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## Unlocking Portfolio Potential:

# The Power of Private Credit

- An elevated correlation between stocks and bonds has created portfolio construction challenges for investors over the last two years, highlighting the need to incorporate investments decorrelated from traditional assets.
- Public equities and fixed income have idiosyncratic headwinds that will continue to present structural portfolio construction challenges.
- Private markets have grown significantly and offer diversification and potential return benefits.
- Private credit is an all-weather investment well positioned to deliver attractive risk-adjusted returns in the current macroeconomic environment.

Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

JANUARY 2024

# Overview

For decades, portfolio construction has been influenced by a single ratio: 60/40. Investors believed that a portfolio of 60% stocks and 40% bonds constituted the ideal mix to achieve balanced, risk-adjusted returns. However, with 2022 resulting in one of the worst years on record for the 60/40 portfolio, many investors are reevaluating the standard asset allocation model and its relevance in the context of the current investment environment.

At a basic level, the logic governing the 60/40 portfolio is that bonds, by virtue of their low and sometimes negative correlation to equities, would serve to dampen portfolio volatility and reduce drawdowns. However, as investors learned in 2022, when fundamentals shift, so can the relationship between these two asset classes.

The market dynamics that existed following the global financial crisis (GFC) provided a favorable backdrop for the 60/40 portfolio to flourish. Now though, investors find themselves in a new interest rate regime with the Fed espousing a protracted period of restrictive monetary policy.

So, what does this mean from an asset allocation perspective? Investors need to be cognizant of the growing risks in embracing a potentially outdated asset allocation approach and recognize how the evolution of the private markets could provide a valuable tool to weather this new investment construct.

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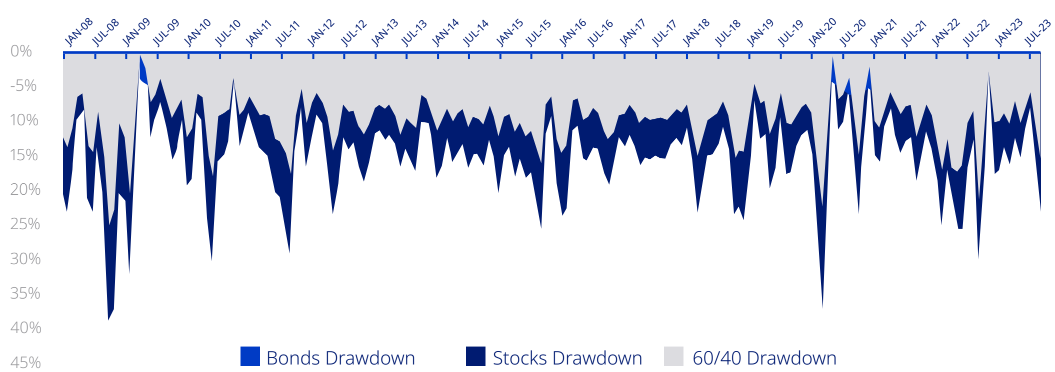
# A Bygone Era?

The idea of a 60/40 portfolio is rooted in "Modern Portfolio Theory" ('MPT'), where Harry Markowitz proposed that the optimal portfolio from a risk-reward perspective should incorporate both return expectations and correlations between asset classes. Under this framework an ideal portfolio consisted of any two assets with positive return expectations but low correlation to one another. Theoretically, both assets would rise over time, while their respective gains or losses would offset one another to smooth portfolio performance, thereby minimizing risk. The optimal MPT portfolio applies allocations among available assets so that expected returns for each unit of risk are maximized. In a portfolio consisting of stocks and bonds, the optimal MPT blend was 60% stocks and 40% bonds.

Secular tailwinds for fixed income provided a favorable backdrop for 60/40 portfolio performance. A benign inflationary environment in the decade following the global financial crisis (GFC) allowed the Fed to embrace loose monetary policy and implement quantitative easing, suppressing long dated bond yields and leading to a protracted bull market in equities. In this environment, bonds performed as well or better than expected, helping to dampen portfolio volatility and minimize drawdowns *(Figure 1).*

