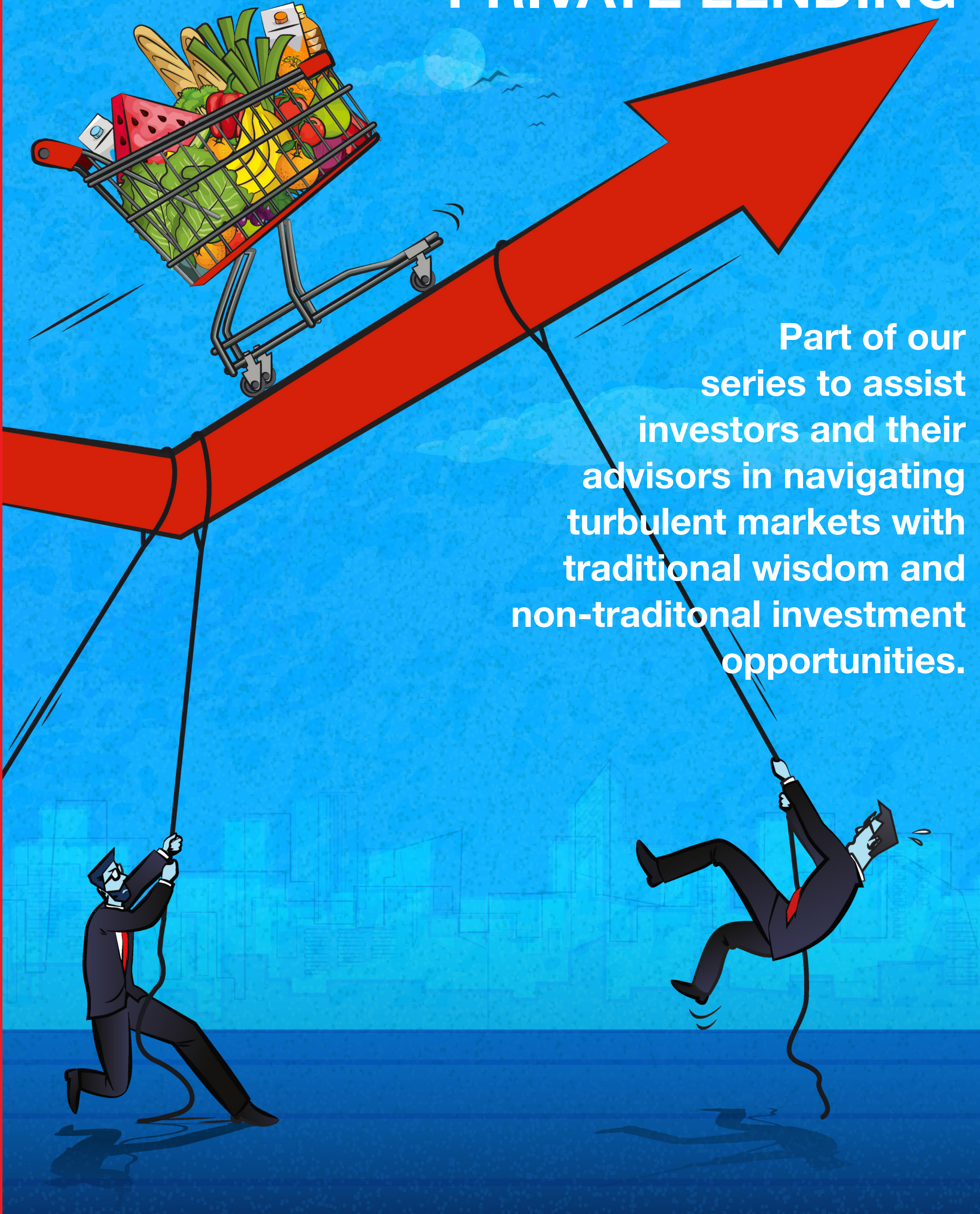
CANADIAN ASSOCIATION OF ALTERNATIVE STRATEGIES & ASSETS

INFLATION FIGHTERS: PRIVATE LENDING



Part of our series to assist investors and their advisors in navigating turbulent markets with traditional wisdom and non-traditonal investment opportunities.

