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Michael Murphy: the questions you should ask your private credit fund

By Perpetual Asset Management

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Private credit is increasingly popular with investors, but do you really understand what you're buying? Michael Murphy explains what to look for.

- Valuation, transparency concerns
- What you need to know about private credit
- Find out about Perpetual's credit and fixed income capabilities

A boom in private credit demand as investors chase higher yields and portfolio diversification is raising concerns around how asset managers are handling valuations, fees, and transparency, says Perpetual's Michael Murphy.

The fast-growing Australian private credit market is estimated to be worth some $40 billion, prompting scrutiny from the Australian Securities and Investments Commission amid concerns that some private credit investments remain untested in market stress scenarios.

But Murphy says it's important for investors to get ahead of any regulatory changes and do their own due diligence on their private credit investments to ensure they capture the attractive returns offered by private credit without taking on unnecessary risk.

"It is important for investors to be asking questions," says Murphy, a portfolio manager in Perpetual's credit and fixed income team.

"It's only when there is real market distress that that will really become an issue – but it's something many investors haven't been thinking about and probably should ahead of that time."

Transparency, valuation

ASIC is seeking feedback on how private markets should be regulated, noting concerns about transparency, valuation of illiquid assets, and how managers are dealing with potential conflicts of interest.

Traditionally the preserve of institutional investors, who are presumed to be better placed to look after their own interests than retail investors, private credit is increasingly popular among retail investors through managed funds and superannuation.

Valuation questions

Murphy says investors should look closely at their private credit exposure to understand how their manager is handling valuation, fee structures, credit ratings, and potential risks that may not be immediately apparent.

He says there is evidence of managers leaving asset valuations unchanged despite broader market downturns – with some managers leaving asset values at par even during periods of extreme dislocation like the pandemic.

"The question to ask is: are your assets marked to market? When assets become impaired, are you marking them down to reflect that? This is the kind of thing that's fine until it's not," says Murphy.

Murphy says failing to appropriately mark down distressed loans can pose even greater risks for investors if managers are perceived to be hiding losses.

"This is important for investors - if they are marking them above what they could actually sell them for, then you create a risk of creating a run on the fund.

"If they are marked too high and there's questions around that, then the investors that are out of the door first will get a good price – but eventually, they will have to gate the fund because those aren't really the true values.

"You want people to have liquidity, but to not disadvantage investors that are staying in the fund."

Credit ratings

Murphy says some managers use self-estimated credit ratings instead of independent ratings from agencies like S&P or Moody's.

"That's a bit like marking your own homework – saying 'we like this deal, so of course it's investment grade'.

"They generally get auditor to sign off, but I don't think they really push back on those in the way you would if it was done by a proper rating house.

"The way we treat those is anything that isn't rated, we have it in a non-rated bucket and tell investors to think of that as sub-investment grade exposures, even though we think they're still really high-quality investments."

Conflicts of interest

Investors also need to watch out for conflicts of interest that can distort investment decisions away from the best interests of investors.

Murphy says some private credit managers retain a proportion of the upfront fee typically paid by borrowers to secure financing, rather than leaving it within the fund.

This can create conflicted incentives, as it may encourage the manager to prioritise deals with higher upfront fees over those with the best long-term risk-return for investors.

"You don't want investors going for deals just because they have the highest upfront fees.

"We think it's best practice to have a flat management fee, so you're aligned to investor outcomes."

About Michael Murphy and Perpetual's Credit and Fixed Income team

Michael is a portfolio manager and senior high-yield analyst with Perpetual's credit and fixed income team.

Michael manages Perpetual Loan Fund – a portfolio of private and syndicated loans that forms a crucial component of the ASX-listed Perpetual Credit Income Trust (ASX: PCI) and Perpetual Pure Credit Alpha Fund.

Perpetual offers a range of cash, credit and fixed-income solutions.

Our credit and fixed income team are specialists in investing in quality debt.

They take a highly active approach to buying and selling credit and fixed income securities and invest extensively across industries, maturities and the capital structure.

Learn more about Perpetual's Credit and Fixed Income capabilities
Questions? Contact a Perpetual account manager

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