



IMAP Independent Thought Podcast

Episode 36: Private Credit - It's in the way you use it!

Join our host Scott Fletcher (Woodbury Financial Services) accompanied by Nehemiah Richardson (Pengana) & Sarang Kulkarni (Vanguard Active Global Credit Bond fund) discussing:

Thinking about portfolio construction !

- Benefits and challenges of investing globally vs investing in domestic credit markets
- Macro and fundamental backdrop for global credit investing over the year ahead
- Public vs private credit ... or both?

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Scott Fletcher - Woodbury Financial Service (00:18):s

Hello and welcome to our IMAP podcast, and my name's Scott Fletcher, Chief Investment Officer of Woodbury Private. And today we'll be talking with two highly experienced credit portfolio managers and credit investors from Vanguard and Pengana Credit.

And it's quite an opportune time, I think, to be talking about global credit and it's interesting that we have Sarang as you are on the more on the public side, if I can put it that way. With Nehemiah, you're on the private side, so it should be a good discussion.

First of all we're joined by Sarang Kulkarni, who's the lead portfolio manager of the Vanguard Active Global Credit Bond Fund, and he joins us from London. So he is made the trip, especially for this <laugh>, I probably don't think so.

And Nehemiah Richardson, who is the Chief Executive Officer of Pengana Credit and lead portfolio manager of the Pengana Global Private Credit Trust. So gentlemen, thanks very much for joining us.

So just to start off with, I thought I'd just get you to give an introduction to yourselves.

Starting with you Sarang, Vanguard is a name that is very well known for passive investing or index investing.

Given it's an active credit fund, just talk us through the approach and how that fits within Vanguard overall in terms of the investment capability?

Sarang Kulkarni - Vanguard (01:44):

Yes, that's a very good point. I mean, active investing is not new at Vanguard. In fact, the very first fund that Vanguard launched was an active fund, and in the fixed income space, we have been managing bond funds since the early nineties. So that there is a long track record.

And in the last 10 or 15 years, there has been definitely a big commitment and a big push towards growing the active side of the business. Today, if I look at our bond funds, we probably have between three to \$400 billion US dollars under management, which probably puts us in the top contract fund managers in the world. But as you said, that's not really well known.

Scott Fletcher - Woodbury Financial Services (02:32):

Quite absolutely. And could you just walk us quickly through or briefly through your approach to generating credit return, or credit alpha?

Sarang Kulkarni - Vanguard (02:42):

Yes, over the years that I've been managing credit mutual funds, I have seen that a lot of managers tend to treat it as a macro asset class and as a result of which they take a very top down approach.

And what ends up happening is because of the correlations that you see between different markets and different sectors within fixed income, you end up with just one or two big bets in the front. And when you get one wrong, the other one doesn't really compensate for, and at the same time, what they're doing is that they're leaving a lot of money on the table.

So the approach which we have is to, as far as possible, try it and avoid taking big direction bets, and we look for these undervalued opportunities in global credit markets where we can drive performance by looking at universe premium spreads where other people are not really paying that much attention.

Scott Fletcher - Woodbury Financial Services (03:44):

Sure. And Nehemiah, I'll turn to you and just ask the same question. Could you just walk us through your approach at Pengana Credit to generating credit return; credit alpha, which in the private market means something different, of course. What's your approach to these sort of issues?

Nehemiah Richardson - Pengana (04:06):

Yes, so just stepping back very quickly, our reason for being was really to try to bring access to the global private credit asset class, and what it brings to investors portfolios.

But to do so in a way that allowed for non-institutional investors to access it on a diversified basis. Because there's a lot of barriers or obstacles to being able to do that, if you're not a significant institution.

And within that, what you have is an illiquid asset class that delivers really nice yields, really good capital preservation, really nice “risk to volatility trade off”. And with that you can get a lot of performance dispersion, between managers. So this is the way that we invest, and this is why we partnered with Mercer, who most would know is a significant global advisor and allocator is to be able to unpick, and really look through where are the managers?

