Private Credit:
Low Correlation, Stable Income

In a protracted low yield, inflationary and rate-rising environment, traditional bond strategies may not deliver the income that pension schemes need.

Designed to deliver stable income in both up and down markets, Private Credit strategies may be a suitable alternative for long-term investors such as **Local Government Pension Schemes (LGPS).**

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What is Private Credit?

While large corporations can access the depth and liquidity of public markets, millions of companies around the world rely on private sources of capital, or Private Credit.

The asset class has grown since the 2007/08 Global Financial Crisis, which imposed tougher regulation on banks, ultimately reducing the amount of bank lending. This led to a funding and capital gap – and therefore to investment opportunities – that asset managers such as CQS are trying to fill.

An example of this is the sharing of risk between banks and investors, a strategy that can be achieved via an instrument called Significant Risk Transfer (SRT) or Regulatory Capital Relief (RCR).

SRT is therefore a risk-sharing transaction, where a bank's performing loans stay on its balance sheet, with the bank's teams continuing to manage the customer relationship and the loan performance.

At the same time, investors agree to take exposure to the performance of those loans in exchange for a regular coupon payment.

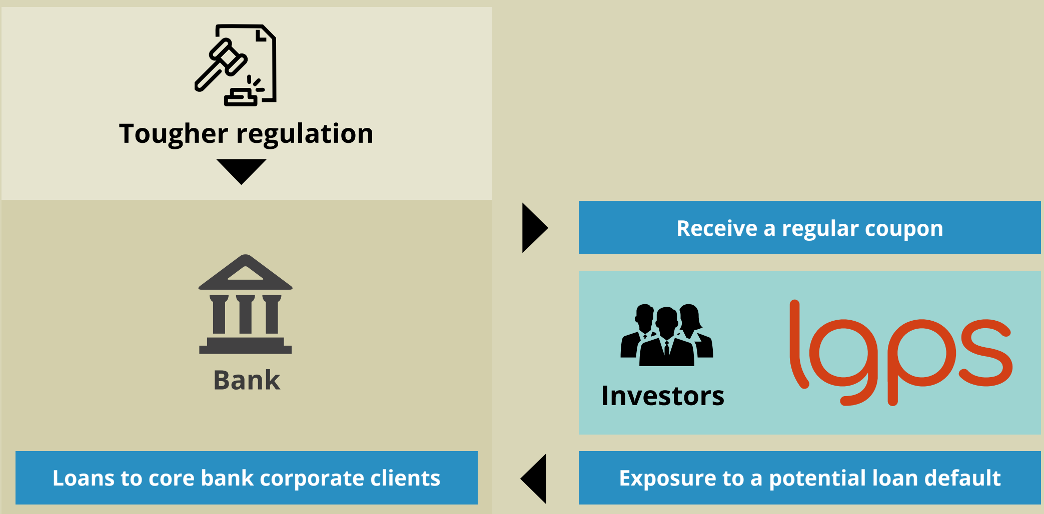
This sharing of risk reduces the bank's exposure to its own loan book, improving its capital ratios, and gives the investor a regular income stream.

CQS at the forefront of this growing and exciting income-oriented opportunity

The strategy offers investors access to a range of diverse, hard-to-source loans which offer compelling yields - currently between 8% and 12%[1] on an unlevered basis.

[1]Source: CQS as at 28 February 2022.

Private Credit: Loan risk in exchange for regular coupons



How Can Private Credit Help LGPS?

While LGPS are at present in a strong financial position, funding levels may be challenged by the ongoing geopolitical and macro uncertainty.

Also, and as seen in Figure 1, the number of pensioners is increasing at the same time that the proportion of those employed remains more constant. This means that current pension contributors are only about a third of the total LGPS's 6.1 million members, forcing employers to lift their contributions (Figure 2).

This, plus the removal or reduction of Secondary Employer Contributions (due to higher funding levels), means Funds need additional income streams - especially from investment income which, at present, only accounts for about a fifth of total income.

Private Credit may therefore help LGPS access regular income as part of a strategic allocation to Alternative or Private Markets more than as an allocation to Credit. This is because the main purpose of SRT, or Regulated Capital, is to provide regular high income - hence it is more comparable to other Alternative asset classes such as Real Estate and Infrastructure.

