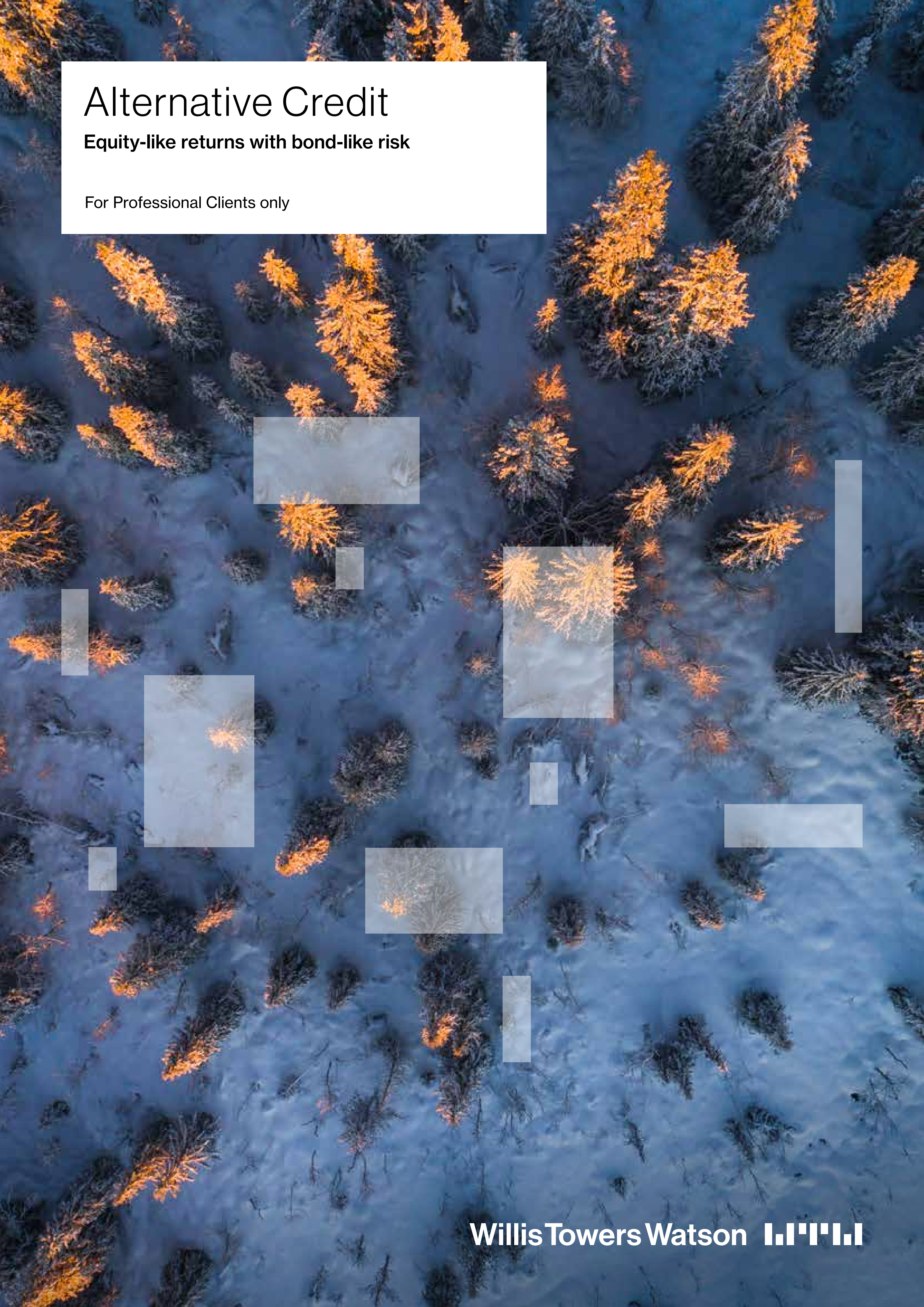
Alternative Credit

Equity-like returns with bond-like risk

For Professional Clients only



Willis Towers Watson

Alternative Credit

Equity-like returns with bond-like risk

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Introduction – an asset class worth a closer look

Acceptable returns from traditional investments are increasingly hard to find. Equities may promise strong returns, but the price is high risk and elevated volatility. Investment grade bonds have delivered for many years, but that era may be over. Alternative Credit (credit investments other than traditional developed market investment grade bonds) has the potential to deliver equity-like returns at much lower risk levels.

How? Credit is vital for business to survive and for economies to thrive. Regulators have made it harder for banks to supply credit. Borrowers still need to borrow though, and investors can bridge the gap and make good returns doing so.

Alternative Credit has a strong tailwind behind it from the global financial crisis, as banks remain under pressure to rebuild capital and reduce their risks. This leaves a sizeable ongoing opportunity for institutional investors to step into the breach and become profitable lenders.

Alternative Credit is a complex area encompassing a large range of lending opportunities. Taking a narrow approach is too risky. But applying a broad approach requires resource and skill. So picking the right partner is vital.

