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Alternative Income for an Unpredictable World: Understanding Private Debt Funds

A Guide for Fiduciaries and Individual Investors

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Executive Summary

In an era of unpredictable rates, Registered Investment Advisors (RIAs) are increasingly seeking out fixed income alternatives that provide robust yields with strong track records of minimal volatility and risk. Private debt funds are garnering greater interest, and increasing fund flows. These funds are offered by specialized financial institutions, often replacing a role played by traditional banks, that exited various lines of business after the Great Financial Crisis (GFC).

- While private debt funds don't have the volatility of publicly-traded investments, they usually come with liquidity restrictions, which makes them more suitable as an anchor of a long-term portfolio.
- Various studies point to a relatively strong level of expected returns for private debt funds in the next decade, on both an absolute and risk-adjusted basis.
- RIAs must ensure they conduct proper and thorough due diligence on private debt funds, the firms that manage them, and their long-term track record. Communicating their relative merits to clients is also essential.
- While near-term economic challenges remain paramount for many advisors, conservative lending standards, with loan-to-value ratios rarely exceeding 65%, have enabled the most prudent private debt funds to largely avoid losses of principal.
- Industry operators tend to deploy their expertise within specific segments of the real estate market and focus on various sizes and durations of loans issued. In some cases, structural leverage can be deployed to enhance returns.

What's in a Name?

There are many names for the industry at the center of this white paper. We will use the term ***private debt funds*** but ***credit funds*** or ***private credit strategies*** would be equally valid. Each of these names focus on this industry from the perspective of investors who want to take advantage of the opportunity to earn returns through lending strategies.

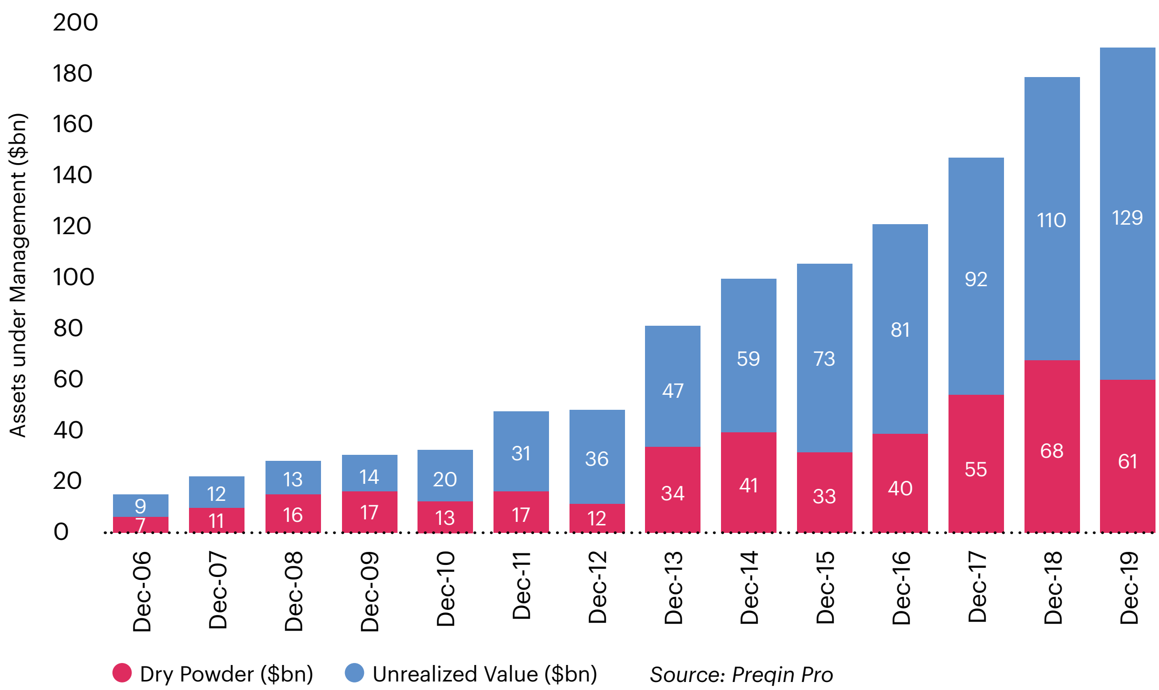
Another approach is to focus on the service provided to borrowers, which is the other side of the same coin. ***Private lending*** and ***non-bank lending*** are two descriptions favored by the authors. Other descriptions have included ***shadow banking*** and ***hard money lending*** (mostly referring to real estate). However both of these labels have negative connotations. These labels do not reflect how the best operators have professionalized this area of finance and brought down borrowing costs for their clients to the greatest extent possible, consistent with meeting investor return expectations.

The Financial Stability Board refers to this industry as ***non-bank financial intermediation*** — which may be the most impartial description of all.

Introduction

This white paper aims to explain private debt funds, with a focus on readers who are professional investment advisers who act as fiduciaries for their clients. This growing asset class has been garnering a greater level of fund flows in recent years. Over 1,000 institutional investors currently allocate to private real estate debt, according to research firm Preqin. As of December 2019, the industry had $190 billion in aggregate assets under management – doubling in size since 2014.

PRIVATE REAL ESTATE DEBT ASSETS UNDER MANAGEMENT, 2006 - 2019



Source: Preqin Pro

Private debt funds, like other alternative investments, may appear to be challenging to understand. Yet investors can benefit from taking the time to understand them, and the key goal of this white paper is to "demystify" this asset class. We hope to help investment advisers understand the key strategies used by private debt fund managers to generate positive and robust absolute returns across economic cycles; how to approach the task of performing due diligence on private funds and non-bank lenders; and how to compare and contrast different debt fund strategies.

Among private debt funds, there are many types of underlying assets that can be used to generate returns, including: real estate; equipment; unsecured business loans; and consumer loans. This white paper uses examples from real estate lending, which is the author's area of expertise, to explain various aspects of debt funds in general. At the end of this white paper is a glossary defining many terms used in the white paper. Terms covered in the glossary are underlined when they are used for the first time.

Readers wanting a short, non-technical summary of the contents of the white paper should turn to page 24. This overview is designed for individual investors.

Finally, readers of this white paper will gain meaningful insight into one of the largest asset classes in existence, namely bonds. More than $10 trillion of the $45 trillion of U.S. bonds outstanding are mortgage-backed securities. By understanding the contents of this white paper, readers will better understand how such securities are created and how they work, from the ground up.

SECTION I

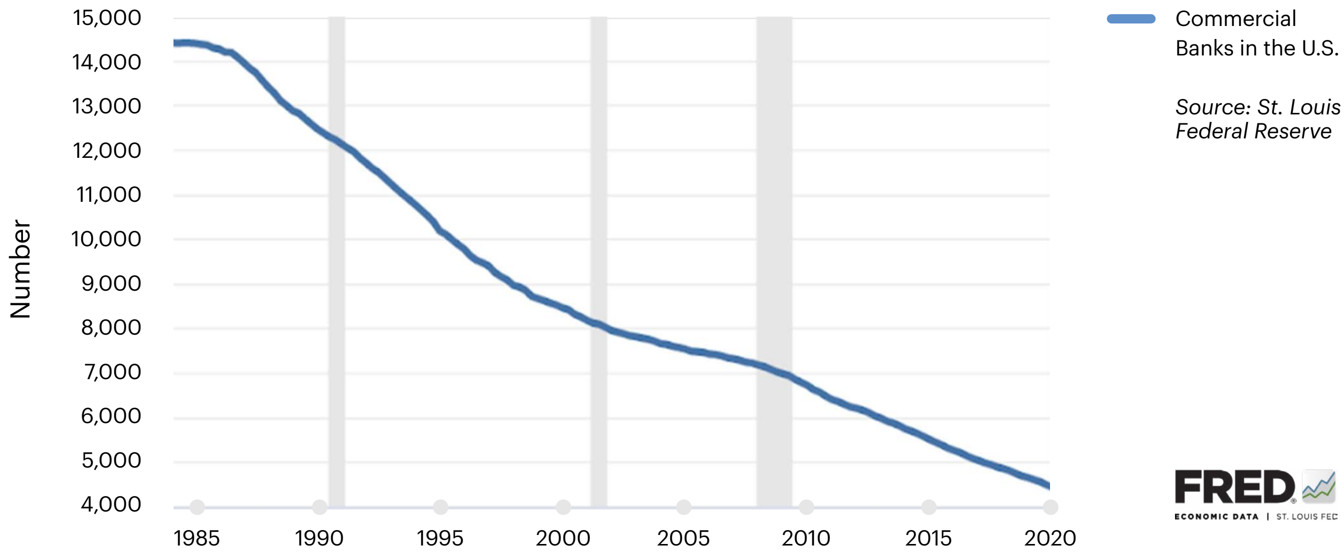
What are Private Debt Funds?

Private debt funds are pools of loans which provide attractive monthly or quarterly distributions. The fund manager typically originates or purchases new loans when the fund has liquidity, either because an existing loan has been paid off, or when new investor capital is placed into the fund. Private debt funds are usually designed to generate income while preserving investor capital. In this regard, they are similar to the fixed income allocation of most portfolios. Equity allocations, in contrast, are focused on total return, with typically only a smaller portion of the return coming from current income.

During the Great Financial Crisis (GFC) of 2008-2012, there was substantial popular resentment toward banks, many of which required a bailout from taxpayers. Banks were perceived as having profited from making risky loans using government-insured deposits from ordinary Americans. Consumers, in contrast, did not receive any bailout from the government.

In response, Congress passed the Dodd-Frank Act, among other laws and new regulations, which forced banks to maintain more capital. These laws also established regular, robust regulatory audits of bank lending activity to ensure that banks were not taking on excessive risk. Compliance with these laws was a clear challenge for smaller banks, which helped fuel further banking industry consolidation. The remaining banks became ever larger and less nimble. The trend is shown in the chart below.

NUMBER OF COMMERCIAL BANKS IN THE U.S.
(Source: Federal Financial Institutions Examination Council (US))



Businesses faced greater challenges in gaining access to credit with the reduction in the number of smaller, local banks due to the stringent lending regulations. For example, real estate investors and developers found it difficult to get loans from banks, unless the borrower profile and project type fit within a very restricted "box" provided by banks. To fill the void left by banks, hundreds of small private lenders—many set up as private debt funds—have emerged to provide loans to small and medium-sized companies. In this way, the GFC created an ongoing, large demand for loans by various borrowers left behind as banks gravitated toward more restrictive lending practices.

Selected Characteristics of Private Debt Funds

Key characteristics of private debt funds from the investor perspective include:

Less liquid than public securities; no public market.

Publicly-traded stocks, bonds and ETFs can be bought and sold at any time. This feature of maximum liquidity explains why the great majority of investor assets are held in public securities. In contrast, most debt funds require capital to be invested for a minimum number of months or years.