**FIGURE 1**

**Max Drawdown[1]**

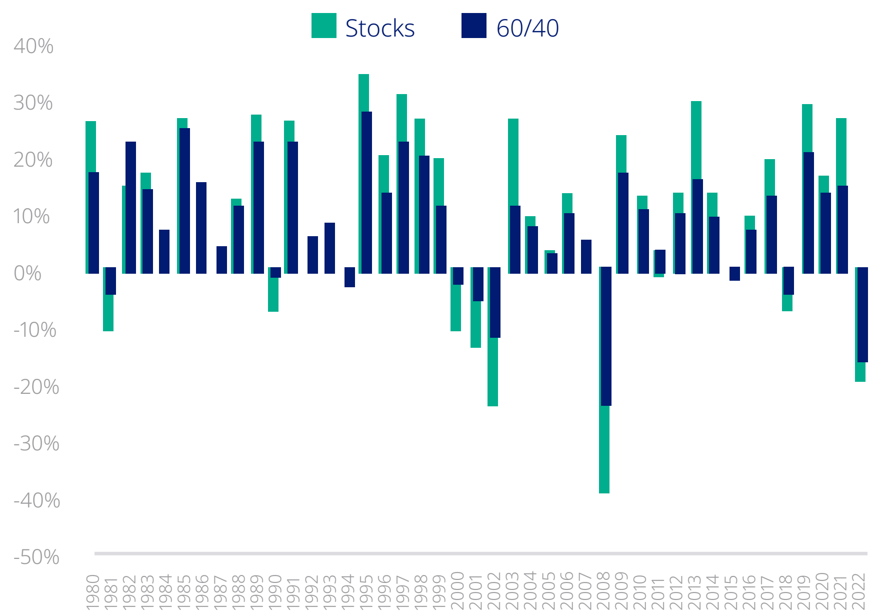



However, many of these tailwinds for the 60/40 portfolio have now become headwinds. Investors today are unfamiliar with how to navigate a higher inflationary regime and unconditioned to a hawkish Fed imposing restrictive monetary policy and the resulting repercussions that it has for traditional asset classes.

(1) Bloomberg. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

**FIGURE 2**

## Annual Performance[2]




In 2022, the 60/40 portfolio lost ~17% and delivered only 300bps outperformance vs the S&P 500. For context, in 2008 the 60/40 portfolio outperformed the S&P 500 by ~1500bps. With both stocks and bonds moving in tandem more over past few years than any time since the mid-90s, it would be surprising if the disappointing performance in 2022 was an aberration *(Figure 2)*.

Going forward, both stocks and bonds each face their own idiosyncratic challenges that result in a structurally challenging framework for the typical 60/40 portfolio. Therefore, it's unlikely that a 60/40 allocation will provide the same benefits to a portfolio that it previously had. Consequently, we believe that an attractive framework for navigating this new macroeconomic regime, improving risk-adjusted performance and portfolio diversification is to incorporate alternative investments.

(2) Bloomberg. Stocks are represented by the S&P 500 Index. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

# Challenging Times for Traditional Asset Classes

## Fixed Income: In need of a Fix

Restrictive monetary policy, elevated correlation to equities, increased debt issuance and waning foreign Treasury demand are just a few of the obstacles fixed income investors must contend with. As investors learned in 2022, when the fundamentals change, so can the role of those assets in a portfolio.

With core inflation remaining entrenched, it appears that investors are starting to come around to the notion that interest rates will remain elevated for an extended period. Looking at market pricing of Fed funds for the next few years, interest rates are only anticipated to decline by ~150bps *(Figure 3),* bottoming out around 4% in 2025, a stark difference from zero interest rate policy (ZIRP) that investors were accustomed to. With bonds having experienced a protracted bear market, it might seem prudent for investors to start contemplating increasing their allocation to long duration assets. While we believe long duration fixed income will always have a place in an investor's portfolio, investors should be prepared for the fact that fixed income volatility is likely to remain elevated because of this new interest rate paradigm. The MOVE index, which is a market-implied measure of Treasury bond market volatility, continues to hover at elevated levels and is likely to stay high if inflation remains entrenched *(Figure 4).* Therefore, fixed income might not provide the same level of portfolio benefits that it did in previous cycles.

FIGURE 3

**Rates Expected to Remain High[3]**

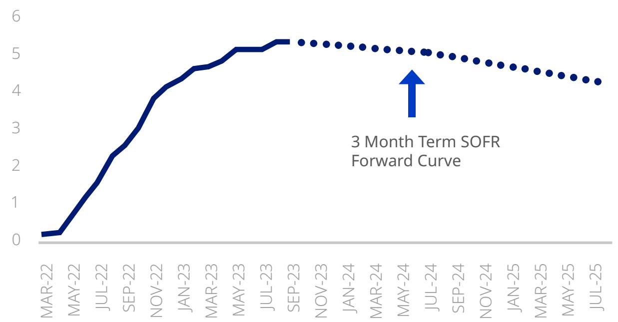
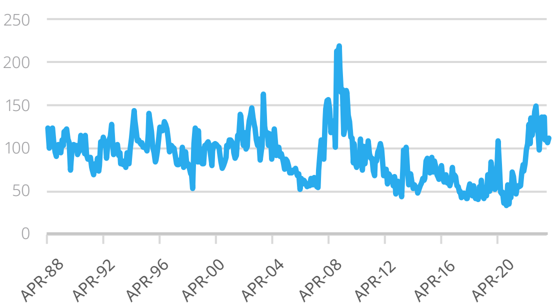



