THIRDLINE CAPITAL

Is It Time to Diversify Your Private Credit Portfolio?

by Larry Eiben

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One of the most popular investments over the last decade has been private corporate credit. Performance has been stellar – with average annual returns over the past twenty years approaching 10% per year.[1] However, some would argue that we've reached a tipping point where too much money is chasing too few opportunities. In this article we'll look at the private credit landscape and consider the benefits of diversifying into asset-backed lending.

So, what is private corporate credit? Private corporate credit generally refers to loans made by private lenders through a bilateral agreement with a single company. So, no bank is involved, and no securities are sold in the public markets. This market is also sometimes referred to as "direct lending" which is the term we will use in this report. Since we've all been inundated with corporate credit offerings of late, below (for your reference) is a list of various corporate credit instruments which, generally, would NOT be considered direct lending.[2]

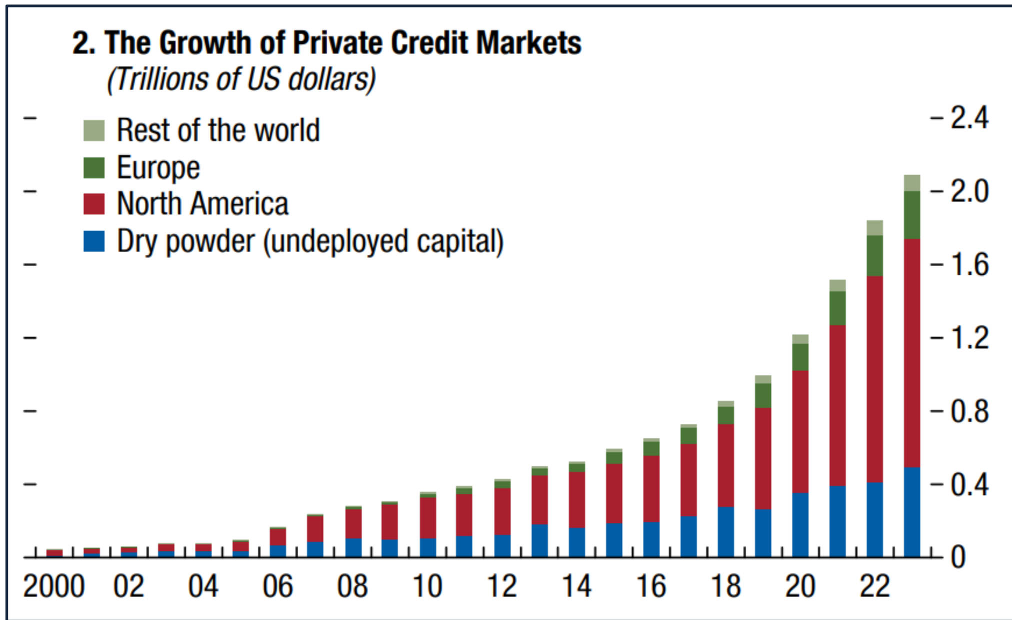
Other Forms of "Speculative Grade" Corporate Credit

Structure	Definition
Bank Loans (including Broadly Syndicated Loans and Leveraged Loans)	As the name suggests, these loans are originated and/or provided by a bank. If you're investing in the loan, it means that the bank sold the loan after originating it. Typical buyers of bank loans on the secondary market include investment funds/ETFs, pensions, insurance companies and CLOs.
Collateralized Loan Obligations (CLOs)	CLOs are pools of bank loans held in a single investment vehicle that are actively managed by an investment firm (e.g., like a pool of stocks being managed in a mutual fund).
High Yield Bonds	High yield bonds are exchange-traded debt securities that a company may issue when raising money from the public markets.