Nehemiah Richardson – Pengana (05:17):

Because I think this comes down to two things generating alpha here.

Number one is diversification. Because in diversification, what you're really trying to do outside of the fact that it's an uncorrelated asset class to what you find in most portfolios, whether it's very low correlation to fixed to traded credit, but within that you want to diversify because there can be performance dispersion across different types of managers, different types of strategies, which you want to eliminate.

So number one is really about the diversification of portfolios by manager. Which is why we are a fund of funds.

And secondly, to be investing in fund structures that have their own wide diversification by single name, so you're not driving concentration in any one name or any one industry.

And then also the second point is really about manager selection. And this is just as important, if not more important, because having a manager that has clear history and demonstrated performance through market cycles is really critical in this space.

And mainly you'll find that those who've been around a long time who have scale and diversified portfolios, who have proven track records of selective origination, really good portfolio management, and very good workout capability are the ones who can really give you the alpha and private credit, which is really about minimising net loss.

Scott Fletcher - Woodbury Financial Services (06:46):

Yes, just thinking about a portfolio construction. So I think if we get to the deeper layers in the onion so to speak, about your sector positioning and things like that, but we just start at the higher level.

Just interested in your thoughts when it comes to portfolio construction.... why is global credit and appropriate core holding in your opinion for a fixed income sleeve?

Sarang Kulkarni - Vanguard (07:16):

Yes, when we talk to our clients about the needs of fixed income in their portfolios, it boils down to four key points.

The first point is they want to source of income and fixed income, we design for that. And, you know, for a very long time there wasn't really much income in fixed income, but now it's yields are higher at a much more attractive level yield, they have come back to being up for stock plays, you're getting paid more in bonds than you are getting in bank deposits.

So from an income perspective, that is definitely good.

The second point is liquidity and you know the public bond markets are the largest markets in the world, so it's ,quite easy to have great allocation changes from one sector such as public markets into another.

Sarang Kulkarni - Vanguard (08:05):

And so that's another attraction for clients. If they want to make allocation changes based on like their own sort of like macro outlook or the views on duration or quality, they can do that quite easily.

The third aspect is returns. And 2022 for public markets was weight testing, because it started off with very low risk premium built to the asset price. It was ended up with a risk premium actually being quite attractive. And if you look at the environment that we're going into, and most of the scenarios that we look at, you can get cash plus returns from investment grade fixed income, which I think is going to be really hard to argue for a number of other asset classes.

Sarang Kulkarni - Vanguard (08:54):

And the last point is about diversification from equities. I mean, you really need a defensive asset that is going to hold its value in the event that you actually do get a sell-off in the equity market.

And public fixed income traditionally has played that role. It struggled to play that role in 2022, but given the yields are back to being a very attractive level. And we can go back to playing those roles. So it's hard to get these four objectives in any other asset class. And that's why you won't have this as a holding, but we can go into the benefits of global, and global definitely has a lot of advantages. And a lot of that is just when you're looking for some of these good risk adjusted opportunities where you can basically get high returns for the same amount of risk, but you take lower risk for the same amount of return you can find more of them in corporate global than state domestic.

Scott Fletcher - Woodbury Financial Services (09:54):

And Nehemiah, I'll throw the same question to you. Maybe if we just join the two together there as Sarang went through it. When it comes to private credit I'd say that there's a lot of listeners on the advice side to this podcast, and there are a lot of approaches to different private credit managers and so forth. Just your views on private credit, what to look out for, what to be aware of when thinking about locating as a core holding in a "fixed income sleeve" in a portfolio.

Nehemiah Richardson - Pengana (10:33):

Yes, sure. I think firstly we have a lot of choices.

So the first choice is Australia versus global. Okay. And I'd say that the key differences there are in the US and Europe, you have a real structural opportunity that's been driven by bank withdrawal of credit into various segments through, as a result of regulation that was really about getting rid of liquidity mismatches, right?