FIGURE 4

**MOVE Index[4]**




(3,4) Bloomberg. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

This sustained increase in volatility will support a higher term premium, or the excess compensation investors require to hold longer duration bonds, which will continue to put upward pressure on yields. In the post GFC era of low rates and quantitative easing (QE), the term premium was less relevant because the Fed suppressed volatility. Fed balance sheet expansion mitigated interest rate risk allowing for the term premium to fall below zero. Now, with a pickup in rate volatility, it's likely for the term premium to remain elevated *(Figure 5)*.

Some of the technical factors contributing to a higher term premium include a ballooning budget deficit, the Fed commencing quantitative tightening and waning foreign demand for longer dated Treasurys. Treasury debt issuance is anticipated to continue to rise as restrictive Fed policy has driven up yields on government debt, making it more costly to finance the budget deficit and legislation such as the CHIPS Act. According to the Treasury Borrowing Advisory Committee, auction sizes on average are expected to increase 23% across the yield curve in 2024, resulting in what could be a record year for Treasury bond issuance.

**FIGURE 5**

**Treasury Term Premia[5]**

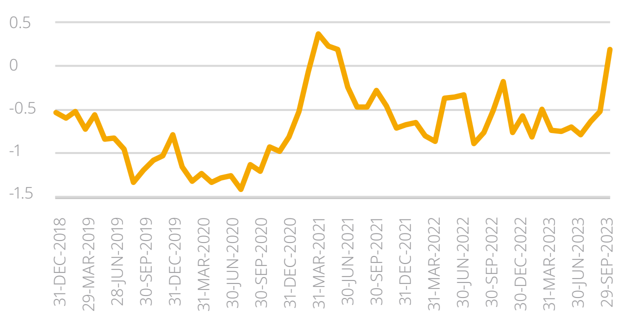
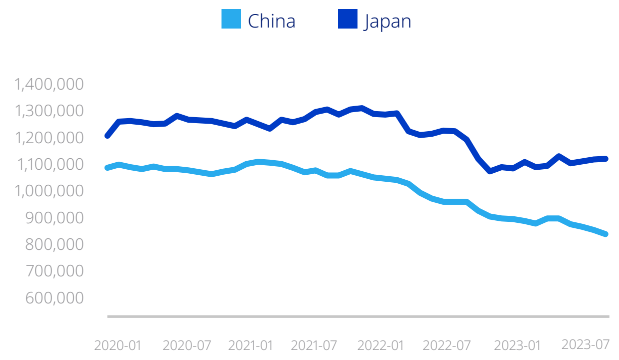



**FIGURE 6**

**U.S. Treasury Holdings ($BN)[6]**



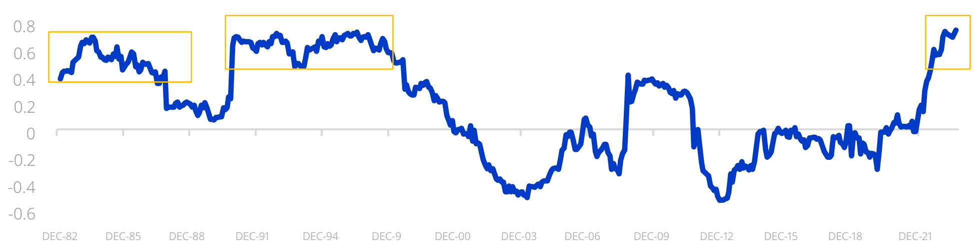

The Fed is also shrinking its holdings of Treasurys, necessitating bigger government sales to other buyers. Unfortunately, this is occurring at a time when foreign demand is shrinking. The two largest foreign holders, Japan, and China, have monetary policies and economic woes causing a reduction in demand for U.S. government debt. Japan is exiting its yield curve control policy framework and the slowdown in China's economy has resulted in fewer dollars to recycle into Treasurys, which further contributes to the need for increased issuance. China has now sold Treasurys in 20 of the last 22 months with total holdings dipping to levels not seen since 2010 *(Figure 6)*. This is likely to translate into bigger swings when the government auctions its securities at a time when banks have diminished appetite for market making, exacerbating volatility in the market.