With a long history of selecting opportunities and engaging with specialist managers, Willis Towers Watson can guide you as your Alternative Credit partner. We aim to provide solutions designed to add dynamically managed Alternative Credit to portfolios using a range of specialists who, combined, have the potential to provide high risk-adjusted returns. Alternative Credit requires specialist knowledge. The asset class is growing and broadening at a rapid pace since the global financial crisis, providing more opportunities and giving rise to diverse strategies. At the same time assets have been flowing into core markets leading to stretched valuations and greater risk in these areas. We identify the best strategies and bring them together in a single proposition.

Whether clients require advice or want to delegate the implementation, we help you invest effectively and efficiently in this potentially profitable asset class.

The ABC of Alternative Credit

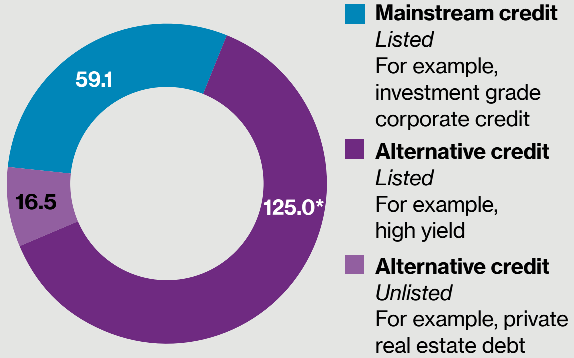
A – Access

Many of the attractive opportunities within Alternative Credit used to be dominated by banks and were largely inaccessible to investors. As the banks retreated, forced out by regulation or profitability issues as a result of increased regulatory capital, they left a gap for institutional investors to step in and potentially generate returns.

We estimate there is now more than twice as much Alternative Credit as mainstream credit (see *Figure 1*).

Figure 1. **Alternative Credit is broader than traditional markets**

Market size in US$ trillion



*We estimate approximately half is accessible to investors.

Source: Willis Towers Watson, data as of 31 December 2016.

Mainstream credit is less than half the credit market!

B – Breadth

Many credit investors focus solely on mainstream credit and a subset of Alternative Credit markets, such as high-yield bonds and bank loans. This is limiting and ignores some $60 trillion of other investible credit opportunities, which can offer attractive risk-adjusted returns and have a substantially positive impact on your portfolio.

Another problem with this approach is it focuses entirely on lending to corporates yet corporate credit risk already dominates investors' portfolios. In order to create a truly diversifying return stream, we believe it is key to also lend to consumers and sovereigns. Indeed at this stage of the credit cycle, we believe the consumer represents a more attractive borrower in many cases than the highly leveraged corporates.

C – Credit standards

In order to ensure that your downside is protected, it is important to focus your capital on opportunities where lending standards are robust – lend where your capital is needed, not where markets are crowded. As different markets become fashionable at different points in the credit cycle, it is important to evolve your Alternative Credit portfolio to ensure you continue to lend where credit standards are most robust.

