

# Lim's Take: Are Private Credit Funds Ready for Battle?

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July 26, 2018 7:30 a.m. ET

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### Are Private Credit Funds Ready for Battle?

The latest wave of private credit is, in some ways, like a newly developed military technology that has yet to face a test on the battlefield.

Cash-hungry pensions have poured more money in recent years into private credit in search of returns that promise to outperform traditional bonds. Private debt funds raised \$116 billion last year, a record since at least 2000 and nearly double the amount raised in 2012, according to research firm Preqin Ltd. These funds span a range of strategies from direct lending to mezzanine debt to distressed investing.

But many funds only emerged after 2008 to fill a vacuum left by banks retreating from risky loans. They have yet to face the test of a downturn, which poses challenges for investors.

"What makes it hard to evaluate these funds is many of them did not manage capital prior to the global financial crisis," Sheila Ryan, a managing director at Cambridge Associates LLC said during the Pension Bridge Private Equity Exclusive conference in Chicago on Tuesday.

Assessing these funds has only gotten harder as competition for deals has caused loan covenants and other lender protections to deteriorate steadily.

"Deals are priced to perfection," Ms. Ryan said. Reporting standards, meanwhile, are weaker and lenders aren't able to receive reports on the financials of borrowers as frequently as before. "All of a sudden, you can't keep really as close of an eye on these situations."

Despite mounting risks, investors continue to allocate more of their fixed-income assets to higher yielding, illiquid debt strategies. A BlackRock Inc. survey of more than 200 institutions showed 58% plan to tilt their fixed income portfolios more heavily toward private credit this year.

Pensions systems from Tennessee to Arizona have increased allocation targets to direct lending in recent years.

For some investors, the cash yield these strategies often generate remains a draw despite a competitive market environment. The Policemen's Annuity and Benefit Fund of Chicago, a \$2.7 billion fund that has some \$10 billion of unfunded liabilities, has been ramping up its exposure to private credit. "The appeal," Chief Investment Officer Aoifinn Devitt said at the panel, "was primarily diversification as well as the cash component."

The Chicago pension fund recently sold its entire private-equity portfolio, she said. It continues to assess how to reallocate the cash proceeds from that sale. Depending on the outcome of those decisions, credit may well loom even larger.

Certainly, an economic downturn could create more attractive investment opportunities for private debt firms by scaring off other risk averse lenders. But for less experienced fund managers or those that loosened underwriting standards to win deals, weathering the test of a downturn will be far more difficult.

If they fail, investors backing those funds will end up suffering casualties.