Several factors have led to the rise in direct lending. Most market experts point to tighter bank lending standards (i.e., post Great Financial Crisis "Basel III" requirements), investor demand for the outsized returns relative to exchange-traded credit investments and the growth of private equity as contributing factors. Private equity deals generally incorporate significant borrowing as part of the investment strategy and have consequently been a major driver of debt demand. As of today, the global direct corporate lending market is estimated to exceed $2.0 trillion in assets.[3]

There is no question that the last decade of performance of private corporate credit has been outstanding. However, if we examine the growth of the market, it's clear that the market today looks very different than it did twenty years ago – notably, it's 10-20X larger (see Figure 1).

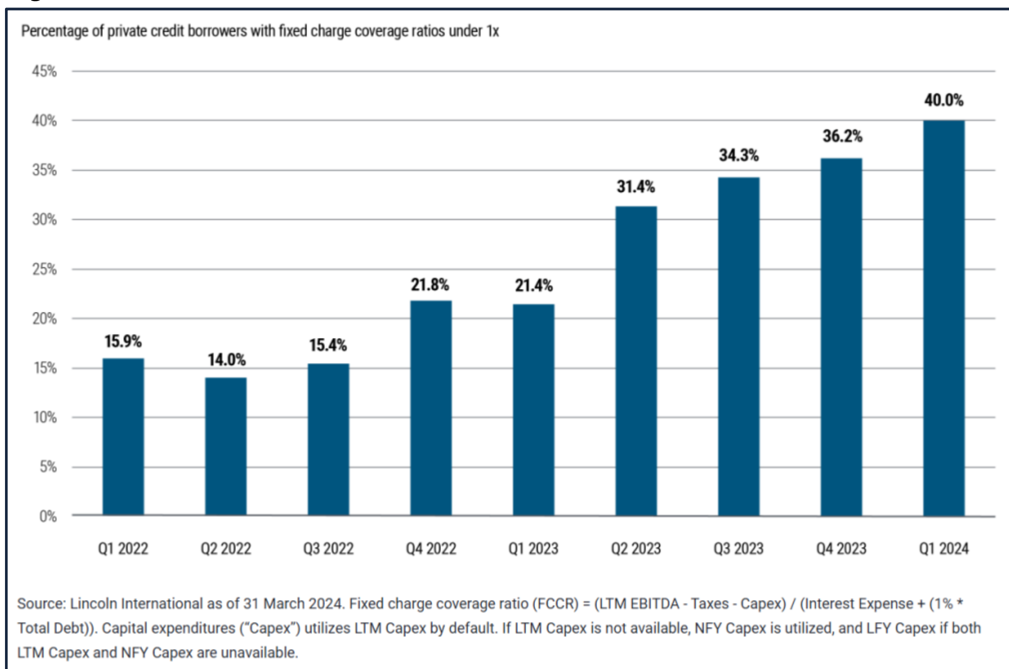
Figure 1



Source: International Monetary Fund

While we are supportive of direct lending to private companies as an asset class, count us as skeptical that the industry will be able to replicate its recent track record on the current pool of assets under management. Moreover, it's noteworthy that the "dry power" (i.e., capital that has not yet been deployed – see Figure 1) sits at approximately $500 billion (which is larger than the pool of *deployed* capital just 10 years ago). One must wonder if the opportunity set is no longer able to match investor demand. In fact, research from PIMCO shows that the return "spread" for direct lending (i.e., risk premium above other corporate credits) has narrowed relative to recent historical averages[4] and a rising percentage of private companies appear strained to make loan payments (see Figure 2).

Figure 2



Source: www.pimco.com/insights

Our opinion is that direct corporate lending is here to stay as an asset class, but investors would benefit from avoiding pure "beta" exposure (i.e., broadly diversified exposure that ensures average market performance) and, rather, seek boutique managers with the potential to create "alpha" (i.e., outperformance) using proprietary processes for sourcing, vetting & underwriting loans. We also believe that income portfolios would benefit from incorporating other private credit categories beyond traditional corporate direct lending. Asset Backed Lending ("ABL") is one possible solution. An asset-backed loan, as the name suggests, is a loan that has a "hard" asset held as collateral for the loan. Table 1 lists a few of the many assets used as collateral for loans in the ABL market.

