Beyond the Bond: Alternative Sources of Income in a Low-Yield Market

By Nick Veronis
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ALTERNATIVE SOURCES OF INCOME IN A LOW-YIELD MARKET

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Bonds historically have been a foundational component of a portfolio, providing income, hedging against volatility, and diversifying risk from the stock market. But bonds have become an increasingly weak source of yield even though they still play a useful hedging role. This is problematic because a large investor cohort is entering retirement—the decumulation phase of the investment life cycle—and needs regular income.

Following more than a decade of accommodative monetary policy, traditional fixed income yields have become negligible. Average coupons on the Barclays U.S. Aggregate Bond Index1 are near all-time lows, with real returns from Treasuries firmly entrenched in negative territory and those from investment-grade corporate debt minimal at best. High-yield debt has become a complete misnomer with sub-investment grade bonds yielding just 3.1 percent at the end of 2021.2

If the factors that have negatively impacted fixed income markets prove to be persistent and structural in nature, then identifying alternative solutions to generate income and protect wealth is crucial.

Advisors or investors may therefore want to consider the often-underappreciated sources of yield available in private markets—specifically private credit and real assets. These investments historically have offered stable income streams and provided higher returns than traditional fixed income with relatively low correlation to public markets via differentiated exposure.

QUALIFIED INVESTORS CATEGORIES

Qualified purchasers: To qualify as a qualified purchaser (QP), an individual investor must have $5 million or more in investable assets exclusive of the value of a primary residence. Only 1.5 million people in the United States qualify as QPs.

Qualified clients: To be classified as a qualified client, an investor must meet one of the following criteria: (1) have $1 million or more in assets under management with an investment advisor or (2) have a net worth of at least $2.1 million exclusive of the value of a primary residence.

Accredited investors: To qualify as an accredited investor (AI), an investor must have had an annual income of at least $200,000 ($300,000 in combination with a spouse) in each of the past two years and have a reasonable expectation of reaching the same income level in the current year. Alternatively, AIs require a household net worth of $1 million or more exclusive of the value of a primary residence. An estimated 13.6 million households in the United States qualify as AIs.

PRIVATE CREDIT

Private credit loans primarily finance middle-market companies, many of which are excluded from public debt markets and struggle to source capital from traditional lenders. This opportunity set is huge. At the end of June 2021, the U.S. middle market contained nearly 200,000 companies generating more than $10 trillion in revenue. For context, on its own this would make the U.S. middle market the fifth largest economy globally.3

Data from fund manager Cliffwater shows that direct lending strategies generated cash income of 9.2 percent over the 12 months to September 30, 2021—the latest available data.5 By comparison, on September 30, 2021, the current coupon for U.S. high-yield loans was just 3.15 percent.6 This level of income from direct lending is not an anomaly; in the five-year period leading up to Q2 2021, it generated an annualized 10 percent in cash income.7

Two key advantages of private credit support these income flows and its historically robust performance.

The first advantage is that interest rates typically float with reference to a benchmark—historically London Inter-Bank Offered Rate but universally transferring to Secured Overnight Financing

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There are, however, sometimes limitations on this credit spread. Floating-rate loans may include caps and floors. As the names suggest, the cap limits the maximum interest rate that the borrower will pay regardless of the reference benchmark, and a floor sets a minimum rate to be paid even if the reference rate falls below a certain level. Irrespective of these caps, these credit spreads typically exceed those available via public markets.

The second advantage is the private lending process, which allows managers to conduct due diligence. This provides insight about the credit quality of a prospective borrower through an evaluation of critical factors such as its cash-flow profile, quality of revenue, competitive positioning within its industry, and the strength of its management team. This diligence process is extensive and can take four to eight weeks. Syndicated loan buyers, by contrast, typically rely on materials provided by the borrower’s underwriter. Private credit managers can take advantage of their diligence findings and direct negotiating positions by including strong structural protections into loan agreements, including financial covenants—typically very limited for comparable public loans—and prepayment penalties.

OUTPERFORMING TRADITIONAL FIXED INCOME

This extensive due diligence and the inflation protection offered by credit spreads have contributed to private credit’s strong total return performance relative to high-yield and investment-grade bonds over longer time periods.

For the 10-year period ending March 31, 2021, private credit outperformed the Credit Suisse High Yield Index by 180 basis points and the Barclays Aggregate Bond Index by 240 basis points. On a 20-year basis, it outperformed by an even wider margin, beating the Credit Suisse High Yield Index by 300 basis points and the Barclays Aggregate by
440 basis points. This resulted in a superior Sharpe ratio (risk-adjusted return) over both time horizons (see figure 1).

