INVESTMENT STRATEGY GROUP

Public/Private Investing:

Fixed Income at a Crossroads

As the line between public and private debt markets appears to blur, the ability to draw on the full suite of fixed income asset classes can help investors navigate a wide range of market environments—through complementary sources of risk and return prospects, enhanced diversification and improved return potential.

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PRIVATE WEALTH

The low-rate environment of the past decade has reached extremes in the context of the COVID-19 pandemic, while financial asset valuations appear full, driving down potential return outlooks across fixed income and equity asset classes. Further, the ability of investment grade fixed income to quell equity volatility in portfolios has come into question due to the low "starting point" of interest rates and the potential risk that they could move higher. Given these conditions, investors continue to look for ways to enhance total return potential and improve diversification while managing risk in a prudent manner. In our view, this has led many to move beyond traditional sources such as investment grade bonds to publicly traded high yield bonds, leveraged loans, emerging market debt, preferred stock and other, higher-yielding options.

The opportunity set continues to expand in private markets as well, driven by post-Global Financial Crisis (GFC) financial regulations that made certain risk exposures untenable for traditional banks, resulting in a structural shift toward nonbank market participants for funding. This has contributed to a threefold surge in private debt assets since 2008 to roughly $1 trillion as of 2020.[1]

While the funding source has shifted, often the underlying type of private debt—corporate, consumer and small business lending, among others—is a relatively mature segment that is familiar to public market investors. What private market investment managers generally bring to the table is an ability to capture risk premia not available in the public markets, such as for liquidity and complexity, resulting in the potential to add incremental return opportunities and diversification. As such, we think private assets have evolved to become a potential core holding in many client portfolios. Indeed, we believe that, moving forward, investors will increasingly look to both public and private markets to achieve their goals. In our view, investing in a range of sectors across both segments can greatly enhance the flexibility and risk/reward framework of fixed income portfolios.

UNDERSTANDING POTENTIAL RISKS IN INVESTMENT GRADE FIXED INCOME MARKETS

We like to think of fixed income assets largely in terms of the stability they have historically offered portfolios (offsetting riskier assets like stocks), their diversification value, steady income generation and liquidity to meet cash flow needs. We believe investment grade fixed income continues to play an integral role in diversified portfolios—as a source of stability and diversification—as was on display during the 2008 GFC and the pandemic-related market turbulence of 2020. For many years, the income function was supported by generous yields. However, those yields dwindled in the decades-long bond bull market, and were reduced to minimal levels as part of last year's monetary easing and intervention in the credit market by the Federal Reserve. There are now some $13.4 trillion in negative-yielding bonds worldwide,[2] while the yield advantage over Treasuries (or spread) for many other bonds is near record lows. Further, investment grade bonds now have greater-than-historical sensitivity to interest rate swings (or duration), in large part because of currently low yields. In our view, this could prove a headwind to bond portfolios should interest rates increase off current low levels, and, coupled with bonds' recent increased correlations with equities, could weaken their benefit as a diversifier in the coming years.