Open-End or Closed-End Funds?

Investors in private debt funds can utilize either an open-end or closed-end approach. Those structures determine when investors can put money into the fund and when they can redeem their capital. Most private equity funds and real estate funds are closed-end.

In a typical closed-end fund, the fund manager brings in capital over the course of weeks, months, or even quarters and then has a fixed period of time to earmark the funds for a package of loans (the "investment period"). This closed-approach is especially well-suited when private debt fund managers want to provide multi-year loans, enabling them to keep funds fully-invested while loans remain outstanding.

Los Angeles-based Calmwater Capital has identified closed-end funds as the ideal structure for its approach to the private debt fund market as it provides for more efficient portfolio management. The firm provides senior secured commercial real estate bridge loans on different property types, ranging in size from $7.5 to $100 million, and typically for a period of 18 to 36 months. To build up a capital base to provide for a few years' worth of loans, funds are raised prior to the investment period until a target amount has been reached, a process that can take between 6 to 18 months.

During the investment period, which can range between 2-3 years, Calmwater proceeds with deploying the capital raised by issuing bridge loans to various borrowers across the United States. In those 2-3 years, the fund is permitted to reinvest capital received from loan payoffs and the fund also provides current yield through quarterly distribution to investors. Upon the termination of the investment period, as portfolio loans start to pay off ("harvest period"), the proceeds are distributed to investors until they receive 100% of their initial investment plus a preferred return.

This isn't necessarily an approach well-suited to typical individual investors, many of whom prefer not to tie up their capital for extended periods. Instead, Calmwater works with institutional investors such as endowments, public and private pension funds, family offices and some high net worth investors. These kinds of investors typically require a longer period of time to become acclimated with the business model.

Calmwater's decision to focus on making loans in the $7.5 million to $100 million range allows the firm to slot into the "lower-middle market", flying below the radar of mega-funds while also being able to dial up loan sizes to have economies of scale. These deal sizes also enable Calmwater to avoid competing on the lower end of the institutional real estate lending market, which tends to see a great deal of competition. As Laura Frega, Head of Investor Relation at Calmwater notes, "Small loans require the same amount of operational support and due diligence as larger loans, and would require us to work with many more borrowers for the same level of capital deployment."

In contrast to closed-end funds, open-end funds, which are also sometimes called evergreen funds, enable investors to subscribe to a fund at any time. Redemptions from open-end funds are easier to obtain, although the fund manager usually has the ability to slow down or "gate" redemptions under certain circumstances. The key to an open-end fund is that investors need not tie up their capital for many years to access the fund's investments. Open-end funds are only practical for investments that can be valued at regular intervals, including publicly-traded securities or certain debt investment strategies such as real estate lending.

Some funds are structured to offer redemption rights, requiring a notice period, which varies in duration from weeks to months, in order to receive redemptions. The authors of this white paper believe that investors unwittingly pay a premium for the real-time liquidity of public markets. Put another way, many RIAs may be missing out on attractive risk-adjusted returns because of their over-attachment to this level of liquidity, while their clients don't really require such instant liquidity for every part of their portfolio.

Private debt funds vary widely in the types of loans they make. Some funds invest in loans secured by heavy equipment while other funds focus on loans secured by works of art, and there are funds devoted to all types of secured and unsecured loans in between.

Less volatile than public market investments.

Private debt funds are typically required to mark their underlying loan investments at "fair value". This means adjusting the value of the investment if the underlying investment is likely to be impaired or if the value has increased. The value of an investment in a debt fund typically does not move unless any individual holding is re-classified as being at risk of non-compliance or default. As will be discussed later in this white paper, the number of such defaults resulting in impairments has been extremely low for many of the industry's leading operators, due to relatively safe loan-to-value ratios, among other factors.

In contrast, the price of a public company stock may move sharply higher or lower due to market sentiment, psychology and/or panic, regardless of the health of the business or soundness of the underlying investments. This volatility can be seen with mortgage REITs, which can be similarly structured to private debt funds but are publicly traded. Private debt fund investments only change in value when the actual value of the underlying investments change—not simply as a result of psychology in the markets.

To illustrate the volatility of public mortgage REITs, consider the case of Broadmark Realty Capital (BRMK). This company operated a private lending fund for many years before merging with a special purpose acquisition company ("SPAC") or "blank check company" in November 2019, at which time its shares began trading on the New York Stock Exchange.

As shown in the price chart nearby, the stock subsequently rose to nearly $13 a share, then slid below $6 in the spring of 2020, before a partial recovery. Even as its shares were volatile, the value and status of the loans owned by Broadmark remained fairly constant. This example shows how the liquidity of public market investments can create unwelcome volatility, despite the underlying soundness of the investment.

Minimum investments and investor qualifications.

Many private debt funds have a minimum investment amount, frequently between $50,000 and $500,000. The larger the fund, the larger the minimum investment that is typically required. Some funds have far lower investment minimums. Also, many private debt funds can only be accessed by Accredited Investors, defined by the SEC as having $1 million of net worth, not including primary residence or annual income that exceeds $200,000. Some funds are limited to Qualified Purchasers, which is an even higher threshold. Recently, the definition of an Accredited Investor was extended to include anyone that is a financial professional with a Series 7, Series 82 or Series 65 license.

Selected Tax Considerations

Income and distributions from debt funds are typically taxed as ordinary income. Real estate debt funds can be structured as a real estate investment trust (REIT) which provides better tax treatment. Specifically, only 80% of income from a REIT is subject to taxes, with the other 20% being tax-free. The result is that REIT income enjoys a higher-after tax return.

Why are Private Debt Funds Worth Considering Today?

Private debt funds of all kinds have garnered widespread interest from a broad spectrum of investors and investment managers in recent years. A very recent example is Apollo Global Management's announcement of a new $12 billion vehicle to issue large corporate loans with the backing of the sovereign wealth fund of Abu Dhabi as its lead investor.[1] Also, Blackstone closed an $8 billion real estate debt fund in September 2020. Direct lending of the kind pursued by private debt funds was so attractive to CalPERS, the nation's largest pension fund with about $400 billion in assets, that it requested authority to change state laws in California to allow the pension fund to compete directly in this market.[2] (Subsequently, the state lawmakers who sponsored the required bill decided to withdraw this bill, and CalPERS announced that it will still pursue private direct lending, but only using third party managers.[3])

Below are some of the reasons that investors find private debt funds to be compelling alternatives to traditional asset classes today.

Low interest rates and returns in traditional investments.

At the end of the second quarter of 2020, 10-year government Treasuries offered a yield of just 0.64%. Moving out to a 30-year maturity increases the yield but it is still only 1.37%, a similar yield to municipal bonds. For investment grade corporate bonds, the yield was below 3.0%. While investors could obtain higher yields with energy-focused Master Limited Partnerships (MLPs), Business Development Companies (BDCs) or High-Yield (i.e. "junk") bonds, such asset classes involve significant economic risk.

TYPE OF DEBT	PROXY INDEX OR FUND	6/30/2020 YIELD
10-year govt.	Treasury	0.64%
30-year govt.	Treasury	1.37%
Municipal bonds	iShares National Muni Bond ETF	1.37%
Investment grade bonds	iShares iBoxx $ Investment Grade Corporate Bond ETF	2.28%

[1] Apollo Launches Platform to Make Big Loans
https://www.wsj.com/articles/apollo-launches-platform-to-make-big-loans-11594031400
[2] Source: https://www.ocregister.com/2020/07/09/why-calpers-the-countrys-largest-pension-fund-is-getting-into-banking/
[3] Source: https://www.bizjournals.com/sacramento/news/2020/08/19/calpers-direct-lending-confidentiality.html

Moreover, financial planners and wealth managers have growing concerns that equity markets are poised to deliver subpar returns after a bull market that lasted more than a decade. As one example, a model created by Prof. Robert Shiller of Yale University predicts that stocks will generate a 0.9% annualized return over the next decade, which is of even greater concern when one considers that stocks also have higher levels of volatility than most other asset classes.

High volatility in public markets increases the value of non-correlated asset classes.

During times of elevated stock market volatility, alternative investments tend to attract greater interest. Not only can they generate positive absolute returns across economic cycles, but they also tend to deliver smoother returns. And layering in such investments into a traditional stock-and-bond portfolio can generate superior risk-adjusted returns.

Hedge Fund Research, Inc. (HFR) looked at various markets over a 20-year stretch ending in 2014, a time which included the first five years of the recent bull market. In that time, stocks rose by an average of 0.79% per month while alternative investments (such as real estate) posted a 0.70% monthly gain. More to the point, alternatives delivered respectable long-term gains with much lower volatility. Over the 83 down months in the 20-year period, stocks fell an average of 3.87%. Alternative investments fell by just 1.07%, according to HFR. Said another way, the stock market's wild swings in that 20-year cycle produced a standard deviation of 15.5% according to Invesco, while alternatives had a standard deviation of 5.7%.

AVERAGE EXPECTED RETURNS: SHORT-TERM VS. LONG-TERM

All Survey Respondents

Asset Class	10-Year Horizon	20-Year Horizon	Difference
US Equity - Large Cap	6.16%	7.06%	0.91%
US Equity - Small/Mid Cap	6.85%	7.56%	0.71%
Non-US Equity - Developed	6.80%	7.48%	0.68%
Non-US Equity - Emerging	7.85%	8.42%	0.57%
US Corporate Bonds - Core	2.60%	3.56%	0.97%
US Corporate Bonds - Long Dur.	2.70%	3.56%	0.86%
US Corporate Bonds - High Yield	4.90%	5.62%	0.72%
Non-US Debt - Developed	1.39%	2.26%	0.87%
Non-US Debt - Emerging	5.16%	5.85%	0.69%
US Treasuries (Cash Equivalents)	1.56%	2.25%	0.68%
TIPS (Inflation-Protected)	1.98%	2.73%	0.76%
Real Estate	5.75%	6.59%	0.85%
Hedge Funds	4.74%	5.71%	0.97%
Commodities	3.19%	4.04%	0.85%
Infrastucture	6.94%	7.30%	0.36%
Private Equity	9.08%	9.87%	0.80%
Private Debt	7.75%	7.85%	0.10%
Inflation	1.97%	2.16%	0.19%

10-year horizon results include all 39 survey respondents.
20-year horizon results include a subset of 18 survey respondents.
Expected returns are annualized (geometric).

Source: Horizon Actuarial Services, LLC, "Survey of Capital Market Assumptions: 2020 Edition"

Looking ahead, private debt funds may deliver more robust returns than equities and many other asset classes on an absolute non risk-adjusted basis. In a survey of 39 investment advisors including Vanguard, Goldman Sachs, JP Morgan, BlackRock and others[4], Horizon Actuarial Services found that private debt should be expected to generate a 7.75% annualized return over the next 10 years, compared to 6.16% for large cap stocks. (That's a notably better outlook for stocks than the earlier-noted Shiller model).

