NEUBERGER | BERMAN

Neuberger Berman Global Fixed Income

Rethinking the Credit Liquidity Continuum

As private credit markets have expanded, matured and democratized, eligible investors can now, in a cost-effective and operationally efficient manner, combine liquid and less-liquid credit assets in one portfolio. This allows investors to increase yield profile and potentially reduce volatility and correlation.

Expanding the opportunity set within credit from liquid to less-liquid assets is not a new concept. However, liquidity constraints and operational and cost hurdles previously made some parts of the credit market less accessible.

Given the evolution and growth of less-liquid credit markets, investors are exploring what else they can do with their credit portfolios. We have collaborated with our clients to create a viable solution, combining liquid and less-liquid credit assets in a single portfolio.

Investors have traditionally seen liquidity as an all-or-nothing proposition, involving securities that are either publicly traded daily or privately placed assets with no secondary market. This view results in assets falling into two camps: highly liquid and illiquid assets, creating a liquidity barbell. Furthermore, investors have wrestled with long-term lockups, ramp-up periods and capital call management.

In our view, the approach to liquidity management is more nuanced, emphasizing that there is a liquidity continuum. The evolution of credit markets has made this more possible.

Our ability to combine this is based on an established process for harmonizing our views on the relative value return opportunities across the liquidity continuum, appreciating liquidity constraints, and having the fundamental bottom-up security selection capabilities to provide insulation from market weakness. Equally as important is the ability to access a broad range of credit capabilities and to tap these markets efficiently. Further, we have overcome operational and cost complexities to provide these elements in one efficient structure.

Opportunity Since the Global Financial Crisis

In the wake of the Global Financial Crisis of 2008 – 09, changes to the market and regulatory landscape had a profound influence on the contours of credit markets. Under pressure, many alternative credit investors reoriented away from illiquid and toward more liquid investments, while banks pulled back on certain kinds of lending that compromised their balance sheets due to new standards. This created opportunity in, and subsequent expansion of, private debt markets, while placing greater emphasis on answering questions focused on liquidity management.

The need for liquidity management stemmed from the relatively new and highly inefficient secondary market for these credit investments. Further, because few investors participate in this new market, we believe that a yield premium is typically associated with the assets as they are not liquid enough for daily vehicles and hedge funds, yet too liquid for traditional private markets strategies.

Although these opportunities are available across multiple areas of the market, we see particular advantages in credit assets with mid-range liquidity in several sectors:

Catastrophe Bonds: These high yield debt instruments are designed to protect insurance companies in the event of natural disasters. They are highly uncorrelated given that their fundamentals have little to do with corporate balance sheets or the macro economy.

Specialty Finance: Non-bank lenders, including of point-of-sale financing, have seen a flood of venture capital money, but they often need debt capital and are willing to pay attractive returns for it. Commercial banks that were providing low-cost accounts receivable financing lines had to step back due to capital constraints. Many of the companies that need such financing have very high credit quality, providing a positive risk/reward relationship.

CLO Debt & Equity: A collateralized structure, secured by a pool of first-lien, senior secured loans, offers lower defaults at the tranche level, complemented by structural yield premiums, with greater diversification.

Fixed Income Co-Investments: Opportunistic co-investments alongside longstanding hedge funds focused on medium duration (one- to four-year) investments. This orphaned segment of the market exhibits higher returns, lower volatility and lower correlations to traditional markets.

Private Debt: Debt investments in private equity-backed companies, through first-lien, senior secured loans, capture a yield premium driven by the size of the company, alongside higher recovery rates across defaulted securities.

These limited examples offer very distinct characteristics. By accessing them, eligible investors may enhance overall portfolio risk/return.

Working With Clients for Optimal Liquidity

An issue investors have to reconcile when seeking higher yields is the degree to which they are compensated for giving up liquidity. Although they see longer-term vehicles as attractive, clients are generally looking for a middle ground along the lines of what we have been describing—between daily liquidity vehicles and long-term lockups—that can be used in their traditional fixed income asset allocation to achieve their objectives.

In our view, this speaks to the ongoing need for creativity and flexibility within fixed income. Recently, we've seen overall yields of about 5.00 – 5.25% generally across liquid multi-sector fixed income. When you include assets with an intermediate liquidity profile, it is possible to increase the overall yield profile. To no one's surprise, generally moving further out on the liquidity continuum allows investors to potentially capture higher and more attractive yield opportunities.

In considering these issues, we believe clients should ask themselves a series of questions around liquidity to gauge the value of embracing a liquidity continuum:

- How do we think about our liquidity needs?
- What is the opportunity cost of investing in daily liquid vehicles with no intention of exercising that option?
- Can we find an adequate bridge that offers reassurance on liquidity but can capitalize on the illiquidity premium?

We can provide an analytical framework with which to assess factors including volatility, correlation, yield and return potential, along with our confidence level on our views, while adding the important element of liquidity to the mix. This provides an efficient frontier with which to track the incremental benefits of pulling back on liquidity.

Importantly, we have found that the array of less-liquid credit that may extend the liquidity timeline can enhance diversification while enhancing yield opportunity.

Conclusion

Clearly, the decision to alter liquidity levels is not a simple one. We have often found that clients, unfortunately, believe this to be an all-or-nothing choice. However, the evolution of the market has, in our opinion, allowed them to access this liquidity premium in a more nuanced fashion.

Less-liquid credit assets have significant differences from more-liquid assets. In order to seek to benefit from this liquidity continuum, selection requires deep fundamental knowledge of issuers and their capital structure, as well as broader business and economic issues. Success may also depend on a manager's ability to capably source deal flow in a competitive marketplace. The benefits of combining credit assets across the liquidity continuum results in higher yields, lower correlation and better returns.

From the client's perspective, illiquid assets must fit within broader decisions on asset allocation. However, we believe that additional value may be achievable across a liquidity continuum, which is something worth examining closely at a time when public market yields remain at exceptionally low levels.

NEUBERGER | BERMAN

Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

www.nb.com