**A BROAD SPECTRUM OF STRATEGIES**

Private credit includes a variety of strategies. Broadly speaking, these fall into four major categories:

- Direct lending
- Mezzanine lending
- Special situations and distressed credit
- Specialty finance

Each of these strategies offers unique approaches to private lending with income streams and risk–return profiles distinct from one another and that of public fixed income investments (see figure 2).

**Direct lending strategies**

Direct loan origination strategies generate most of their returns from income and fall at the lower end of the risk–return spectrum.

Each of the approaches in this category pays a variable coupon, typically quarterly, providing interest rate and inflation protection, but also may generate returns via the original issue discount (OID). The OID is generated when the debt instrument is issued for less than face value. The OID typically adds 100–200 basis points to the overall return. Arrangement fees also may add incremental return. These are upfront fees paid by the borrower for the successful closing of a loan. Terms vary widely based on market conditions, the size of the loan, and the risk profile of the borrower.

Direct lending strategies generally are categorized as either real asset–based, senior secured, or unitranche lending.

Real asset–based lending is secured against hard assets, such as infrastructure and real estate, and therefore offers a lower risk profile. Senior secured direct lending typically involves newly originated loans that have a first lien on the assets of small and mid–market company borrowers. These strategies take on slightly greater risk than real asset–based lending. Unitranche direct lending is the highest risk form of originated senior debt—though overall risk remains low. It combines the terms of both first– and second–lien loans and offers a marginally higher interest rate than a typical senior secured loan (see figure 3).

**Mezzanine lending**

Mezzanine debt investments typically generate higher yields than senior loans because they are subordinate in the capital stack and not secured against assets. These investments often include negotiated structural protections to attempt to mitigate this risk, but they generally still have lower recovery rates and higher potential losses than direct lending strategies.

It is common to see mezzanine loans that pay interest with a payment–in–kind structure in which, though interest accrues over time, it is only paid out upon maturity or refinancing in one lump sum.

**Special situations, stressed and distressed credit**

Moving further up the risk–return spectrum, private credit includes special situations and stressed and distressed credit strategies. These are, however, generally more focused on capital appreciation than on producing regular income.

Special situation lending targets companies unable to raise traditional financing because of balance sheet or operational challenges, and therefore it typically has significantly higher interest rates than direct lending. Other strategies focus on the secondary market for stressed and distressed debt securities, seeking out securities trading at discounts to par value, often between 80 and 90 cents on the dollar.

Distressed investing is even higher on the risk–return spectrum and relies even less on income, involving either taking non-controlling or controlling stakes in companies with a high likelihood of filing for bankruptcy or restructuring.

**Specialty finance**

Specialty finance occupies more of a niche than other strategies in private credit, including a variety of less traditional lending activities. Specialty finance managers originate credit or credit–like investments in markets such as consumer loans, trade receivables, equipment finance, aviation leasing, litigation finance, life settlements, and royalties. These strategies typically require highly specialized underwriting and sourcing skill sets and may exhibit lower correlations with other asset classes.

**THE RIGHT STRATEGIES AT THE RIGHT TIME**

For investors seeking a secure source of regular cash yield with stronger capital preservation attributes, direct lending strategies could prove a useful addition to a portfolio—though each of the strategies could play a role given specific portfolio needs and the right market context.

Lenders have different degrees of negotiating power at various points of the credit cycle, which can affect their ability to negotiate covenants and terms. The cycle also can have a big impact on a fund’s return potential and risk profile.
Opportunities for direct lending and specialty finance strategies—and the overall risk–return profile—remain fairly consistent across the cycle. A private credit manager equipped with capital is ready to lend in most environments. Although demand for new loans falls during a recession, this is usually offset by the reduction in the supply of credit from competitors, such as banks and public syndication markets.

During or coming out of a downturn, distressed investments can generate equity–like returns, making them a useful counter–cyclical tool.

In contrast, timing is crucial for distressed and stressed strategies. During or coming out of a downturn, distressed investments can generate equity–like returns, making them a useful counter–cyclical tool. However, returns may be weak during a sustained expansion.

Mezzanine strategies, absent the protections offered by senior lending, are more exposed to losses during economic downturns, but they tend to perform best immediately following downturns when the economy has stabilized.14 As a relatively expensive source of capital, mezzanine is frequently a last resort for good borrowers when traditional lenders have withdrawn and there is a reduced supply of credit.

REAL ASSETS
Certain real assets strategies also may be good sources of regular income. Some share other characteristics with private credit, including inflation protection and returns with lower correlation to public investments.

Investing in real assets via private funds provides differentiated exposure to a large universe of tangible assets in the real estate, infrastructure, and natural resources sectors, many of which have income profiles significantly different than those available via public funds.