It's important to note that in the Horizon survey, stock market returns are expected to come with an expected standard deviation of 16.2%, compared to an expected standard deviation of 12.1% for private debt. In our view, as noted elsewhere in this report, the volatility of returns for many real estate private debt funds (as measured by standard deviation), has turned out to be

[4] Source: https://www.horizonactuarial.com/uploads/3/0/4/9/30499196/rpt_cma_survey_2020_v0716.pdf

substantially lower than that forecast. Simply put, private debt returns have proven to be quite consistent over time.

Expectations for private debt returns also compare favorably to long-term corporate debt. Strategists in the Horizon survey project a 2.6% annual return for high-grade debt in that time frame, and a 4.9% return for high-yield (i.e. "junk") debt in that time. Private debt also compares favorably to those other asset classes over a 20-year time horizon, according to the survey respondents.

Small balance bridge and renovation loans for real estate investors are well-suited to the goals of many private debt fund investors.

One final note about that survey: participants project that U.S. large cap stocks and private debt have a 57% correlation of returns, suggesting a sufficient degree of non-correlation to provide enhanced risk-adjusted returns in portfolios.[5]

Most investors avoid private debt funds, helping to elevate returns.

Investment returns are suppressed by too much capital pursuing any given opportunity. Conversely, returns remain more robust when capital flows to a particular opportunity are restricted. Some niches may face sustained restricted capital flows for a variety of reasons. Each of these reasons will be discussed in greater detail later in this white paper. In the authors' view, private debt funds remain mysterious to many investors, curtailing capital flows and increasing risk-ajusted returns, all other factors being equal.

Selected Risks of Private Debt Funds

Some of the risks and issues to consider regarding any particular fund include:

- "Name brand" funds may not be able to efficiently put enough capital to work, and as a result, may have to refrain from investing in certain asset classes. Or they may have to incur two layers of fees to access these assets, by hiring a loan origination specialist or sub-manager who has deal flow in each specific niche.

[5] Source: Horizon Actuarial research report, pg. 13.

How One Larger RIA Uses Private Debt Funds

Kayne Anderson Rudnick Investment Management (KAR) is a $37 billion RIA that has come to utilize private debt funds for client portfolios. The firm seeks exposure to real estate "up and down the capital stack," according to Allen Kim, KAR's Director of Research & Investment Solutions. That means access to both real estate equity and debt, and even within debt, exposure to investment vehicles that have a range of risk and yield profiles.

With real estate debt, KAR prefers funds that have a large level of safety, which has been their experience with private debt funds. Kim concedes that RIAs have a series of misperceptions about private debt funds, which can only be dispelled through due diligence. One example is company risk. Many operators of private debt funds are smaller firms, and it's important to ensure that management has a strong and long track record and suitable risk controls in place. In the four years that KAR has been investing in private debt funds, the results "have exceeded our expectations." says Kim.

A key misperception for RIAs is that private debt funds carry the risk of defaulted loans and the need to work them out. In practice, the relatively low loan-to-value ratios in place means that such a scenario has happened only rarely.

"People hear that the funds are involved with real estate development, which sounds risky," says Kim. "But the proper level of due diligence helps them to understand that such perceived risks are often times unfounded."

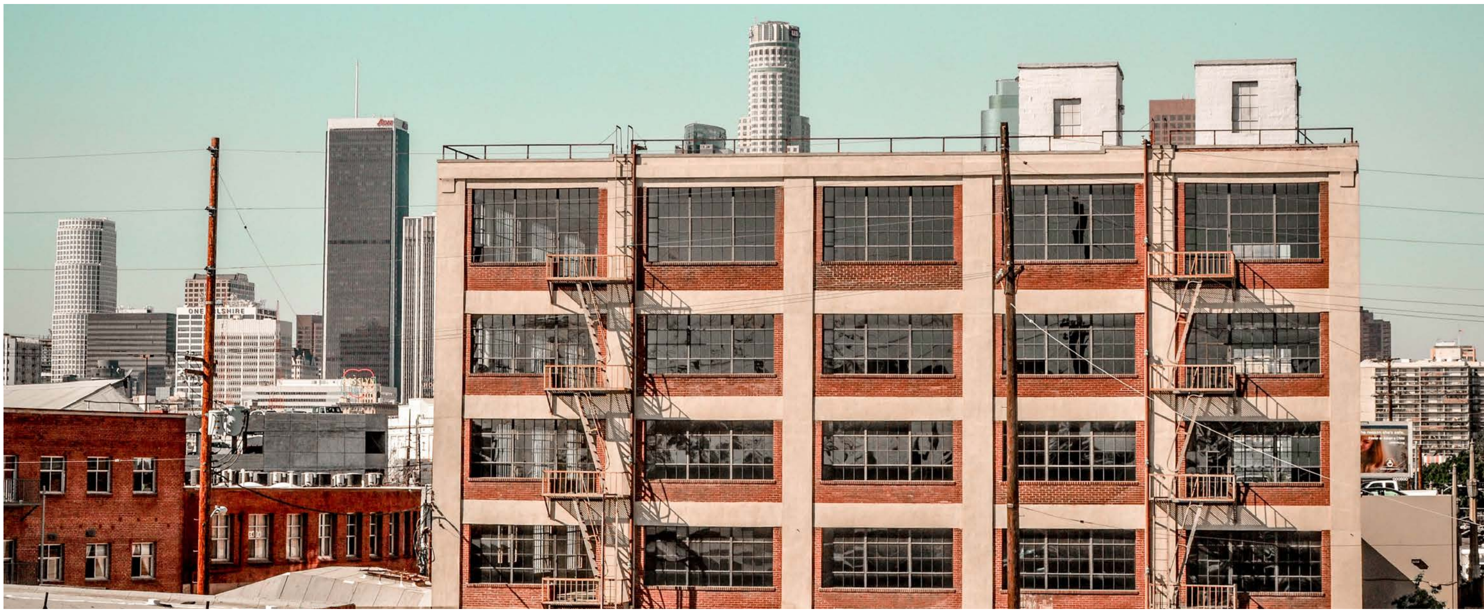
For its clients, KAR will allocate a certain percentage of a portfolio to private debt funds. Kim says they aren't well-suited to clients that are extremely risk-averse. And even for the clients that are more risk tolerant, portfolio allocations to private debt funds will be limited to a certain (though unspecified) percentage.

- Fiduciaries tend to avoid less well-known funds, for fear of harming relationships with their clients in case of adverse outcomes.
- Debt funds can use many levers to generate extra returns and many investors are not well-equipped to understand how some levers affect risk and volatility of returns (for example, structural leverage and other nuances of debt funds discussed in this white paper).
- Unlike publicly-traded bonds, which are rated by rating agencies, the area of private debt funds has not yet seen any significant third party research function emerge. Such research would help investors assess the risk of a fund or strategy.

As a result of these factors, fiduciaries such as RIAs willing to do their own research may be able to utilize debt funds to generate attractive yields and total returns.

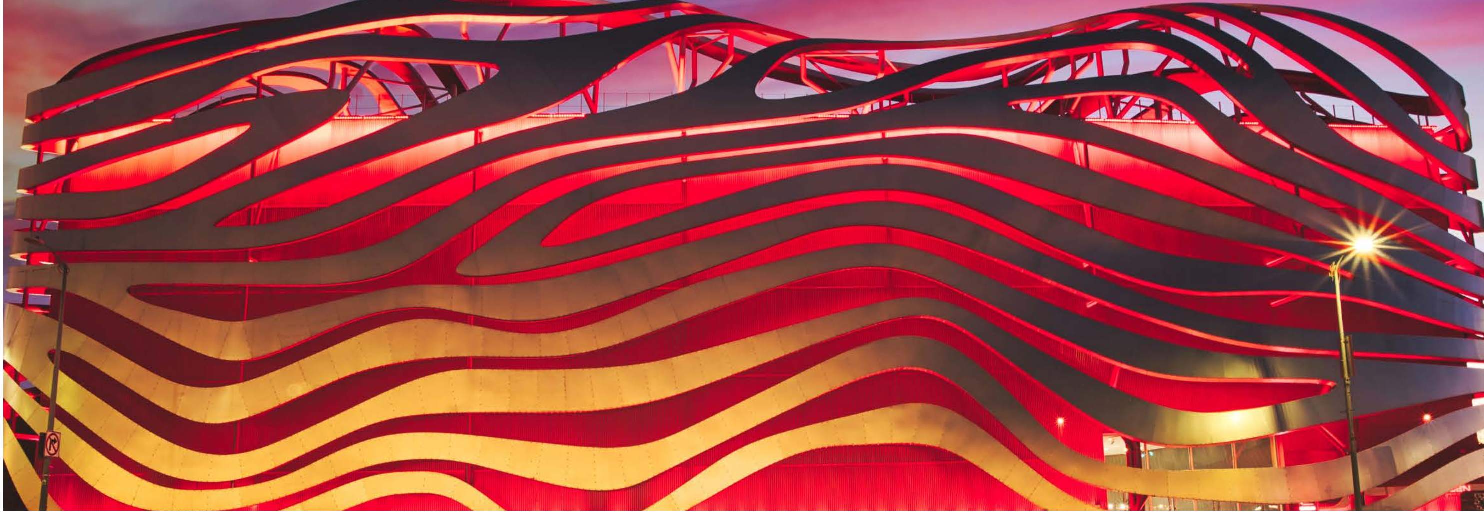
RIAs may want to consider the recent findings from research firm PERE. In that firm's *Investor Perspectives 2020* report regarding private real estate lending and investing, the authors write:

"Just 10 percent of investors polled report they are overallocated to the asset class going into 2020, with 32 percent saying they are underallocated. Further, 35 percent of respondents are looking to commit more capital this year. Only 9 percent say they will invest less. Investors are also largely content with the performance of their investments with 56 percent saying the asset class either met or exceeded benchmarks in 2019—only 7 percent feel they were short changed. Happily, private real estate is expected to deliver in 2020 too, with 65 percent of investor respondents foreseeing benchmarks being met or exceeded. Just 15 percent anticipate performance will fall short." [6]



There is little question that private debt funds will see ample demand for their capital that they raise. RCLCO Real Estate Advisors notes that "the single-family rental market will likely be undersupplied over the next 10 years...currently, approximately 6% of new single-family homes are purpose-built for-rent, which would result in approximately 700,000 new units over the next 10 years."[7] Given demographic trends, RCLCO forecasts much greater demand than the current pace of production. To help fill the anticipated gap in the supply of housing, private debt funds are expected to see greater opportunities for an expansion in lending volumes.