Table 1

TYPES OF HARD ASSET COLLATERAL USED IN ABL
Inventory
Recievables
Equipment
Land
Real Estate

Though the types of ABL are varied and growing, this article will focus on the largest category of ABL which is real estate credit (estimated at $4.5 trillion). The real estate credit market is still dominated by banks, insurance companies and Government-Sponsored Entities ("GSEs"), together originating greater than 85% of outstanding loans.[5] Of course, many senior loans are securitized and sold in the public market as "Asset-Backed Securities" (e.g., MBS, CMBS). While this is a large and liquid market, the returns are muted as evidenced by the "ICE BofA U.S. ABS & CMBS Index" which is a benchmark that tracks the performance of investment-grade asset-backed securities issued in the U.S. domestic market (see Figure 3).

Figure 3

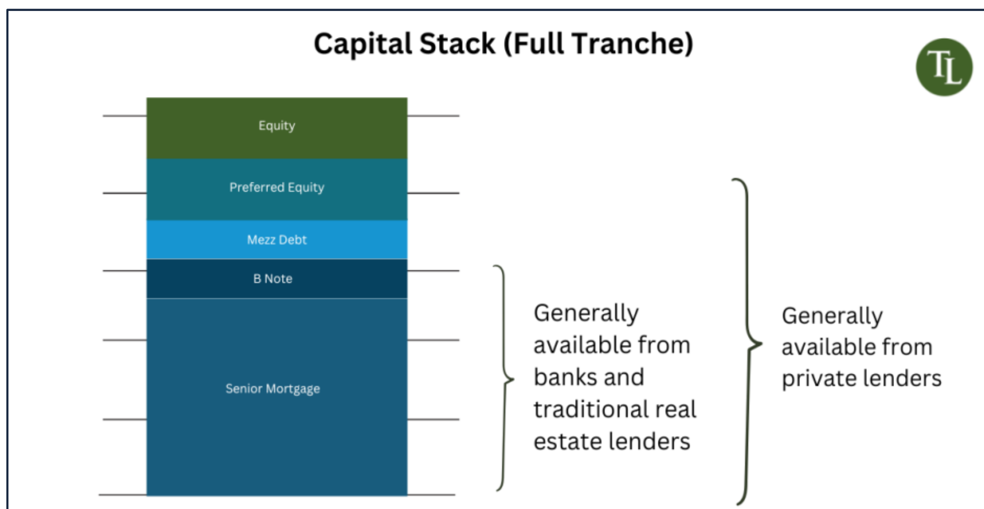
Annual Returns

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
ICE BofA U.S. ABS & CMBS Index	0.81	2.71	2.84	1.75	5.89	5.20	0.05	-7.20	5.56	5.96

Source: www.ice.com/

After the Great Financial Crisis, and again since COVID, bank lending standards have tightened which has led to a funding gap that is often filled by private lenders. In some cases, private lenders are providing loans that banks simply won't provide, or borrowers may choose private lenders to obtain higher loan amounts. In other cases, private lenders are providing "mezzanine loans" or "preferred equity" (i.e., forms of credit that are junior to senior loans) to enable project sponsors to reduce a project's required equity (see Figure 4).

Figure 4



The general rationale for diversifying into ABL is that it may generate higher risk-adjusted returns given the tangible asset backing the loan. Please see our prior article, "The Case for Private Real Estate Credit" which covers why we believe private real estate credit may produce the highest risk-adjusted returns of all income-oriented investments. The focus of this article, however, is on the benefits of partially diversifying assets away from private corporate credit and into real estate credit.