We would like to thank the following CAASA members for helping to make this paper possible:

chmic.ca

morexcapital.com

morrisonfinancial.com

www.harbourfrontwealth.com

About CAASA & This Paper

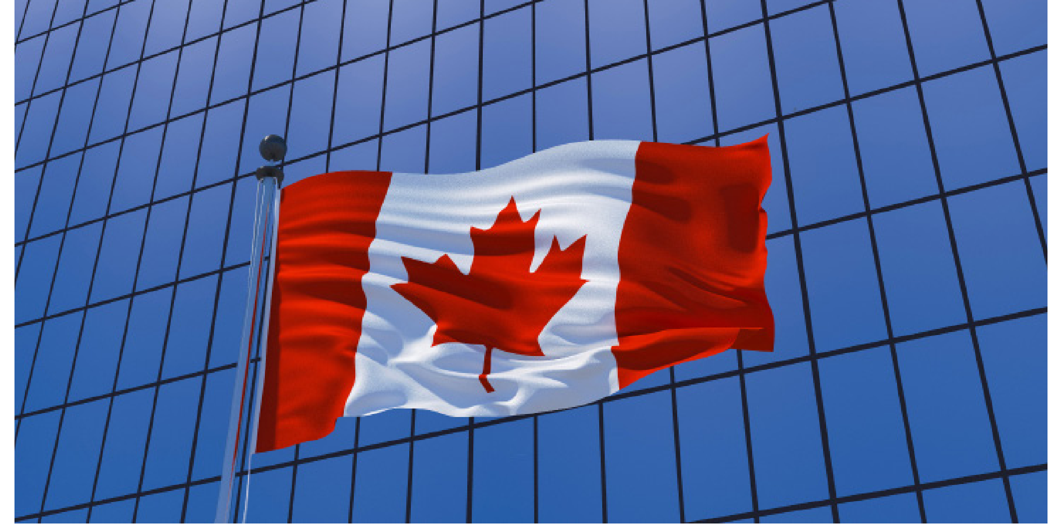
Inclusive, Active, and Pan-Alternative

The Canadian Association of Alternative Strategies & Assets (CAASA) was created in response to industry requests for a national group to represent the Canadian alternative investment participants, including investors, asset managers, and service providers. CAASA is inclusive in that it welcomes participation from all companies active in the space (375+ members in 2022) who might want to participate in committees and working groups — or simply attend member events — without their employer being a member of the association.

CAASA is very active, organizing numerous conferences, webinars, socials, and podcasts throughout the year. Pan-alternative, for CAASA, encompasses all alternative strategies and assets including hedge funds/alternative trading strategies, private and public real estate (funds and direct), private lending, private equity, infrastructure, development and project finance, digital assets/crypto-assets, weather derivatives and cat bonds, and all aspects of diligence, trading, structuring, dealing, and monitoring alternatives in a stand-alone portfolio and as part of a larger investment strategy.

As with all our papers, we use an external writer to draft it from interviews with participating members and it represents, in the end, our views and not necessarily that of every participating member.

For more information, please visit www.caasa.ca.



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Thanks to Hill + Knowlton Strategies for their part in interviewing our participating members and drafting this primer.

