Alternative credit: the next big portfolio building block?

The past decade has seen a lot of changes in the financial markets. One has been the rise of alternative credit, an area where there are now lots of opportunities to be found.

Alternative credit encompasses a number of different sub-asset classes, including distressed debt, structured credit and direct lending, and is an increasingly popular choice among investors.

Rooted in the great financial crisis

Like many market developments, the rise of alternative credit can be traced back to the great financial crisis. Banks were forced to become more careful about who they lent money to as regulators imposed stricter rules to make the financial system more stable and increase banks' capital buffers. But companies still needed access to finance, leading other institutions such as pension funds to step in and provide the capital that companies need.

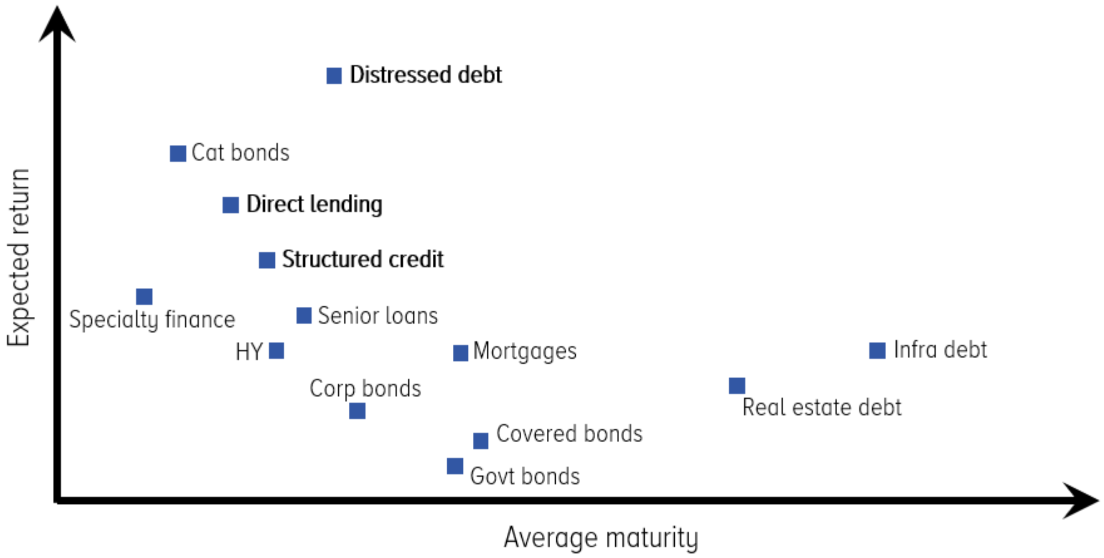
Two big benefits

Why has alternative credit become so popular among investors? We see two main reasons.

First, over the past few years the yields of traditional forms of fixed income have hit all-time lows, which means standard bonds are simply unable to provide the returns that many investors need. What's more, with limited further upside potential, they're no longer the safe haven that they used to be.

Investors have therefore been forced to look elsewhere. Alternative credit is a highly attractive option, providing a yield pick-up of 100–500bp[1] relative to traditional forms of fixed income depending on the credit rating.

The fixed income universe of opportunities



Source: Kempen, Jan 2021. Illustrative representation

Second, alternative credit provides good diversification benefits. Not only do its returns have a relatively low correlation with those of traditional bonds and equities, it also provides useful diversification of counterparties. That's because it involves lending money to different kinds of borrowers, such as smaller businesses and households – something that isn't possible with most other asset classes.

A sustainable option

With sustainability moving to the top of many investors' agendas, it's good to know that alternative credit provides plenty of scope to invest responsibly. Green bonds are increasingly being issued in several alternative credit asset classes, and sustainable benchmarks have been made available. It's possible to exclude issuers with poor sustainability profiles and still build a balanced alternative credit portfolio.

Turn to an experienced manager

Alternative credit provides some compelling benefits, but of course it involves some potential drawbacks too. For example, it's generally less liquid than traditional credit markets, and also more complex.

That means finding the best opportunities requires a lot of time and expertise, which makes turning to a skilled manager very important.

[1] Source: Kempen, Jan 2021

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