[6] Source: https://www.perenews.com/investor-perspectives-2020/
[7] Source: https://www.rclco.com/publication/growing-demand-for-built-to-rent-single-family-homes/



SECTION II

How to Conduct Due Diligence on a Private Debt Fund

In this section, we provide some insight into how to analyze and conduct due diligence on a private debt fund manager and his or her fund. We use the insight we have gained from managing such a fund for more than 10 years, across more than 1,600 investments, to highlight the areas that we believe distinguish the best-managed funds from all the others.

We have divided the diligence checklist into qualitative factors and quantitative factors. Qualitative factors include the reputation of the key individuals. Quantitative factors include the measurable parameters such as the amount of leverage used to achieve returns.

Qualitative and Manager-Focused Due Diligence

Key people

The most important initial screen for any business relationship is the people involved. For most alternative investments, including private debt funds, the limited partners are placing their trust with the general partner or fund manager, who acts as primary decision-maker for the fund. For that reason, establishing the integrity of the key people is critical. Items to research should include the following:

Reputation

Are you comfortable working with the key decision-makers for the fund? Funds are typically structured as partnerships or limited liability companies that are very similar to partnerships. Just as you would choose a business partner or life partner very carefully, you should choose the fund general partner diligently. A key step in this process is speaking or meeting with the partner (in-person or via videoconference). Another step is to check references. A great way to find good sources is LinkedIn, which allows you to see connections that you might have in common with the fund manager. These mutual connections may be able to provide very valuable candid input, particularly if they are well-acquainted with both you and the fund manager.

You should also ask to speak with an existing investor in the fund. Rather than accept a reference that the fund manager chooses, ask whether the manager will accommodate an investor reference chosen at random, for example, based on the last digits of the investor's account number. The most transparent managers should have nothing to hide and should be willing to accommodate thorough due diligence.

Understanding their life goals & priorities

What are the life goals of the fund manager? And how does the manager prioritize different goals? You want a manager that considers their reputation to be paramount. You want to avoid managers who are overwhelmingly focused on their image or material possessions, even more than their reputation with investors. Excessive concern with impressing others with material wealth could lead the manager to make decisions at some point that are not good for investors in the fund. For example, it is best to avoid managers that are in the midst of a challenging year and will pursue a "Hail Mary" high-risk investment in order to turn the year around in one fell swoop. Even worse is a manager who doesn't handle investor money properly. Because many of the best private debt fund managers are not large global alternative investment managers, you will need to learn about the key people yourself, enough to feel comfortable that you understand their core motivations.

Team culture & cohesiveness

What is the culture of the company that manages that fund? What types of people have the founders brought on to build the company, and what amount of turnover has there been? Some turnover is acceptable and inevitable, particularly if it involves bringing on the right senior people to manage the company's growth. However, a firm that has a history of excessive turnover may be driving away top talent, which may be a sign that the business is totally dependent on one or two key people. Such a culture inhibits a firm's ability to grow and respond nimbly to market conditions. One of the author's mentors has conducted due diligence on fund managers for some of the largest public pension funds. He finds that some of the best information he receives happens during on-site due diligence. For example, the receptionist or office manager frequently knows how things really work at the company and may be able to provide candid input on the subject.

Track record

Like anyone's reputation, a fund manager's track record follows the manager throughout his or her career. The best fund managers likely bring an almost obsessive focus to how they have performed for investors. This does not mean they will avoid any losses, but rather that the track record is objectively superior to that of most other fund managers in the same category.

How long is the track record? Does it include at least one period of market turmoil, so that

Lending to the Lenders

Just as private debt funds require a high degree of specialization for success, the same can be said for those who provide financing to these firms. Western Alliance Bank, which lends to a range of types of borrowers, has worked closely with private debt fund firms. The bank currently has around $2 billion in committed capital to private debt funds.

Private debt funds often take out a loan as a credit line that gets taken up and down as cash needs ebb and flow. For example, if fresh equity comes in, the private debt fund will pay down the line of credit. And if an opportunity to make end-user loans becomes available, the private debt fund will borrow to make the loan on a timely basis.

Industry lenders such as Western Alliance suggest that the criteria for clients are the same ones that should be used by investors in private debt funds. "It's crucial to clearly understand the controls in place against bad loans, fraud, etc." says Seth Davis, a senior director at Western Alliance Bank. "It's best to focus on private debt fund management teams with long track records," he says.

Davis takes the scrutiny needed by investors one step further. "It's important to understand the markets being served by a private debt fund, as various segments of real estate have divergent fortunes in a changing economy," he says.

Davis has been watching private debt fund managers through various economic cycles and has seen first hand how changes in interest rates impact the segment. In recent years, falling rates have led to a compression in margins for private debt funds. As a result, the returns they are able to offer investors have come down to the upper single-digits. That's still very impressive in an era when many other fixed income investments sport miniscule yields.

Why do margins compress as interest rates fall? "Wholesale lenders (such as Western Alliance) don't lower their lending rates as fast as private debt funds must lower their own lending rates to provide competitive terms," says Davis. In contrast, an eventual rise in interest rates will enable private debt funds to expand their spreads as wholesale borrowing costs would rise more slowly than real estate borrowers' lending terms.

investors can ascertain how the fund manager performed relative to others during this period? As we will explore later, it can be easy to outperform most managers in good times by taking on extra risk, but it is the challenging times that expose the cost of a risky approach.

In addition, when evaluating a firm's track record, completeness and transparency are both critical. Be sure that you are seeing all investments, not only the attractive part of the track record. And you should be able to receive answers and detailed documentation addressing any questions you have about the track record. It may be useful to ask the fund manager or their staff about which other funds they see as direct comparables. Try to talk to these other funds as well, in order to assess their track records on an apples-to-apples basis. Of course this topic is very nuanced and would require specialized training to perform in great detail. Any extra work you can do assessing the track record is better than simply accepting whatever the manager offers on this subject in the standard fund marketing materials.

Elevator test—"explainability" to clients

Whether acting as a fiduciary for clients, or investing on your own behalf, it is important to be able to explain a debt fund's strategy quickly and easily to a lay person in a clear and concise manner. The simpler the strategy, the better. For example, a strategy based on making loans on real estate that you can see and visit for yourself may be safer than an esoteric strategy that involves a degree in finance to understand. The more complex the strategy, the greater the chance that your results will be harmed at some point by an investment variable you did not grasp or could not anticipate. As the name implies, it is ideal if you can explain the strategy to someone in the time it takes to ride in an elevator.

Secular vs. cyclical underlying opportunity

Some strategies target a cyclical opportunity. An example might be auto loans which are closely tied to consumer purchases of new cars. In a cyclical strategy, demand for loans exists when the economy is doing well. Other strategies target a secular opportunity which plays on a larger trend that will continue whether the economy is expanding or contracting at the moment. For investors seeking to invest in a fund and enable the funds to keep working for many years, a secular strategy is preferable, as the investor will not need to make portfolio changes as frequently in order to ensure that conditions for favorable returns remain in place. Many debt funds that have emerged after the Great Financial Crisis (GFC) are able to target niches that were previously served by banks, where banks retreated because of new regulation that came into effect after the GFC. An example of a secular strategy is one that provides loans to real estate investors, where the declining number of banks has created a long term opportunity for non-bank lenders.

Moat test

When explaining his investment approach, Warren Bufffett has espoused the benefits of businesses that have a "wide and long-lasting moat" around them.[8] The same is true of debt investment funds. Some have a proprietary approach which enables them to deliver superior returns to their rivals over time. Usually this takes the form of a strong reputation and brand, resulting in a steady stream of good loans earning attractive yields for investors. A good indicator of this "moat" effect is the degree to which loans are made to repeat borrowers. If borrowers find there is a high switching cost, and they prefer to stay with their existing lenders, they will likely pay a slightly higher interest rate. In contrast, a lending business that has no moat and no loyal borrowers will need to compete in other ways to attract loans. They may need to offer higher leverage than other lenders, which will result in higher risk and more volatile results. Or they may need to compete on price, resulting in lower interest rates and returns for investors.

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[8] Source: https://www.cnbc.com/2018/05/07/warren-buffett-believes-this-is-the-most-important-thing-to-find-in-a-business.html

Quantitative & Granular Due Diligence

Loan-to-cost and loan-to-value of underlying loans

One of Warren Buffett's favorite concepts is "margin of safety". In a lending or credit investment fund, the starting points for analyzing the margin of safety are loan-to-cost (LTC) and loan-to-value (LTV).

Let's illustrate with an example from real estate. Suppose an investor can buy a building for $1 million and after spending $400,000 on improvements, the building will be worth $1,800,000. For simplicity, we will ignore sales commissions and holding costs in this example. If a lender provides a loan of $750,000 on the purchase, the LTC would be $750,000/$1 million or 75%. Suppose that the lender also provided $300,000 or 75% of the renovation costs. The total loan amount would be $750,000+$300,000 or $1,050,000. The total value upon completion is $1.8 million. The ultimate LTV would be $1.05 million/$1.80 million, or 58.3%. In real estate lending, this is sometimes called the LTV on "after-repair value" (or LTV on ARV).

From the lender's perspective, the margin of safety on day one is 25% or $250,000. Once the project is completed, the margin of safety is higher, namely, about 42% or $750,000 ($1.80 - $1.05 million). All other things being equal, a lower LTC or lower LTV indicates a safer investment. When considering a fund, the investor should ask, "is the fund getting paid adequately for the risk of the underlying investments?"

Volatility of underlying assets

Continuing with the real estate loan example, suppose that two loans are both made at an equal LTC and LTV. Let's use the 75% LTC and 58% LTV based on ARV from the previous section. This margin of safety seems attractive, but if the value of the underlying real estate changes too much and too quickly, the margin could be eroded or even eliminated. By way of example, consider home values in Phoenix during the GFC. As shown in the chart below, they fell more than 50% in the span of several years. In contrast, home values in West Los Angeles fell by a much smaller percentage.

