"Good entry point for high yield and private debt"

Jeroen Boogaard - 28 juni 2022

The MV Dual Credit Fund invests in global multi-asset credit (including high yield and investment grade bonds) as well as in European private debt. Yields have risen in both markets, providing attractive investment opportunities, said Murtaza Merchant, Head of Fund Optimization at MV Credit.

Due to the historically low yields in the regular bond markets, institutional investors have turned to private debt in recent years. Merchant also sees a lot of interest in MV Credit's private debt funds. As part of Natixis IM, MV Credit has been focusing on the European private debt market for over twenty years.

“Investors would like to invest in private debt, but the market is not easily accessible. Due to the illiquid nature of this asset class, the capital of investors is usually locked up in closed-end funds for seven to ten years. In addition, the capital is not invested in one go, but is spread out over three to five years via 'capital calls'. That doesn't work well for many investors," says Merchant in an interview with Investment Officer.

In order to give them better access to this fast-growing market, MV Credit has teamed up with Loomis Sayles, a specialist in liquid multi asset credit, and also an affiliate of Natixis IM. The result of the collaboration is the MV Dual Credit Fund, launched in April of last year, which targets an investment of 50 percent in liquid fixed-income securities and 50 percent in European private debt. Thanks to the liquid assets in the portfolio, the fund offers daily tradability.

Merchant: “We should be able to offer this liquidity even with some volatility in the market. However, we would like to emphasize that the fund is not suitable for short-term trading, a long-term investment horizon is required. For investors, however, it is reassuring to know that they can get out when they need cash. The majority of the Loomis portfolio can be liquidated in a week. However, if tensions in the market rise, this will happen at less favourable prices. We would expect an investor to sell their more liquid positions ahead of the allocation in the MV Dual Credit Fund”

The Loomis Sayles portfolio is highly diversified with over two hundred individual titles spanning investment grade, high yield, EMD and bank loans. At least 20 percent is in investment grade corporate bonds and at most 80 percent in high yield globally. The private part has an allocation of at least 80 percent to European senior leveraged loans from medium-sized companies owned by private equity.

“This mostly concerns First Lien assets, with a senior position in the capital structure. We only have small positions at the bottom of the risk ladder, with up to 20 percent in subordinated loans. In this way we can enhance returns, with a relatively moderate risk profile,' according to Merchant.

Significant losses

While the bond markets are down significantly this year, the fund performance is still relatively good. In the first quarter there was a negative total return of 2.9%. The private debt investments have a variable interest rate, based on the money market rate plus a fixed surcharge. As a result, we are less exposed to interest rate risks. If the interest rate rises, the coupon will rise. The interest rate is contractually agreed for the life of the loan. This offers a lot of stability for investors. The volatility of the fund is low.”

The fund started with a 100 percent allocation to liquid fixed-income securities and has since gradually increased its share of private debt.

Investors who enter now benefit from the optimal target allocation divided between liquid credit and private debt. Moreover, the yields in the market have risen.' The target for the private part is an effective gross return of 6 to 6.5 percent per year, depending on the investment mix. “We also benefit from the illiquidity premium here. The returns on liquid investments naturally depend on market conditions. The aim for the fund is to deliver an attractive annual return for the entire portfolio of 5-6 percent and outperform the composite benchmark over an investment cycle", says Merchant.

He sees many investment opportunities. “Now is a good time to get into high yield and private debt, in our view. Due to the sharply increased risk premiums, a lot of bad news has already been priced into the high yield market. Spreads have also increased in private debt. In the European private debt market, the spread increase is between 1 and 2 percent, depending on the position in the capital structure. In addition, the yields here have increased because the flexible interest component in the senior loans moves along with the short-term interest rate.’

More defaults

The private debt market has seen strong inflows in recent years and there is still a lot of money on the sidelines. Because there is still a lot of dry powder, credit margins on new loans remain relatively low, Merchant indicates, “What counts, however, is the content of the private debt portfolio. Experience and a good track record are important, especially now that the economic outlook is deteriorating. We invest throughout the cycle with a long-term horizon. In this way we benefit from market corrections, as we are now.”

He thinks that more companies will find themselves in financial difficulties in the coming years. “We are leaving the era of ultra-low default rates. Rising inflation and interest rates will put pressure on companies’ results. This is expected to be reflected in an increase in defaults, although we are not likely to approach the peak levels seen during the financial crisis in 2008,” said Merchant.

“We take this into account in our models and stress cases. We mainly invest in companies active in defensive sectors such as technology, healthcare and business services. These are companies with stable cash flows that are not likely to run into problems if interest rates rise.

In addition to the senior nature of the loans, this should offer sufficient protection in a recession.”