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Michael Korber: How to find higher income without excessive risk

By Perpetual Asset Management
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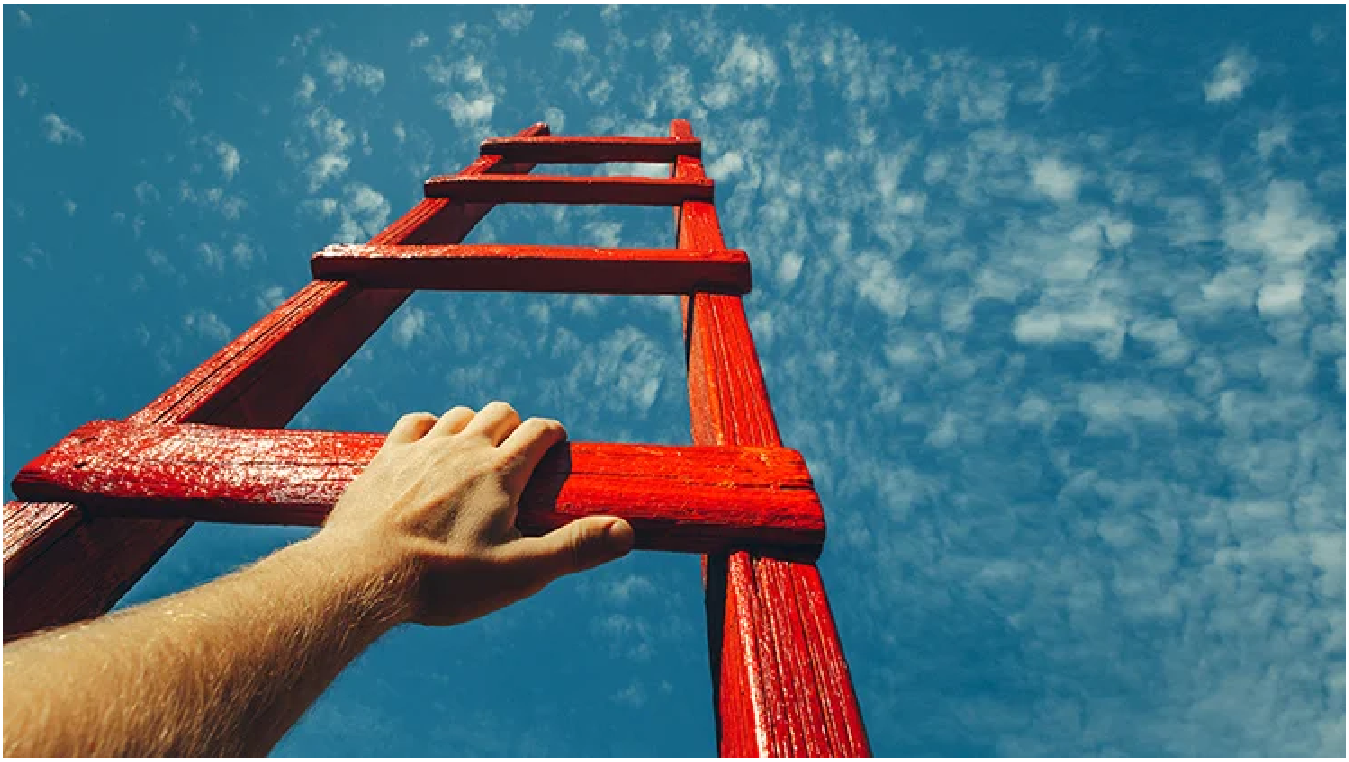

Investors tempted by private debt's higher yields should beware of taking on excessive risk, argues Perpetual's Michael Korber

- Beware risks underlying private debt
- Quality the key to sustainable returns
- [Find out more about Perpetual’s credit and fixed income capabilities]

The growing popularity of private debt is leading many investors to take on excessive risk in the search for higher returns, says Perpetual’s head of credit and fixed income Michael Korber.

Two main factors are driving interest in private debt: the hunt for higher yield and tighter regulation pushing banks out of their traditional lending roles.

But there is a wide range of quality in the fast-growing asset class – and investors should take a close look at the underlying investments, says Korber, who has four decades of experience in fixed income investing.

“There is a lot of noise in investing — you see all this advertising for all sorts of high-yielding strategies.

“People are tempted by private debt because it offers a headline return well above term deposit rates.

“There is sense in investors taking on additional risk, up to a point. But beyond that, it's just not worth it.

“What you actually receive is highly dependent on who the money has been lent to.”

Caution on private debt

Private debt appears attractive because it sounds like a homogeneous asset class and has gained some respectability due to its label, says Korber, who oversees Perpetual’s Credit Income Trust and Pure Credit Alpha Fund.

But in reality it encompasses a wide range of loan qualities.

“Private debt is not a security you can trade – it’s just a loan contract between two parties.

“Lending is the bread and butter of banks, and the quality of loans can vary significantly.”

Many private debt products lack a significant track record and transparency and are typically heavily exposed to real estate markets, says Korber.

“It can be high quality. One example in our portfolio is Arnotts, an extremely resilient, household name.

“But it can also be low quality — for example a third mortgage on an individual trying to develop a block of flats.

“It can be attractive, but it can also be just awful.”

Risk ahead

While fixed income investments are typically expected to provide a certain rate of return, this expectation can fail if a borrower defaults.

“Through any economic cycle, there are periods where loose lending is very productive because there's money around and borrowers can pay,” says Korber.

“But when conditions tighten, many borrowers fall by the wayside.

“The true quality of these assets is often not visible to investors, and you have no real way of gauging this until economic conditions worsen.

“These products are often sold as blue-chip investments, but the reality can be starkly different when the market turns. Investors might find themselves losing substantial amounts of money.

“What can sometimes be missing is an element of fear among investors about getting too aggressive — you should be confident that you can do better than cash or term deposits, but acknowledge that if you push the envelope too far, you could come unstuck.”

Quality assets are key

Where should investors turn to find better income returns?

One answer is to focus on high-quality assets.

“At Perpetual, we have been doing this for a long time. We're an institutional-quality investor, so we attract good-quality borrowers who are worth investing in.

“We are not of the view that rates will drop in a huge hurry – and the assets we invest in are somewhere between two to six years average maturity, so you have a longer coupon flow than your typical term deposit.

“From our perspective cash has had a good run, credit has had an even better run — that should continue, but don't fall into the trap of too much of a good thing.”

Learn more about Perpetual’s Credit and Fixed Income capabilities

Find out about Perpetual Pure Credit Alpha Fund

Questions? Contact a Perpetual account manager

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