Perspectives From a Leading Auditor of Private Debt Funds

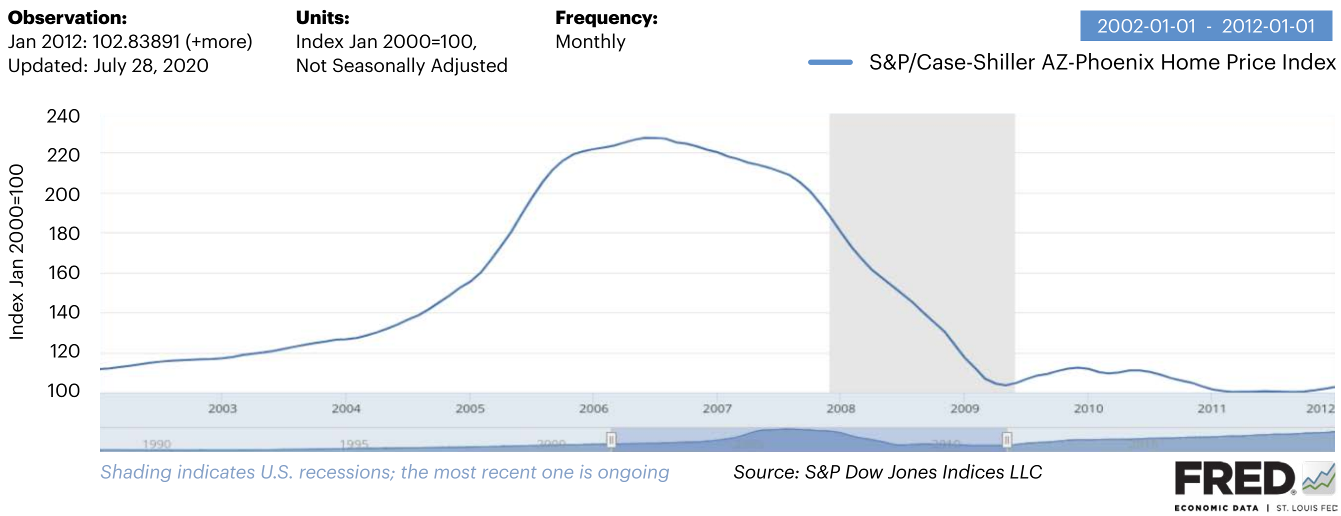
Maier Rosenberg is a senior managing director at CohnReznick, an accounting firm that audits and works with a wide range of private debt funds. Maier notes that the greatest risk for investors in private debt funds resides with the quality of the fund manager and their decision-making. "They make so many critical decisions that can have a tangible impact on fund results." As an example, he cites the decision to stick with the industry norm of 65% loan-to-value thresholds. "Some will lend at 75% or even 80% LTV ratios, which boost the risks in a portfolio," he says.

Rosenberg also stresses the importance of a fund manager's knowledge of each deal, asking questions such as: "How strong is the borrower and the collateral in place?"; and he also asks if managers have a clear sense of how they will be able to re-market a distressed property in the event of a loan default. That's why it is important for fund managers to stay focused on areas of lending and types of real estate that are within their core expertise. "I've seen managers do a poor job of assessing borrowers and their properties. They had to take back a property and it took quite a while to get their funds back," he says. "At that point, they are no longer operating in an area they know well." Citing one example, Rosenberg says if a fund is focused on construction loans, the manager should have a clear sense of how the construction industry operates, as well as asking whether "they know how to complete a project and sell it if they need to".

Investors in private debt funds need to understand accounting practices as they are not uniform across the industry. There are two approaches that a private debt fund can take for financial reporting purposes: 1) fair value and 2) as an operator. The majority of real estate debt funds that CohnReznick audits use fair value accounting as they fall under the Investment Company Guide (ICG) rules. As such, loan loss reserves are not permitted under the ICG; rather all loans must be marked to their fair value. Therefore, if there is a concern about not recovering the principal (and accrued interest) of a loan, the loan should be revalued to its fair value. This adjustment is treated as an unrealized loss. This market adjustment can adjust back to par value if the loan ultimately performs, at which time it is recognized as an unrealized gain. If a loan is ultimately sold or settled for less than its par value, the loss would be recognized as a realized loss at the time of disposition. Loan loss reserves are permissible if the fund is presented as an operating entity.

As a result, the lender faced more risk lending in Phoenix when compared to lending in West Los Angeles, where the supply of homes available for development is much more constrained. Investors wanting to assess volatility in their own area can reference the city and regional indices tracked by the Federal Reserve Bank.[9] Also, Zillow estimates home values by neighborhood and Zip code. For example, Zillow provides a home value trend that is specific to the Westwood area of Los Angeles near UCLA, among many others.[10]

S&P / CASE-SHILLER AZ-PHOENIX HOME PRICE INDEX (PHXRNSA)



Several factors can influence the volatility of market values including the following:

- Property type (consider hotel or retail property values during COVID-19 which are down dramatically, versus home values which have not dropped significantly);
- City (for example, Phoenix vs. Los Angeles during the GFC);
- Urban core vs. periphery (West Los Angeles vs. Inland Empire commuter cities such as Fontana, during the GFC);
- Price point, for single family homes (ultra luxury homes in Los Angeles, which in some cases have fallen in value substantially during COVID-19, versus more entry-level or mainstream homes in the same market, which have not fallen in value).

Borrower profile

Independent of all the other factors discussed so far is the borrower. The best borrowers expect to borrow at lower rates, all other things being equal. Factors that make a borrower attractive to the lender include the following:

Creditworthiness

What is the borrower's liquidity and credit score?

Relevant experience

Does the borrower have a track record of creating value with the type of real estate investment being financed? Can the borrower execute successfully on his or her business plan?

[9] For further details, go to: https://fred.stlouisfed.org/categories/32261
[10] For further details, go to: https://www.zillow.com/westwood-los-angeles-ca/home-values/

Relationship vs. transactional

Is the borrower a repeat borrower who has shown a desire to maintain a long-term mutually beneficial relationship with the lender? A repeat borrower who values relationships is much less likely to default than one who views each transaction individually, as a chance to negotiate the most advantageous outcome on that one transaction.

In conducting due diligence on a fund manager, it pays to understand the underlying borrowers. What percentage of the fund's loans are to repeat borrowers? How experienced are the borrowers at doing the type of project being financed? And what is their financial strength?

Discussion of Fees

The following questions should be considered:

- What is the difference between the gross returns and the net returns of a fund?
- What is reasonable compensation for the fund manager?
- How much of that compensation should come from fund investors vs. fees paid by borrowers to the fund manager or their lending affiliate?
- What is the right balance of incentive fees vs. other fees for a private debt fund?

A detailed discussion of fees is beyond the scope of this white paper.

Use of Structural Leverage

This topic is part of the quantitative due diligence but it has its own separate section because it is a topic unto itself that requires attention when structural leverage is used. Some fund managers use structural leverage to boost returns. In this section we will introduce a number of terms used in structured finance. These terms are defined in the glossary at the end of the white paper.

A third-party lender such as a bank may provide some of the capital to fund one or more loans, charging a relatively low rate because their position is more secure than the fund manager's position. The bank loan is known as a warehouse line of credit or it may also be called a repo line of credit. To use a warehouse line, the fund must pledge loans that it holds on its balance sheet into a borrowing base. Every warehouse line of credit has a prescribed advance rate. Suppose the advance rate is 65%. This means that if the fund manager pledges a loan of $1 million into the borrowing base, the fund can borrow $650,000 against that loan. When the $1 million loan is paid off, the fund must repay $650,000 of the warehouse line of credit, unless there is sufficient other collateral (loans) in the borrowing base to keep the overall warehouse line of credit in balance within the maximum 65% advance rate.

Structural leverage can provide for higher returns for the lender. However, leverage works both ways. If there are losses on a loan, the impact of those losses becomes magnified, compared to a fund that does not use structural leverage.

As an example, consider a loan of $10 million that has an 8% interest rate. Suppose that a private lending fund puts $5 million of investor capital into the loan, and borrows the other $5 million from a bank at a 5% interest rate (using the $10 million loan as collateral). This is known as "one turn of leverage", because for every $1 of capital invested, there is $1 of bank financing. We can calculate the effect of the structural leverage on returns as follows:

Interest income on whole loan	$10 MM x 8%	$800,000/yr
Interest expense on structural leverage	$5 MM x 5%	($250,000)/yr
Net return to lending fund	Difference	$550,000/yr
Return expressed in %	$550,000/$5 MM	11%

Even though the underlying loan generates an 8% return, in this example the fund generates an 11% return (before management fees). However, note that if the whole loan generates a loss of $500,000 (that is 5% of the $10 MM loan amount), it is actually a 10% loss relative to the fund's investment in the loan of $5 MM. In other words, structural leverage enhances returns on good investments, but also magnifies losses on bad loans. In this respect, using some bank financing on loan investments is just like using some leverage when buying and holding real estate. Moderate use of leverage can make sense for some investors, but excessive leverage creates the risk of much more volatile results—particularly when structural leverage is combined with one or more of the other risk factors discussed in this white paper.

When Structural Leverage Takes the Form of a Rated Bond

When a private debt fund uses structural leverage, in many cases the fund borrows money from a bank. When the size of that line of credit gets big enough—say, more than $200 million—then the private debt fund may find more advantageous terms by using the public markets to borrow the money. The process of issuing a bond backed by interest income from a pool of loans is called securitization. It pays to understand securitization because in the U.S. alone there is over $10 trillion of mortgage backed securities outstanding, making this asset class one of the largest parts of the fixed income investment universe, as shown in the chart below. As a result, understanding private debt funds and structural leverage is a good way to understand what you or your clients really have in your portfolio when you own bonds.

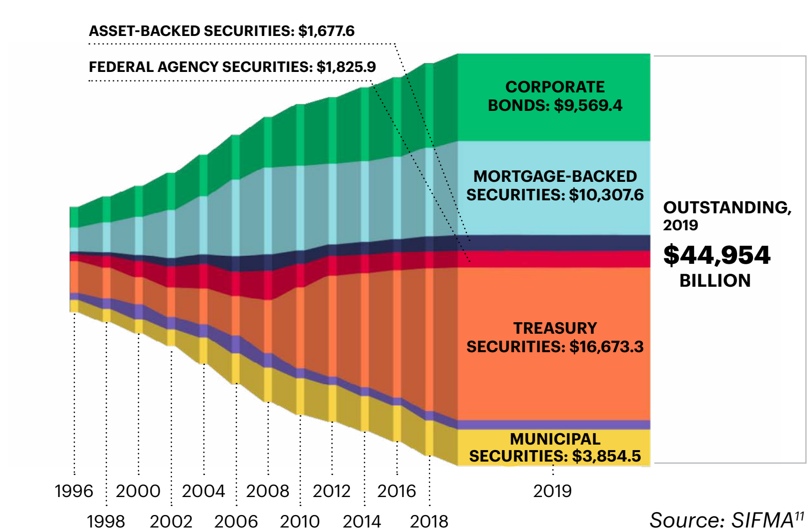
Frequently, the intermediate step to securitization is to use a repo line provided by a Wall Street investment bank. The repo line allows the investment bank to get a feel for the underlying loans produced by that lender, and to monitor their performance, as a kind of test prior to issuing a bond backed by these loans.

Once a portfolio of loans is held on a repo line of credit, the next step is to get a rating from a rating agency for a potential bond that will be backed by these loans. Because many private debt funds are comprised of short-term loans, sometimes securities backed by these loans allow for a substitution of loans backing the security. When one loan pays off, another loan with similar characteristics may be placed into the vehicle to replace it.