D – Dynamism

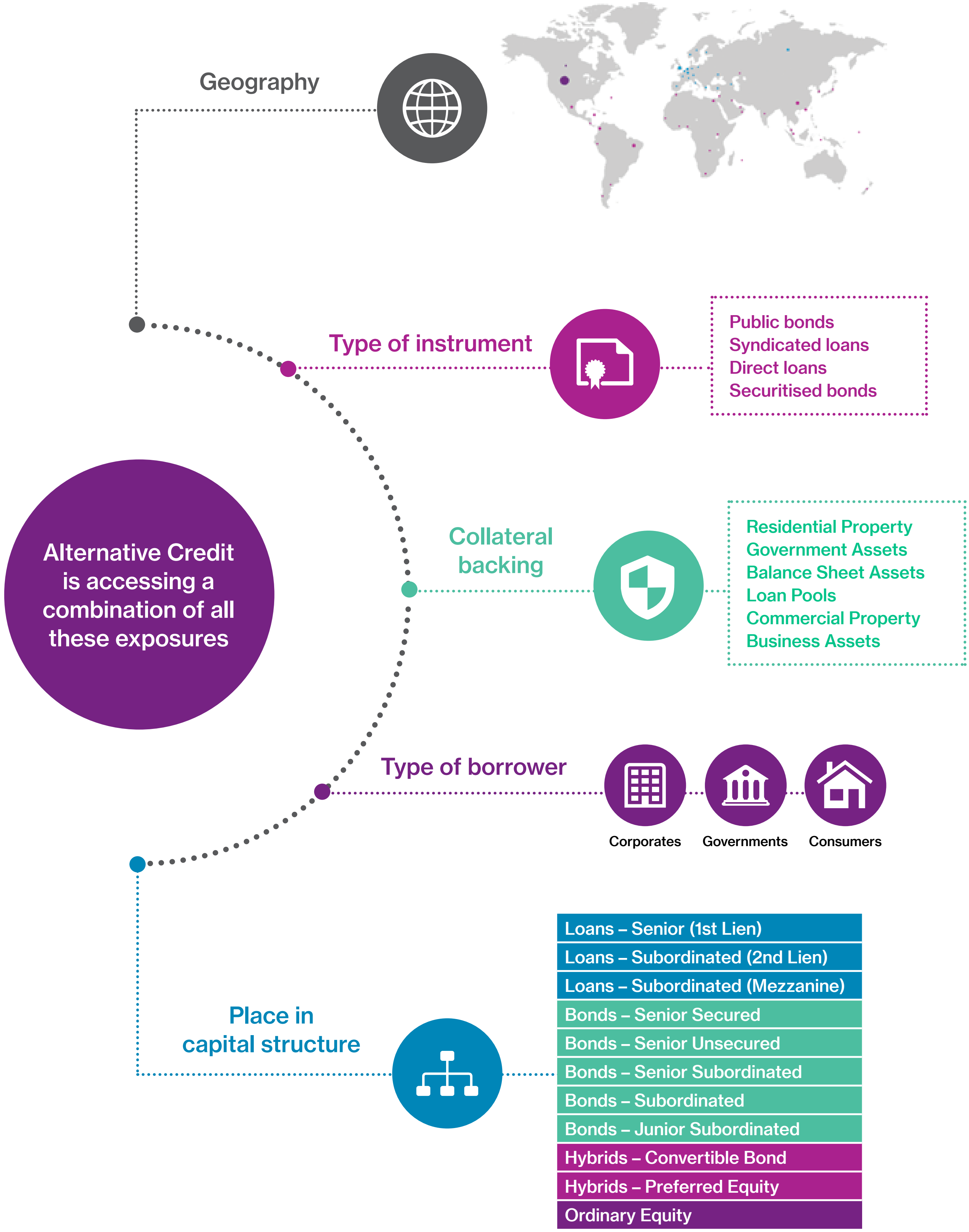
We believe tactical asset allocation is difficult to get right. However, we do believe a good portfolio management process should tilt into areas of credit that appear better rewarded as this is likely to generate better performance in the long run.

E – Experts

Alternative Credit requires specialist knowledge. The asset class is growing and broadening at a rapid pace since the global financial crisis, providing more opportunities and giving rise to diverse strategies.

Given the breadth of the asset class, as highlighted previously, we believe the only way to capture the attractive returns available is to work with specialist teams in each area. For example, a mortgage expert should not be hired to lend to emerging market governments.

Figure 2. **Looking at the credit universe using multiple lenses**



Increasing your return – finding value in surprising places

Another key benefit of Alternative Credit is the illiquidity premium. Illiquid opportunities, such as private debt funds, return more than their public, or liquid counterparts. Lenders often have less competition, can impose higher interest rates, and demand fees for arranging or changing the terms of a loan.

Many investors with long time horizons have the ability to lock up their capital for longer than they actually do. Investors should exploit their tolerance for illiquidity as a competitive advantage. But they need to take care on timing as illiquidity premium will vary over the credit cycle.

In recent years we believe meaningful investor capital has flowed into the private debt market, making it more challenging to find value today, in particular in easily accessed asset classes such as direct lending. However, we feel there is value to be found if investors remain selective, using their precious illiquidity budget to focus on opportunities where:

- The market has attractive tailwinds supporting asset prices
- There are regulatory and other impediments reducing capital inflows
- It is difficult to scale the opportunity, which reduces competition
- The market appears to offer attractive compensation for the risk assumed, rather than relying on manager skill to compensate for an unattractive market beta

Private debt continues to offer meaningful return pick up and strong value for risk taken for those investors willing and able to go the extra mile and unearth interesting opportunities.

Finding value in surprising places

Most attractive returns can be found in less crowded and capacity constrained markets where we have been spending most of our time over the past decade

Accessing more uncorrelated sources of return

Dynamically evolve your portfolio to keep your capital focus where its needed

Bank replacement theme remains strong

Pressure on banking system continues to create opportunities in private debt, however these are sometimes hidden and requires a specialist team to uncover and unlock value

How Alternative Credit can benefit your portfolio

By investing in Alternative Credit, you are lending to the real economy. As with all lending, you receive the promise of income from interest, coupons and fees which, subject to careful lending, should more than compensate you for the risk that your capital is not fully repaid when it is due.

Alternative Credit is different from mainstream credit, such as investment grade bonds. It has a much higher expected return, more like the returns you hope for on your equity investments. This is thanks to its higher income. And yet its volatility and risk is much lower than that of equity – equity holders start to lose value from their investment in a company long before the company is in danger of defaulting on its debt.