Real estate is the largest single segment within real assets, accounting for 51 percent of total assets under management (AUM), but this share has fallen over the past decade as investors have diversified their real assets allocations. AUM in the asset class excluding real estate has grown at an annualized 15.5 percent in the period since 2006, against 6.7 percent for real estate funds.15

REGULAR INCOME GENERATION FROM REAL ASSETS
Income is an important component of returns from real assets that helps reduce overall volatility. Both real estate and infrastructure investments, particularly in core and core–plus strategies at the lower end of the risk–return scale, may generate regular cash yield.

Core real estate strategies target stabilized, often fully leased, properties in major markets requiring little improvement and with limited leverage. These generate regular and recurring rental income for investors, and this yield accounts for the lion’s share of returns, with capital appreciation accounting for far less.

Similarly, core infrastructure strategies may generate as much as three–quarters of their returns from income. Core assets typically benefit from stable, predictable cash flow from long–term contractual payments, but they experience only modest capital appreciation.16

The composition of returns from natural resources varies, but income again forms a significant component. For example, agricultural land typically is leased on multi–year contracts, which results in regular income from farm rent in addition to the expected value appreciation of the land.

Timber investments also generate regular income during harvest. Furthermore, if harvesting occurs at a rate equal to the natural growth of the trees, then income is achieved without loss of value to the asset, which is akin to interest on principal.

INFLATION PROTECTION
The structure of income from real assets also offers a degree of inflation protection.

For example, the long–term contractual payments in infrastructure investments usually have built–in inflation escalators that help protect yields against the
impact of rising costs. Real estate investments, meanwhile, generally offer protection against inflation via the opportunity to periodically adjust rents.

The fortunes of assets in the natural resources space also typically improve during inflationary periods. Sectors such as energy and mining, with exposure to commodities priced in dollars, tend to have the highest returns when inflation is running above average, but agriculture and timber also are sensitive to price changes—and are usually components of and beneficiaries of global commodity price rises.17

This has meant that in years with high inflation—in excess of 3 percent—over the past 20 years, real assets have generated annual returns of just under 18 percent, nearly on par with that from private equity (see figure 4).18

**COMPELLING RISK–RETURN PROFILE**

This regular cash yield and inflation protection has contributed significantly to strong overall returns from the asset class over the past two decades, with comparatively low volatility.

Figure 5 shows a model portfolio of real assets for the period 1999–2020 generating an annualized return of 9.6 percent compared with 5.0 percent for bonds and 7.2 percent for public equities.19 Private equity generated an annualized 12.8 percent over the same period, though with greater volatility.

Real assets produced these returns with 9.3 percent annualized volatility or risk, compared with 15.9 percent for private equity and 17.6 percent for public equity. As a result, real assets had an attractive Sharpe ratio of 0.83, compared with 0.69 for private equity and 0.31 for public equities.20

**REAL ASSETS’ LOW CORRELATIONS TO PUBLIC INVESTMENTS**

Returns from real assets also have relatively low correlations to both stocks and bonds.

Analysis of annual return data for 1999–2020 by private–market investment firm Hamilton Lane found a correlation coefficient of 0.17 between real assets and stocks (recall that 1.0 is perfect correlation).21 The analysis also found a negative correlation of −0.22 between real assets and bonds and a mild correlation of 0.41 between returns from real assets and private equity.

This makes real assets a potentially valuable defensive allocation option in low-growth environments that also will provide broader diversification benefits. A combination of asset classes with low correlations to both public markets and other private investments can enhance a portfolio’s risk-adjusted performance.

Furthermore, the distinct and disparate risk–return profiles of sectors that fall under the collective label of real assets provide diversification within the asset class itself. This variation presents a strong case for allocating to a diversified mix of real assets investments to help mitigate risks and optimize risk-adjusted returns (see figure 6).

**INTEGRATING ALTERNATIVE INCOME INTO A PORTFOLIO**

As noted, certain private credit and real assets strategies offer the potential to generate complementary cash yields. In an era of exceptionally low public yields and uncertainty about the trajectory of inflation, diversifying income streams could prove extremely valuable for...
high-net-worth investors. In addition to having strong profiles in their own right, including robust inflation protection and strong returns, private credit and real assets provide exposure to very different borrowers and segments of the market than public fixed income instruments.

Furthermore, they also can provide diversification benefits for those already invested in private markets. For example, certain structural characteristics of private credit—including consistent cash yield and shorter duration—can mitigate some of the cash-flow challenges faced when investing in private equity.

It is thankfully easier than ever for individual investors to gain exposure to these asset classes. The number of investment options available to accredited investors and qualified purchasers has grown considerably in the past few years, particularly among interval funds, non-traded real estate investment trusts, and business development companies, which allow for frequent redemptions of a portion of their AUM. Several large, well-established firms have entered the credit and real assets markets or broadened offerings in the space, leading to increased competition, downward pressure on fees, and attractive terms that make these investments worth revisiting.

