

PRIVATE CREDIT

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Private credit has captured significant attention in recent years. Private credit can enhance yields. However, it is important to evaluate private credit in the context of your overall portfolio strategy. For many investors, high fees and leverage make traditional publicly traded bonds better building blocks of a diversified portfolio.

Private credit refers to loans made to companies outside of traditional bank lending or public bond markets. Instead of borrowing from banks or issuing bonds that trade on exchanges, companies receive financing directly from institutional investors, private equity firms, and specialized credit funds.

Characteristics of Private Credit:

- Direct negotiation between lenders and borrowers
- Typically, illiquid investments with 3-7 year terms
- Higher yields than traditional fixed income
- Customizable terms and structures
- Alternative to traditional bank financing and public market

Types of Private Credit Investments

Direct Lending

- Senior secured loans to middle-market companies

Distressed/Special Situations

- Companies facing financial difficulties
- Higher risk, higher potential returns

Asset Based Finance

- Commercial real estate financing
- Rail Cars
- Auto Lending
- Credit Cards
- Equipment Leases
- Construction and bridge loans
- Intellectual Property

A Brief History

The private credit industry expanded largely as a response to regulatory changes following the 2008 financial crisis. New banking regulations, particularly the Dodd-Frank Act and Basel III, made it more expensive and complicated for banks to make certain types of loans. This created an opportunity for non-bank lenders to step in and fill a void.

What started as a niche market is now a trillion-dollar industry. Private credit has evolved to encompass a wide range of complex and opaque offerings. The asset class has been marketed as offering higher yields than traditional fixed income with "controlled" risk, but this framing deserves close scrutiny.

Clear Roles for Fixed Income and Equities

Before diving into the specifics of private credit, it's important to consider the role of equities and bonds as major components of your portfolio. Each component serves a distinct purpose:

Fixed Income should provide stability, liquidity, and the potential for portfolio risk mitigation during extreme market downturns. When equity markets decline, high-quality bonds often hold their value or even appreciate, cushioning your portfolio and providing peace of mind. At the portfolio level, fixed income can serve an important role as a potential safety net.

Equities are your portfolio's growth engine and have been among the best long-term hedges against inflation. While stocks experience meaningful volatility and periodic downturns, they have historically provided superior long-term returns. You accept short-term volatility in exchange for long-term wealth accumulation.

The key to effective diversification is holding assets that behave differently from each other. When one zigs, ideally the other zags.

Where Private Credit Falls Short

Private credit occupies an uncomfortable middle ground that may not optimize your portfolio's risk-return characteristics. Here's why:

1. The Liquidity Problem

Unlike publicly traded bonds or stocks, private credit investments are often illiquid. Once your money is committed, it may be locked up for years. You have limited ability to rebalance your portfolio in response to changing market conditions or personal circumstances. You may also miss opportunities to deploy capital when attractive investments emerge.

While private credit managers advertise extra returns (an "illiquidity premium") to compensate for this, the premium may not adequately reflect the true cost of giving up liquidity. The quoted yields may not account for what you might have earned by being able to move capital to better opportunities over time.

2. Diversification That Doesn't Diversify

Effective diversification means holding assets with low or negative correlation to each other. Private credit may not deliver this benefit especially during times of extreme market stress.

Private credit loans are primarily made to companies, often smaller or leveraged businesses, that are more vulnerable to economic downturns. When equity markets decline due to economic stress or recession fears, these borrowers often face the same headwinds. Default rates rise, recovery values fall, and private credit may perform poorly alongside your equity holdings.

In other words, private credit may struggle at precisely the same time as your stocks. It often doesn't provide the countercyclical balance that high-quality bonds tend to offer. You may take on equity-like risk without equity-like returns or bond-like stability.

3. Fee Drag

Private credit funds typically charge high management fees, plus performance fees. These fees are substantially higher than those of traditional bond funds or ETFs. Over time, this fee differential compounds and can consume a large chunk of any excess earnings. You need meaningfully higher gross returns just to break even with traditional fixed income options. The fee structure can also incentivize managers to take on more risky bets.

4. Fund-Level Leverage Amplifies Risk

Many private credit funds don't just invest your capital directly into loans, they borrow additional money to amplify returns. This fund-level leverage can magnify both positive returns and losses and contributes to higher fees.

Some fund managers earn fees on the gross asset value (including borrowed money), not just on your capital, creating an incentive to use leverage even when it may not be in investors' best interests.

5. Credit Quality

Many private credit loans are made to companies that don't qualify for traditional bank financing or access to public bond markets. While not universally true, there's often a reason these companies are borrowing from private lenders rather than banks. These companies can be profitable in good times but vulnerable when economic conditions deteriorate.

6. The Transparency Challenge

Private credit investments lack the price transparency of public markets. You may receive limited information about the actual loans in the portfolio. Funds may provide summary statistics and general descriptions, but you may be largely trusting the manager's representations. You won't see daily valuations or market-based pricing. Instead, loans are valued using models and periodic appraisals, which can smooth out volatility artificially and create a false sense of stability. This "smoothed" return profile might look attractive on paper, but mask underlying risks. When trouble emerges, it can appear suddenly in the form of defaults or write-downs rather than gradual price declines that give you warning and opportunity to adjust.

7. Uncertain Behavior in Market Stress

While private credit advocates point to relatively stable historical performance, the asset class hasn't been truly tested by a severe, prolonged economic downturn in its modern form.

We don't know how private credit will perform in a deep recession, a sustained period of corporate defaults, or a credit crisis. Credit facilities that funds rely on can be pulled or repriced during turbulent periods, forcing fire sales at the worst possible time. Given the illiquidity, leverage, and credit quality profile of many underlying loans, it is possible losses could be substantial.

Opportunity Cost Matters

Perhaps most importantly, allocating to private credit means not allocating to something else. Every dollar in private credit is a dollar not in high-quality bonds providing risk mitigation, or in equities providing long-term growth potential.

Given private credit's correlation with economic conditions (like equities) but without commensurate return potential, and its lack of defensive characteristics (unlike quality fixed income), it may not contribute to the optimal combination of risk and return.

Instead Use A Time-Tested Approach

We believe that a more traditional approach achieves appropriate portfolio diversification through a better calibrated approach. Such an approach emphasizes:

- High-quality fixed income (government bonds, investment-grade corporates, municipals) for stability and liquidity.
- Diversified equity exposure for long-term growth and as a potential hedge against long-term inflation.
- Clear roles for each component with meaningful differentiation in how they behave. The equity bond mix can be calibrated based on the investor's goals and risk tolerance.

This approach provides genuine diversification, maintains liquidity for opportunistic rebalancing and personal needs, minimizes fees, and has been time-tested through various market environments.

The Bottom Line

Private credit occupies a middle ground that may not maximize diversification benefits, often charges high fees, surrenders liquidity, and introduces complexity which may not come with commensurate reward. Private credit is not inherently a "bad" investment, but it generally does not serve a compelling role in portfolios designed to efficiently balance growth and tolerance for downside risk.

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