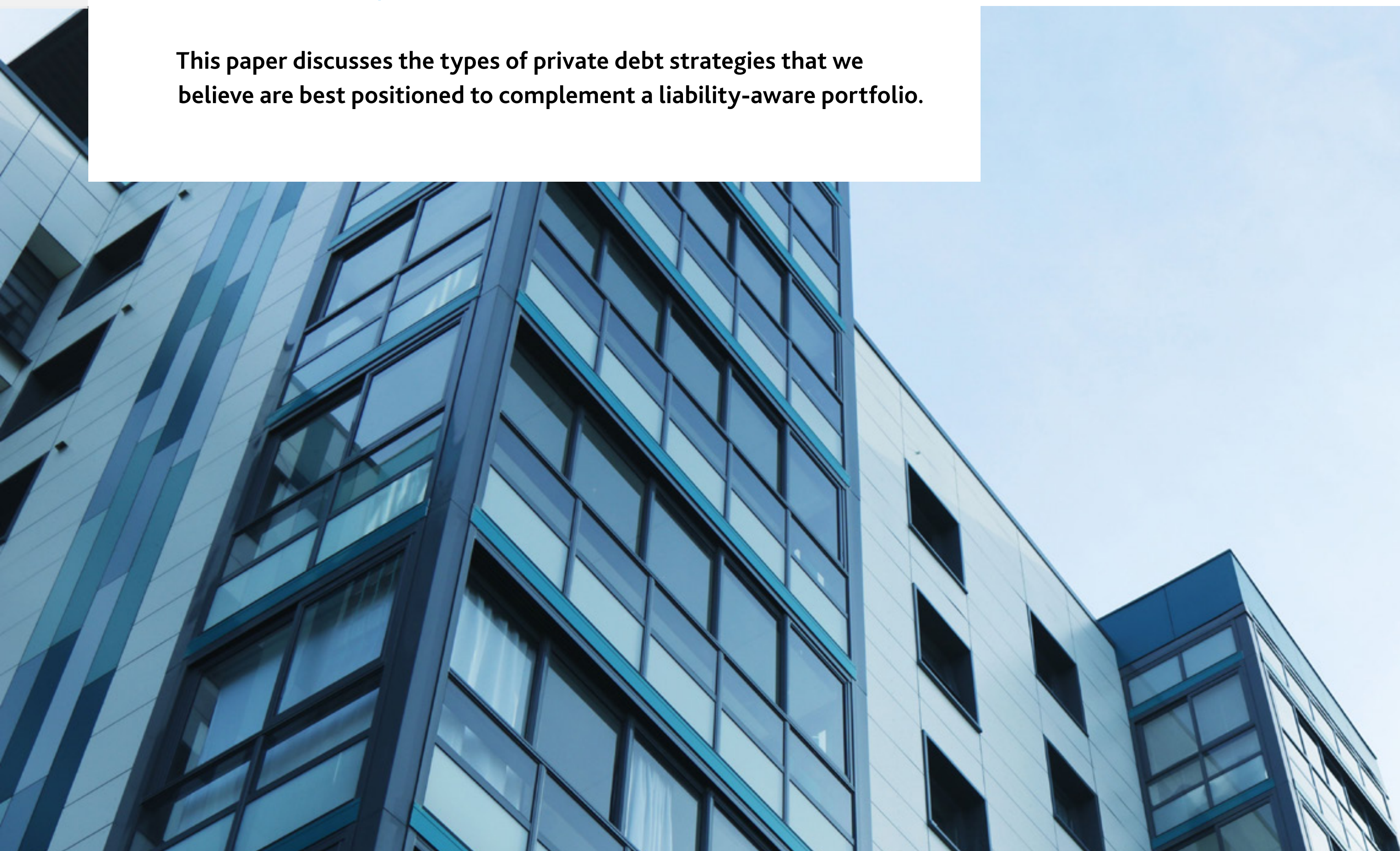
OCTOBER 2022

FIERA PRIVATE DEBT

The Role of Private Debt in a Liability-Aware Portfolio

Over the years, Canadian pension plans have been increasingly adopting private debt strategies. At the same time, higher interest rates have also afforded plans the opportunity to de-risk and reduce funded status volatility.