Ideally, we would start this as an empirical discussion (i.e., what does the data tell us about performance and correlation?). However, the data is limited. The National Council for Real Estate Investment Fiduciaries (NCREIF) has several indices (dating back to the 1970s) showing performance of asset prices and institutional equity fund managers but very little data on credit managers.[6] The John B. Levy & Company claims the "First and only third-party measure available to monitor high-yield debt performance" in the CRE lending space (the "Gilbert-Levy High Yield Real Estate Debt Index (G-L 2)). The index annual returns since inception are approximately 8.0%, but the data is inherently limited. More specifically, the performance only goes back to January 1, 2010, includes only 1000 loans and the average loan size is $55 million.[7] At this loan size, the index represents the upper end of the middle market which, in our view, is not as attractive as the more fragmented and inefficient lower end of the middle market.

Looking beyond the data, there are some key inherent benefits in diversifying credit portfolios. We are all well-versed on the benefits of combining non-correlated investments and, we believe, many investors are under-utilizing this advantage in the credit space. Table 2 highlights some key investment risks that are mitigated by diversifying credit investments into real estate credit.

Table 2

Risks	Supporting Data
Volatility of Collateral Value	Real estate credit is backed by a tangible asset whereas corporate credit is backed by enterprise value. We believe enterprise value is a much more volatile asset than real estate.
Economic Factors	Direct corporate lending and real estate credit represent materially different sectors. For example, the highest sector concentrations within direct corporate lending are information technology and healthcare (together exceeding 50%).[8] While these sectors and real estate are clearly "pro cyclical" (i.e., they will perform better in good economic times) different economic sensitivities exist.
Interest-Rate Sensitivity and Return Stability	Direct corporate loans are predominantly variable-rate that are inherently a function of the Federal Funds Rate ("FFR"). As such, dividend distributions may fluctuate materially with FFR, and these assets face additional financial challenges during yield curve inversions. Private CRE lending can vary exposures greatly (e.g., Thirdline has made >90% fixed rate investments in the last 18 months) which enables dividends to be more consistent and mitigates FFR impacts.
Performance Degradation	As previously commented, direct corporate lending may be getting crowded whereas the real estate debt market is nearly 2X larger and private lending represents less than 15% of the activity in the market.[9]

In summary, private credit markets offer tremendous opportunities for income investors to achieve better outcomes. Corporate direct lending has been a reliable income tool for over a decade but faces increasing challenges in a crowded marketplace. Those with exposure to direct corporate lending may benefit from diversifying into other credit instruments including asset-backed lending and real estate credit which are less saturated by private lenders.

About the author

Mr. Eiben is Co-Founder and Co-Portfolio Manager at Thirdline Capital, an investment advisor and manager of a real estate credit interval fund and other private real estate investments. Prior to Thirdline, Mr. Eiben spent over 15 years at TFS Capital, a firm that specialized in developing liquid alternative investment strategies, where he served as a Portfolio Manager and Chief Operating Officer.

Notes

1. Cliffwater LLC, Cliffwater Direct Lending Index Returns Since Inception, www.cliffwaterdirectlendingindex.com (2024)
2. International Monetary Fund, Fabio Cortes, Mohamed Diaby, Caio Ferreira (co-lead), Nila Khanolkar, Harrison Samuel Kraus, Benjamin Mosk, Natalia Novikova, Nobuyasu Sugimoto (co-lead), and Dmitry Yakovlev, under the oversight of Charles Cohen, The Rise and Risks of Private Credit – Chapter 2 (2024).
3. Ibid
4. PIMCO, Mohit Mittal, Navigating Public and Private Credit Markets: Liquidity, Risk, and Return Potential (2024)
5. Cohen & Steers, Rich Hill, The Commercial Real Estate Debt Market: Separating Fact from Fiction (2023)
6. National Council of Real Estate investment Fiduciaries, ncreif.org/data/ (2025)
7. John B. Levy & Company, www.jblevyco.com/giliberto-levy-research#gl-2 (2025)
8. International Monetary Fund (see note 2)
9. Cohen & Steers (see note 5)

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