(5) Federal Reserve Bank of New York. (6) U.S. Department of Treasury TIC data. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

Increasing volatility is not the only portfolio construction challenge for fixed income. The correlation with equities has historically increased during periods of higher inflation. With entrenched core inflation, it's likely the current uptick in correlations we have witnessed over the last year will persist for some time. Fixed income is typically thought to act as a 'shock absorber' through being decorrelated to other asset classes. However, looking at historical data, fixed income has not always acted as a portfolio diversifier. There have been long periods where correlations between equities and bonds have been high which limit the downside protection *(Figure 7)*. It is also important to factor the role quantitative easing played in suppressing yields after the GFC, as it likely led many investors to overstate the importance of fixed income as a portfolio diversifier. Confronted with these dynamics, investors should consider how alternative investments can provide the portfolio diversification benefits that fixed income traditionally provided.

FIGURE 7

**Rolling 3YR Stock / Bond Correlation[7]**




## Equities: All about the beta

Like fixed income, equities have their own idiosyncratic challenges that investors must factor into portfolio construction. With inflation and higher discount rates eroding real returns and increasing concentration within public market indices reducing the opportunity set, there are portfolio implications from both a return and diversification perspective.

(7) Bloomberg. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs.
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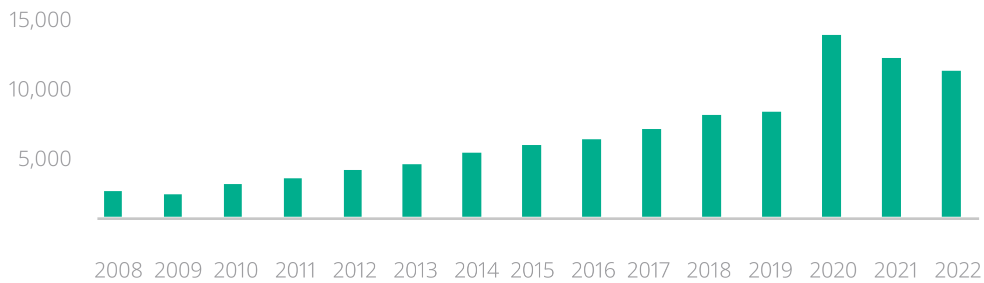
The universe of public companies is shrinking, with the number of publicly listed companies traded on U.S. exchanges falling from a peak in 1996 of around 8,000 to just 3,700 companies today. The decline in the number of publicly listed U.S. companies has been driven mainly by increasing M&A activity. Of U.S. companies with over $100M in revenue, 87% are private.[8] Therefore, most of the growth and innovation that would traditionally occur post-IPO is now occurring in the private markets. Additionally, because of a robust VC ecosystem and changes in the regulatory landscape, many early-stage companies are forgoing their initial public offerings and staying private for longer. The boom in private equity fundraising is likely to support a continued decline in public market listings and further facilitate startups staying private longer *(Figure 8)*.

One of the consequences of fewer high growth public market companies has been investors piling into a handful of stocks that offer attractive earnings growth. As result, the top 10 companies now comprise over 30% of the S&P 500 index. Performance is therefore dependent on only a handful of companies, leaving investors with the difficult choice of either being concentrated in a select group of stocks or being more diversified and risk underperforming the S&P 500. To contextualize this, through the first three quarters of 2023 the S&P 500 was up 11.68% while the S&P 500 equal weighted index was only up 0.27%.

**FIGURE 8**

**U.S. PE Backed Companies[9]**




(8) S&P Capital IQ. (9) Pitchbook LLC. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

Compounding the portfolio construction conundrum equity investors face is that the equity risk premium (ERP), or the return pickup from investing in equities compared with bonds, has been steadily declining for much of the last 18 months. This is due to a narrowing in the spread between the S&P 500 earnings yield and the U.S. 10-year Treasury yield.  This means that equities are increasingly more expensive relative to bonds. Over the past two decades, the risk premium has averaged 331bps; but at the current level of 57bps it is at its lowest point since 2002, suggesting the long-term risk-reward in equities is very unattractive *(Figure 9)*.

These dynamics make it difficult for investors to find alpha in equity markets today, so investors should view equities increasingly as a source of beta. To find alpha, investors should consider investment opportunities available in the private markets and evaluate how they can help overcome some of the current portfolio construction obstacles.

FIGURE 9

**Equity Risk Premium[10]**


(10) Bloomberg. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

# Private Markets: A Viable Alternative

Private markets have grown at around 13.5% CAGR since 2000, with the diversity and breadth of private market offerings providing investors tools to dampen overall portfolio volatility, enhance returns and reduce cross-asset correlations. At the most basic level, private market investments are assets or financial instruments that are not listed on an exchange and covers a broad universe *(Figure 10)*. Traditionally only available to institutional investors, innovation in fund structures, such as evergreen funds structured as non-traded business development companies (BDCs), permits retail investors to incorporate private markets more easily into a portfolio and access many of the portfolio benefits institutional investors have long enjoyed.