With the bond rating in hand, the investment bank then approaches bond investors to sell the security. Typically the yields on these bonds are quite low, because they often have investment-grade ratings. From the issuer's perspective, they also often provide a higher attachment point than what banks will allow. In other words, they allow the issuer to use structural leverage fairly aggressively, with many turns of leverage, relative to what a bank will allow, which increases the issuer's returns on their remaining capital invested in the pool of loans.

When the real estate loans are backed by income property such as commercial real estate or apartments, the securities created in the way described here are called commercial mortgage backed securities, or CMBS. When backed by single family home loans, they are called residential mortgage backed securities, or RMBS. Another type of security used in a similar way is the collateralized loan obligation or CLO. For a more detailed discussion, please reference "Commercial Real Estate Lending: The CLO Factor" by Franklin Templeton.[12]

FIXED INCOME SECURITIES OUTSTANDING IN THE U.S.



Source: SIFMA[11]

[11] Reference: https://www.sifma.org/resources/research/fixed-income-chart/
[12] Source: https://www.leggmason.com/en-us/insights/market-outlook/real-estate-lending-the-clo-factor.html

SECTION III

Case Studies

How Morton Capital Utilizes Private Debt Funds to Deliver Robust and Consistent Returns

While not all RIAs have adopted alternative investments in their client portfolios, some firms consider them to be an important driver of investment income and total returns. Calabasas, CA-based Morton Capital makes it clear to clients that alternatives are a core focus for their advisors and research team. And private debt funds have proven to be a strong area of focus for Morton over the years.

Meghan Pinchuk, Chief Investment Officer at Morton, notes that some clients may have up to 16-18% of portfolio assets placed with private debt funds. That's a higher percentage than some advisory firms tend to pursue, yet Pinchuk and her team have found that private debt funds provide an ideal combination of solid returns (which often exceed the rates found on high yield, or "junk" bonds), along with lower volatility and risk.

Morton Capital is very selective in the types of debt funds it will invest in. For example, the firm avoids cash-flow based (unsecured) lending vehicles, which bring with them too many variables to ensure consistent payouts. "Asset-based lending is a lot more predictable, especially when loan-to-value ratios are kept at healthy levels," says Pinchuk. "We have a lot more comfort with this approach."

Pinchuk notes that there is a wide range of private debt funds to choose from, from aggressively-focused lending strategies that hold the promise of exceptional returns to conservatively managed funds that ensure that risks are kept to a minimum.

When discussing real estate lending, default risk (also known as "foreclosure risk") comes to mind. Yet conservatively-run private debt funds can virtually eliminate losses due to foreclosures, according to Pinchuk. For starters, loan-to-value ratios rarely exceed 65%. If for any reason a borrower that taps funds from a private debt fund runs into trouble with a real estate development, the significant amount of equity in the property pledged to the private debt fund serves as a strong guarantee of salvaged value. While private debt fund managers have little appetite to press their legal rights in a default and assume control of a distressed asset, their ability to unload that asset and be made whole is an important risk mitigation feature of this strategy.

Notably, a tiny fraction of private debt fund loans ever reach the point of default. That's testament to the intense scrutiny that potential borrowers of private debt funds must overcome to qualify for loans.

It's fair to ask how private debt funds can generate yields above those offered by junk bonds. And the answer comes down to liquidity. Unlike publicly-traded investments that can be monetized with a click of the mouse, investors in private debt funds understand that the timing of distributions must be discretionary. Forced liquidations of a fund, at an inopportune time, can be damaging to all interested parties.

"We understand, and explain to our clients, that it is in our interest to accept liquidity restrictions," says Pinchuk. "Such restrictions are actually preferred, because without them, other investors might liquidate their interest, leading performance to suffer for those investors that remain in the fund. You want the funds to be able to have complete control of liquidity timing."

And private debt funds bring another "cost" to the equation—complexity. These funds generate K-1s, which creates some extra paperwork at tax time, because they require an enhanced level of scrunity. Morton Capital is large enough to conduct a substantial amount of due diligence to fully understand the dynamics of the investment vehicle, the philosophy and track record of the management team, and the ongoing status of the fund in terms of the health of the loans in the portfolio.

Pinchuk raises a few more topics that should be part of every advisor's due diligence: "This can include analyses such as how will the lender be able to handle challenging economic periods? Do they have safeguards and proper risk controls in place?" Pinchuck says that her firm spends many hours with the management teams of private lenders, ensuring a high degree of comfort with their approach and experience.

The SEC requirements in terms of due diligence are a bit of a gray area. Firms like Morton Capital extensively document their due diligence process and retain extensive notes. "That's just in the upfront process," says Pinchuk. "We also do an extensive amount of ongoing due diligence from quarter to quarter so we can stay abreast of trends, liquidity events, and other key matters."

While there is no such thing as guaranteed returns, Pinchuk has found that asset-based private debt returns have been very predictable throughout the 10 years her firm has been investing in them. Of course, the current era of falling interest rates has put somewhat of a damper on returns. "While we were able to get double-digit returns a decade ago when interest rates were higher, we are still able to garner upper single-digit returns these days, which is an extremely competitive return," adds Pinchuk.

So what distinguishes one private debt fund lender from another? "The quality of the valuation process by the lender is the most critical aspect for success," says Pinchuk. "Done properly, you are likely to see very low default risks," she says, adding that "defaults don't mean losses for us, but they can alter the timing of liquidity and lead to a temporary drop in returns."

Morton Capital has a preference for funds that make many short-term loans rather than fewer long-term loans. That helps to eliminate duration (interest-rate) risk.

Make no mistake, a core challenge for firms like Morton Capital is to ensure that their clients understand these non-traditional investment vehicles. Pinchuk says her firm lays out a robust education process about the merits of this and other alternative investment approaches. "We are known for focusing on alternative investments, so we attract the kinds of clients that would be amenable to alternative investments like private debt funds," she says.

Pinchuk concedes that most RIAs have yet to embrace private debt funds, usually because they avoid alternative investments in general. Alternatives have a reputation for exoticism and opacity. Pinchuk argues, however, that private debt funds are far less complex and far more transparent than many other "hedge-fund style" alternative investments.

How Arixa Capital and Lone Oak Fund Focus on Different Corners of the Real Estate Lending Market

Private debt funds have the ability to focus on specific segments of the real estate market. The decision to specialize enables management teams to develop a deep understanding of specific market dynamics, as well as provide for long-term, trusting relationships with experienced borrowers in that kind of real estate. Examples of such niches include single-family home renovations and multi-unit property construction in the residential segment. In the commercial segment, lenders can focus on office buildings, mixed-use, warehouse/logistics, retail, industrial and others. Below are two examples of private debt funds with slightly different areas of focus.

Arixa Capital manages levered and unlevered funds that are primarily focused on single-family and multifamily real estate projects. Over the past decade, the firm has focused on supply-constrained urban West Coast markets that have historically had less price volatility. Since inception, Arixa has funded over 1,600 loans representing in excess of $3 billion invested on behalf of its fund investors, and has generated positive investor returns for every month since Arixa launched its first fund in 2010.

According to Greg Hebner, Managing Director at Arixa, the firm's lending platform provides a one-stop shop for clients that handles all aspects of the lending process, from origination through servicing. "This enables Arixa to deliver a consistent and high-quality service experience for its valued clients," says Hebner. "This level of service is a primary component of the firm's marketing strategy, and the great majority of loans are made to existing borrowers, or referrals from those borrowers."

The firm measures its customer satisfaction through a robust Net Promoter Score (NPS) program for each loan originated to ensure it is delivering on its customer service promise. Historically, Arixa's NPS ratings have been in the mid-90s, which places the firm in the highest decile of U.S. companies.

Arixa's loans are short-maturity (6-18 mos.) and range in size from $500,000 to $15 million. In the majority of cases, these loans involve the renovation or repositioning of the property by the firm's borrowers. Arixa's goal is to make loans in which the borrowers are creating meaningful value during the time the loan is outstanding, with a goal of bringing the final loan-to-value ratio into the 60-65% range.

Lone Oak Fund, LLC has lent on a wider variety of property types than Arixa Capital. Lone Oak has retained a steady focus on lending for apartment buildings and industrial buildings. As far as CEO and Co-Founder Jerry Ducot is concerned, these types of commercial buildings tend to have the lowest risk in terms of occupancy rates. In contrast, lending on office building and retail-focused buildings holds greater risk, and therefore, less appeal.

Lone Oak's approach has led to a strong track record of limited foreclosures and consistent 6% or higher returns. Unlike some private debt funds, Lone Oak does not use structural leverage. "We are less interested in yield and more interested in security," says Ducot. Lone Oak's loans are typically up to $25 million in size.

How has a firm that has completed over 6,000 loans seen very few loan defaults? Lone Oak keeps the loan-to-value ratios below 60% on almost all loans it issues. Even on the rare occasions that a loan has defaulted, "each one of those assets were re-sold at break-even or a profit," notes Ducot.

The firm currently has 450 loans in place, and that level of diversification helps shield against the impact of a few loans having workout challenges. Unlike some lenders or traditional banks, Lone Oak doesn't provide forbearance during challenged economic times. "Our borrowers have access to other assets and funding sources and we insist that they pursue those options instead of forbearance."

There are two other notable differences between Lone Oak and Arixa Capital. First, Lone Oak considers its main clients to be mortgage brokers who maintain relationships with property owners. Arixa makes most of its loans directly to investors and developers, without a mortgage broker involved. The two firms define their target customers in a totally different way.

A second difference is that Arixa Capital's loans frequently include a number of draws or incremental funding events, during the renovation stage. In contrast, Lone Oak does not fund any construction draws, even if the borrower is renovating the subject property. The advantage Lone Oak enjoys is a simpler business that allows it to manage more money with fewer employees. The advantage for Arixa is that it knows its borrowers and projects intimately, and its borrowers tend to add a great deal of value to the properties Arixa lends on, so that the lender's margin of safety increases over time.

Dynamics in a Downturn

Investors need to understand the impact of economic cycles on the returns of private debt funds. It's important to distinguish between the factors behind an economic downturn. In the economic crisis of 2008/2009, real estate values plunged, quickly subverting the economics of short-term real estate improvement or construction loans. As noted in this paper, lenders aim to maintain loan-to-value ratios that provide a substantial cushion against any price drops, with LTVs typically in the 65-75% range. As a result, the better private debt fund lenders tended to generate flat to slightly positive returns at the height of the Great Recession.

Anchor Loans is one example, having made more than $7 billion in private debt fund loans in the past two decades in 47 states. The lender focuses on renovation loans on single family homes (with 1 to 4 units) and finances speculative ("spec") construction. While the firm has generated annual returns for investors in excess of 9% since 2010, Anchor also managed to break-even in 2008/2009.