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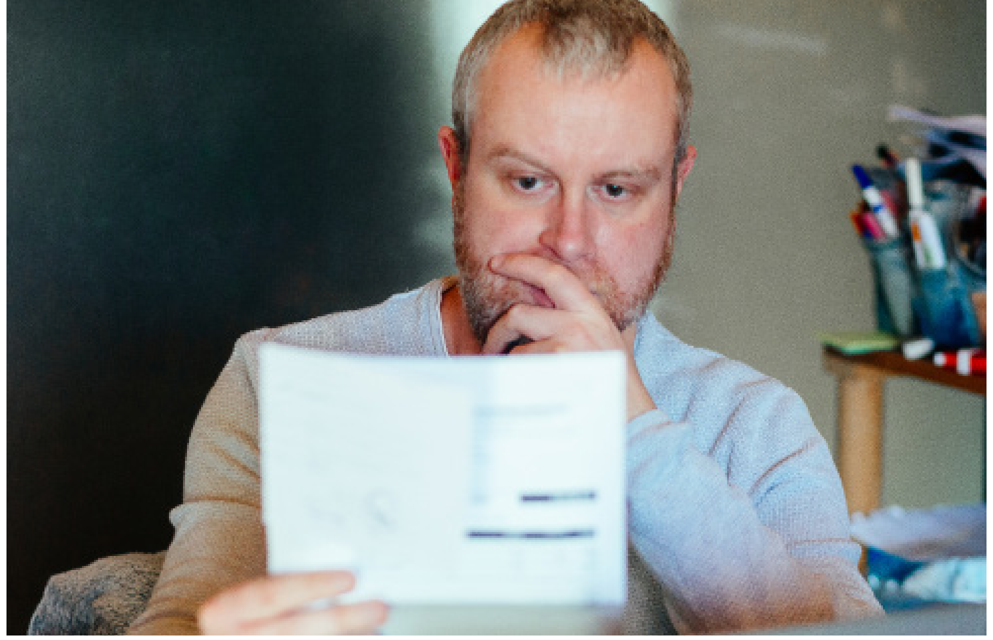


Foreword

This is the second in our Inflation Fighters Series - one that we believe will have legs simply because the economic backdrop of the last decade and a half has primed the pump to continue asset bubbles, massive sovereign debt, and (thanks to money-printing) inflation across the globe.

The Great Financial Crisis of 2008 brought with it not only huge stimulus packages (only to be eclipsed by the helicopter money of COVID relief programs), but also a wholesale change in how banks calculate their risk capital and, more importantly, the 'hair-cuts' they receive. Put short, banks' balance sheets were overhauled to reflect a draconian view of risk and it caused many to step away from markets they had hitherto dominated. Thus, an opening was made for today's private lenders to ply their trade not in the shadows of giant money-centre banks, but in their stead in many cases.

For investors, this meant more options as these fund managers opened new funds and gathered increasingly high levels of AUM. If they are in a crowded market or simply taking the place of others is up for debate - but what is certain is their offerings can be excellent inflation fighters.

James Burron, CAIA

Co-Founder & Partner, CAASA

Private Lending: An inflation fighter

Inflation – or a general rise in prices – has been on everyone's minds and hitting everyone's wallet. Everyone has an opinion on the cause: some claim it's a byproduct of the quantitative easing pursued by many central banks during the COVID-19 crisis, while others maintain that it's caused by bottlenecks in supply chains and a temporary, but acute, energy crisis caused by the war in Ukraine.

Irrespective of the cause, however, one thing is for certain: investors will feel the effects.

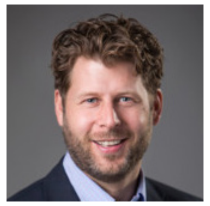
One of the primary effects of inflation is that cash loses its value. An investor who is holding a lot of cash is therefore at great risk, as the value of that cash will erode due to its decreased purchasing power. Investors who hold fixed-income securities like GICs or public bonds are also at risk.

This does not account for the risk that uncertainty and market volatility play – or the risk that the inverse correlation between stocks and bonds, the basis of the traditional 60/40 portfolio, might not hold up in a highly inflationary environment.

This has major implications for investors who have followed the typical advice and invested their money in the typical 60/40 portfolio. Without action, they may see their yield drop, and the value of their portfolio erode.

These investors would be well-advised to look into assets that limit the risk of inflation to their portfolio.

They need to look for an inflation hedge.



"For an investor, what inflation does is, it eats the value of your savings. So you may want to reconsider certain investments, particularly fixed-income products. There are certain inflation fighters -like real estate, commodities, and direct lending. Alternative mortgage lenders are a form of direct lending that an investor may consider."