And what you have in Australia is more subordinated credit, or credit where banks do not have risk appetite. It's less so the fact that the regulator's actually trying to drive a change in the mismatch. So that's the first thing, which is why you'll see a very different sort of risk profile.

Number two, you then say, okay, well where do I play in strategy?

Nehemiah Richardson - Pengana (11:27):

And there are three predominant strategies in global profit credit being"

- direct lending, which is mid-market corporate lending, which is where you've had that structural opportunity.
- second is in structured finance, which is a structural opportunity, but with different return drivers.
- And then thirdly, credit opportunities, which is really distressed debt and special situations fund, that tend to be more closed than IRR accumulation funds.

So within that, in strategy, do you want a focus on income? Do you want to focus on capital appreciation or some of both?

So you have different choices that you can choose depending on your return and liquidity requirements. If I say on the risk averse, high income capital preservation end of the equation, that's where you really see direct lending.

Nehemiah Richardson - Pengana (12:25):

Not all direct lenders are playing in the same place and provide the same opportunity.

So what I mean by that is where you really want to play, there are managers who have long track records of history through cycles, number one.

Number two, that they're actually playing in the core, the real core part of the mid-market and predominance of their portfolios. So what do I mean by that?

I mean the space in the market where companies don't really have alternatives to credit, so it's either sub-economic or they're not able to access traded credit.

What they call upper mid-market is larger managers who compete with the bank syndicated or with the leveraged loan market.

So there's a very different risk reward trade off that you get when you're competing with the traded credit market versus the pure illiquid part of the market.

Nehemiah Richardson – Pengana (13:21):

And that's of critical importance, because you'll find that managers who play in that illiquid space, if you look back to the GFC, will have had both, (if you look at the GFC), they would have had net asset values that might've been written down 5% that realized net losses of less than 50 basis points, and were paying cash yields of around 10%. meaning your net return, even in Covid, even in GFC, coming out of those funds, because of the high income and the very good capital preservation characteristic would've been 5, 6 or 7%.

So I just point that out that the key message here is make sure you really understand in each one of those buckets, the manager selection, where they actually play, and what their historical performance has been against that strategy.

And if you really want to be where the best bits are, you want to be where you have a structural gap, and you're not competing with traded credit markets, because they have very different deal structuring, very different protections than what you would get in the illiquid kind of private credit side of the market.

Scott Fletcher - Woodbury Financial Services (14:28):

Great. And Sarang going a level up I guess on the macro and fundamental backdrop, we've seen so many changes geopolitically macroeconomically over the couple of years, but particularly over the last say 6 to 9 months with US elections, and policy questions and all sorts of things.

How are you (Vanguard) more broadly looking at the challenges some of those fundamentals, and the fundamental backdrop?

We do hear a bit about valuations in terms of high yield spreads being quite tight, those sort of things. So if you just give a feel for how you are seeing the world for global credit investing, things like valuation psychological factors market, those type of factors.

Sarang Kulkarni - Vanguard (15:20):

I'll start off by saying that in the credit market, opportunities generally come out of volatility, that not everything can be treated the same way.

And sometimes that does what happen. So you can find some really good opportunities, a really cheap price risk at different points of the cycle we can take it from the macro picture, I think that's a really interesting point, because from six months ago, I think the outlook that most people was quite predictable

I think soft landing was considered the best case, but I'd probably say in the last couple of months, it's anything but predictable with everything was happening in geopolitical front, and the changes that that might happen on the back, so there will be like a lot of volatility that does come up.

Sarang Kulkarni - Vanguard (16:14):

I think you have to look at the outcome in terms of what are the different possible scenarios and try to look at how that's really being reflected in asset prices and valuations.

And so when you look at see credit valuations, you've got to look at that in context of what's actually being priced in other parts of the market.

And I do think credit spreads are tight, but you know they have been at a tighter level, and they've stayed like that for a longer period of time. So it is quite possible we will stay in a narrow range for a reasonable period of time.

That's one scenario that you are looking at. And another kind of scenario you're looking at is, you could see like a small soft phase in credit markets, but public markets is where the advantage comes in.

