E X P E R T Q & A

Generating alpha and being able to quickly put capital to work are key advantages of fund finance, says Matt Hansford, European head of Barings Portfolio Finance

The many sub-asset classes within fund finance

Q Is fund finance an asset class that is open to institutional investors?
Fund finance is absolutely an investable asset class for institutional investors. In many ways, it is following the same path as direct lending and other parts of private credit over the past three decades, with the transition from bank capital to institutional capital.

With bank balance sheets challenged by regulatory constraints and the growth of fund finance, managers are innovating and creating products and access points for institutional capital. This is part of the shift to 'private credit 2.0', with portfolio finance and fund finance playing a meaningful role in that natural expansion we have seen elsewhere.

SPONSOR
BARINGS

Fund finance is often identified as one of the newer investable asset classes, but it is not actually one singular product – it includes a number of sub asset classes. This breadth becomes really interesting for institutional investors, as these sub asset classes offer different risks, durations and returns, creating opportunities for different allocation buckets.

For example, if you start with capital call or subscription line finance, that is typically very short-term, one-year bullet duration and rated A to AA.

Portfolio finance, lending to a diversified pool of underlying private market assets, is typically rated investment grade AA to BBB. It typically has a three- to seven-year weighted average life, so it can fit really well into an insurance allocation. It can also go into similar duration buckets as direct lending, but with investment grade risk – which can be particularly beneficial to sovereign wealth funds and pension funds.

Finally, there are unrated NAV lending strategies that typically have a two- to five-year weighted average life, but returns that are more aligned with direct lending or credit opportunities.

Across those three different axes of risk, return and duration, investors can consider where this strategy fits within their broader allocations and then decide which part of the fund finance universe they want to focus on.

Q Why are investors attracted to portfolio finance?

Many investors look to portfolio finance for the potential to achieve strong alpha-generating returns and a spread pick-up to public markets.

Take an insurer as an example, though this applies to other institutional investors: They might have a big investment-grade fixed income book, but it can be difficult to differentiate that book from another investor's because, like everyone else, they are buying bonds in the public markets.

But there is a real hunt for returns. The insurance annuities market is competitive, and to offer the best product to its customers, an insurer has to create the best returns. So, with that investment-grade fixed income book, there is a need to get outsized returns. Portfolio finance can offer the same low risk, diversified profile but often generates as much as 200 basis points of excess spreads over public benchmarks.

Another key consideration is that portfolio finance is defensive by nature, so investors are typically not increasing risk compared with public market investments. That defensiveness comes from the diversified nature of the individual underlying transactions and the strong controls in the facilities, as these are typically structured in bespoke ways to provide strong alignment between managers and borrowers.

Finally, there is real scale in these transactions. There is an opportunity to build a book of these quite quickly since each transaction has size, meaning that excess spread can be put to work and make a meaningful difference to your programme.

Q Which drivers are creating demand from the asset managers using portfolio finance?

We estimate the annual investment opportunity in portfolio finance to be in excess of $200 billion, and even larger when you look at the broader fund finance universe, including sublines.

The first growth driver is the growth of private markets. The opportunity to put capital into a market that is expanding and searching for capital, as part of that natural transition from public to private markets, is significant and unlikely to fade anytime soon.

The second is the ability to tailor returns for investors. If you are a large investor and you can put down a large separately managed account, you can have returns tailored by adding financing or leverage into that. Investors are looking for that tailoring and portfolio finance is supporting that trend.

Then you have portfolio management within private markets. Private markets asset managers are not just finding deals, making investments and waiting for that to be realised. The concept of portfolio management from top to bottom is much more important for enhancing value and providing additional firepower for follow-on investments. Your typical closed-end funds have a limited amount of capital, so portfolio finance is a tool to enhance value.

Then you have investors managing their own portfolios of LP stakes. Because of the growth of the secondaries market, they are much more actively managing their books, and there is an option to sell assets in the secondaries market or put in preferred equity and keep them. Portfolio finance adds an additional credit solution to help with portfolio management, creating liquidity or to invest further in a portfolio, rather than just adding equity or selling. It is all about adding further optionality into the market.

Q What are the challenges facing portfolio finance?

The biggest challenge today, arguably, is education, and there is a real risk of a misunderstanding around the different types of fund finance available. It is still an issue among GPs to some extent, but certainly among investors.

There is a lot more education needed to unpack the breadth of fund finance and show investors it is not just one asset class but a range of options that exist and can be additive to their portfolios. Often, investors may hear about one part of the market only, not realising there are actually numerous levels of risk, return and duration.

On the GP side, managers are still educating themselves about how they can use this strategy in their portfolio management. We see many more managers building capital markets teams and dedicated expertise around how they can use these tools to enhance value, provide options for investors and engage with different parts of the fund finance market.

LPs have typically used the secondaries market for portfolio and liquidity management, but portfolio finance is a clear alternative or can be supplementary. Building understanding of that option is important for the market.

Q What's next for portfolio finance?

The next shift will be in how people use those different axes of portfolio finance, and how that will lead to interesting partnerships and blends of different capital sources to create solutions.

An example we are beginning to see is an investment grade portfolio finance provider teaming up with a preferred equity provider to create more liquidity from a portfolio for an investor without selling. You can put those two tools together to create a more holistic solution in a way that generates liquidity closer to par but retains upside.

We expect to see that spectrum of different parts of the fund finance tool kit being used in combination as capital markets teams within GPs start to really understand and innovate around them.

Right now, the priority is in education and helping market participants get comfortable with this tool kit and how it can be used, because innovation is only going to continue as the market matures. This is positive for asset managers as the toolkit expands, and positive for investors as there are more options to generate alpha in their portfolio. ■