Antares Capital

Five *in* Five

Antares' Head of Asset Management, Vivek Mathew, sits down with Ed Cass, Chief Investment Officer of CPP Investments for a five-question discussion on portfolio construction, opportunities ahead, the attractiveness of private debt and more. CPP Investments is a global investor managing one of the world's largest pension funds on behalf of more than 21 million contributors and beneficiaries of the Canada Pension Plan, with total Assets Under Management of C$576B as of September 2023.

1 CPP Investments has a somewhat different approach to portfolio construction than many of its peers. Would you describe your philosophy regarding portfolio construction and risk management?

Yes, we differ from a lot of our peers from the perspective that instead of targeting a specific return, we begin by targeting an appropriate market risk appetite. So, when we approach portfolio construction, we think about how much risk we should take to generate sufficient investment returns. From there, we then build the total portfolio focused on diversification and look to areas of the market where we can earn alpha.

We've worked to implement a strategy with enough flexibility for a range of macro conditions – the sign of a well-constructed portfolio is when an investor can weather storms without being pushed off course. We analyze the fundamental risk / return factors that underlie each asset class and strategy that we invest in to identify our preferred mix of exposures. Based on that analysis, we then optimize the portfolio to maximize returns for our targeted risk level.

On the risk management side, we take an integrated approach that allows us to create and safeguard value. We mitigate risks, including geopolitical, by monitoring how they can impact our assets and investment strategy, assess how they evolve to determine the likelihood of tail scenarios occurring, and undertake stress tests to quantify how these scenarios may impact the portfolio.

2 Where do you see opportunity in the market?

Right now, we are seeing opportunity in credit. We feel that credit looks attractive, especially relative to equity valuations and earnings growth expectations.

What's interesting is that credit for a while was tracking the equity risk premium. The equity risk premium started trending down about six to eight months ago. Credit followed it a bit but then diverged. You've seen the equity risk premium continue to collapse whereas credit spreads have actually started to move out a bit.

If you think about dynamic capital allocation and where it might be attractive to allocate capital, there are compelling reasons to go into credit where you get a historical risk premium. From a tactical basis, it strikes me as not a bad entry point.

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***Edwin Cass**, Chief Investment Officer, CPP Investments*

3 What do you find attractive about private credit?

We see private credit as offering attractive risk-adjusted returns as it continues to be a very important part of our portfolio. In private credit today, the level of spreads look attractive and historical loss ratios are low, so it's a good time to be an investor.

Private credit is interesting right now because you have a lot of money coming into the asset class. I think that's driven by this big theme out there that banks are no longer going to be the warehousers of credit products. Banks want to originate, want to get paid a fee and want to distribute afterwards. Banks want sustainable earnings without being exposed to the variations in the overall pricing instrument afterwards. You're seeing that across the market, and I think that's why you have so much money going into private credit right now as people are anticipating this kind of broader move away from banks.

While there have been a lot of new entrants into the private credit space that have taken advantage of banks retreating from the syndicated market, one thing to consider is that a new, smaller fund isn't going to have the same risk management, oversight, governance and procedures compared to a larger, more established manager. We have had a long period of relatively forgiving market conditions and low default rates, but as stress levels rise we will no doubt see a greater dispersion of performance among lenders.

4 What are some of the characteristics you look for in a private credit manager?

If you take a look at how we evaluate who we partner with on the private side, for example we own 83% of the equity in Antares Capital, I'd say there are probably four key drivers that we examine. These factors have been reliable predictors of a manager's capacity to consistently generate returns going forward.

Sourcing:
Sourcing is tremendously difficult. You have to have trusted relationships, you have to be shown deals, that's key.

Underwriting:
The ability to underwrite transactions and make sure that you're getting paid the appropriate amount for the risk that you're taking is critical to being successful.

Asset management:
What we're finding more and more through a lot of our private investments is that it's not just what you bought, it's how you can work with that investment over time to improve your prospects of success. On credit, obviously that comes down to workouts, or what happens when the credit goes bad. Managers with robust workout capabilities are in a much better position to be successful.

Portfolio management:
How well-diversified are the investments? How recession-resistant are the industries within the portfolio? We try to ensure we have a large portfolio where no position is larger than 1% which helps to significantly mitigate downside risks.

I think all investors that are trying to get into private credit should focus on the track record of the manager. What are the competitive advantages they have? Are those things going to be persistent? Then really trying to lock up those relationships with those partners that you do feel are best in class. We've found that that's just tremendously predictive of future success.

5 Do you think the U.S. Federal Reserve can achieve a soft landing?

It's been hard historically to achieve a soft landing. You certainly can't look back at historical evidence and say there are many examples of it happening, perhaps one or two. The overwhelming historical evidence is that monetary policy acts, but it acts with a lag. However, the timing of when the lag will impact the economy remains very difficult to forecast.

During COVID-19, the government was transferring a substantial amount of money to households. Then they began transferring money to corporations in the form of fiscal stimulus. Trying to predict the speed at which the stimulus dollars flow through the economy is really complicated. So those two things go a long way to explaining why this cycle has been different, why demand has stayed stronger than perhaps we would have anticipated. But these things have a runway as well. Household wealth is almost down to zero. The Inflation Reduction Act is potentially a bit more open-ended. But when we look at the impact of rates finally biting, we think that it's inevitable and it probably happens within the next 6 to 12 months.

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