Additionally, Private Credit offers:

Floating-rate nature

- Most transactions have a floating rate nature, which reduces the impact of rising rates – a crucial risk for those schemes with benefits linked to inflation.

Additional diversification

- The asset class may help diversify away from large allocations to equity and fixed income markets.

Low correlation

- SRT bears low correlation to traditional equity and fixed income markets, reducing overall risk.

Lower volatility

- Performing bank loans with core clients tend to bear low levels of volatility.

Sustainability

- Investors such as CQS may select which loans integrate the pool that they will be exposed to, giving them the chance to pick sustainable candidates.

Speed

- Investing in Private Credit is normally far quicker than for either Real Estate or Infrastructure. This may reduce volatility in periods of stress.

These advantages may be vital, especially at a time when traditional income classes are challenged by low yields and rising inflation.

Figure 1: Stable contributors, more retirees

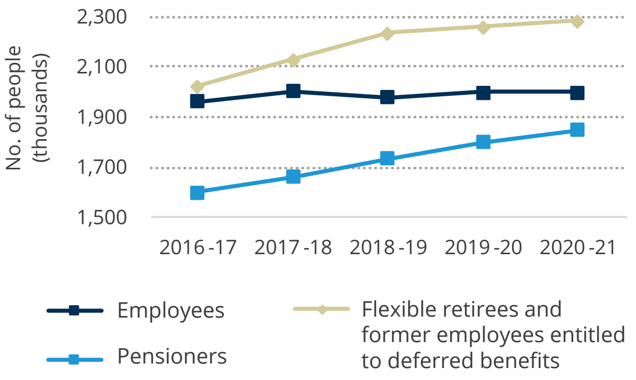
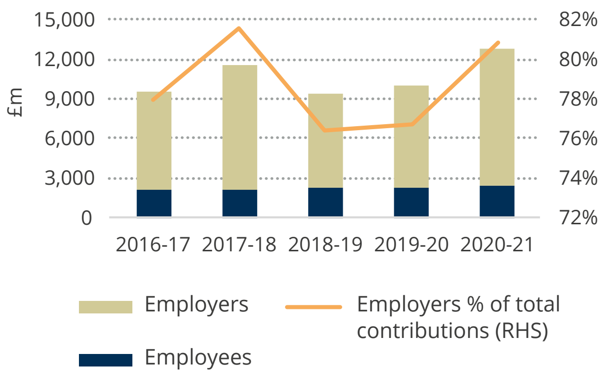


Figure 2: LGPS Contributions

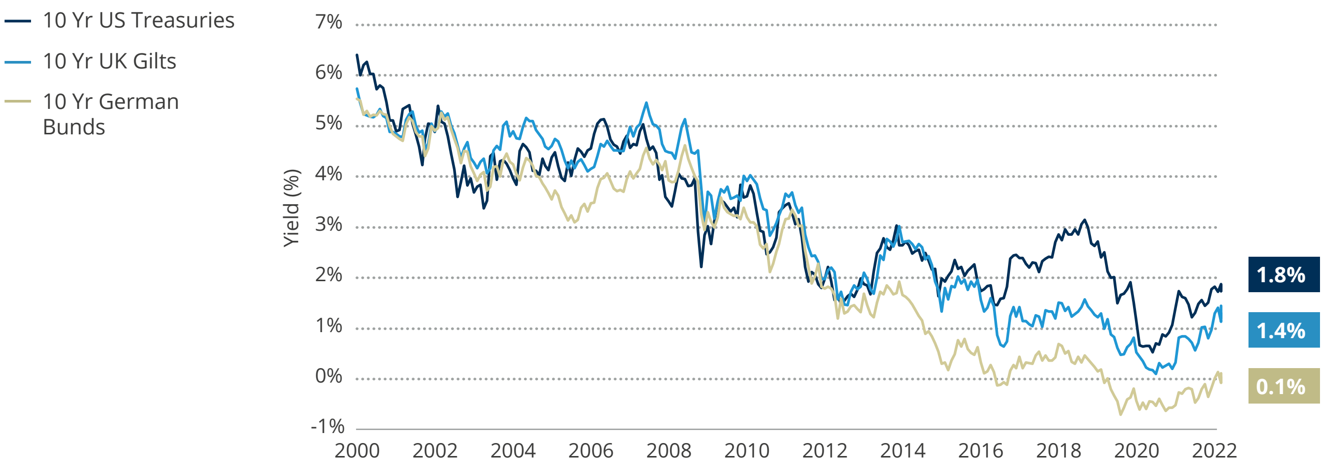


Source: All charts latest (2020-21) LGPS Statistical Release for England and Wales.

