%)

We continue to pursue opportunities in alternative alternatives as they can offer private debt-like return profiles with very limited correlation to the broader market.

We continue to extend our research in a range of uncorrelated strategies, building out strategy maps and establishing relationships which allow for easier triangulation and referencing as new opportunities arise. Commitments to new strategies in 2020 included drug-trial financing, a credit intermediation vehicle which offers exposure to short term credit risk which arises as part of the clearing process, and investments related to professional sports, which include a fund which invests directly in professional athletes in exchange for a participation in their future earnings.

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