Hamilton Lane

Does High Inflation Have You Confused About Where To Invest?

May 2022 | Nayef Perry, Co-Head of Direct Credit Investments

Inflation is sending investors across the public and private markets mixed signals, leaving them searching for direction on what asset classes or strategies might prove to be a safe harbor. One such strategy is private credit. Why? Historic trends have shown that high inflation motivates the Fed to raise rates, which is good for floating rate yields, (though stressful on interest coverage ratios).

And while no rising rate environment looks the same, we believe private credit investors will be rewarded in this market, and that the asset class is poised to deliver the stability and performance it has historically offered.

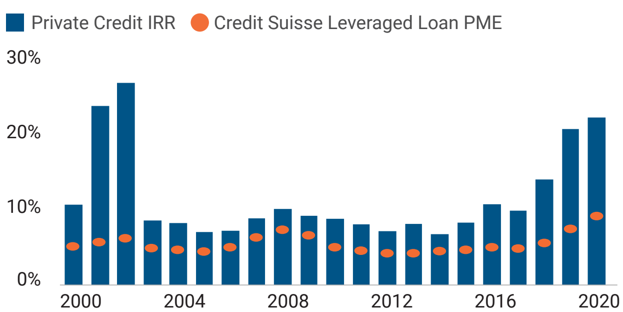
But before we demonstrate that, let us address some of the investor fears being triggered by inflation. For starters, input costs are rising. The consumer-price index rose by 8.5% in March from the same month a year earlier. The gasoline index rose 48% over the last year and on the labor front, business and government employers spent 4.5% more on worker costs in the first quarter compared with the same period a year earlier. And let's not forget the topic du jour - supply chains. The average composite index of the World Container Index year-to-date is $9,116 per 40 ft container, a whopping $5,908 higher than the five-year average of $3,208 per 40 ft container, so shipping costs are up significantly.

At the policy level, signs point to continued rate hikes. In early May, the Fed raised its benchmark interest rate by half a percentage point. Inflation fears have prompted expectations of continued half-point interest rate hikes at each of the next three scheduled policy meetings and there is speculation the Fed could raise their benchmark rate by as much as 75 basis points in June, marking the first 75-basis-point increase since 1994. Rising input costs and rising rates have investors concerned for two basic reasons. First, a rising cost structure puts pressure on EBITDA and margins, which creates the potential for a deterioration in credit quality, particularly for highly leveraged companies. Second, persistent rate hikes by the Fed could slow growth and push the economy into a recession.

What are investors to do? The answer is simpler than you might think. Focus manager selection on general partners with scale, market access and credit discipline. It's likely those managers are gravitating towards recession-resilient sectors and companies with pricing power, flexible cost structures, conservative capital structures, and strong free cash flow conversion, which are some of the key credit attributes required to safely navigate an inflationary environment.

Despite these pesky inflation pressures, private credit investors have a lot to be optimistic about. To begin with, Hamilton Lane compared private credit IRR over a 20-year period against the Credit Suisse Leveraged Loan public market equivalent or 'PME'.

Private Credit IRR vs. PME

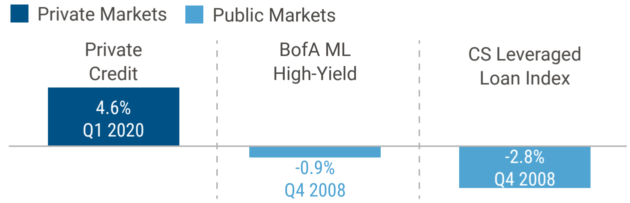


Source: Hamilton Lane Data via Cobalt, Bloomberg (January 2022)

Not only did the asset class have consistently positive performance over that time, but it also outperformed the PME every year and with a very narrow dispersion of returns. It is also worth noting we have been through three recessionary periods during that time. Pretty impressive huh? Wait, it gets better.

Hamilton Lane also evaluated the worst five-year annualized performance of the strategy going back to 1995. At its worst, private credit demonstrated positive 4.6%, outperforming all other private and public markets strategies across equity, credit, and real assets. Private credit did not lose money; therefore, I'll pause to let that sink in.

Lowest 5-Year Annualized Performance - Credit
1995-2021



Infrastructure from 2006–2021, Natural Resources from 1998—2021
Source: Hamilton Lane Data via Cobalt, Bloomberg (January 2022)

For investors with exposure to floating rate credit, which is a healthy proportion of the private credit universe today, yields are likely to improve. On April 1, 3-Month LIBOR broke above typical LIBOR floors of 50-100 basis points and reached approximately 1.16%. The forward 3-month LIBOR curve is forecast to exceed 2% over the next twelve months, which would create a nice IRR boost for investors with floating rate exposure. For those wondering what this means for SOFR, there is some encouraging news there too. This time next year, the SOFR forward curve suggests the benchmark rate will break 3%. Not too shabby.

But, if consistency and yield aren't your thing, you might want to reconsider as some of the public alternatives are less compelling. The bond market is on course for the biggest loss since 1920. As of April 29, year-to-date returns for High Yield were -7.54%. Over the same period, the leveraged loan market has returned 0.07%. Need we look at public equities? Why not: The NASDAQ is having its worst ever start to a year, at -21.2%. As of April 29, the S&P was down 12.4%, which marks its worst start to the year since 1942. Needless to say, it's been a rough start to 2022 for most public alternatives.

Whether new to the asset class or an existing investor, the data suggests that private credit has been resilient through periods of volatility and has consistently delivered public benchmark outperformance – a worthy consideration for any portfolio. Based on Hamilton Lane research, a +35-year lookback at performance of private credit showed that credit funds investing during rate hikes outperformed credit funds investing during all other periods. So, the next time you find yourself confused by mixed market signals, take a moment to remember the benefits of private credit.

ENDNOTES

STRATEGY DEFINITIONS

Credit: This strategy focuses on providing debt capital.

INDEX DEFINITIONS:

BofAML High Yield Index: The BofAML High Yield index tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

Credit Suisse Leveraged Loan Index: The CS Leveraged Loan Index represents tradable, senior-secured, U.S. dollar-denominated non-investment grade loans.

OTHER

PME (Public Market Equivalent): Calculated by taking the fund cash flows and investing them in a relevant index. The fund cash flows are pooled such that capital calls are simulated as index share purchases and distributions as index share sales. Contributions are scaled by a factor such that the ending portfolio balance is equal to the private equity net asset value (equal ending exposures for both portfolios). This seeks to prevent shorting of the public market equivalent portfolio. Distributions are not scaled by this factor. The IRR is calculated based on these adjusted cash flows.

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As of May 20, 2022