Jesse Bobrowski
Vice-President of Business Development
Calvert Home Mortgage Investment Corporation

The Risk that Inflation Poses to Bonds

Fixed-income securities are just that – securities that pay out a given amount of income over time. The majority of the fixed-income securities that an investor will purchase will be bonds or other types of debt, issued by a government or a corporation, but category also includes so-called Guaranteed Investment Certificates (GICs).

Each of these securities has a face value – the amount that is 'lent' to the entity that issued the bond. It also has a 'coupon' – a regular payment delivered to the holder of the bond.

Inflation poses a risk to the holder of a bond in two ways: the face value of the bond is eroded, as is the value of the coupon, as a bond's interest rate does not change. This risk is present in all bonds, but it is greater in longer-term bonds than in shorter-term bonds, as holders of longer-term bonds will see their value eroded due to the greater length of time the money is 'lent out'. They will also face an opportunity cost due to not being able to invest their money in an alternative bond, paying out at a higher interest rate.

Further, bond prices and interest rates tend to be negatively correlated. As interest rates rise, bond values decrease as more attractive, higher-paying bonds are newly available on the market.

In this environment, investors who are allocated to bonds are well-advised to look into investment vehicles that can fulfill the same function but improve on yield, irrespective of inflation.

Private lending opportunities are one such vehicle.

Private Lending Opportunities

Private lending opportunities are a type of alternative investment that can fulfill a very similar function to the fixed income component of a portfolio, but with the benefit of superior yield in an inflationary environment, and a value that is largely uncorrelated with the stocks and bonds that can be purchased on public markets.

A common type of private lending opportunity is mortgages whether they are issued to ordinary people or to property developers, to finance the construction of a new housing project.

These opportunities are attractive in an inflationary environment for multiple reasons:

• **Yield profile –** The yield on private lending is often superior to the yield of bonds purchased on the public markets, particularly in an inflationary environment where rising interest rates suppress bond prices. For example, some private lending opportunities are in mortgages to individuals who have not been approved for mortgages from more traditional institutions, and who must therefore pay a higher interest rate. Others are loans to projects that may be taking on various types of risk. For example, the political risk assumed by a developer acquiring land for which they will seek a rezoning and, as such, pay out at a higher yield.

• **Correlation with Central Bank overnight rates** - Like bonds, private lending opportunities tend to be better hedged against inflation when they have a shorter time frame.

Short-term loans will tend to be highly correlated with the prime rate, which is directly tied to the overnight rate set by central banks so as central bank overnight rates increase, so will the yield on these loans. Short-term loans also enjoy a faster mark-to-market (a method of measuring the fair value of accounts that can fluctuate over time).

Longer-term loans will also be influenced by the interest rate set by the central bank but to a lesser degree.

Some private debt instruments will be on a 'floating rate'. They will have an interest rate that is directly tied to the prime rate. These will be highly sensitive to central bank activity, and thus will make for an excellent inflation hedge.

• **Uncorrelated return** – Private debt instruments provide an attractive risk-adjusted yield but, critically, this yield is uncorrelated with securities that can be purchased on the public markets. This makes them attractive when building a diverse portfolio, particularly in a time of economic uncertainty.

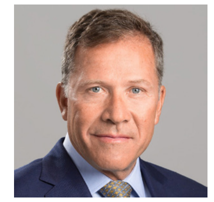
• **Security** – Like all debt, private lending opportunities are secured against an asset. In the case of mortgages, they are secured against a real asset. Real estate is well-understood to be an inflation fighter, due to the fact that rent is a necessary spending priority.

Unlike bonds traded on public markets, however, private debt can be illiquid. The amount of time an investor must remain invested in a given fund will vary from product to product, but a typical term may look like a year.

Illiquidity can be a risk for obvious reasons. Investors who require immediate access to money, either to reallocate it or to spend it, will not be able to access it until a liquidity event occurs.

However, some position illiquidity as a benefit. Valuations on public markets can be sentiment-driven, particularly during periods of volatility. Illiquidity prevents sentiment-driven decision-making, ensuring that sell or hold decisions are made on a rational basis, not an emotional basis.