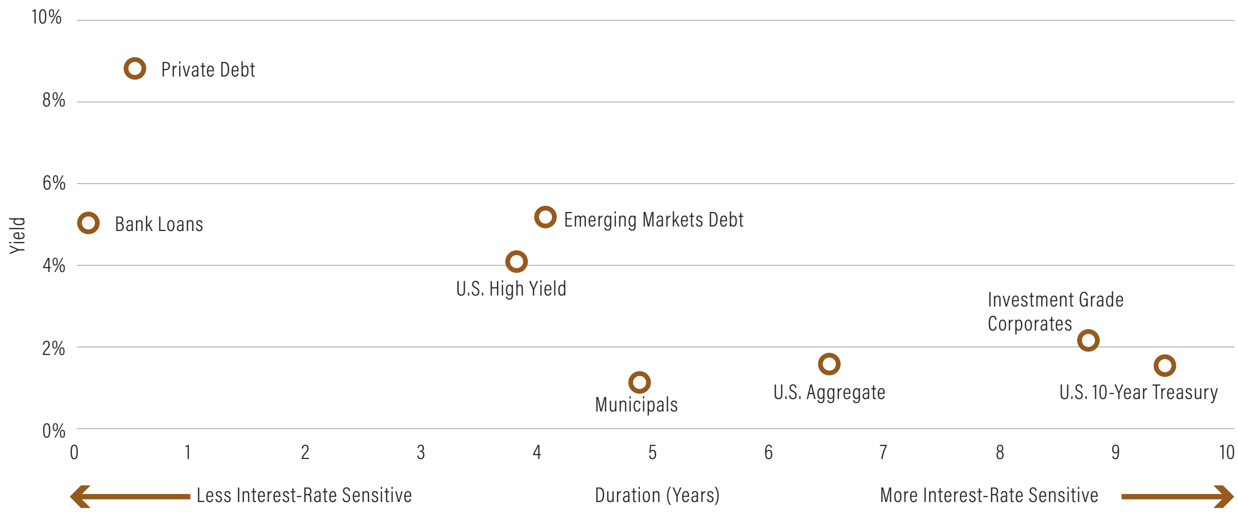
Given this backdrop, we believe it has become especially important to broaden fixed income investment options to seek more favorable yield opportunities, while enhancing diversification through differentiated sources of risk premia (across public and private arenas) and limiting interest rate risk in the process. Figure 1 plots various fixed income options based on their yield and duration, including private debt.

[1] See Figure 2.

[2] As of October 4, 2021.

FIGURE 1. VARIED CHARACTERISTICS REINFORCE FIXED INCOME DIVERSIFICATION

Yield and Duration*



*Data as of September 30, 2021, except for private debt, which is June 30, 2021.

Source: Bloomberg. Asset classes are represented as follows: municipals, Bloomberg Municipal Bond Index; U.S. aggregate, Bloomberg Barclays U.S. Aggregate Bond Index; investment grade corporates, Bloomberg Barclays IG Corporate Bond Index; high yield, Bloomberg Barclays High Yield Index; bank loans, S&P/LSTA Leveraged Loan Index; emerging markets debt, EMBI Global Diversified Bond Index; private debt, Cliffwater Direct Lending Index. Benchmark performance is presented for illustrative purposes only to show general trends in the market for the relevant periods shown. The investment objectives and strategies of each fund in a benchmark may be different from the investment objectives and strategies of a particular private or public fund and may have different risk and reward profiles. It should not be assumed that any correlations to a benchmark based on historical returns would persist in the future. Indices are unmanaged and not available for direct investment. Investing entails risks, including possible loss of principal. Past performance is not indicative of future results.

For some investors, it may make sense to draw on multisector fixed income strategies that provide diversified exposure across these various publicly traded sub-asset classes in one vehicle. By accessing these exposures in a single fund, we believe investors may benefit from the experience of fixed income professionals that can quickly and efficiently rotate portfolios into areas of opportunity and away from areas of risk based on relative valuation and bottom-up security selection. In our view, this flexibility is increasingly important in today's rapidly shifting investment landscape.

Further, we think many investors may be under-allocated to the rapidly growing private markets. We seek to demystify this asset class in the following section.