While both public equities and fixed income will always play a role in a portfolio, the headwinds these asset classes are confronted with would make it prudent for investors to evaluate incorporating private markets in a more meaningful way. Private markets, however, are not homogeneous and when considering an investment, it's important to understand the different risk-return profiles private market offerings may have. Two of the largest private market asset classes, private credit and private equity, have generally outperformed comparable public market investments over the last two decades and offer a superior expected risk-adjusted return profile *(Figure 11)*. With enormous scale and breadth, both private equity and private credit can serve as suitable substitutes to public equity and fixed income.

**FIGURE 10**

**Private Markets Growth ($ BN)[11]**

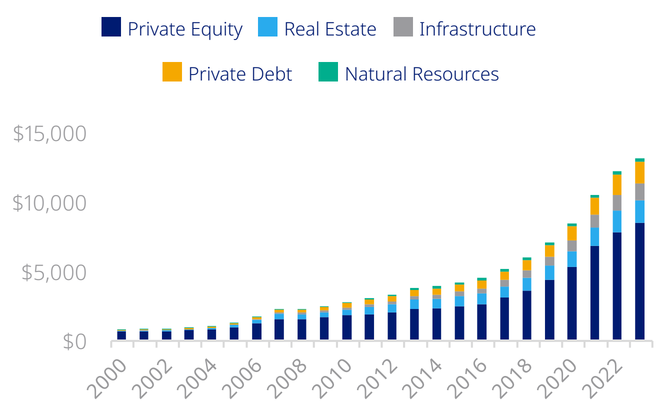
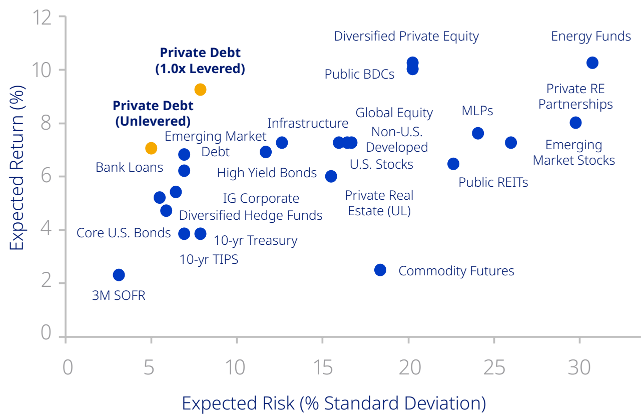



**FIGURE 11**

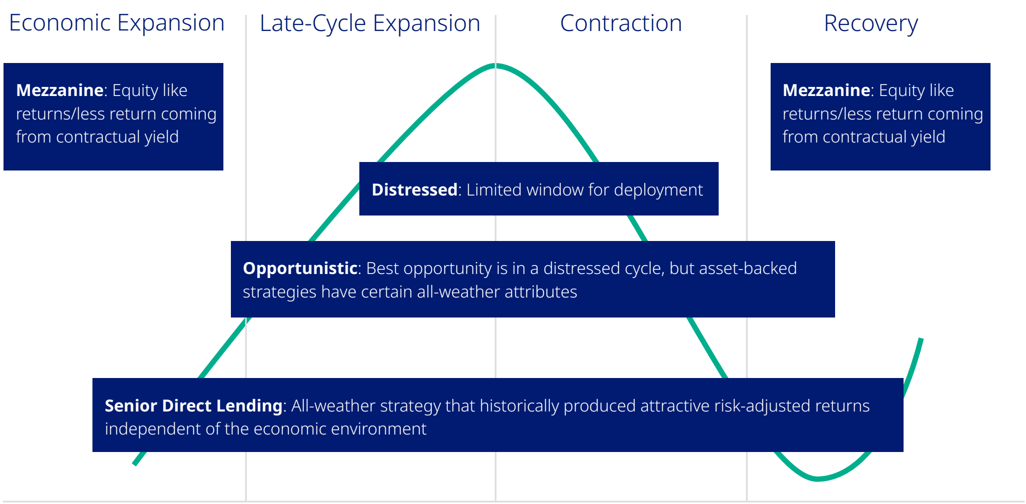
**Asset Class Expected Return[12]**




(11) Preqin. (12) Cliffwater LLC published July 2023. Reprinted here with permission. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

FIGURE 12

## Private Credit Strategies




However, in the current macroeconomic environment, we believe that investors should consider increasing allocations to more inflation resistant assets that are decorrelated from traditional markets, such as private credit. Private credit has historically demonstrated outperformance relative to public fixed income across economic cycles, with much lower volatility. Against an economic backdrop that has many hallmarks of a late cycle economy, investors should employ a more defensive posture and evaluate how private credit can be a powerful tool to improve risk-adjusted performance.