Limited Income From Traditional Fixed Income

While fixed income has benefited from two decades of falling bond yields, this began to reverse as central banks became more hawkish last year, dampening returns.

Figure 3: Government Bond Yields

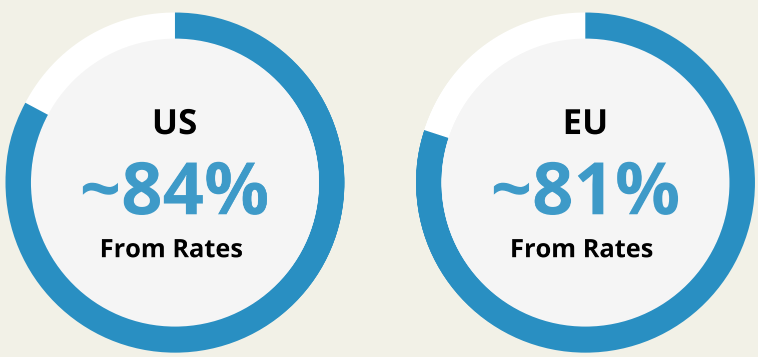


Source: Bloomberg as at 8 March 2022.

Still, and as Figure 3 shows, yields are near-record lows, given the pandemic-driven fiscal and monetary largesse of the past two years. Despite the recent pick up in yields, the level of income expected from traditional sources, such as UK Gilts or Investment Grade (IG) Credit, is expected to remain at historical lows.

IG Bonds, Heavily Exposed to Interest Rate Risk

Although a traditionally low-risk, high-return asset class, IG debt is highly sensitive to interest rates, given its high correlation to government bonds. Over the last 20 years, 80%+ of IG returns have come from the sovereign debt that they use as a base – after which they add the credit and other premiums. There is therefore substantial risk associated with this rate reliance, so investors should tread with caution.



Source: ICE BofA Indices (CF0X, EN00) as at 28 February 2022.

Inflation: An Increasing Challenge

The ongoing geopolitical and energy crisis, following Russia's invasion of Ukraine, has added to already broad-based, post-pandemic rises in core inflation around the world. This is a challenge for real yields and income.

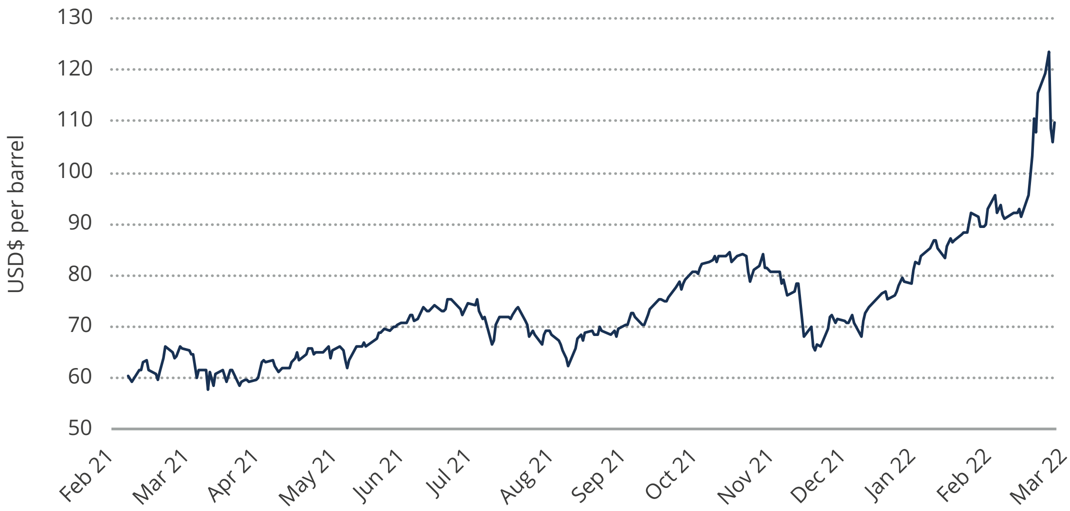
Annualised inflation figures have reached 7.9% in countries such as the US, and 5.5% in the UK. Global supply chain disruptions, combined with the pick up in oil, gas and grain prices, means that inflation may become an increasing problem in the future.