This paper discusses the types of private debt strategies that we believe are best positioned to complement a liability-aware portfolio.



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Taking Advantage of the Current Environment

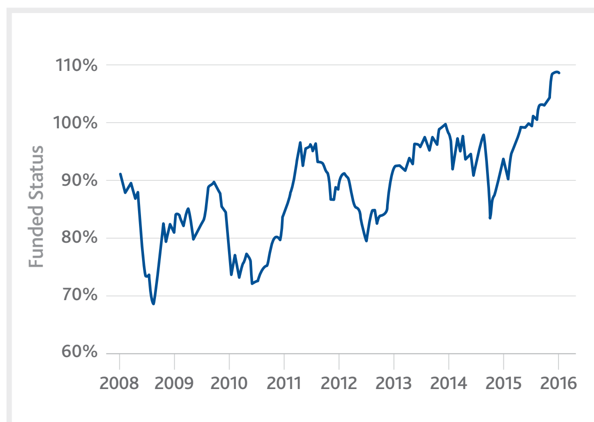
The post-pandemic landscape has ushered in the fastest tightening in financial conditions experienced in recent history.

While asset prices have suffered, Canadian pension plans have benefitted from rising rates and decreasing liability values. The result is a median Canadian pension funded status of 109% – the strongest condition we have seen pensions in since the financial crisis.

Against this backdrop, many plan sponsors are now eager to lock-in funded status gains through duration extension and cash-flow matching. These exercises usually focus on selling assets that are not correlated to liabilities and moving proceeds into long duration, high-quality fixed income products.

We believe private debt mandates can complement a liability-driven strategy by adding diversification and predictable cash flow to further de-risk a portfolio. However, not all private debt strategies can meet this objective and plan sponsors must be selective in choosing the right type of strategy to best accompany their chosen liability-driven approach.

Canadian Pension Funded Position



Source: Mercer Pension Health index

Evaluating Private Debt Options for Liability-Aware Investors

From the perspective of a liability-aware investor, a private debt allocation should closely resemble a traditional fixed income instrument as opposed to a return seeking private debt strategy focused on non-investment grade, leveraged credit. Floating rate exposure, fund level leverage and lower credit quality are all characteristics that may work against a plan's de-risking goals. And yet, these are also the most common characteristics seen amongst major private debt offerings.

When adopting a liability-aware approach to portfolio allocations, investors must reframe their priorities. If considering the inclusion of private debt, we believe investors should focus on several key factors including but not limited to:

Allocating to strategies which are accretive to duration versus the duration drag from floating rate vehicles

Allocating to strategies that have higher credit quality to minimize default/write down risks

Allocating to strategies which offer structural liquidity that are ideal for helping to match short/medium term liabilities

Allocating to strategies that offer attractive industry diversification when compared to mandates focused on larger transactions within fewer industry segments

Identifying Optimal Duration

For many pension-plans, the early stages of liability aware investing entails better matching the duration profile of assets to liabilities to reduce future funded status volatility. In this context, duration risk is a desired exposure regardless of the future path of interest rates.

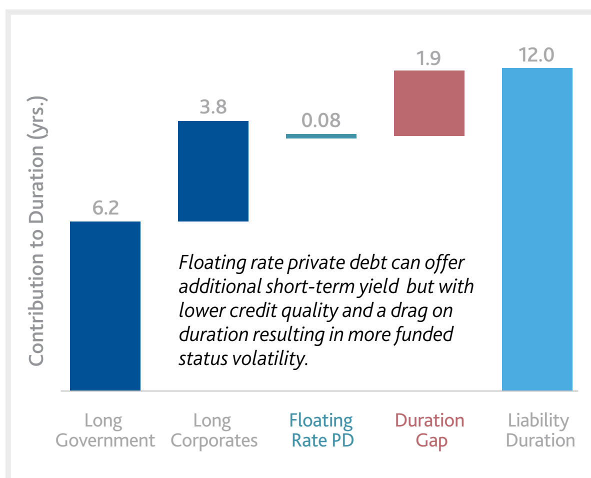
An allocation to floating rate private debt strategies may run counter to this objective as floating rate loans have a near-zero duration profile. As a result of this characteristic, each dollar allocated to floating rate private debt strategies may reduce the ability to match the duration of liabilities. While floating rate private credit structures may help counter rising rates by resetting coupons higher, they also expose investors to the risk of lower coupons if/when interest rates move lower through the cycle. Moreover, rising coupons increase the potential for default risk for the underlying investments. Given these characteristics, we would argue floating rate private credit strategies may be more "return-seeking" in nature rather than liability hedging.