Private credit consists of multiple sub-strategies with varying risk-return profiles *(Figure 12)*. Direct lending, the largest sub-strategy within private credit, entails providing a senior-secured floating rate loan to a company in a private transaction. These companies range from medium-sized to large corporates and are often backed by private equity firms.  Within direct lending, managers traditionally specialize in either the lower middle market, which is defined as companies with less than $25 million in EBITDA or the core to upper middle market, comprised of companies with $25-100 million in EBITDA. More recently, as the asset class has matured, direct lenders are now capturing significant market share from banks in large corporate direct lending, as larger companies are attracted to the reliability of financing solutions not subject to public market volatility.

We believe that because direct lending has a historically low correlation to traditional assets, provides a natural inflation hedge via floating rates and the loans are senior in the capital structure, it serves as an all-weather investment best suited for the current investment landscape. Other strategies, such as mezzanine, where credits are typically fixed rate and subordinated in the capital structure or distressed, which lacks scalability and has high performance dispersion, may not provide predictable returns given heightened economic uncertainty.

Direct lending strategies compensate investors for the added complexity and illiquidity in the form of an illiquidity premium. Direct lenders are often able to achieve higher origination fees and coupon rates because borrowers are willing to pay a premium for certainty of execution *(Figure 13).*

FIGURE 14

## Average Annual Loss Rate (2011- 2022)[14]

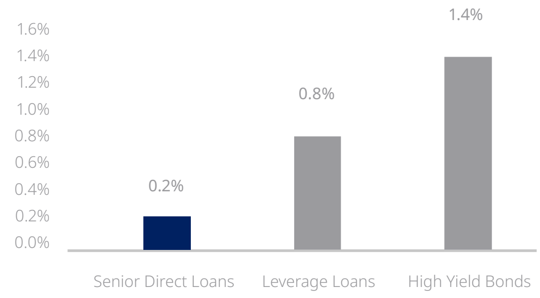
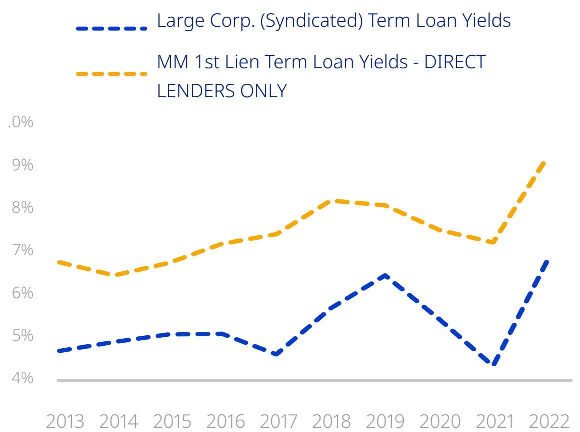



FIGURE 13

## 1st Lien Term Loan Yield Premium (3-Year)[13]




Direct loans deliver a stable stream of income to a portfolio through regular interest payments, mitigating the "J-curve" effect because once loans are made, coupon payments begin and provide cash distributions back to investors. Furthermore, the floating rate nature of direct loans helps to protect investors from rising rates and inflationary pressures. This is because direct lending coupons rise as interest rates increase, generating higher current income for investors. Direct loans tend to be the senior-most debt in a company's capital structure, typically secured by first-lien claims on assets which, in an adverse scenario, can result in lower loss rates and higher recovery rates *(Figure 14).*

(13) Refinitiv LPC. (14) Cliffwater LLC and Fitch. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

The increased income investors receive in a higher rate regime helps to insulate against potentially higher losses that typically result from a slowing economy. Protective covenants aid lenders in identifying early indications of financial stress and allow them to proactively address issues to better maximize recovery value in the event of a default. Direct loans are generally not marked-to-market which helps to lower their volatility profile. The sponsor-backed nature of direct loans also provides downside protection because in times of financial stress, the private equity sponsor may provide additional equity infusions to help the borrower remain solvent. Historically, the unique attributes of direct lending deals have translated into a return profile that is decorrelated from public equity and debt markets and less sensitive to the overall macro environment, resulting in direct lending outperforming public fixed income alternatives during both recent bull and bear markets *(Figure 15).*

In the current market environment, where public market volatility has resulted in subdued public credit issuance, direct lenders with available capital and access to steady deal flow are well positioned to benefit. Additionally, larger companies are showing a willingness to borrow at a premium to ensure certainty of execution, allowing managers to underwrite higher quality businesses with the operating models and balance sheets to weather economic growth and inflation headwinds. Furthermore, capital structures are more conservative as sponsors are "over equitizing" deals to put capital to work, allowing for direct lenders to underwrite deals with lower leverage and loan-to-values, establishing ideal conditions for private credit managers to be highly selective and prudently deploy capital *(Figures 16 & 17).*

