STEPSTONE

Direct lending's attractive risk-adjusted returns

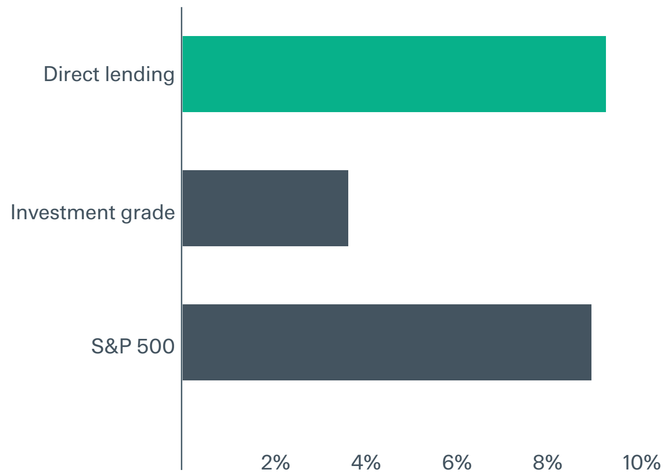
Private debt | JANUARY 2024

The surge in interest rates over the past two years has brought renewed attention to credit markets. Within private credit, interest in direct lending has increased significantly owing to its floating rate coupons, relatively low volatility, and track record for attractive risk-adjusted returns.

As a result, some posit the traditional allocations to public equity and fixed income may be outdated; a greater allocation to direct lending may be warranted. Doing so could increase portfolio returns without materially upsetting the portfolio's risk profile.

Historically, direct lending has generated equity-like returns, equivalent to an annualized total return of approximately 9.4% (**Figure 1**).

FIGURE 1: HISTORICAL ANNUALIZED TOTAL RETURNS (2005–2023)



Sources: Bloomberg and Cliffwater, as of September 2023.

Historically, direct lending has provided investors with equity-like returns while experiencing drawdowns similar to IG bonds. The low duration of direct lending loans has also resulted in lower interest rate–induced volatility relative to IG bonds.

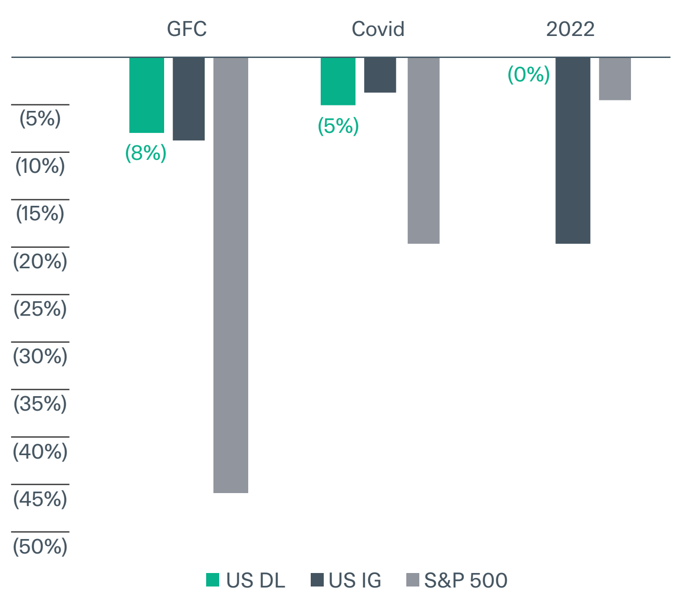
Equities (read: the S&P 500) by comparison delivered an annualized return of 9.5%. The difference is even more pronounced when focusing on fixed-income markets.

The axiom "higher risk, higher rewards" would lead some to believe that direct lending's superior return potential comes with great risk. While liquidity and credit risks remain, direct lending experienced drawdowns similar to investment-grade (IG) bonds in times of financial stress.

In 2022, the low duration risk of direct lending protected the asset class from the sharp markdowns that occurred in the IG market. Going forward, this low interest rate risk should keep the asset class volatility down.

Looking at the current risk compensation offered by each asset class above the 10-year Treasury yield (i.e., the equity risk premium), direct lending compares favorably by offering a spread of nearly 450 bps above the risk-free asset, adjusted for losses and fees.

FIGURE 2: MAXIMUM DRAWDOWNS (2005–2023)



Sources: Bloomberg and Cliffwater, as of September 2023.

In contrast, equity has been compensating investors less and less for the risk they onboard. Currently, the equity risk premium—defined as the earnings yield minus the 10Y Treasury yield—is just 56 bps.

Comparing the long-term expected annualized returns from unlevered and levered direct lending funds with US equities and IG bonds, direct lending once more distinguishes itself by having the most promise, per Amundi and Cliffwater.

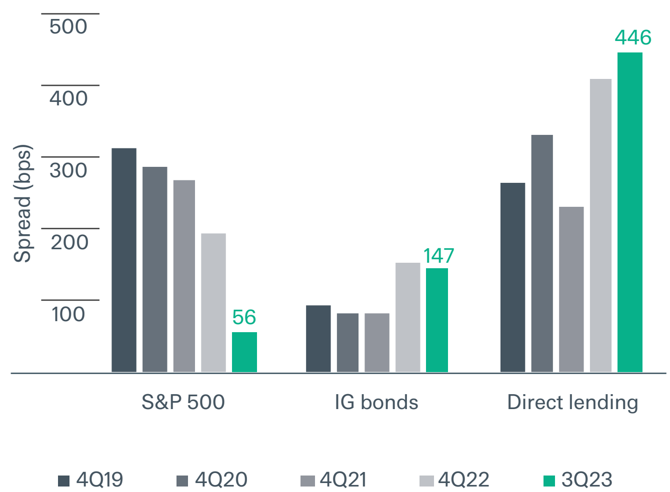
Even unlevered direct lending is expected to deliver returns higher than the ones in the equity market with significantly lower risk of drawdowns and volatility.

A moderate leverage ratio (e.g., 1:1) can enhance returns for direct lending. Net of fees, a levered direct lending fund has the potential to generate double-digit returns—optimal for investors looking for higher returns without necessarily onboarding risks akin to the ones seen in the equity market.

With interest rates likely staying higher than in the previous decade, direct lending is expected to continue to offer attractive risk-adjusted returns. Owing to the low risk compensation provided by the equity markets, it does not seem sensible to rely on equities for outsize returns, particularly when direct lending promises potentially higher returns while experiencing lower drawdowns. Similarly, direct lending compares favorably with fixed-income securities thanks to its floating rate loans, which shield it from sharp revaluation due to interest rates' moves.

> Current risk compensation for direct lending is superior to the risk compensation for equities and IG bonds.

FIGURE 3: SPREAD OVER 10-YEAR TREASURY YIELD



Sources: Bloomberg & Refinitiv LPC, as of September 2023.

FIGURE 4: LONG-TERM RETURN EXPECTATIONS

Assets	Range
US equities	6.6–7.2%
IG bonds	5.2–5.4%
Unlevered direct lending	7.5–8.5%
Levered direct lending	9.5–10.5%

Sources: Amundi Asset Management 3Q23, Cliffwater Allocation Report 2024, StepStone estimate.

If rates were to fall sharply, the yield offered by traditional fixed income securities would plummet. But because direct lending employs an interest floor, it can provide downside protection. Regardless of the interest rate regime, we believe direct lending is the most sensible choice.

As one of the largest allocators in private markets, our firm is ideally placed to offer solutions for institutional and private investors looking to expand their allocations to direct lending through our offering of levered and unlevered products, which are able to cater to the increasing specific needs of today's investors.

All data is as of October 2023 unless otherwise noted.

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