Figure 4: UK CPI Inflation: The rise may not be short-lived

Source: CQS & Bloomberg (year-on-year), as at 28 February 2022.

Inflation has been largely driven by oil prices, which started increasing last year as geopolitical tensions intensified. The disruption that the Russia-Ukraine conflict has generated may continue over the next few months.

Figure 5: Oil is pushing inflation higher

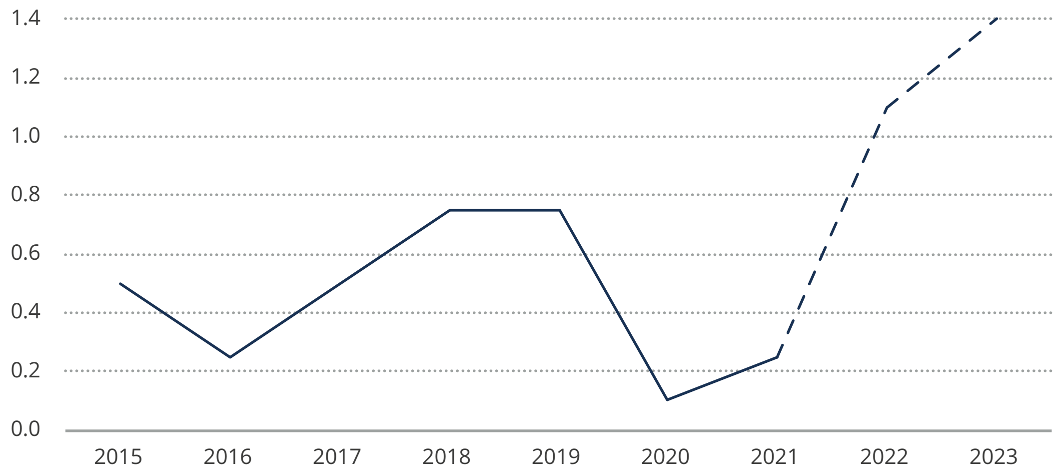


Source: Bloomberg, as at 11 March 2022.

High inflation, higher rates

High inflation may force central banks to lift interest rates. Figure 6 shows the market implied forecast for the Bank of England base rate. A less rate-dependent, income-generating solution, such as Regulatory Capital, is becoming increasingly crucial in order to meet any future liabilities.

Figure 6: Bank of England: on a rate rising path



Source: Bloomberg as at 9 March 2022. Dashed line indicates market forecast (from Bloomberg, based on market expectations).

FLOATING RATE OPPORTUNITIES

Insulate against rising interest rate risk

In this period of rising inflation, an attractive feature of SRT is that most deals are floating rate. As a manager, we only undertake transactions that are 100% floating rate in order to mitigate the impact of rising rates, a key risk in the current environment.

Capturing Income From Private Credit

With asset-level yields between 8 and 12% on an unlevered basis, Regulatory Capital offers a compelling investment opportunity relative to other asset classes, as shown in Figure 7.

SRT yields are attractive because they are generated by hard-to-source performing loans: the strategy allows investors to access bank loans that generally are not part of mainstream equity and fixed income markets. At CQS, we have participated in the Regulatory Capital Relief market since 2014, building strong relationships with issuers and participating across all types of transactions.

These relationships have given us access to opportunity in the following fields:

Core lending

- We can access so-called senior priority loans, or core lending facilities that companies use to operate on a day-to-day basis. For instance, they include the revolving facilities that businesses rely on to access liquidity and also for working capital.

Small & Medium Enterprises (SMEs)

- Core loans to small and medium companies, tailored to their specific needs.

Commercial Real Estate

- Opportunities to fund offices, hotels, restaurants and other real estate projects.