**FIGURE 15**

**Private Credit: Whatever The Weather[15]**

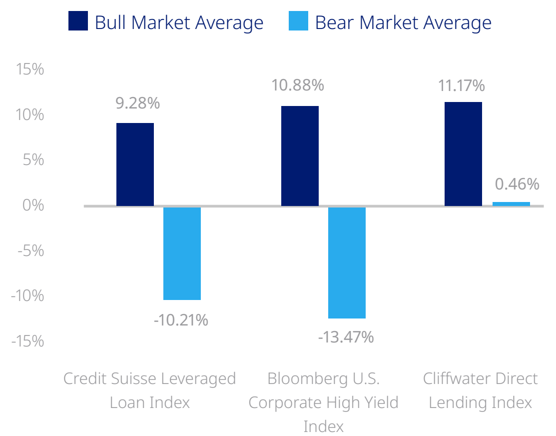



**FIGURE 16**

**Avg. Issuer Total Debt/EBITDA for Non Bank Lenders[16]**

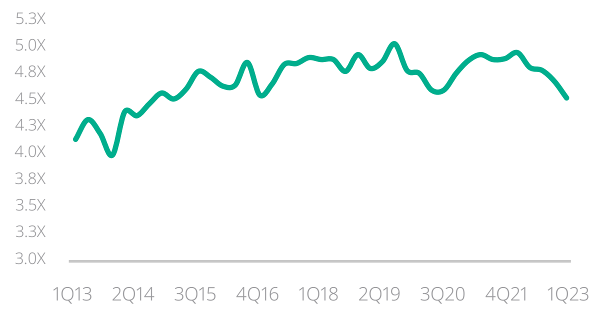
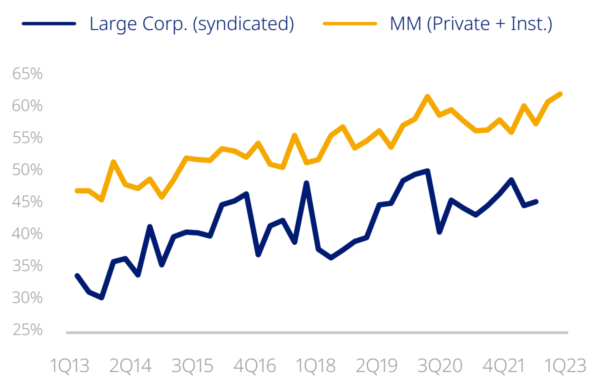



**FIGURE 17**

**LBO Total Equity Contribution Comparison[17]**




(15) Pitchbook and Cliffwater LLC. (16,17) Refinitiv LPC. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

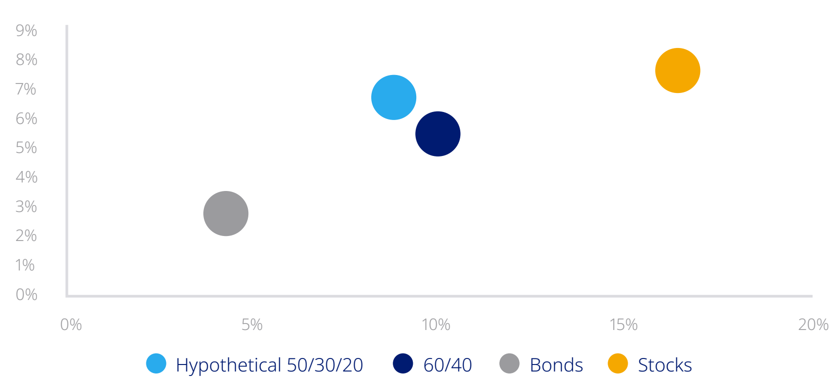
# Allocating To Direct Lending

Given the all-weather benefits and strong fundamentals, direct lending remains highly attractive. There is however not a perfect answer as to what constitutes the appropriate allocation to direct lending strategies, as every investor has unique circumstances. For illustrative purposes, if an investor were to allocate 50% to stocks, 30% to bonds and 20% to direct lending, they would achieve significantly better risk-adjusted performance relative to the historical performance of a 60/40 allocation *(Figure 18).*

A 20% allocation may seem aggressive, especially given the fact that many investors remain substantially under-allocated to alternatives. However, this allocation reflects the upper bound of what some leading consultants recommend and consistent with what some large institutional investors have implemented.[19] We believe that the macroeconomic regime we are experiencing warrants a considerable allocation to assets that can improve portfolio diversification and reduce volatility. Other private market capital preservation strategies, such as real estate and infrastructure seek to deliver predictable returns similar to private credit, but we believe given the availability of semi-liquid vehicles, private credit offers an attractive option to quickly scale an allocation for both high net worth and institutional investors.