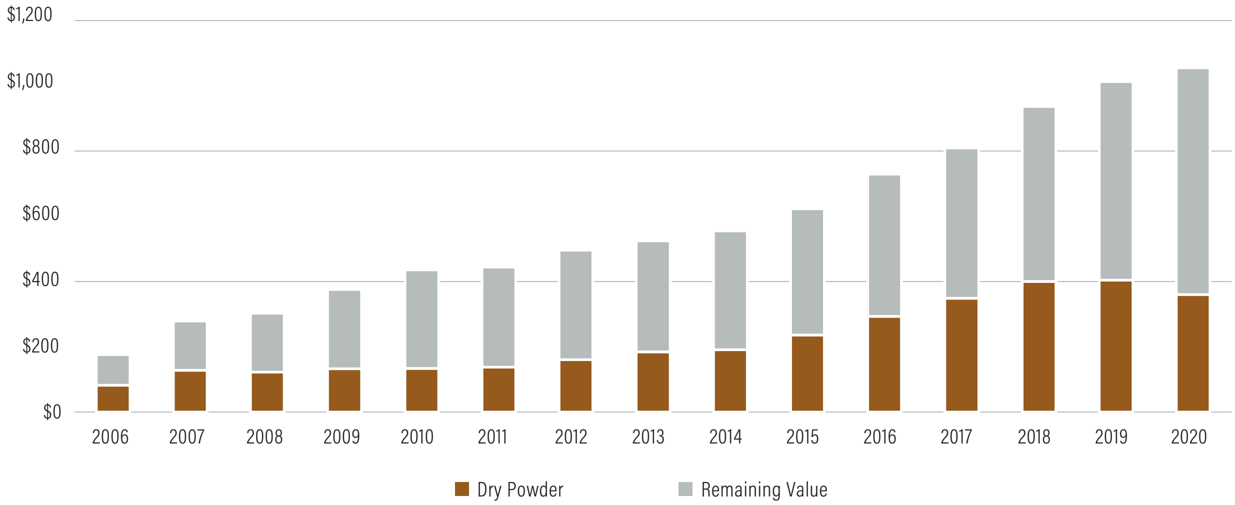
PRIVATE DEBT: EVOLUTION OF AN ASSET CLASS

Despite the historical treatment of private debt as an "alternative" asset class, we believe it has evolved to become a core holding in many client portfolios, acting as a complement to existing public fixed income exposure.

What is private debt? Simply put, it involves entities (including private companies, consumers and small businesses) borrowing from nonbank lenders such as investment firms or fintech platforms rather than from banks, or issuing debt in the public markets. These investments are often not registered with the Securities and Exchange Commission and typically carry a reduced liquidity profile.

FIGURE 2. HISTORICAL GROWTH OF PRIVATE DEBT MARKET

Assets Under Management ($ Billions)



Source: PitchBook. As of December 31, 2020. For illustrative purposes only. Nothing herein constitutes a prediction of future economic or market environment. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is not indicative of future results.**

Private debt is a broad term that includes categories such as direct corporate lending, asset-backed lending, specialty finance, consumer lending and residential mortgage lending. This discussion focuses on corporate lending, which is the largest segment of private debt.[3] Although the sector has been around since the beginnings of the high yield market in the 1980s, it really took off in the wake of the Global Financial Crisis in 2008 – 09, when regulators clamped down on lending provided by traditional banks. Particularly among smaller, private equity-backed companies, managements have looked to private, nonbank lenders for access to capital and flexible terms. Also driving growth has been the boom experienced by private equity generally. The increase in supply has been met with enthusiasm on the demand side. While investors' search for yield in the post-GFC low-interest-rate environment has provided a tailwind to private debt adoption, we believe the shift is more long term in nature, as investors recognize the opportunity to diversify their fixed income exposure and capture risk premia that are more readily available in private markets.

Private debt risk premia come through in the form of enhanced yield opportunities, which compensates for the additional complexity of customized, negotiated transactions, as well as a reduced liquidity profile. As shown in Figure 1, this tends to result in an attractive yield versus public market counterparts despite similar, and often reduced, credit and interest rate risk. In addition to enhanced yield potential, private debt offers several other attractive structural features:

- **Seniority in the capital structure** helps reduce default risk and, in the event of default, increase recovery rates.
- **Low interest rate sensitivity** due to floating-rate debt feature in most investments that can efficiently hedge the risk of rising interest rates.
- **An extended investment period,** often three to four years, allowing private debt funds to deploy capital over time, increasing the ability to take advantage of a shifting investment landscape.
- **Limited liquidity,** while an important consideration for investors in sizing private debt, can help to mitigate volatility during market sell-offs, as investors are less affected by "mark-to-market" volatility and can avoid becoming forced sellers. Instead, private debt valuations are typically affected only by permanent impairment of capital through fundamental adjustments to valuation and/or default. As such, security and manager selection is key in the space.
- **Negotiated transaction terms** can lead to a customized risk and return profile with improved investor risk mitigation.