Sarang Kulkarni - Vanguard (17:03):

From a total return perspective, any kind of selloff and spreads could be compensated by rally in the underlying yields market. As a result of which you might be getting somewhere closer to 8 to 9% returns as total returns in that kind of scenario.

And we looked at possible selling options. So I think when we look at risk premium that cause different asset pluses and you go back over time to see, have they been in similar kind of positions in the past and how would that play out?

Then I do see the relative value, equity was premier, credit premier, term was premier, it was very similar to what you saw towards the end of 2000.

Sarang Kulkarni - Vanguard (17:57):

And if you look at the performance of like credit versus equities are up point in time like credit outperform where equity bonds like 10 to 15% over a six to 12 month horizon.

So even though spreads can be tight, the yields are actually really quite attractive.

I mentioned before about the roles that fixed income plays in adviser portfolios. I mean, it's **definitely practical to playing that**. And you know, that's why public has difference scenarios, and different outcomes.

The only one you're got to be worried about for fixed income is if inflation comes by and central banks start hiking again.

Scott Fletcher - Woodbury Financial Services (18:43):

Nehemiah, your views on the outlook that you are seeing for global private credit over next 12 months?

Nehemiah Richardson - Pengana (18:54):

I look at it this way, just really simplistically, which is we live in a way more volatile world with way more uncertainty. And when you have someone in the White House who every day is creating some different potential policy or executive order that makes it very difficult to predict the direction of anything.

That just means a lot more uncertainty, and a lot more volatility.

And so within that context, I think it's important for people to introduce robustness into portfolios and that's where I think private credit fits in well and really on two bases.

Number one if you want to get the best out of it with the best managers, what you want is people who, like I said before, have differentiated origination robust fund structures where you have very diversified portfolios, people who skew to sectors that are more resilient and non-cyclical, which may be a little bit tricky in some cases, but for the most part are way more predictable.

And staying away from consumer discretionary. You have resilient deal structures where managers control the positions, are senior secure, they have a lot of equity cushion that actually helps to support the senior risk that they take. Very tight documents, with great lender protections around covenants to allow them to at least intervene and change the game if they actually need to.

Nehemiah Richardson - Pengana (20:31):

For companies that go off track when things are inherently uncertain (because they always are anyways) that's oointone.

And then point two, it's just making sure you have a diversified portfolio, right?

That's why I think you don't want to take single manager risk.

You don't want to take one single segment of the market risk, which is why the way we think about things that, and go to credit is we have senior direct lending and we diversify by geography, you know, us and Europe, we skew to managers who are

playing in the structural gap and we diversify across managers, because we want to actually have diverse portfolios, and where you minimize the set of managers who have the same names in all of their portfolios, which is why we focus on bilateral.

And then, I guess the final piece is, we do take exposure with multi managers who have the ability to play in dislocated markets, because when you actually have an all-weather portfolio because of the illiquidity, you want the ability at the margin to be able to take advantage of dislocation, which is way easier to do obviously in traded credit markets than it is in private markets.

Nehemiah Richardson – Pengana (21:39):

So we have managers that have numerous strategies that allow them to take advantage of that. And then finally we do have a master fund, and within that fund we also have closed end funds that play distressed and special situations, types, strategies on a closed end basis.

So when things go crazy, and you have downsides in markets or companies that get into distress for not necessarily their operating reasons, but more for balance sheet structural reasons, then as an example, we have the ability to get super returns out of those who take advantage of that situation.

And that's we constructed a private credit portfolio that plays all of those strategies. So in a way we worry about it, but we don't worry too much about it because, because of where we sit in the capital structure, and the diversity we have across strategies and managers.

Scott Fletcher - Woodbury Financial Services (22:34):

Thank you. We're just approaching the end of the podcast, so Sarang I'll go to you first in terms of portfolio positioning. So Nehemiah, you made a good about dislocation markets, and where to from here, potential for more dislocation. And generally you're finding that because of the increased variance, or width of the scenario sets that investors are facing. What sectors, regions are you favoring? What are you more cautious about?

