Prioritizing High-Yield Strategies For Income Generation Within Diversified Portfolios

By Danielle Correa | April 4, 2019

Nonprofits looking to ensure financial security should turn to income-yielding assets to pay their dues, according to a new whitepaper from private markets firm StepStone Group.

In *The Hunt for Yield*, the firm notes that institutional investors have moved toward private markets as an alternative solution, mainly due to the critical nature of deployment on a large scale, highlighting that fundraising across private markets has more than doubled to roughly $800 billion in 2018 from 2010, according to estimates by Preqin.

Yield-driven strategies seek to generate income and attract investor capital because of their diversification potential and defensive characteristics that can provide returns with lower variance and loss ratios, according to the report.

"I think what's happened recently is increasingly investors are looking for current income. If you take the prism of a nonprofit organization, they'll have that requirement for income every year. If they have endowments and/or contributions, they will typically want to make an income off of that to fund their operations," said John Bohill, a partner on StepStone's private debt team.

Bohill highlighted private debt and infrastructure as asset classes "that provide a constant income during the life of an investment," which "can be attractive."

"Strategies such as private debt and infrastructure can help to diversify a portfolio with different risk and return characteristics," said Bert Feuss, senior v.p. of investments at Silicon Valley Community Foundation, in an e-mail. "We diversify our portfolios across different asset classes, strategies and managers to increase the likelihood of achieving the target return objectives over market cycles and different economic environments. For example, real estate, real assets and infrastructure investments tend to perform better during inflationary environments."

Feuss believes, "The best way to implement these strategies is with a thorough due diligence process conducted by a qualified investment advisor, consultant and/or investment committee and a clear understanding of the role of the investment in the portfolio and how it will contribute to the portfolio's overall risk and return objectives. That said, complex and illiquid assets have no place in many nonprofit portfolios if the portfolio is small or the organization lacks qualified oversight."

Bert Feuss

"A large proportion of private debt market growth in recent years has been reassigned from fixed-income budgets and that's where we've seen very large allocations come from. I would expect it's the same story in the nonprofit sector," Bohill said.

Private debt can be deployed quicker and return capital sooner as a result, the report notes.

"Private debt could be a useful tool," said Peter Madsen, cio at the Utah School & Institutional Trust Funds Office, in e-mailed commentary. "Most nonprofits are allocating in a manner similar to the endowment model, and have a reasonable tolerance for illiquidity and higher fees. However, we should also define the term private debt. Similar to private equity there are multiple sub-asset classes or strategy types with differing risk and return profiles."

While infrastructure may be slower to deploy and have a longer duration, these differentiators attract investors, according to the report, which notes regulators in key mar-

kets have steadily lowered the weighted average cost of capital, lowering the cap on returns that privately-financed infrastructure projects can generate.

"Infrastructure investments represent opportunities where the underlying assets are fundamentally essential to society," said Jon Levin, president at GCM Grosvenor. "Therefore, they are in many ways protected from market volatility and market dislocations. Whether they be public plans or nonprofits, investors have either a long duration liability stream or a goal of making long duration returns from reasonably safe assets."

Bohill believes infrastructure is making headway as the strategy "had much of its institutional beginnings in places such as Australia and Canada, but is now growing to other markets in a big way."

"A key feature of infrastructure is that it is clearly secured by a hard asset, such as a road or a bridge, which may generate income over a long period," he added.

Meanwhile, investors have become more sophisticated and able to vet fees and fee structures. LPs should aim to put fee structures in place that fit each asset class and the returns they offer to help them fine-tune their allocation to private markets and potentially benefit from the expansion and diversity of the market.

Private equity managers are compensated through carried interest structures that reward capital gain strategies. On the flipside, direct lending managers tend to earn most of their revenue from management fees. With 35% of revenues coming in the form of carried interest, this can lead to a mismatch between investors' expectations and managers' strategies.

John Bohill

"There are innovations in fee structures, whereby the yield that the LP generates is senior to the management fee," Bohill explained.

A slight difference exists in the percentage of gross returns that private equity and direct lending managers are paid. Perhaps investors have varied return expectations for each asset class, potentially creating a perception issue due to the difference in return profiles. Paying 25% of returns to an income-generating manager can be justified if investors consider the value of diversification to their portfolio, capital protection and the stability of those returns instead of solely return enhancement.

StepStone has recently seen several core funds with open-ended structures that use a yield-based carry mechanism, which may be instructive for private debt investors looking to reduce the gross-to-net spread and better align themselves with the GPs with whom they've entrusted their capital.

Peter Madsen

"Liquidity can be a double-edged sword," Bohill said. "Open-ended structures rely on current valuations and if it's a difficult time in the market, valuations can go down and then you're exposed to market risk. Sometimes that's the wrong time to sell and unfortunately that's when a lot of investors do sell. So, liquidity has a cost."

Private debt and real assets may not deliver the same returns as private equity, but they can generate the income that cash-strapped investors desire, according to the report, which notes that investors in yield-based asset classes have worked with GPs to make income generation a priority.

"[Nonprofits] may require certain income [and may not be] so much concerned with doubling their money over a period of 10 years," Bohill said. "They may require income certainty for the coming year, in order to fund their outgoings."

He recommends nonprofits with a specific range of capital use the private debt strategy.

"We have clients that have enough room for a $5 million investment into private debt and we have clients that are investing $1 billion in private debt. I think if you have less than $5 million of investable capital into this asset class, then it becomes difficult to execute because you're typically not large enough to write the check and get into a fund that has institutionality."

Madsen offers caution, noting that "before modeling or implementing a private debt allocation it makes sense to determine your objective for the asset class. If you're trying to create a highly-secure/core fixed income substitute you'd go in a different direction than an opportunistic mandate such as distressed for control. Arguably, it's less about how you label it and more about aligning the nature of the various sub-asset classes within private debt to the purpose you are trying to fill or objectives you've set out in the portfolio."

Levin concluded with, "An institution's number one focus should always be on appropriate diversification. That's a critical element of portfolio construction for any investing strategy. Institutions should also focus on diversification of its partners in terms of who is helping you deploy the capital. A diversified approach to one's portfolio construction and implementation is certainly what we think is smart for all asset classes and infrastructure is no exception."

The whitepaper can be found on StepStone's website.