Investors who require access to their money sooner should consider this need, and their tolerance for liquidity risk, before deciding to invest.



"Private debt funds are not all created equal – and it depends on the nature of the underlying loans in the fund's portfolio, specifically their duration characteristics. A fund comprised of short-duration loans can be highly responsive to inflation – and typically, those loans would be prime rate based, meaning that it is sensitive to the actions of the central bank. For example, all our agreements with our borrowers are prime rate based. So, when interest rates go up, my yield goes up – because my loans are highly correlated with prime, and prime is correlated with inflation. It's a great fit. But private debt funds that are invested in term loans – such as for apartment buildings – these loans typically have longer terms, and their rates won't change when prime changes. One must assess the characteristics of the debt vehicle itself."

Graham Banks
Senior Vice President
Morrison Financial Services

"One of the risks of public investments is liquidity. An investor being able to sell at any second creates fear and sensationalism and excessive upside and excessive downside volatility. When you eliminate that, like in the private credit space, you reduce that volatility because of lack of liquidity. And you also don't get the price compression that you see on the public markets because they're typically short duration, or floating-rate, loans. So as interest rates rise, in the private credit space, the yield on the portfolio actually rises."

Travis Forman
Portfolio Manager
Harbourfront Wealth

"The way that these loans work is very much tied to the prevailing interest rate at the time. If inflation is rising, interest rates are rising. And because of that, we're able to raise our rates as well. So it's sort of a natural hedge against inflation – because if we get inflation, that means we can charge more, which means investors can earn more. And because the loans that we're doing are short-term loans, typically six months to a year, we're able to reset the terms of our loans, because based on the terms prevalent at the time – so if rates have gone up, that loan's interest rate has gone up as well. Further to this, inflation increases the market value of the collateral we hold (i.e., real estate), which is another inflation hedge you can count on."

Charbel Cheaib
Partner
Morex Capital

Using Private Lending to Hedge Inflation

An investor with a typical 60/40 portfolio may understand the need to hedge against inflation – but how, specifically, ought they go about it?

When it comes to private lending opportunities, there are two schools of thought. An investor can include a private debt component in the fixed income portion of their portfolio – or they can leave the 60/40 model behind altogether and create an entirely new section of their portfolio dedicated to private assets.

• Take from fixed income – An investor heavily allocated to fixed income may decide to reallocate some of that portion of their portfolio to private debt instruments. This investor should ensure that the private debt instruments that they choose are effective inflation hedges – e.g., have a short term duration or are 'floating rate'. However, investors should be aware that private debt can have low liquidity, and should understand how to mitigate this risk.

• Devote a new section of the portfolio to private assets – Sophisticated investors, such as pension funds, have been increasingly eschewing the traditional 60/40 model in favour of a portfolio heavily allocated to alternatives – even as high as 40 to 50%. Investors hungry for yield may choose this model. However, these investors should be aware that pension funds have extremely long time horizons, and so are able to assume liquidity risks that other investors cannot. Of this 50%, private credit could assume 25% of the portfolio – with the balance being made up of real estate and private equity.

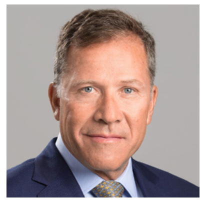
Investors choosing to allocate this much of their portfolio to private credit should be knowledgeable and experienced, to ensure that they are able to do their due diligence and that they are making the right investment decision for their needs.

When allocating to private credit under this model, the investor should, again, ensure that the debt instrument is structured as a hedge.

The model that is right will vary from investor to investor – dependent upon their time horizon, risk tolerance, and need to access capital.

