High Probability ADVISORS

INVESTING INSIGHTS

Private Credit Under Pressure: What Investors Can Learn

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With headlines focused on geopolitical risks and oil prices, another source of stress has been building in markets: losses and liquidity strain in parts of private credit. Some have labeled it a "Private Credit Crisis." It is not a repeat of the Great Financial Crisis (GFC) in scope or in systemic importance. But it does offer **useful investing lessons** – especially about what happens when an illiquid strategy is packaged for investors who may not be positioned to hold it through a downturn.

First, today's private credit stress is unlikely to become a system-wide banking crisis. The GFC was a broad threat to the U.S. financial system because the lending excesses were concentrated in mortgage credit and were embedded – often with high leverage – inside banks and key funding markets.

After the GFC, tighter bank regulation and more conservative bank balance-sheet management reduced the supply of many types of loans – particularly to middle-market companies. As bank lending dried up, both demand for non-bank financing and the supply of private capital grew, and private credit expanded to fill the gap. Taking advantage of this demand growth, private equity (PE) increasingly relied on (and often owned their own) private credit lenders to finance buyouts and refinance aging portfolio companies.

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Much of the exposure to private credit sits inside private credit funds, Business Development Companies (BDCs), and insurance company balance sheets. These pools of investments can experience meaningful losses and tighter liquidity for their investors, but they generally do not carry the same combination of leverage and interconnectedness that made 2008 so destabilizing. In short: this episode is more likely to be painful for holders of some private credit products than catastrophic for the broader economy.

Second, this episode is a reminder of some enduring best practices, such as avoiding unnecessary opaqueness, complexity, embedded leverage, and yield-chasing. For investors who can truly commit long-term capital, well-researched and transparent private credit can be attractive because returns may include both a credit risk premium (risk of default) and an illiquidity premium (compensation for tying money up when you cannot easily sell).

Over time, however, Wall Street has built private credit “products” – funds and public BDCs with promises of similar returns but more liquidity – and sold them to a broader, retail-adjacent audience. Too often, however, the product design and marketing emphasized enhanced yields while downplaying what the higher yield was paying investors to accept: limited transparency into underlying loans and limited ability to exit when conditions worsen.

Now that credit fundamentals are weakening in some pockets of the market, those liquidity limits matter. When portfolios face borrower stress and valuation uncertainty, many funds limit investors’ ability to redeem their shares – exactly when some investors most want access to their money.

This is why High Probability Advisors emphasizes transparency. We start by making sure an investment’s risks – including credit risk, leverage (if any), and liquidity risk – are understandable and appropriate for a client’s objectives and time horizon. Whether we are evaluating public or private investments, the strategy and exposures should be clear enough that clients and advisors can identify what could go wrong, not just what could go right. Finally, we size and diversify exposures so no single product, manager, or strategy can dominate outcomes.

In our view, disciplined, transparent portfolio construction is the best defense when markets turn and when yield-chasing comes home to roost.

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