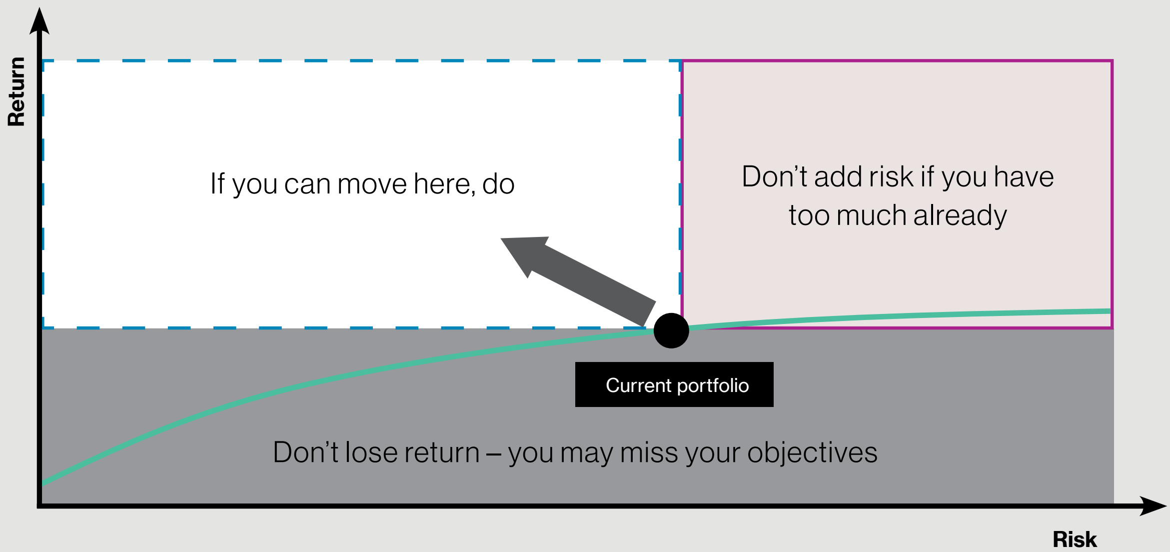
Adding Alternative Credit makes most investors' portfolios more efficient. Switching from equities sustains expected returns but usually reduces risk, while switching from bonds generally adds little risk but may considerably boost returns. These benefits are illustrated in *Figure 3* below.

For investors building assets to buy out liabilities or move gradually into cashflow-generative assets, the benefits of Alternative Credit can be substantial reductions in sponsor contributions, increased cashflows used to pay for pensions or a significantly shorter journey to full funding. It can also help avoid drawdowns, which can lengthen this journey considerably.

Why go outside the mainstream?

- **Boost your returns** – our solutions can enhance the returns of your fixed income portfolio
- **Reduce risk** – Alternative Credit can provide exposure to uncorrelated return streams (see next page) and a well-diversified portfolio can reduce drawdown risk if funded from equities
- **Capture a wider opportunity set** – across borrower and collateral types, geography and instrument increasing the robustness of your portfolio
- **Reduce sponsor burden** – Alternative Credit can lead to substantial reductions in sponsor contributions or a significant shorter journey to full funding

Figure 3. **Adding Alternative Credit to your portfolio can increase your returns and reduce your risk**



Uncorrelated returns

The factors that drive returns from Alternative Credit are different from those of traditional asset classes (see *Figure 4*), so the correlation with a portfolio's traditional investments is low. Alternative Credit can tap into such themes as rising wealth in emerging economies and the shortage of bank lending in many regions of the world.

Traditional fixed income return drivers such as term and inflation risk have relatively little influence on returns from Alternative Credit. Equally, while equity risk is largely driven by quarterly earnings from big companies, Alternative Credit tends to involve lending to smaller companies (many of them unlisted), as well as to consumers, real estate owners, governments of varying sizes and stability, and loans secured on almost any asset.

Frequently asked questions

Isn't owning high yield enough?

Listed high-yield corporate credit tends to be a poor standalone solution for Alternative Credit exposure because it is an index-led crowded market and highly correlated with equity.