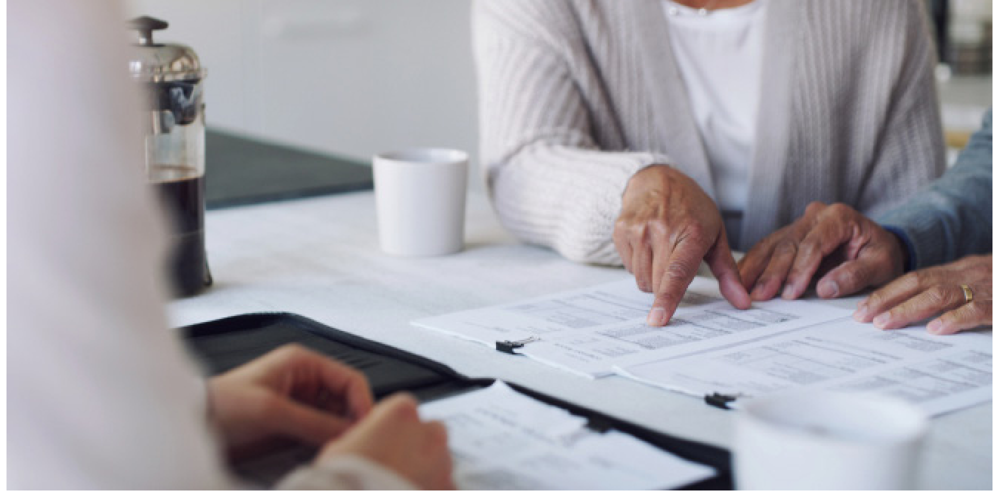
"In an inflationary environment, if you've got the typical 60/40 allocation, and you're holding bonds, those are going to be affected – especially if they're fixed-rate bonds. If you're holding public equities, those are taking a hit right now, as well – especially if they are in sectors that are being hit by inflation particularly hard. So because of this, private assets are attractive. You're not subject to the market fluctuations and volatility that we are seeing in public markets. With a private lending product, you're shielded from that – you don't have the daily adjustment in market value."

Charbel Cheaib
Partner
Morex Capital



"What's happening is – you've got these 60/40 type investors, and they're getting older. And as they get older, their investment advisor – or they themselves – end up increasing their percentage in fixed-income, because it's a lower-risk strategy. But as they do that, their returns go down, and they don't like it. One of the things you can do to secure a greater yield is to make an investment in alternative strategies – specifically, in private debt funds, because they can fit the fixed-income component. But you need to be careful of who the manager is, assess their competence, and understand the characteristics of the underlying assets – to ensure that they meet your requirements."

Graham Banks
Senior Vice President
Morrison Financial Services



Consider Private Lending

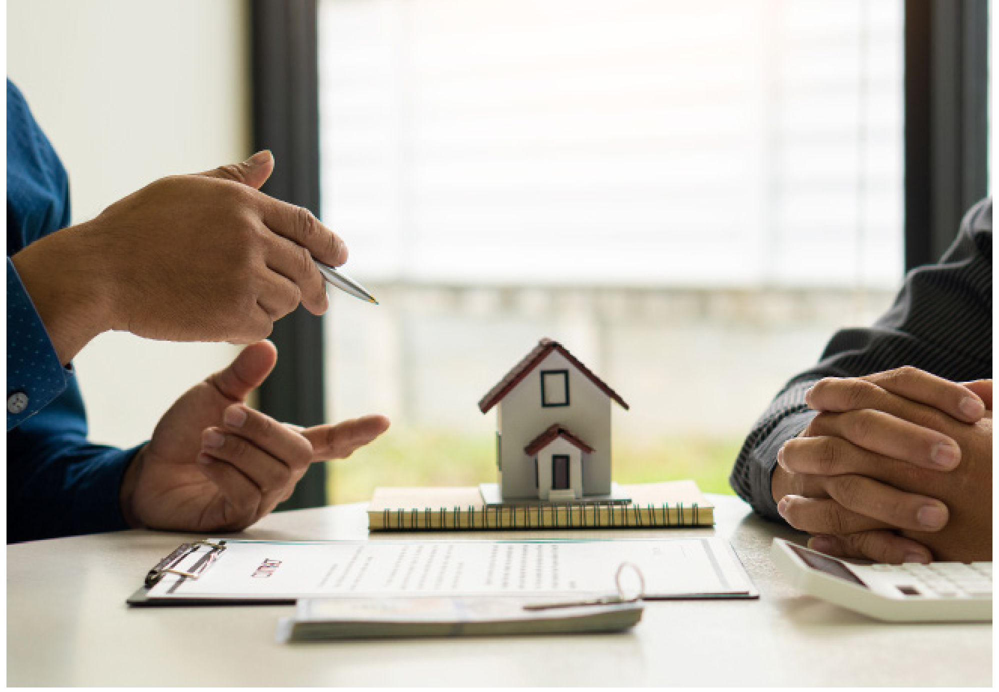
Sophisticated investors like the Canada Pension Plan and Ontario Teachers are allocating increasing amounts of their portfolios to alternatives and the rest of the market is following suit, with not only high net worth individuals but also accredited investors allocating capital to private lending opportunities.