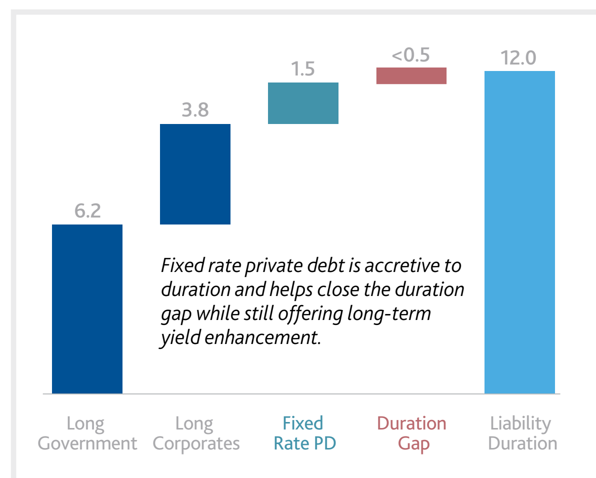
We believe fixed rate private debt strategies can offer significant yield enhancement versus public corporate bonds. The long-term yield enhancement is also superior to floating rate debt if/when interest rates revert to historical levels. In addition, the longer duration profile of fixed rate strategies may not cause the same drag on portfolio duration that comes with floating rate loan strategies. Thus, plan sponsors may benefit from both the liability hedging and long-term yield enhancement from a fixed rate strategy versus the short-term, return seeking characteristics of a floating rate allocation. Fixed rate strategies are both accretive to a plan's duration target and still offer the yield advantage of private debt.

To illustrate this point, the figures below provide a snapshot of a hypothetical liability hedging portfolio allocated across long duration government bonds, long duration investment grade public bonds and an allocation to a fixed rate versus floating rate private debt strategy. The duration profile is then compared to a liability duration of 12 years.

An allocation to fixed rate, investment grade private debt provides a closer match to liabilities with a small duration gap. Conversely, an allocation to a floating rate, non-investment grade strategy (as most floating rate strategies are) results in a significant duration drag with a gap nearing 2 years. While the sub-investment grade, floating rate strategy may seem attractive based on yield today, when considered in the context of liability awareness, the allocation may result in higher funded status volatility, thereby countering the goals of the LDI strategy.

Duration Breakdown of Allocation to Floating vs. Fixed Rate Private Debt ("PD")





Source: Cliffwater, FTSE Capital. Please see final page for index definitions.

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Credit Quality for a Liability-Aware Portfolio

As a pension liability is a promise to fund a future cashflow to a pensioner, plan sponsors must ensure the risk of not meeting this promise is minimal. As a result, liabilities are often valued using "high quality" government and corporate bonds, usually investment grade rated. Given the high quality, low risk profile of liabilities, asset allocations to sub-investment grade strategies may run counter to a plan sponsor's de-risking goals. The majority of private debt funds focus their strategies on the high-yield equivalent universe of companies spanning from BB to CCC rated equivalents with some managers holding distressed debt and equity risk.

While these strategies offer attractive yields, their total return characteristics may not be conducive to a liability-aware portfolio. The lower the credit quality of a debt strategy, the higher the correlation to equity markets due to the higher levels of default risk inherent in those market segments. This runs counter to the goals of liability-driven investing whereby equity risk needs to be reduced and diversified over time.

Total Return Correlations Increase When Moving Down the Credit Spectrum

Asset Class	Correlation to Equities
HY B	80%
HY BB	79%
HY Private Debt	78%
Leveraged Loans	67%
HY FRN	66%
Corp BBB	54%
Corp A	45%
Corp AA	35%

The lower the credit quality of the investment universe, the more "equity-like" the return profile becomes, which undermines the fixed income/liability characteristics that liability-aware investors are targeting.