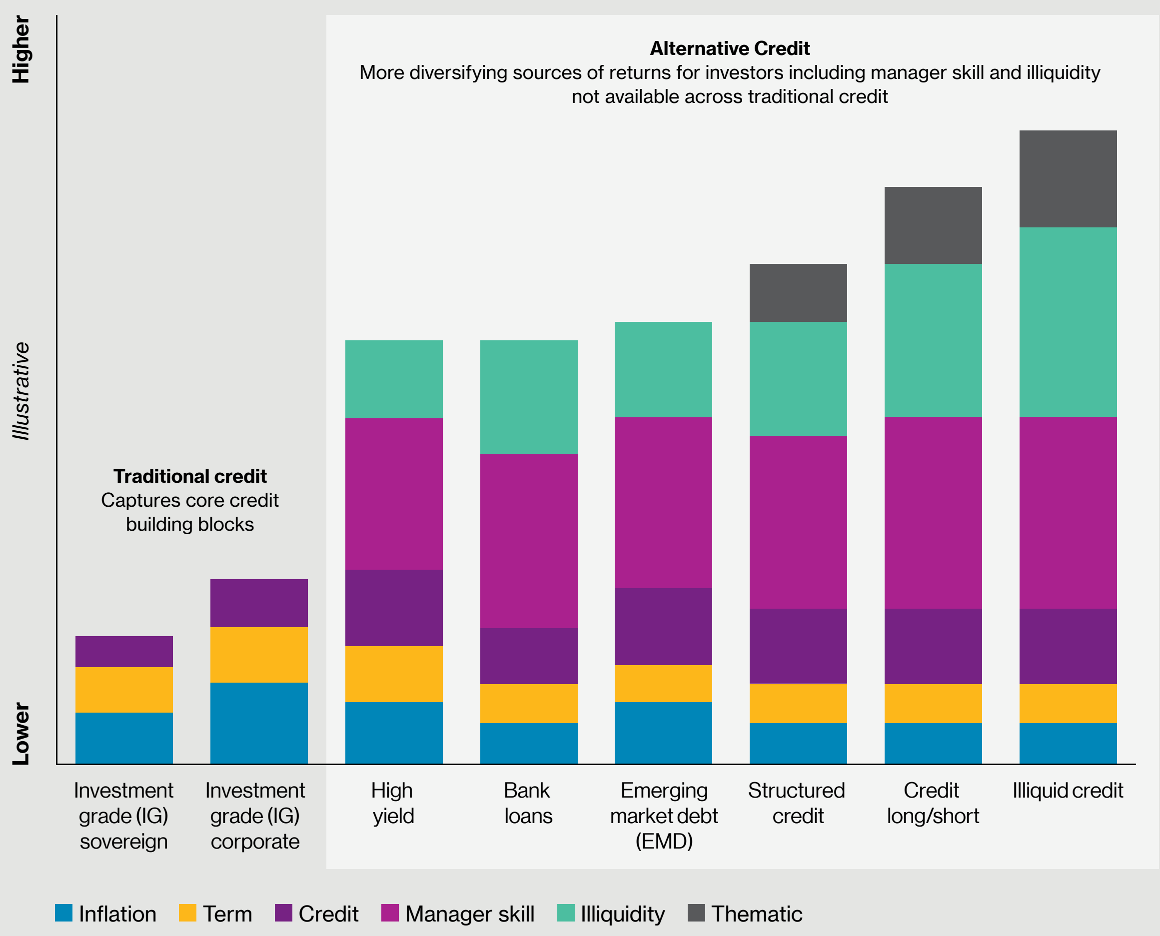
Why can't I keep my multi-sector Alternative Credit?

Multi-sector Alternative Credit offers lower returns and relatively little breadth.

Why don't I just keep my Core Plus manager?

Your Core Plus manager is unlikely to be an expert Alternative Credit investor and will often be too generalist to access valuable niches where the best opportunities can be found.

Figure 4. **Understanding the sources of return**



Getting the best out of Alternative Credit

In our opinion, getting the best out of Alternative Credit is about gaining access to the full breadth of the asset class through multiple specialists and managing the portfolio dynamically. This is easily said but harder to achieve.

Clients should consider a broad opportunity set to exploit diversification and access markets where active management can be better rewarded. Portfolios are more resilient when they are diversified across a range of specialist managers, as *Figure 5* below shows.

As mentioned previously, the most attractive opportunities in private debt are often capacity constrained and investment in several opportunities is required to build a robust portfolio.

Risk control and diversification are vital in credit, where downside risks are larger than the upside potential. We engage with managers to improve outcomes and consider costs as an important factor.

Figure 5. **We advocate investing in a diversified portfolio of specialist managers**

We believe clients should consider a broad opportunity set to exploit diversification and access markets where active management can be better rewarded.

Finally, we believe implementation can be the difference between a good and a great return outcome. We are in a hugely valuable position when investing in Alternative Credit given our long history in the asset class, relationships with the investment community (or managers) and our ability to pool our clients' assets. These factors mean we are not forced to buy off-the-shelf, standard term manager products. Indeed we rarely do this.

Instead, we engage with skilled managers and create tailored strategies. We helped design and launch over half of the vehicles for our Alternative Credit proposition. This means we can recommend and integrate products when they will benefit our clients, not when asset managers want to push them. We work with managers to identify their best strategies at a particular time, which are often just a small part of their larger pooled funds and strip these out for our clients and do so at attractive fees and terms.

We believe portfolios need to be positioned dynamically to exploit opportunities as they arise and divest strategies where the opportunity has been diluted. We have the skill and resources to do this and we are able to use our brand, our knowledge and our buying power to achieve remarkable cost reductions which can be significant.

The difference between good and great implementation of an Alternative Credit strategy can translate into increased return of 1-2% a year in the current investment climate and can contribute significantly to the long-term success of the portfolio as illustrated in *Figure 6*.