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ENDNOTES

1. The Bloomberg Barclays U.S. Aggregate Bond Index is the MSCI World Net TR USD Index, which covers approximately 85 percent of the capitalization on the London Stock Exchange main market. The index includes Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities (agency and non-agency).


4. Source: Pitchbook. 46.0 percent of fund-raising across private credit. Data from 2017 to December 30, 2021, as of January 20, 2022.


8. Source: Eaton Vance, PIMCO, Callan. For every 1 percent increase in rates, the price of a bond falls for every year of duration. The current duration of the Barclays U.S. Aggregate Bond Index is 6.5 years, with a 2.5 percent coupon. A 1 percent increase in rates would cause bonds to fall approximately 6.5 percent. This is equal to more than two years of income.


11. Source: Hamilton Lane via Cobalt, Bloomberg. Data as of September 2021. Indices used: Hamilton Lane Private Credit with volatility de-smoothed; Credit Suisse High Yield Index; Barclays Aggregate Bond Index. Geometric mean returns in USD. Assumes risk free rate of 2.1 percent, representing the average yield of the 10-year Treasury over the past 10 years.

12. Credit Suisse High Yield Index is a market-weighted index that tracks the performance of the public, U.S. dollar-denominated high-yield debt market.

13. Source: Hamilton Lane.


16. Source: Hamilton Lane. For illustrative purposes only.


18. Source: Hamilton Lane. For illustrative purposes only.

19. Source: Hamilton Lane. Real Assets Portfolio weighting—the Real Assets Portfolio uses the following indexes to create a portfolio with the following weightings: real estate, 40 percent; energy, 20 percent; infrastructure, 15 percent; mining, 10 percent; agriculture, 7.5 percent; timber, 7.5 percent. Real estate uses the NCREIF Property Index (NPI), a quarterly time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only. All NPI properties have been acquired, at least in part, on behalf of tax-exempt institutional investors, the great majority of which are pension funds. As such, all properties are held in a fiduciary environment. Source: Bloomberg. Energy uses the Cobalt Energy Manager Universe, which includes all private energy energy managers during 1987–2020 that Hamilton Lane clients are invested with either on an advisory or discretionary basis. Source: Cobalt. Energy also uses the S&P Oil & Gas Exploration & Production Select Industry Index, which comprises stocks in the S&P Total Market Index that are classified in the GICS oil and gas exploration and production sub-industry. Source: Bloomberg. Infrastructure uses the Cobalt Infrastructure Manager Universe, which includes all private equity infrastructure managers during 1994–2020 that Hamilton Lane clients are invested with either on an advisory or discretionary basis. Source: Cobalt. Agriculture uses the NCREIF Farmland Index, a quarterly time series composite return measure of investment performance of a large pool of individual farmland properties acquired in the private market for investment purposes only. All properties in the Farmland Index have been acquired, at least in part, on behalf of tax-exempt institutional investors, the great majority of which are pension funds. As such, all properties are held in a fiduciary environment. Source: Bloomberg. Timber uses the NCREIF Timberland Index, a quarterly time series composite return measure of investment performance of a large pool of individual timber properties acquired in the private market for investment purposes only. All properties in the Timberland Index have been acquired, at least in part, on behalf of tax-exempt institutional investors, the great majority of which are pension funds. As such, all properties are held in a fiduciary environment. Source: Bloomberg. Mining uses the FTSE Small Cap Index, an index of small market capitalization companies consisting of the 351st to 619th largest-listed companies on the London Stock Exchange main market. The Index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group. Source: Bloomberg. Mining also uses the FTSE 350 Mining Index, a market capitalization weighted stock market index incorporating the largest 350 mining companies by capitalization on the London Stock Exchange. Source: Bloomberg. Also used is the MSCI World Net TR USD Index, which covers approximately 85 percent of the free float-adjusted market capitalization.
across the World Developed Markets equity universe (large and mid-cap) (source: Bloomberg); the S&P GSCI Industrial Metals Index, which provides publicly available investment performance from the industrial metals market (source: Bloomberg); the S&P GSCI Precious Metals Index, which provides publicly available investment performance from the precious metals market (source: Bloomberg); the Cobalt Mining Manager Universe, which includes all private equity during 2006–2020 that Hamilton Lane clients are invested with either on an advisory or discretionary basis (source: Cobalt). Private equity uses the Cobalt Private Equity Manager Universe, which includes all private equity during 1979–2020 that Hamilton Lane clients are invested with either on an advisory or discretionary basis. Real estate, fund-of-fund, and secondary managers/ investments are excluded. Source: Cobalt. Stocks use the S&P 500 Index, a basket of 500 of the largest U.S. stocks, weighted by market capitalization. Source: Bloomberg.

20. Ibid.
21. Ibid.

IMPORTANT INFORMATION

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