Why more retail investors are pouring money into private credit – and the risks

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Private credit refers to loans made by non-bank lenders to companies that bypass public markets.

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Retail investors are becoming increasingly interested in private credit as a way to diversify their portfolios and potentially earn higher returns.

However, industry experts warn of the risk associated with investing in what's often an opaque and illiquid alternative asset, even amid a growing number of publicly traded funds offering access to the space.

Private credit, also known as private lending, refers to loans made by non-bank lenders to companies that bypass public markets. The loan terms can be customized and typically carry higher interest rates than publicly traded debt instruments such as bonds or Treasurys.

It's partly those higher rates that have more investors flocking to the asset class in recent years, says Victor Kuntzevitsky, portfolio manager with Stonehaven Private Counsel at Wellington-Altus Private Counsel Inc. in Aurora, Ont.

"When you're looking at it from the outside, it looks like the ideal space," Mr. Kuntzevitsky says, but notes that the rates are floating, which means they move up and down with broader interest rates.

The private credit industry has more than US$2.2-trillion in assets globally, up from US$100-billion in 2010, according to a recent report from the Switzerland-based Bank for International Settlements (BIS).

The report states a "striking recent development" is the rise of retail investor participation in the sector, which has historically been the domain of institutional investors. The report notes that retail investments in the sector have jumped to US$280-billion, or 13 per cent of global assets, up from "virtually zero" in the past decade.

It attributes the rise to the growth of business development companies (BDCs)– a type of closed-end private credit fund that's usually publicly traded - and more exchange-traded funds (ETFs) entering the space.

"Private credit ETFs seek to capitalize on the popularity of both ETFs and private credit," the report states. "They promise retail investors higher returns from exposure to illiquid long-term private loans while providing liquid shares that trade daily."

Private credit expansion in Canada

In 2019, Canada introduced regulatory changes that enabled non-accredited retail investors to invest in liquid alternative investment funds, giving them access to private credit markets.

That, in turn, led to more private-credit products being offered in the country, says David Wong, chief investment officer and managing director, total investment solutions, at CIBC Asset Management Inc.

“Private asset managers are looking for new outlets for growth as they’ve saturated the institutional market largely,” says Mr. Wong, whose firm offers CIBC Ares Strategic Income Fund, which includes a range of private credit investments, is available to accredited investors, and sold through advisors.

Calgary-based Accelerate Financial Technologies Inc. launched Canada’s first private credit ETF, Accelerate Diversified Credit Income Fund, in March, 2024. The fund aims for a 10-per-cent yield by providing exposure to a portfolio of senior-secured floating-rate direct loans to U.S.-based private middle-market companies.

Accelerate doesn’t underwrite the portfolio but acquires private-credit funds from top U.S. private-credit managers on the secondary market. The company also has a Canadian-dollar hedged version of the fund. There are also a few U.S. ETFs that follow a similar structure.

Risks for retail investors

A recent Moody’s report states that retail investor money in private markets is “one of the biggest new growth frontiers in the industry.” Still, it notes that private markets are “still largely opaque,” and liquidity risks could increase as retail investors expect easy access to their cash. That’s unlike institutional investors that can hold for the long term even amid market downturns.

Moody’s says the introduction of more liquid private-credit products could mean that “in volatile markets, retail investors may run for the exits, which would exacerbate liquidity needs and the risk of potential mismatches between a product’s available liquidity and what investors are expecting.”

The BIS report notes that private credit ETFs combine shares in a liquid public market with those in an illiquid private market, creating a "mismatch" that could lead to "the emergence of steep and persistent discounts between the ETF price and the value of its underlying assets in periods of stress."

The report says discounts "may serve as a safety valve against fire sales of illiquid assets." However, "they can raise doubts about the quality and accurate valuation of the underlying assets and lead to losses for investors."

The other risk associated with rising demand from retail investors is that it could lead to increased competition for limited-quality assets, the Moody's report adds.

"This may lead some managers to assume more risk by investing less prudently to capitalize on this new opportunity."

'Not all private credit funds are made equally'

Mr. Kuntzevitsky says investors and advisors should be well-versed in private credit funds, their portfolio managers and their fees before making a purchase.

"Not all private credit funds are made equally," he says, "and you should really watch out for who you're investing with."

He recommends paying attention to how they underwrite and originate loans, as well as how they generate their returns, noting that some funds leverage investors' money and include this in their return figures.

"We're in a time that the macroeconomic picture is really good, but the concern is if and when we're in a recession, when the economy doesn't perform so well, when the companies within don't perform so well, that's when you're going to see some issues," Mr. Kuntzevitsky says.

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