Figure 6. **Implementing an effective Alternative Credit portfolio should consider the following elements**

Breadth

- Consistent and in a wide range of market conditions
- Focus in on only the best opportunities
- Invest with specialist experts not broad multi-strategy products – carve out the best
- Collect illiquidity and complexity premiums

Dynamism

- Dynamic asset allocation over the cycle
- Transparent fee structure
- Dynamically managed with no ongoing cash contributions

Drawdown protection

- Downside protection in falling markets; Avoid crowded markets
- Strong yield cushion
- Ensure low default rate through careful lending and highly skilled specialist teams

Implementation

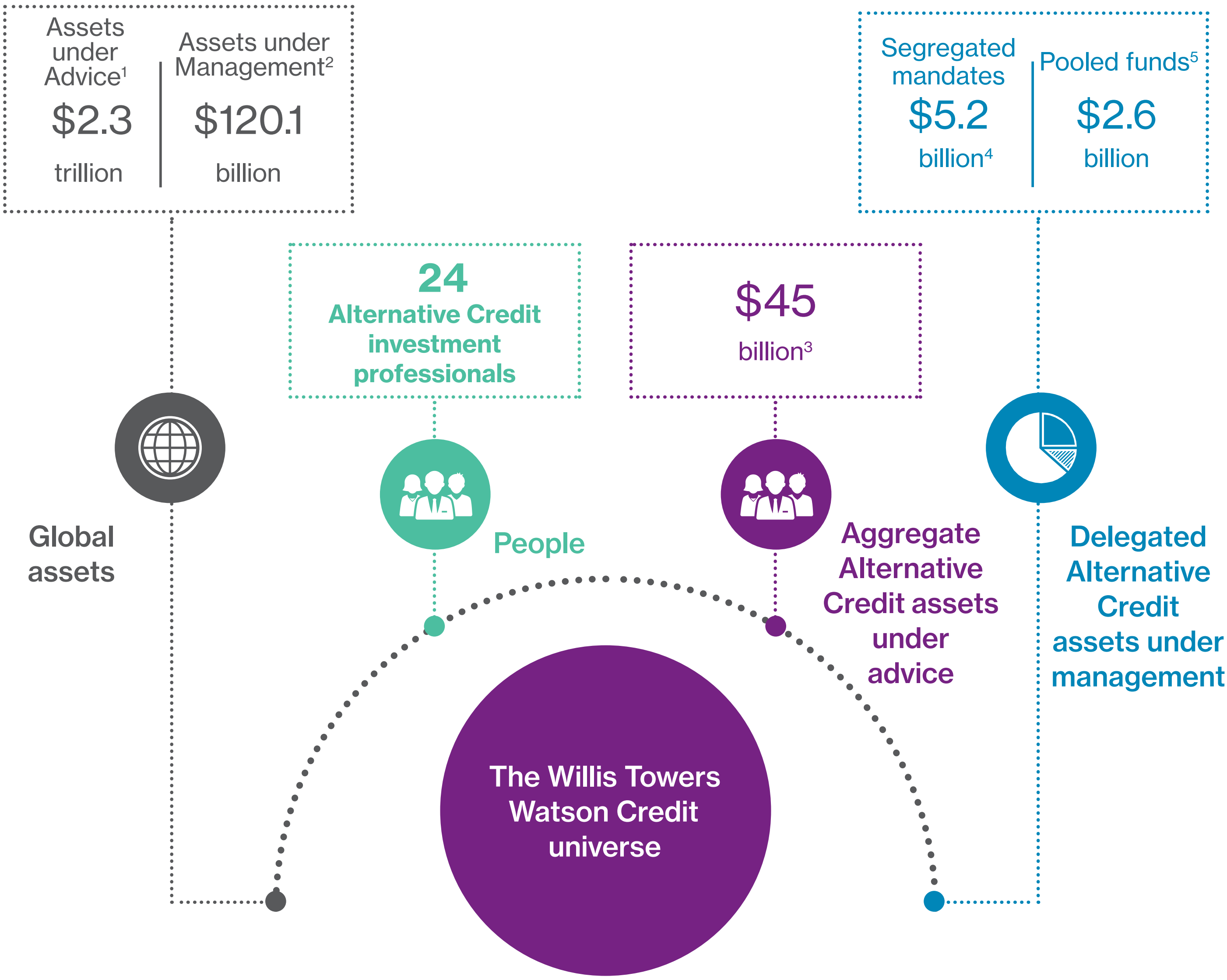
- Access to full breadth of Alternative Credit and private debt in single line item
- Reward managers only on outsized performance
- Very low fees for core mandates, higher fees for more complex strategies – pay only for value
- Negotiate significant reduction in fees and cut additional expenses

Expected returns based on Willis Towers Watson modelling assumptions. Net of all fees and expenses.

Willis Towers Watson as your partner

Willis Towers Watson offers market leading, dynamically managed Alternative Credit solutions selectively capturing some of the best opportunities across the full breadth of Alternative Credit including private debt. These are available on a standalone basis or as part of our full fiduciary service.

Figure 7. **A leading investor in Alternative Credit**



Notes: All figures are subject to change.

Source: Willis Towers Watson and BNY Mellon Fund Services (Ireland) Limited, data as of 31 March 2018 unless otherwise stated.