The structural features outlined above come with some considerations prior to making an allocation to private debt markets—including liquidity profile, (often below-investment-grade) credit risk, smaller company size than public market high yield, current valuations and transaction terms. On balance, we believe these considerations can be effectively managed through appropriate sizing of private debt exposure and thoughtful security and manager selection.

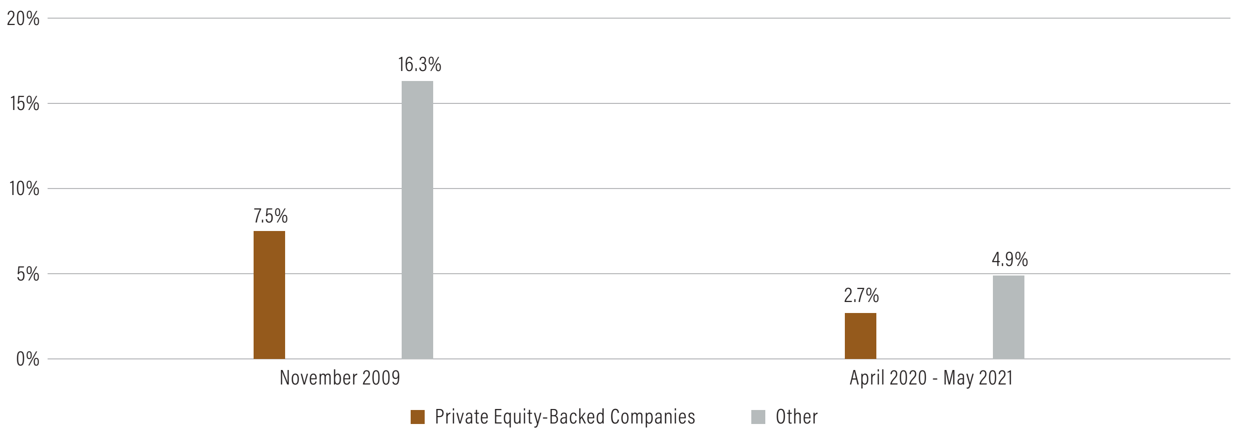
[3] Source: PitchBook, June 2021.

DURABILITY IN DIFFICULT TIMES

The period during the COVID pandemic has reinforced the durability of the private debt asset class, with borrowing businesses showing resilience in the face of revenue and operational challenges, and benefiting from government stimulus and continued support of the Federal Reserve. Moreover, we believe that the involvement of private equity managers in many borrowing companies has also been an advantage, as we have seen private equity funds provide additional capital where needed to support operations and liquidity, as well as to become actively involved in the strategic and tactical direction of the business. This has resulted in significantly reduced default rates for private equity-backed companies over time, particularly during times of acute distress, as reflected in Figure 3.

FIGURE 3. DEFAULT RATES DURING CRISIS: LOWER FOR PRIVATE EQUITY-BACKED COMPANIES

Peak Default Rates



Source: S&P LCD. Includes default rates of leveraged loans for all companies in the S&P LCD Index. For illustrative purposes only. Nothing herein constitutes a prediction of future economic or market environment. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Indices are unmanaged and not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is not indicative of future results.**