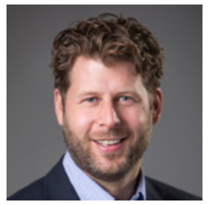
Investors who do not have immediate need for access to their money will find private credit attractive. Investors with a shorter time horizon may also find it attractive, but will need to balance the illiquidity of certain private debt instruments against their needs, and allocate capital accordingly.

Certain retail investors may therefore find private credit opportunities attractive. But due to the complexity of the investment vehicle, these investors should ensure that they have the knowledge and expertise needed to do their due diligence, or seek the counsel of a qualified wealth manager.

"I'm a believer in R&D - which is 'replicate and duplicate'. If we can agree that the world's most prudent investors are the endowment funds and the pension plans and if we can agree that they have more resources available than the rest of us, and if we take a look at investors like the Canada Pension Plan, we can see that they are huge adopters of private and real asset solutions. That is persuasive to me. I say: if they're adopting private or real asset solutions to meet the future obligations of Canada, shouldn't we be doing the same things as fiduciaries for our clients?"

Travis Forman
Portfolio Manager
Harbourfront Wealth





"The individual investor very much has to think about their capacity for risk exposure – their concentration, liquidity, all those components. And when you're a smaller investor, you may want to look at a publicly-traded option, so there's a lot of liquidity, documentation, and transparency. But the bigger you are, the more differently you look at, and understand risk. In general, we are seeing more and more sophisticated investors go into alternatives and real estate – and real estate lending, real estate debt is part of that."

Jesse Bobrowski
Vice-President of Business Development
Calvert Home Mortgage Investment Corporation

Inflation, Asset Allocation, and Security Selection

Private credit is attractive in an inflationary environment, but the trend of sophisticated investors investing in alternatives and private assets far pre-dates inflation or COVID-19. Investors hungry for yield have been increasingly investing in alternatives for years.

The present inflationary environment is a good reason to consider allocating capital to private credit. But due to its attractive yield profile and its uncorrelated return, private credit is an excellent addition to any diversified portfolio, even after inflation subsides.

Veterans of the markets will sagely advise that one's overall asset allocation is a large determinant of longer-term performance - perhaps as much as 90%. This can lull one into a feeling that having a seemingly well-thought asset mix is all one needs, but security selection (and/or selecting the right asset/fund management companies) can make a great difference in overall returns - and the risks taken.

Whether in stocks, bonds, hedge/alternative strategies, real estate, or private lending: investors and their advisors need to ensure that top-quality securities (or borrowers) and asset managers are used to ensure not only suitable performance, but to side-step operational risks that could lead to catastrophic losses in times of market stress or idiosyncratic situations that tend to weed out the weaker players from time to time.

Back to inflation, investors should see it (and its rarer cousin deflation) as potential risks at any time and construct their portfolio accordingly such that when these market regimes show themselves they stand to lose less (or possibly even make more) than a naive portfolio. Private lending, with its typically floating rate returns, are great in inflationary times and the yield pick-up compared to more liquid bonds, bond funds, and bank-notes/paper can provide a buffer in deflationary times.

All said, investors should see private lending investments as a tool their toolbox, like that of real estate and other assets, that can provide true diversification and return enhancement over an economic cycle.

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