[1] Data as of 31 December 2016.

[2] AUM – Willis Towers Watson, data as at 31 March 2018

[3] Aggregate Alternative Credit assets under advice as at 30 June 2017.

[4] Data as of 30 September 2017.

[5] Pooled funds – BNY Mellon Fund Services (Ireland) – 31 March 2018.

Figure 8. **High-quality, multi-disciplinary team contributing to your portfolio**

Large specialist, global team

24 Alternative Credit investment professionals

6 Offices

Leverage wider resources

- **Asset Research Team** provides top-down thinking
- **Operational due diligence** manages risk
- **Implementation team** executes
- **Quant and systems** build and maintain robust models and tools

Highly relevant experience

Team includes investment bank strategists, asset management portfolio managers and specialists from fund of funds.

Source: Willis Towers Watson, August 2018.

"We have one of the largest teams of credit researchers in the world. A large team allows us to actively search for new managers and monitor those we have already rated."

Proven track record

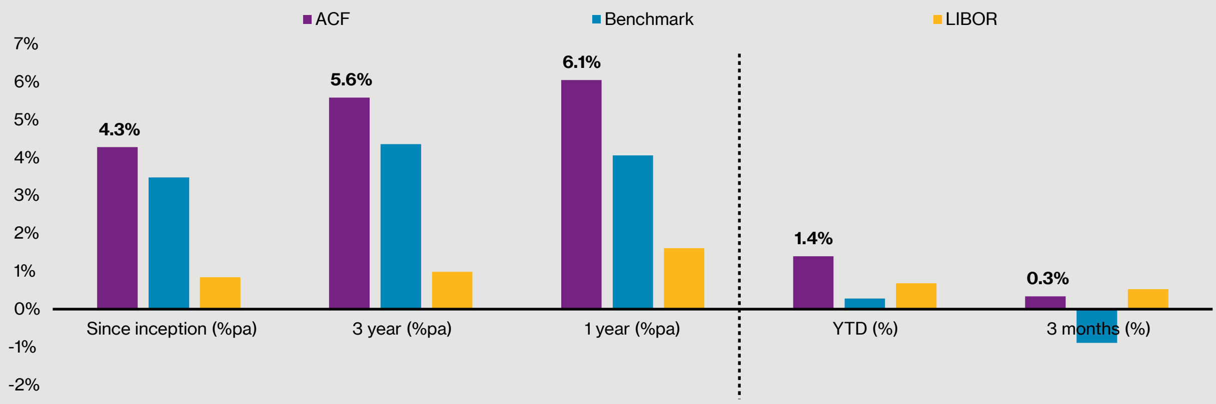
Unlike some other organisations, we do not operate a 'coverage' model seeking to rate all strategies. The coverage model would waste resources on researching and monitoring managers considered unskilled and likely to fail to add value net of fees.

We only research and monitor managers where we, or our clients, believe the managers are skilled (meaning they have the potential to add value net of fees). Our resources, combined with a high degree of focus, give us a competitive edge in finding and monitoring skilled credit strategies; we aim to know our managers better than any other investors. We believe we are the most focused on innovation and engagement with our preferred managers, leading to better solutions and better returns for our investors.

Many of our clients have opted to incorporate their Alternative Credit allocations within a delegated structure. Alternatively, other clients invest via the Towers Watson Alternative Credit Fund (see *Figure 9*). This fund targets equity-like returns of 3% to 5% more than cash over the medium term, with much lower volatility than equities.

Towers Watson Alternative Credit Fund has performed in line with its longer-term target of cash – 3-5% and significantly better than the Alternative Credit market (as seen in Figure 9) – albeit this is a very short track record. We have a longer track record for the composite performance for all our delegated clients' Alternative Credit investments since 2009. Composite return is 9.5%pa, a little short of equities (12.0%) but with less than half the risk and almost twice the Sharpe ratio of equities. The beta of that return stream to equities is just 0.3.

Figure 9. **Towers Watson Alternative Credit Fund delivering strong risk-adjusted returns**