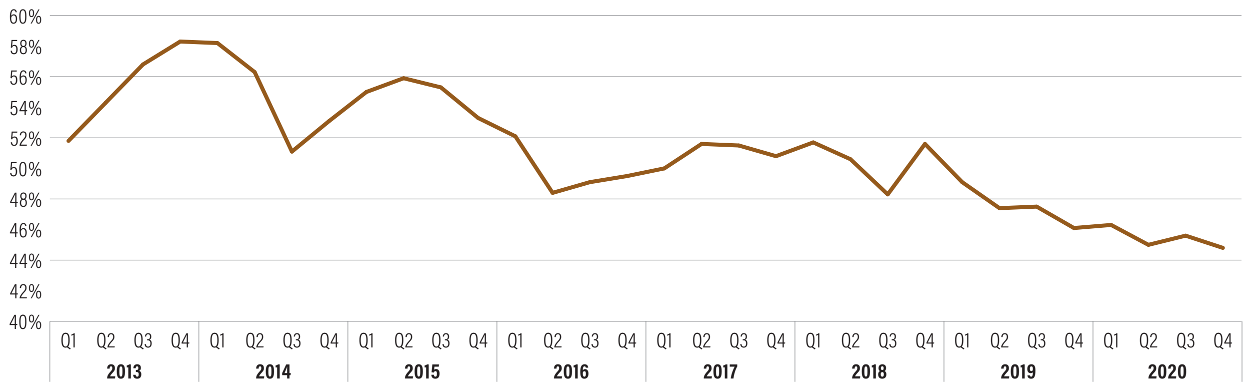
Along with other fixed income sectors, private equity's yield over Treasuries (or spread) has narrowed, but we see a number of trends that should be reassuring to investors.

Although deals have generally become more friendly to borrowers (in terms of documentation and covenants), Neuberger Berman's Private Debt team believes they have largely moved back to pre-COVID norms, while leverage levels for borrowers are consistent with late 2019. The team also believes the quality and growth prospects of these companies have improved versus previous investment cycles. This reflects an industry-wide shift from the early days of private equity, which focused on financial engineering involving the addition of significant leverage to steady, low-growth businesses. Instead, many private equity firms are currently focused on topline revenue growth potential and effecting material improvements in the underlying operations of high-quality businesses.

Using the private equity universe as a proxy (given its overlap with private debt), some 65% of companies where Neuberger Berman's Co-Investment team committed capital in the first six months of 2021 projected an annual earnings growth outlook of 10% or more, compared to just 26% six years ago. Further, a combination of added equity cushion from increased valuations and a subdued increase in absolute debt levels has resulted in a significant improvement in private company balance sheets (see Figure 4). Given the high position of private debt in companies' capital structure, we believe this provides added reassurance regarding preservation capital even in dire circumstances.

FIGURE 4. MULTIYEAR LOW IN PRIVATE EQUITY-BACKED COMPANY DEBT LEVELS

Median U.S. Buyout Debt-to-Enterprise Value Ratio (Rolling 4-Quarter Periods)



Source: PitchBook, U.S. PE Breakdown Q1 2021. For illustrative purposes only. Nothing herein constitutes a prediction of future economic or market environment. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is not indicative of future results.**

IMPLEMENTATION

Although conceptually a part of fixed income, as a practical matter private debt often remains an "alternative" asset class—that is, typically subject to asset or income qualification levels, as well as relatively high investment minimums and multiyear fund lives. However, as outlined in our paper, "Private Equity in Focus,"4 new investment structures are providing broader access to private markets, including that of private debt. In addition, fixed income portfolios are increasingly incorporating public and private elements based on the opportunities available across both areas—a trend we see becoming more prevalent. Even for those investors where private and public are in separate formal buckets, we believe a sensible approach is to consider aggregate portfolios from multiple perspectives—volatility, duration, income, liquidity, etc.—which can better identify the potential impact of an asset like private debt overall, while clarifying broad positioning in relation to overarching portfolio goals.

FINAL THOUGHTS

In our view, the array of challenges facing fixed income markets require that investors take a flexible approach to generating yield opportunities and limiting potential risk. As a first step, this may entail drawing on multiple sectors and geographies, and potentially leveraging investment strategies that can pivot to opportunities and away from hazards. It may also include a broadening of investment universe to private markets, which can offer a unique set of characteristics and return/yield potential. In our view, fixed income markets are at a crossroads, where investors will increasingly draw on both public and private options in seeking to achieve their goals. Careful planning and an understanding of the potential risks and benefits of both segments can help surmount current obstacles and set the table for performance over time.

[4] July 2021.

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