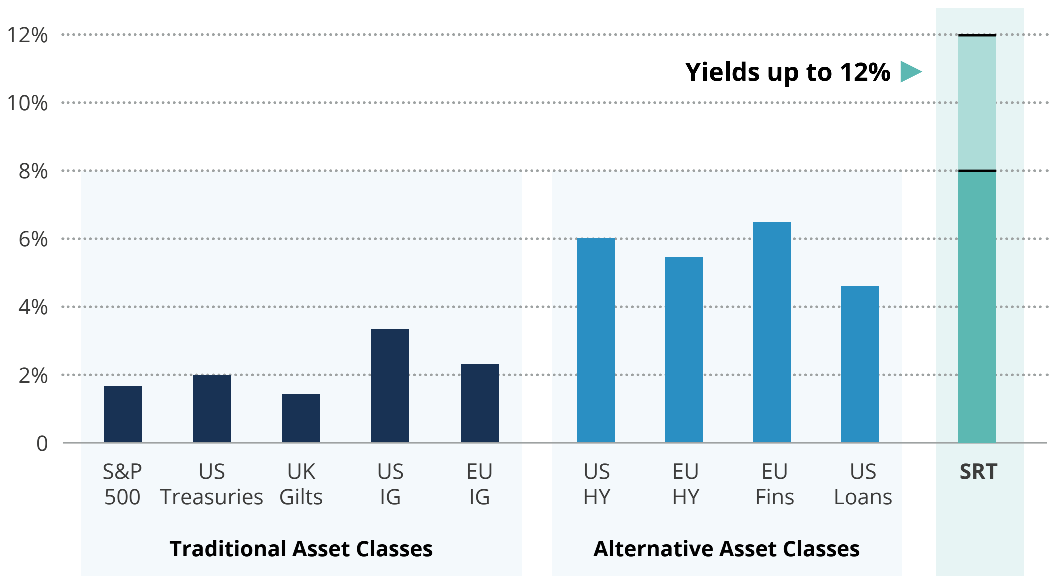
Mortgages

- Access to pools of quality mortgage loans in strong real estate markets.

Renewables / ESG

- Lending to developments in solar, wind and other renewable energy sources.

Figure 7: Traditional vs Alternative Income sources



Source: CQS as at 28 February 2022.

Investors and Banks: Aligned Interests

As part of more stringent financial regulation, banks are now required to have skin in the game, or that they keep some of the loan's risk. The rest may be shared with investors such as CQS via an SRT transaction.

As part of the SRT deal, banks continue to manage the loan performance and the customer relationship, aligning their interest with the SRT investor.

This mutual relationship is a win-win for the two partners: on the one hand, banks improve their capital buffers, which allows them to increase their lending; for investors, the transaction provides access to a range of diverse, hard-to-source underlying loans such as revolving credit facilities, project finance, SME loans, commercial real estate and social housing.

The Regulatory Capital market has also been buoyant, with increased levels of issuance as banks aim to improve their capital ratios.

There has also been a significant rise in ESG-compliant issuance, given the increasing number of underlying loans for social housing, renewable infrastructure and green commercial real estate projects.

The Regulatory Capital universe: diversified by issuer, industry, geography and type

Issuers	Global systematically important banks. Issuers with an established credit risk transfer platform vs new entrants.
Issuance Formats	Broadly syndicated, club deals and bilateral deals.
Geographies	UK, US, Europe, Asia
Underlying Sectors	Large Corporates, Commercial Real Estate, Trade Finance, SME, Agriculture, ESG, Mortgages, Consumer Lending, Renewables