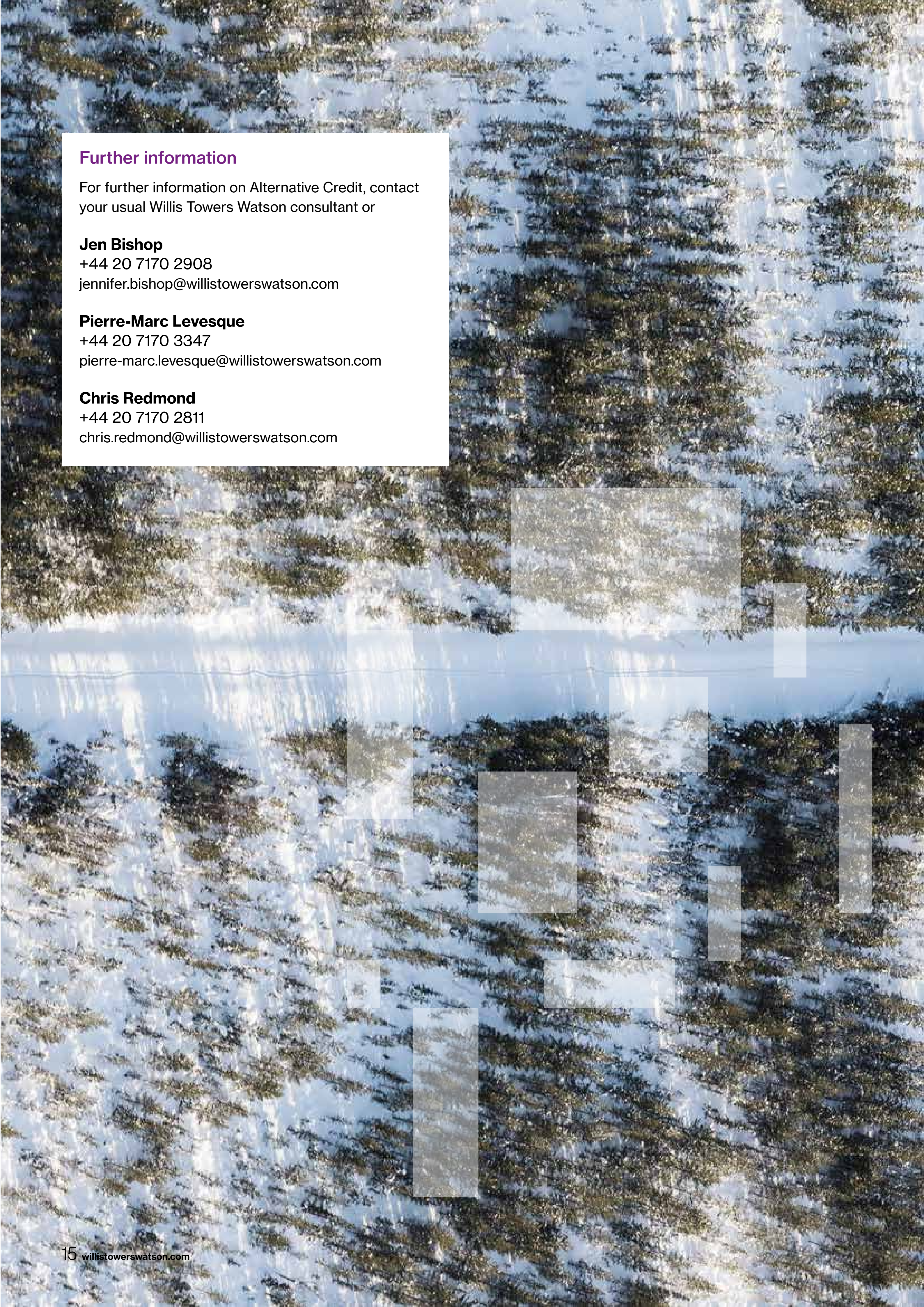
Since inception	ACF	Benchmark
Return (% pa)	4.2%	3.6%
Risk (% pa)	3.5%	4.5%
Sharpe ratio	1.0	0.6
Beta to equities	0.25	0.32
% of equities volatility	33%	43%

Returns	ACF	Benchmark	LIBOR
Since inception (%pa)	4.2%	3.6%	0.8%
3 year (%pa)	5.8%	5.0%	0.9%
1 year (%pa)	6.2%	5.4%	1.5%
YTD (%)	0.7%	0.6%	0.5%

Past performance is not a reliable indicator of future returns

Notes: Figures may be subject to rounding. Performance for the Towers Watson Alternative Credit Fund shown for A Share Series (USD), net of fees. Inception date is 1 August 2014. Equities are MSCI All Country World Index (ACWI). The Benchmark is Beta benchmark from Willis Towers Watson's representative index for the returns in Alternative Credit. It is the equally weighted average of the indices that follow; 1/3 Bloomberg Barclays US High Yield 2% Issuer Cap USD Hedged, 1/3 S&P/LSTA Leverage Loans Index USD Unhedged and 1/3 of (50% Bloomberg Barclays Hard Currency Barclays Sovereign + Quasi 5% Cap USD Unhedged and 50% Bloomberg Barclays Local Currency Sovereign 10% ex-Korea USD Unhedged).

Source: BNY Mellon Fund Services (Ireland) Limited, Bloomberg LLP, S&P Dow Jones Indices, MSCI Inc. and ICE Benchmark Administration, 30 June 2018.



Further information

For further information on Alternative Credit, contact your usual Willis Towers Watson consultant or

Jen Bishop
+44 20 7170 2908
jennifer.bishop@willistowerswatson.com

Pierre-Marc Levesque
+44 20 7170 3347
pierre-marc.levesque@willistowerswatson.com

Chris Redmond
+44 20 7170 2811
chris.redmond@willistowerswatson.com

About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has over 40,000 employees serving more than 140 countries. We design and deliver solutions that manage risk, optimise benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas – the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

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