Sarang Kulkarni - Vanguard (23:10):

So in terms of style, we don't really focus about top down allocation. So I'd probably say from a regional perspective, this is largely driven by valuations.

We did have a stock preference, that we grew up in the US and that's actually been doing really well. And I think it's getting close to best value.

You know, when we look at a very high level, we look at the quality of the European index versus the US index. You find that credit terms are very similar, but the European index is a lot shorter in terms of duration. So you should be seeing European markets trading inside US market. I mean, of course if people are worried about like the fundamental deterioration of Europe, you should see that come through in the difference in credit quality.

Sarang Kulkarni - Vanguard (24:01):

But I think generally in the case of Europe, people are more scared than actually does transpire. European companies are extremely well diversified globally and have access to one of the deepest capital markets that they have there.

So as a result of which, most of them been able to hold onto their credit quality quite well, but you know, they trade a proper premium that's becoming tight. Yes, I see some good opportunities at emerging markets because of everything that's happening on the geopolitical front. As I mentioned, there has been a lot of volatility in that space, and with the volatility you do get some more opportunities.

We are finding better opportunities in emerging markets, but our “bread and butter trades” are finding things that we think are like structurally undervalued and could focus in on a recent one we had like the Australian utility AUSGrid where their bonds in Euros were trading extremely cheap according to our estimate.

Sarang Kulkarni - Vanguard (25:06):

And if they have another refinancing in the Euro market, the spreads of the existing bonds, and the new bonds have tightened. So those are kind of trades we try to talk about it, apologies if you are not a cricket fan, but we're not trying to like step up and hit sixes and fours on every one, as this is not a 20/20 cricket gig, this is a test match and you have to carefully wait for your opportunities and just keep the score ticking along.

Scott Fletcher - Woodbury Financial Services (25:40):

Yeah, absolutely. And if there's any Americans listening, we could use home run or something like that. I'm a bit of a cricket fan <laugh>.

So Nehemiah just your views on this in terms of taking a step back when we see approaches in the market from private credit managers and a lot of advisors would be seeing this, as I mentioned before it's often Australian private credit, which brings you pretty quickly into the real estate private debt world, which has its own particular idiosyncrasies.

How does your positioning in your global private credit fund cross over with the Australian type of exposures that a lot of investors may currently have? Or does it, should I say?

Nehemiah Richardson - Pengana (26:35):

When you say cross over, just make sure I understand the question. How does our portfolio cross over or how did the asset classes crossover?

Scott Fletcher - Woodbury Financial Services (26:44):

What is your portfolio in terms of preferred sectors, regions and what are you cautious about? Are you cautious about some of those more real estate credit driven sectors?

Nehemiah Richardson - Pengana (26:55):

So firstly I'd say we don't invest in any Australian private credit. We're purely global, okay?

And that's really because right from the start, we always thought when you look structurally at what's happened in the US and Europe, it's the risk adjusted returns you get and where you play in the capital stack, and where you have a structural opportunity where banks have withdrawn means through your managers you're quite selective about where you want to play, which is why you have a skew to defensive industries, who are very predictable companies and place and companies that really

don't have many alternatives for credit finance to grow their businesses. And that gap is only widening. So that's the first thing I'd say.

Nehemiah Richardson - Pengana (27:48):

So there really isn't any crossover with Australia.

A way of thinking about it is, you can diversify your overall credit budget in Australia in trading credit and with global, (I would say everybody should be looking at global because of the risk reward trade off that you get).

Secondly, if you said we're within that, would you invest?

I think today there's kind of two important dynamics. I think number one is if you want to get the best out of the asset class in the US you want to play with managers who are more in core direct lending, meaning you are not playing with managers who have a significant skew in their portfolios to the part of the market where private credit and traded credit are becoming a bit more liquid. Because illiquidity premiums there are probably 50 basis points when say two years ago they might have been a 100 to 250 basis points.