Protect the Downside and Outperform During Periods of Stress

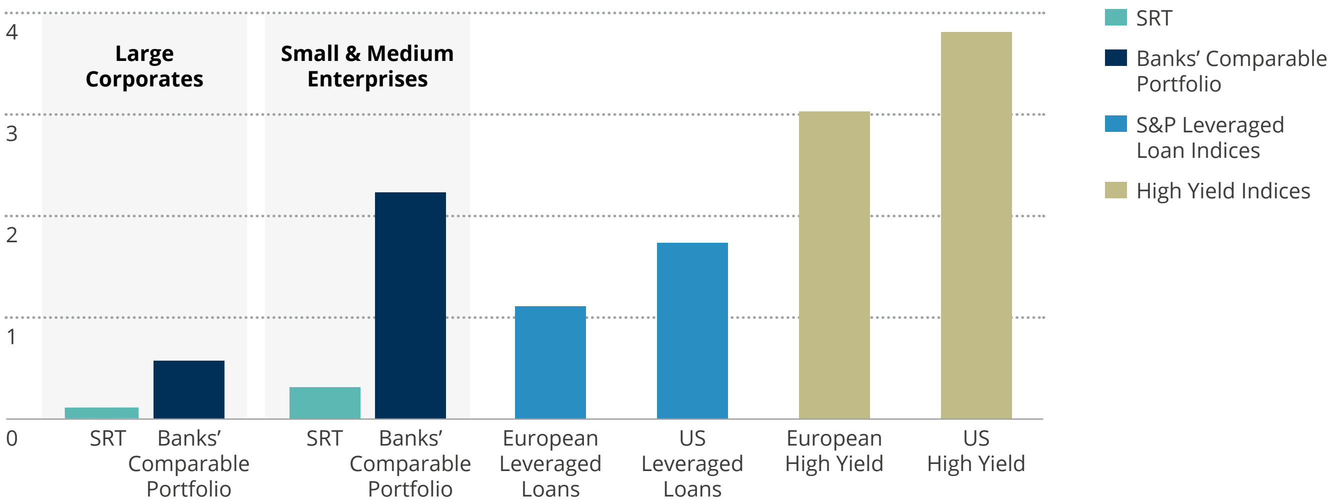
Alongside the alignment of interests, another crucial characteristic of SRT transactions is that only the better loans on a bank's balance sheet are included. Deals consist of 100% performing loans at origination (predominantly secured on assets), providing dependable collateral for investors. This is a key element that differentiates SRT.

That said, positive selection is very important as the primary risk associated with this strategy is default risk. As illustrated by Figure 8, the default rates of SRT portfolios have been markedly lower than banks' broader but comparable portfolios and indeed broader alternative credit markets. It is therefore paramount to have the experience and knowledge to analyse and differentiate between various deals in order to select the best investments for a portfolio.

Historically, core assets within SRT portfolios outperform similar bank portfolios, particularly during periods of stress - for example in the Global Financial Crisis (2008-2009), Sovereign Debt Crisis (2011-2012), Oil & Gas Crisis (2015- 2016) and Covid-19 (2020-to-date). This track record underlines the outperformance of these transactions versus broader but comparable bank portfolios, and speaks to the strong asset quality and core nature of the assets.

As markets remain uncertain, this high-yielding portfolio of SRT assets is designed to provide protection in periods of volatility together with a quarterly distribution stream. Additionally, the strategy has low correlation to wider credit markets, providing valuable diversification for investors, especially during periods of stress.

Figure 8: Average Realised Default Rate, %



Source: EBA, CQS, LCD and the Moody's Default Report, as at 31 December 2018. Average Realised Default Rate between 1 January 2017 and 31 December 2018, the period when the majority of the SRT deals were originated. Please refer to the end of this document for Index descriptions.

Investing in Private Credit, Sustainably

CQS has been at the forefront of private market opportunities which capitalise on banks actively managing their balance sheets. We have actively participated in these markets since 2014 with consistently strong performance.

Our due diligence methodology is based on sophisticated and proprietary credit risk pricing models and a data-driven, bottom-up re-underwriting methodology that is specific for the asset class. This approach has resulted in cumulative credit losses* below 0.1% since 2014 and demonstrates both our disciplined underwriting process and also the quality of the underlying assets.

Our approach is holistic as we conduct comprehensive top-down and bottom-up analysis. First, we want to understand the drive and long-term motivation for banks to launch SRT deals. We conduct a deep dive analysis of the loans and where relevant, we can use the extensive know-how of CQS' corporate loan teams. This allows us to construct a balanced portfolio and manage liquidity via careful deal and maturity selection. Part of our due diligence process is to ensure that the loans are a true representation of the bank's core lending portfolio and we will decline deals if this is not so. We also embed sustainability analysis into our investment process to evaluate long-term ESG risks and opportunities, and where possible access sustainable transactions.

Many of the banks using SRT deals are European with a growing number in North America. CQS' experienced Asset Backed Securities team is located between our London headquarters and our New York office. Having the team in these locations puts us close to the key issuing banks and has created enhanced relationships. This allows us to create bespoke transactions solely for the benefit of CQS investors, especially with regard to the SRT sector, and to actively participate in club deals. Our investment scale provides the ability to drive structures, especially within bespoke bilateral transactions.

The ABS team benefits from the wider research, investment, trading and risk management resources of CQS globally, including top-down geopolitical and geo-economic analysis.

