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The Power of the Pivot

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Public markets sprint while private markets crawl. This has rarely been more evident than in the first six months of 2022 when nearly all public markets have sprinted lower, yet private markets have only exhibited limited re-rating.

You can count on one hand the number of times that stocks, Treasuries, and credit have moved down together in this magnitude and for such a sustained length of time. Interestingly, private markets have not adjusted to nearly the same extent. While volumes in both private equity and private credit have slowed, valuations and credit terms have been slower to react. This is exactly why we have always argued that to truly be opportunistic, investors need to be able to pivot between both the private and public markets.

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Opportunistic investing takes advantage of the mispricings across markets that are created by strict investment mandates, forced technical selling, and short-duration capital. During benign periods like we saw in 2021, lofty equity multiples and rock-bottom interest rates led to attractive relative value in private credit. Borrowers who did not have access to traditional sources of capital sought the flexibility of private lenders that could tailor solutions to meet bespoke needs. This created an opportunity to negotiate terms with downside protection and upside participation that were not available in public markets.

However, with many public instruments now down 10-25 points this year, there has been an incredible adjustment on the public side. Investors have responded to the twin fears of higher inflation and increased odds of recession by selling risky assets and shunning longer-duration fixed income. While this reaction is logical, it is within these wholesale sell-offs that we look for opportunities.

Whenever markets move quickly, there are bound to be mispricings. In particular, large moves in the credit market tend to affect similarly-rated instruments equally, even though there are often significant differences in business and credit quality among them. By maintaining research on hundreds of credits, experienced investors are able to quickly assess which securities are best of breed and identify these diamonds in the rough.

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It is markets like these that highlight the truism that "purchase price matters." Investors typically assess return by comparing it to risk. In credit, this usually means comparing the amount one can earn from coupons and repayment of principal relative to the amount one can lose if a company defaults. As debt purchase prices move lower (in terms of cents on the dollar), the cost gets closer and closer to the ultimate default recovery value. In other words, there is less and less downside should that default occur. On the other hand, the more of a discount from par at which you buy an instrument, the more potential upside there is if the company ultimately recovers.

Purchase price matters so much because as it goes down, not only do you reduce your downside, but you also increase your upside. Yet, ironically, it is often when prices are declining that investors with shorter-term capital who are facing redemptions or with strict mandates who can no longer own such a security are most inclined to sell.

Over the long term, we believe that each of the private and public markets will at varying points in time offer compelling opportunities. Having the flexibility to pivot between the two and tactically capture both of these return streams should ultimately yield the best portfolio life-cycle results.