Nehemiah Richardson - Pengana (28:42):

If you looked at core mid-market where you don't have that phenomenon, you're still capturing between 200 and 300 basis points of illiquidity premium and on a really nice senior secured package.

So that's number one.

Number two, Europe versus the US. Its a different industry structure, because it's very hard to build a pan-European platform. The preservation of the illiquidity premium is, is higher and if you're invested with the right managers in that market, you're probably picking up a little bit more premium today.

And then thirdly there's the whole structured finance bid, which I would say bucket that more into real assets because there you're talking about pools of assets, some could be financial, some could be hard assets.

You know, in the environment where you have all of this uncertainty and potential volatility based on changes in policies and terrorists, et cetera.

Nehemiah Richardson - Pengana (29:41):

Structured finance is also quite a good place to be in private credit, because not only do you get the illiquidity premium, you get a complexity premium because it's way more specialised lending.

And it's a place where a lot of banks are trying to move pools of assets to shore up capital and get more capital efficiency in an environment where the regulators are imposing higher capital requirements on them.

So I think that's why we think about this as a multi-strategy approach. But I think it's really those 3 places you want to focus on.

If you're investing in the asset classes, corridor lending in the US, you want some exposure to Europe, and because of the structural differences that you get.

That additional premium for risk and then thirdly in structured finance.

Scott Fletcher - Woodbury Financial Services (30:26):

Right. The final question so this will test your abilities to play nicely in the sandbox. It's not often you get private and public credit experts on the one phone call.

So public versus private or both. So I'll switch the order and Nehemiah I'll let you address that question and then Sarang you can speak.

Nehemiah Richardson - Pengana (30:50):

Well, I think there's two parts to that.

Number one is you really have to be clear on what your liquidity budget is, and what you're trying to get out of the investment in the portfolio.

So within that context, I have a preference personally to prefer credit only because unless I can find a manager that will always capture yield to maturity for me in traded credit markets, because that's, for me, my bias against fixed income was, (unless I bought direct physical bonds myself to hold them to maturity), was being invested in open-ended funds, that weren't appropriately managing the yield to maturity so that you're not subject to the daily liquidity, and the "fear factors" of people trading in and out, so you don't capture it.

Nehemiah Richardson - Pengana (31:43):

So I think there's a place for fixed income in every portfolio, because it's daily liquid and it does give you real liquidity, if you need liquidity daily, it should be in the asset class.

My second point is around liquidity. And, for us in our funds, we provide quarterly liquidity or we have daily liquidity through the market and our listed trust, but it's a more illiquid asset class and you pick up a premium.

So you have to decide how much volatility tolerance do you want to pay for the liquidity versus how much illiquidity premium do I need for less liquidity, but with more stability.

So I think there really is a place for both depending on where you're at in your investment life, accumulation versus decumulation, et cetera.

Scott Fletcher - Woodbury Financial Services (32:33):

Sarang ?

Sarang Kulkarni - Vanguard (32:34):

I definitely think there's a place for both. I guess in terms of the issues that one has to think about is, that because we're in such an unpredictable macro environment, there are scenarios in which things look good, and there are scenarios in which things look not good.

And my preference is to be able to exit positions rather than get into a complicated workout situation. So there's a role for both.

For example I don't know what it's like in Australia, but in the UK a lot of people have these "buy to let" property investments. I'd rather own a private credit fund over like a "buy to let" property.

But as I said, you do want to have a part of your portfolio, if things are not going to plan, it can give you some diversification against your other holdings, and you can get out of that position if the situation is actually getting deeper. So that's why there's a role for both.

Scott Fletcher - Woodbury Financial Services (33:33):

Well, that was extremely well behaved on both your parts. <laugh> So on that note we might wrap it up there.

We're out of time, so **Sarang Kulkarni** from **Vanguard**, thank you very much for joining us today and **Nehemiah Richardson** from **Pengana Credit** again thanks..

And I'm **Scott Fletcher** from **Woodbury Private** and to those listening in. Thanks for joining us and until next time bye for now.

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