This approach benefits our investors as we use our deep relationships to source transactions that others may not. We then use the breadth of the CQS platform and knowledge to access all underlying sectors in order to select the best deals for our investors.

*CQS as at 30 September 2021. Final Credit loss as percentage of tranche: 0.0892% since inception of the strategy in 2014.

A Responsible Approach

By embedding Responsible Investing into our investment process, we enhance our ability to mitigate risk and to identify investment opportunities thereby generating the best possible risk-adjusted returns for our clients. We are planning to classify future SRT strategies as Article 8 under the EU Sustainable Finance Disclosure Regulation. To our knowledge, this would be a first for a strategy in this space.

Approach

- Assessing each issuer's ESG approach through third-party data providers and CQS bottom-up analysis
- Review originators Corporate Social Responsibility (CSR) policies within their lending commitments
- Evaluate long-term ESG risks and opportunities of the underlying collateral pool
- Determine appropriate spread and pricing

Engagement

- We make clear to issuers that E, S and G factors are important to us and where required, we will seek change to certain risks and issues
- We engage with issuers where required during due diligence to reduce or remove exposure which are outside of ESG parameters (ie defence weapons industry, nuclear energy industries or palm oil)

Sustainability

- Evaluate issuers' response to the CQS ESG Due Diligence questionnaire
- Engage for process improvement and adoption of policies which promote Net Zero alignment, including joining the Net Zero Asset Managers Initiative
- Assess underlying issuers' ESG approach through third-party data providers and CQS bottom-up analysis (where we are able to look through)
- Evaluate long-term ESG risks and opportunities of the underlying collateral pool, leaning in where possible to sustainable transactions
- Determine appropriate spread and pricing

Signatories

Signatory of:

In our first year of reporting for the Principles for Responsible Investment, we are pleased to confirm CQS scored an A for the Strategy & Governance of our overall process, and across each of the three direct fixed income modules, we scored a B.

Managing the impact of the transition to a low-carbon economy is essential to deliver returns, outcomes and mitigate risk as we seek to deliver for our investors. We recognise our role in directly financing the real economy and as a signatory to the Net Zero Asset Managers initiative we are part of the global goal to achieve Net Zero greenhouse gas emissions by 2050 or sooner.

CQS is a public supporter of TCFD (Task Force on Climate-related Financial Disclosures), with climate disclosures a core component of our ESG Engagement Framework. TCFD reporting is available on our website.

CQS is a signatory to the UK Stewardship Code 2020 (the "Code"). Our Stewardship and Shareholders' Rights Report sets out how we have complied with the Code and have applied its principles in the context of our global credit investing.

As a participant of Climate Action 100+, CQS actively supports engagement with some of the largest carbon emitters globally, as we collectively seek strong accountability & oversight for climate risk, action on GHG emissions and proper company disclosure.

CDP (formerly the Carbon Disclosure Project) is a key collaboration amongst asset owners and asset managers in the drive for greater transparency on Climate Change, Forestry & Water Stress.

CQS is a founding signatory. We are pleased to have collaborated with the SBAI to produce the Review on Responsible Investment Regulatory Expectations.

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Index Descriptions: It is not possible to invest directly in an index.

S&P/LSTA Leveraged Loan Indices are capitalisation-weighted syndicated loan indices based upon market weightings, spreads and interest payments.

S&P/LSTA Leveraged Loan Index (LLI) covers the US market back to 1997 and currently calculates on a daily basis.

S&P European Leveraged Loan Index (ELLI) covers the European market back to 2003 and currently calculates on a weekly basis.

ICE BofAML US High Yield Index (H0A0) tracks the performance of US dollar-denominated below investment grade corporate debt publicly issued in the US domestic market.

ICE BofAML European Currency Fixed & Floating Rate Non-Financial High Yield Constrained Index (H9PC) contains all non-financial securities in ICE BofAML European Currency Fixed & Floating Rate High Yield Index but caps issuer exposure at 3%.

ICE BofAML US Corporate Index (C0A0) tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market.

ICE BofA Euro Non-Financial Index (EN00) tracks the performance of non-financial EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets.

ICE BofAML US Non-Financial Index (CF0X) tracks the performance of non-financial US dollar denominated investment grade corporate debt publicly issued in the US domestic market.

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S&P 500 Total Return Index (SPXT): The Standard & Poor's 500, is a stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

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