Anchor deploys various mitigation controls to reduce or eliminate risks, including conservative loan-to-value ratios, a focus on repeat business to establish a long-term track record with existing clients, and structuring loans as "blanket loans," which compels clients to place all open loans under one agreement so the client isn't in a position to declare a default on just one loan.

Fast forward to 2020, and a very different backdrop is in place for real estate, even as the broader economy endures a profound contraction. That's because real estate lending practices never grew out of hand in the slower-growth economy of recent years. Banks maintained tighter lending standards while homeowners and building owners have maintained more substantial levels of equity in their properties.

"This economic downturn is very different, and far less risky than the last one, which is why Anchor is maintaining but not tightening its lending standards," says Anchor CEO Steve Pollack. "There is now much more equity in real estate than before, and banks have also been generally more prudent," and as a result, "we haven't paused our lending."

While Anchor didn't see a huge impact from COVID-19, lending activity in general saw a slowdown. Industry research firm Preqin found that U.S. commercial real estate activity slowed in the summer of 2020. "Just $7.3 billion of private equity real estate deals were completed in Q2 2020 up to June 15th, compared with $31 billion in Q1." The researchers added that "with $147 billion of dry powder waiting to be deployed in US commercial real estate, the market is poised to return to action as it emerges from this crisis."

Offsetting an otherwise cautious economic backdrop, a low interest rate environment provides support to real estate asset-based lending. Yet it is fair to wonder how such an approach might fare in a rising rate environment. If interest rates increase, there will be fewer potential buyers/borrowers, and some private debt fund clients may need to hold on to their properties for a little longer than they anticipated. "The experienced flippers know how to navigate these environments, for example, by adjusting their sales prices to exit their investments in reasonable time frames," says Pollack. Nonetheless, loan volumes for Anchor would fall.

In such a scenario, it would be crucial for investors to focus on private debt fund managers that maintain the same level of lending discipline across economic cycles. Some firms may be tempted to lower lending standards to maintain the volume of loan origination, yet that would likely lead to lower quality loan portfolios and more loan losses.

Summary of Rewards & Risks

Private debt funds can offer attractive income and non-correlated returns. Investing in these funds does require due diligence, but this effort can pay off for investors and their advisers. Please refer to Appendix A for a full overview of the summary of rewards and risks.

About the Authors

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Jan Brzeski founded Arixa Capital, one of the West Coast's most active private real estate lenders providing small balance bridge and renovation loans to lower middle-market residential investors and developers. Since starting Arixa in 2006, his firm has originated approximately 1,600 real estate loans, investing over $3 billion on behalf of Arixa's fund investors. Jan earned a bachelor's degree in physics from Dartmouth College, and a master's degree in philosophy, politics & economics (PPE) from Oxford University.

David Sterman
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David Sterman founded Huguenot Financial Planning in 2018 to fulfill a long-standing goal of empowering consumers as they prepare for a prosperous future. Previously, he worked as a research analyst on Wall Street and also as a financial journalist, as Director of Research for *Individual Investor* magazine, Managing Editor at RealMoney.com and Chief Market Strategist for StreetAuthority, LLC. David earned a dual bachelor's degree in philosophy and political science from Emory University, and a master's degree in the science of management from Georgia Tech. David also holds a CERTIFIED FINANCIAL PLANNER™ certification.

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Overview of Private Debt Funds for Individual Investors

Most investors have typically built and protected their wealth by investing in stocks, bonds, mutual funds, and more recently, index funds that invested in public market securities. Some investors owned real estate such as rental properties, while more sophisticated and very wealthy investors participated in more esoteric investments such as private equity, venture capital and hedge funds, collectively known as "alternative investments".

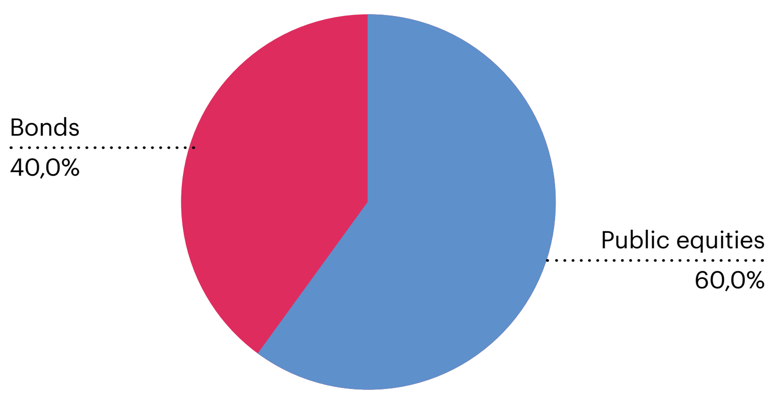
Given reduced expected returns and high volatility of traditional public market investments, alternative investments are now garnering greater interest from wealth advisers and their clients. Among alternative investments, private debt funds are capable of generating attractive income while maintaining a margin of safety. These funds are especially well-suited for investors willing to spend the time to ramp up their understanding of debt funds.

This two-page summary is meant as background for a white paper entitled, *Alternative Income for a Low Interest Rate World: Understanding Private Debt Funds*. The white paper suggests that profitable opportunities exist for alternative investments—noting that comprehensive studies have not yet been generated to prove conclusively that private debt funds in particular make a portfolio perform better than a traditional portfolio of only stocks and bonds. However, many investors in such strategies know from experience that these investments can be an attractive complement to volatile, low-yielding public stocks and bonds.

There's more to investing than stocks and bonds

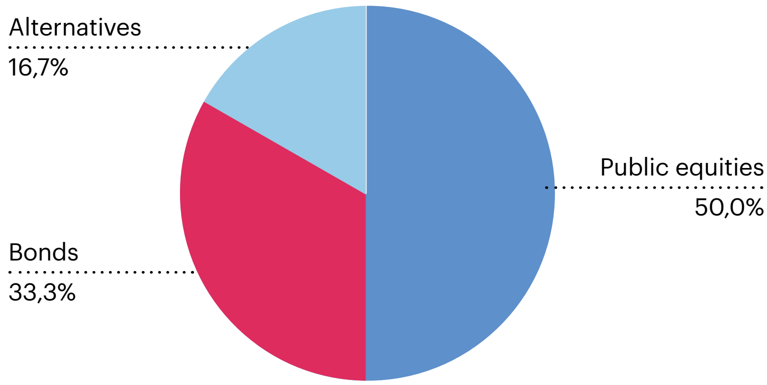
The chart below shows a traditional recommended portfolio for individual investors, split between stocks and bonds.

TRADITIONAL PORTFOLIO



The Federal Reserve has indicated that ultra-low benchmark interest rates are expected to remain in place for at least the next several years. Furthermore, public market investments remain volatile: The S&P 500, for example, fell 33% between February 19, 2020 and March 23, 2020. Over the longer-term, equities have fared well since the Great Recession of 2008/2009, which has led to a reduction in expected future returns for stocks. Meanwhile, bonds deliver paltry yields. In response, some investors are now adding alternative investments to their portfolios, as shown in the chart below. The largest pension funds and endowments have endorsed this approach strongly and have tended to increase their allocation to alternative investments over time.

PORTFOLIO WITH ALTERNATIVE INVESTMENTS



Potential benefits of well-run private debt funds

Certain niches may offer very attractive returns relative to their risk—for example, making senior secured loans to real estate investors who renovate properties—as long as the loan-to-value ratios remain conservative. Benefits of private debt funds may include:

- Returns in many such funds have been relatively steady over the past 10 years, in contrast to the volatility of public market investments.
- Many such funds generate significantly more income than either stocks or bonds.
- Some investors are prone to panicking and selling their investments precisely when markets are most depressed. By reducing volatility, and taking some time to liquidate, private debt funds may reduce this temptation.

Issues to consider before investing in a private debt fund

At the same time, investing in private debt funds requires time, energy and the ability to apply your own common sense and trust your instincts. Like any investment, they come with risks. Some issues to consider before investing include:

- Ensure you or your financial adviser are able to conduct real due diligence on the fund, the manager, and their strategy, before you invest.
- Understand the underlying investments that the fund makes, and all the key risks that the fund may be taking on to generate its returns.
- Study the fees charged by the fund manager and ask whether the likely returns justify these fees.
- Private debt funds are not liquid like stocks and bonds. Understand how long it will take to get your money back when you need it.

In summary, private debt funds may reward investors willing to conduct due diligence on their investments. Most major pension funds and endowments have embraced alternative investments in recent decades. Now may be a good time for individuals to explore private debt funds as a relatively simple way to complement a portfolio that is otherwise tied to the volatile public markets.

Types of Real Estate Loans

Real estate loans come in many shapes and sizes, and they perform very differently from one another in each economic cycle. Real estate loans can be categorized according to three different dimensions—property type, loan size, and maturity.

Property type

Consider loans on single family homes being renovated; apartment buildings; retail buildings; hotels; and industrial buildings. During COVID-19, single family homes have been selling briskly at robust prices, and industrial buildings and apartments have been bright spots, but many retail tenants have stopped paying rent, while many hotels remain completely shut down. In contrast, in the Great Financial Crisis, single family homes dropped in value—particularly in the distant suburbs of major cities.

Loan size

In some cases, the loan size makes a big difference in terms of the interest rate that a borrower pays. For example, a loan on a large apartment building that is going to be renovated may feature a lower interest rate than a loan on a small apartment building. The lender on the large loan has economies of scale in originating and servicing the loan, and is more likely to have capital from institutional investors who are eager to invest in these types of loans. Also, the buyer of a large building is more likely to be an institutional investor and more systematic about creating competition among lenders, thereby commanding better terms than the buyer of a small building.

Loan maturity

Bridge loans are short term loans that borrowers typically use for one to three years, while repositioning a property. Bridge loans used to purchase property are sometimes known as acquisition loans or purchase money loans. Loans with construction draws are called renovation loans or construction loans. Permanent loans, by contrast, typically have maturities of 5-10 years. Borrowers are more sensitive about the interest rate for permanent loans because they intend to pay the interest for a longer period of time. Many private debt funds focus on shorter-maturity loans because these loans offer the prospect of higher returns, all other things being equal.

Glossary

Advance rate
The advance rate relates to debt funds that use structural leverage to enhance returns. When banks provide a warehouse line of credit to debt funds, one of the key terms of the warehouse line is the advance rate which refers to how much the fund can borrow on any given loan, and on a portfolio of loans, relative to the value or principal amount of those loans. With a 65% advance rate and $100 million of loans pledged, a debt fund could borrow $65 million. The advance rate is similar to the loan-to-cost (LTC), except that the advance rate pertains to the borrowing between a commercial bank and a debt fund on a portfolio of loans, whereas the LTC refers to the borrowing between a real estate owner and a debt fund on a single property. Among bond traders, the advance rate is sometimes referred to as the "attachment point."