FIGURE 18

**Annualized Risk / Return (Jan 08 - Jun 23)[18]**




(18) Bloomberg and Cliffwater LLCS. (19) Institutions such as Arizona State Retirement System (ASRS) allocate ~70% of their credit exposure (~$8B) to private credit. Cliffwater LLC, a leading consultant, recommends a 15-25% allocation to private credit for institutional investors. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

Furthermore, if investors were to adopt this asset allocation strategy, they should not fear that reducing equity exposure will result in portfolio underperformance even if we are witnessing a new secular bull market. To illustrate this point, a hypothetical portfolio of 50% stocks, 30% bonds and 20% direct lending would have outperformed a 60/40 portfolio by 31% since 2008 with significantly lower volatility. *(Figure 19)* Additionally, investors should not worry about having to time their deployment. Looking across a 5-year time frame, direct lending consistently outperforms public market fixed income and equity investments, suggesting a deliberate approach to capital deployment would not serve as a drag to portfolio performance *(Figure 20).*

**FIGURE 20**

**Worst 5 YR Annualized Performance (Dec 04 - Dec 22)[21]**

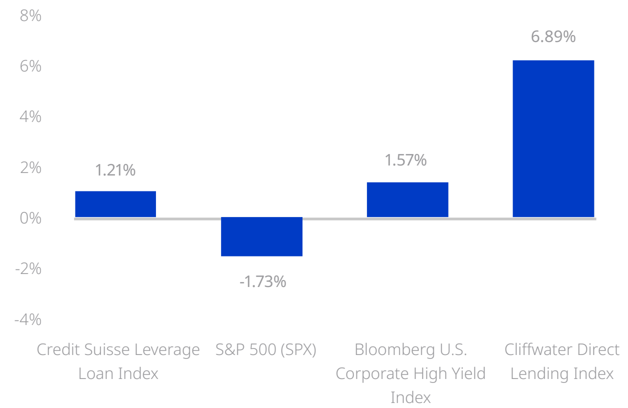
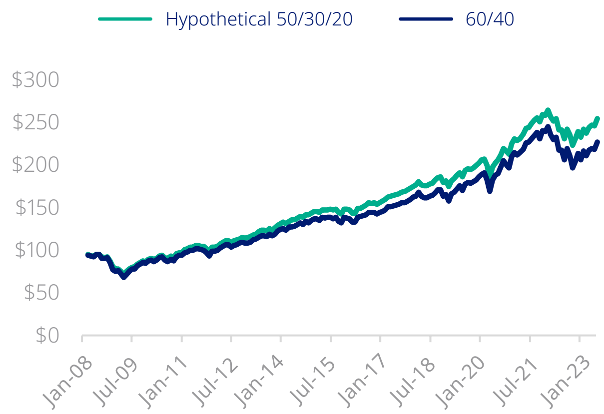



**FIGURE 19**

**Growth of $100 (Jan 08 - Jun 23)[20]**




(20,21) Bloomberg, Cliffwater LLC and Pitchbook. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

# Conclusion

We believe that investors must take note of the of the new environment we have entered. The portfolio construction framework that worked in the prior decade, might not be suited for an environment with persistent inflation, elevated interest rates and a lasting positive correlation between stocks and bonds. A secularly tight labor market, de-globalization and geopolitical uncertainty are inflationary forces investors must contend with. In our view, an attractive way to construct a portfolio to overcome these challenges is to meaningfully incorporate investments such as private credit into a portfolio.

As investors think about incorporating private credit into their portfolio, it's important to understand that all managers are not created equal. Dispersion of performance varies significantly based on the skill and experience of the manager, making finding the right partner critical. With heightened economic uncertainty, it's important to select a fund manager with numerous levers they can pull to ensure portfolio stability. Private credit managers with stress-tested investment processes and experienced workout teams are better equipped than many newer entrants to manage portfolios in times of volatility and combat potentially higher default risks.

## About Antares

Founded in 1996, Antares is an experienced and cycle-tested alternative asset manager and a leading provider of financing for PE-backed borrowers. With one of the most seasoned teams in the industry, Antares is focused on delivering attractive risk-adjusted returns for investors and creating long-term value for stakeholders. The firm manages $64B+ of capital under management and administration as of June 30, 2023, and maintains offices in Atlanta, Chicago, Los Angeles, New York, Toronto and London. Visit Antares at **www.antares.com** or follow the company on LinkedIn at **http://www.linkedin.com/company/antares-capital-lp.** Antares Capital is a subsidiary of Antares Holdings LP, (collectively, "Antares"). Antares Capital London Limited is an appointed representative of Langham Hall Fund Management LLP, an entity which is authorized and regulated by the Financial Conduct Authority of the UK.

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