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FUND FINANCE FRIDAY

Learning to Live with Lower for Longer

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The low yield environment is backing long-term investors into a corner. “Pension World Reels from ‘Financial Vandalism’ of Falling Yields,” a *Bloomberg* headline aptly summarized in late August. While stock indices are up nicely year-to-date, the rally in bonds presents profound challenges to liability-matching investors in 2019. Nearly a third of government and corporate debt globally trades at negative yields, according to a recent *Financial Times* estimate.

Negative yielding debt holds important implications for fund lenders. We expect to see more fund-level asset leverage deployed to counter declining investment returns. Large investors may also turn towards portfolio leverage to aid returns and free up buying power ahead of a dislocation. Finally, as low rates persist, pressure to move farther out the risk spectrum will continue for funds, investors and lenders.

Declining government bond yields necessarily filter into expected returns for all asset classes. But you don’t have to be an adherent of modern portfolio theory to be a believer: 2019 has seen a parade of down-round IPOs – initial public listings at valuations below the implied value at the last round of private fundraising – and of private-to-public listings that settle into trading ranges below the IPO price. Public markets, in these cases, have been more willing to be critical of valuation than private investors and so call into question exit assumptions.

Dry powder, sitting at a record $2.44 trillion at mid-2019, according to Preqin data, may also weigh on future returns because it signals steep competition for assets. Funds face pressure to deploy capital in an environment of high valuations, slowing growth and low returns. At the same time, private funds manage to an 8% preferred return component under a structure that dates back to the decade of "Cheers," Drexel Burnham Lambert, big hair bands and 10-year Treasury yields between 9% and 11%. The preferred return, initially intended as proxy for the risk-free rate, is now five times higher than the 10-year Treasury yield.

Given this backdrop, we expect that more sponsors will turn to fund-level asset leverage. Fund-level leverage allows sponsors to prioritize asset quality while at the same time defending returns. While generalizations in this area are of limited value, over the past two years or so, we've seen low attachment point NAV facilities price at an average margin of around 280 bps over LIBOR and hybrid facilities at roughly 240 bps. While these margins are comparable to what's available in the corporate loan market, fund-level facilities can (1) finance a variety of asset types, (2) look to a dynamic pool of assets as collateral, including future acquired assets, and (3) offer one-stop shopping logistical and cost advantages compared to financing individual assets.

These benefits may become more appealing to U.S. funds over time as low yields persist. Based on internal data, a full 60% of the fund financing originations in Europe our team has worked on in 2019 consists of NAV or hybrid facilities. The ECB's euro area 10-year government bond yield index has held below 1% over the past four years. If Europe is a forerunner in the low yield paradigm, the European fund finance experience may well be instructive to U.S. lenders.

Pressure on returns is not unique to funds. Pension plans posted median returns of 6.47% for the year ending June 28, 2019, according to data from Wilshire Trust Universe Comparison Service. Since then, the challenge has only intensified. In August, high yield bonds of 14 European issuers crossed below 0% on a yield-to-call basis. Defined-benefit pension funds are particularly exposed to the shift lower in returns.

Not surprisingly, portfolio leverage at pension funds seems to be gaining interest. CalPERS CIO Yu Ben Meng is reportedly considering leveraging the fund's portfolio. This is not a new discussion at CalPERS, but one that may be gaining traction. (A June presentation summarized how the use of fund leverage could play a role in bridging a market dislocation without forced asset sales). Canadian pension funds have led the way in using fund level leverage, often employing an array of borrowing tools under tight overall constraints on leverage.

Where does this leave fund lenders? We think lenders should consider defining their mission broadly. Fund lending, from our vantage, will increasingly encompass more than subscription lines. Lenders that thrive may be those that solve today's challenges facing funds and their clients. While today's risk-and-return environment is demanding, we see continued opportunities for growth and innovation in the fund finance market.