After-repair value or ARV.
This term is used mainly in one area of real estate lending, namely, renovation loans. Furthermore, with larger commercial real estate loans or apartment loans, the alternate term "stabilized value" is more commonly used, whereas ARV is often used for single family home renovation projects. Suppose a property is purchased for $1 million. After a $400,000 renovation and addition, the estimated value upon completion will be $1.8 million. In this case the ARV is $1.8 million.

Borrowing base
A borrowing base is a group of loans that are pledged to a bank as collateral for a portfolio-level loan such as a warehouse line of credit. Fund managers are limited in the amount they can borrow based on the value of loans in the borrowing base and the advance rate prescribed in the warehouse line loan documents.

Closed-end fund
In a closed-end fund, a group of investors is locked in at some point in time, and no new investors are added after that. Typically in a closed-end fund, when the fund reaches the end of its intended life cycle, all investors are redeemed out together at the same time, or "pari passu". See also "open-end fund".

Debt fund
A debt fund is a pooled investment vehicle that owns a portfolio of debt investments rather than equity investments. For example, a real estate debt fund would own loans secured by real estate, whereas most real estate funds own whole properties or equity interests in properties. Debt funds may invest in private loans or in debt securities that are traded publicly. Some debt investment vehicles may be structured as separate accounts, joint ventures, or a "fund of one" investor. The main distinguishing feature of a fund is that there are typically many investors in a fund rather than a single investor.

Evergreen fund
See "open-end fund."

Fair value
Under generally accepted accounting principles (GAAP), a fund manager is required to hold each investment in a fund on its balance sheet at fair value. This means marking an investment up or down as needed if the value of the investment has changed from the original value. For open-ended funds, fair value is important as relates to redemptions. If one or more loans are impaired, investors may see a reduction in their capital account and may lose principal. See also "impairment".

Gearing
See "Turns of leverage."

Impairment
A loan is impaired if the value of that loan becomes lower than the principal amount of the loan. Suppose a lender makes a loan of $3 million and due to a decline in the value of the collateral, the lender expects to recover only $2.5 million. In this case the loan would be impaired by $500,000. The impairment can also be expressed as a percentage, namely, $500,000/$3 million or 16.7%.

Junior loan
A junior loan is referred to as junior because it is subordinated to another loan. Specifically, it is subordinated to the senior loan. The senior lender is paid off first from any proceeds from the sale or refinance of the underlying collateral. Only after the senior lender is paid off in full, with any interest due, does the junior lender receive repayment of principal and any interest due.

Loan loss reserves or LLRs
Like a bank, a non-bank lender may build up loan loss reserves over time. The mechanism to do so is to withhold a small portion of income each month. For example, a fund generating an 8% return might pay out 7.75% in a given year, which would build up LLRs by 0.25%. If the fund subsequently suffered a loss on one of its loan investments, it could use the LLRs, before impacting fund returns or capital accounts. The appropriate level of LLRs for a given fund may be the subject of discussion and debate between fund managers and the fund's auditors. Different auditors may have slightly different interpretations of what is appropriate policy as relates to LLRs, under generally accepted accounting principles.

Loan-to-cost or LTC
LTC is a ratio used by lenders to identify an important risk characteristic of a given loan and is expressed as a percentage. The numerator is the loan amount and the denominator is the cost of a project. A loan of $3 million on a project whose total cost is $4 million would have an LTC of $3 million/$4 million or 75%.

Loan-to-value or LTV
LTV is similar to LTC with one important difference. Instead of using the cost of a project as a denominator, LTV uses the value. A loan of $3 million on a project whose value is $5 million would have an LTV of $3 million/$5 million or 60%. The lower the LTV, the greater the margin of safety of a given loan.

LTV on ARV
This term is used by professionals who deal with renovation loans. It is short for “loan-to-value on after-repair value”. Suppose a home is purchased for $1 million and the renovation budget is $400,000 for a total project cost of $1.4 million. Upon completion it is expected to be worth $1.8 million. Furthermore, suppose a lender agrees to lend a total of $1 million out of the total project cost of $1.4 million. The LTV on ARV is $1 million/$1.8 million or 55.6%.

Margin of safety
Margin of safety is a central concept in the field of investment management and was made famous by Warren Buffett who mentions this concept frequently. As relates to loan investments, the margin of safety is the difference between the loan amount and the value of the underlying collateral. For a loan of $3 million on a project worth $5 million, the margin of safety is $5 million minus $3 million, or $2 million. The margin of safety may also be expressed as a percentage, namely $2 million/$5 million or 40%. The value of the underlying collateral would need to go down by 40% before the loan investment would become impaired.

Mezzanine loan
Also see “junior loan.” In real estate, a mezzanine investment may or may not be structured as a recorded mortgage or junior loan. Mezzanine investments are so called because in the order of priority of payoff in case of a sale or refinance of the underlying property, the mezzanine investor is in between the owners/equity investors, who are last to be paid, and the senior lender, who is first to be paid.

Non-bank lender
See “private lender”.

Open-end fund
In an open-end fund, investors can and do come into the fund or leave the fund at various times. There may be no defined end to the fund's life, but instead the fund manager can operate the fund so long as he or she has investors with a critical mass of investment capital, and opportunities to make investments that the fund manager deems attractive. In an open-end fund, investors have "redemption rights" which determine their ability to get their capital account returned to them in cash. Some real estate debt funds use the open-end structure while others use a closed-end structure. Each structure has advantages and disadvantages for the investor and for the fund manager.

Origination (of a loan)
Loan origination refers to the process of making a new loan to a borrower. Some key steps in loan origination include issuing a term sheet; meeting the borrower; inspecting and underwriting the collateral; drafting, negotiating and executing loan documents; and finally funding and recording the loan. Many credit funds do not originate loans themselves because all the steps in loan origination require specialized expertise and significant resources and staffing.

Private lender
A private lender is a non-bank lender who originates loans, which loans may be secured by real estate, equipment or other assets, or may be unsecured. Private lenders have a balance sheet which typically consists of investor capital and may also include bank financing (see "structural leverage"). Some private lenders are affiliated with one or more particular debt funds. The private lender and the fund may be one and the same entity, or the private lender may have a small balance sheet and may regularly sell loans to one or more debt funds to recycle capital to make more loans.

Real Estate Investment Trust or REIT
A vehicle for holding real estate equity or debt investments that enjoys certain tax benefits for investors. A REIT may be publicly-traded or private.

Redemption rights
In an open-end fund, investors have the ability to request that their capital be returned to them. The redemption rights built into the fund partnership agreement or operating agreement determine how such redemptions work, typically stipulating a minimum investment period; the amount of notice required for redemption requests; target redemption timelines; and the rights of the fund manager to slow down or halt redemptions under certain circumstances.

Repo line of credit
Similar to a warehouse line of credit, a repo line of credit allows debt funds to borrow money against the loans they hold in their portfolio. Repo lines differ from warehouse lines in that when a loan is pledged in a repo line, the repo lender, which is frequently a Wall Street investment bank, actually takes control of the underlying collateral, making it faster and easier for them to assert their rights in case of non-performance by the fund. Repo lines frequently allow an advance rate higher than what warehouse line providers will offer, and they often charge even lower rates, however the Wall Street lenders who offer repo lines create more uncertainty for the fund manager when the financial markets are volatile, as compared to the commercial banks that provide warehouse lines of credit.

Senior loan
A senior loan is one in which the lender has the most secure position. In real estate a senior loan is also known as a "first lien." The loan is senior or in first position, in that in case of a sale or refinance of the underlying property securing the loan, the senior lender receives principal and interest due before any other lender receives any principal or interest repayment.

Structural leverage
Structural leverage is used by some lenders to increase returns to investors. Typically a bank provides financing at a relatively low rate, so that the returns from a lending program end up higher than they

would otherwise be. The amount of structural leverage can be expressed either in "turns of leverage" or as a percentage. The authors prefer to refer to turns of leverage to avoid confusion with LTC and LTV ratios. Suppose a fund manager raises $100 million from investors, and is able to also borrow $100 million from a bank, in order to make $200 million of loans. The result can be described as "one turn of structural leverage" because for every $1 of bank borrowing there is $1 of investor equity.

Turns of leverage
Also known as "gearing", turns of structural leverage refers to the amount of bank borrowing in a lending vehicle, compared to the amount of investor capital. If a borrower uses $2 of bank financing for every $1 of investor capital, this equates to "two turns of leverage". The higher the turns of leverage, the greater the returns that investors typically earn, but high structural leverage also increases volatility of returns. By way of example, consider a 10-speed bike in the highest gear. The rider can go fast in this gear on a flat road, but if he or she encounters a steep hill, the rider needs to shift to a lower gear quickly, or risk finding it too hard to pedal and falling off the bike.

Underwriting (of a borrower and/or a loan)
Underwriting refers to a particular type of research and analysis performed by lenders when they are considering originating a new loan. In real estate lending, elements of the underwriting process include evaluating the borrower's expertise, background and credit-worthiness; and understanding the borrower's collateral and business plan for that property, in detail. This analysis includes assessing the as-is value of the property; the budget for any planned improvements or construction; and the expected future value of the property upon completion of the proposed improvements. This future value is sometimes called the "after repair value" or ARV.

Warehouse line of credit
In the context of this white paper, a warehouse line of credit is a loan from a bank made to a debt fund. The fund holds a portfolio of loans and can pledge these loans into a borrowing base, which provides collateral for the warehouse line of credit. Because the bank is in the safest position of any of the parties, it usually charges a relatively low interest rate on the warehouse line of credit, which in turn enhances returns for the investors in the fund. The warehouse line of credit is in effect a senior loan secured by the whole portfolio of loans, making the fund and its investors subordinate, for which they receive a premium return.

APPENDIX D

Recommended for Further Reading

"Why CalPERS, the country's largest pension fund, is getting into banking," by Ben Christopher. Orange County Register, July 9, 2020.
https://www.ocregister.com/2020/07/09/why-calpers-the-countrys-largest-pension-fund-is-getting-into-banking/.

"Survey of Capital Market Assumptions: 2020 Edition," Horizon Actuarial Services, LLC, July 16, 2020.
https://www.horizonactuarial.com/blog/category/publications.

"2020 Preqin Global Private Debt Report", Preqin, February 4, 2020.
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"PERE Investor Perspectives 2020", PERE Reports,
https://www.perenews.com/investor-perspectives-2020/.

"Growing Demand for Built-to-Rent Single Family Homes," by Gregg Logan and Todd LaRue. RCLCO Real Estate Advisors, August 13, 2020.
https://www.rclco.com/publication/growing-demand-for-built-to-rent-single-family-homes/.