Source: Bloomberg, FTSE Capital. Based on monthly returns for the 10-year period ending June 2022. Please see final page for index definitions.

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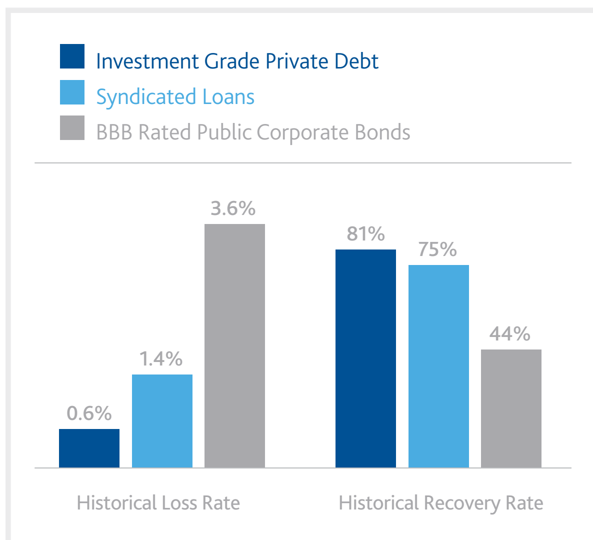
Conversely, investment grade equivalent strategies offer the optimal risk/return tradeoff for liability-aware investors. Investment grade strategies offer credit risk profiles closer to the instruments underpinning liability values while still capturing a yield premium over public fixed income. This results in a "cheaper" option to fund short/medium term liabilities by capturing the yield enhancement offered by private debt but without venturing into lower-quality, equity-like risk/return profiles which can contribute to increased funded status volatility.

We believe by enhancing yield while maintaining high grade credit quality, plan sponsors can fund more of their liability payouts with less dollars committed and without undermining liability matching benefits. To illustrate this concept, the figure below shows the amount of invested capital required within a $200M liability-hedging portfolio to fund the same amount of pension liabilities depending on which asset class is utilized – investment grade private debt, public investment grade corporate bonds or provincial bonds. The private debt allocation covers more pension liabilities with a similar level of credit risk to public investment grade and without the higher correlation to risk assets that comes from a high-yield equivalent private debt allocation.

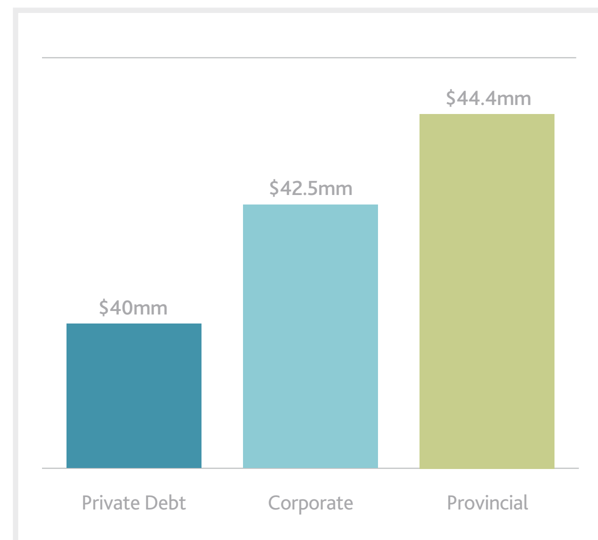
Investment Grade Equivalent Private Debt Strategies Offer Lower Defaults



Source: S&P LCD, S&P Credit Pro and Fiera Private Debt Inc.

Mid-Market, Investment Grade Private Debt Inc. based on Fiera Private Debt Inc. historical rates. Please see final page for index definitions.

Investment Required to Cover Same Portion of Pension Payments



Source: Fiera Capital & Fiera Private Debt Inc. Assumes liability duration of 12 years on a 4.6% discount rate. Rates of return based on public market yields as of August 2022 and indicative IRR for private debt investment at end of capital raising period. Corporate bonds assume 50% A-rated/50% BBB-rated.

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Increasing Cashflow Production to Help Match Liabilities

As pension plans move further along their de-risking journeys , they may find that duration matching alone does not provide the level of liability matching accuracy they need. Consequently, we believe plan sponsors can benefit from a shift towards cash-flow matching – a strategy where private debt can play a role.

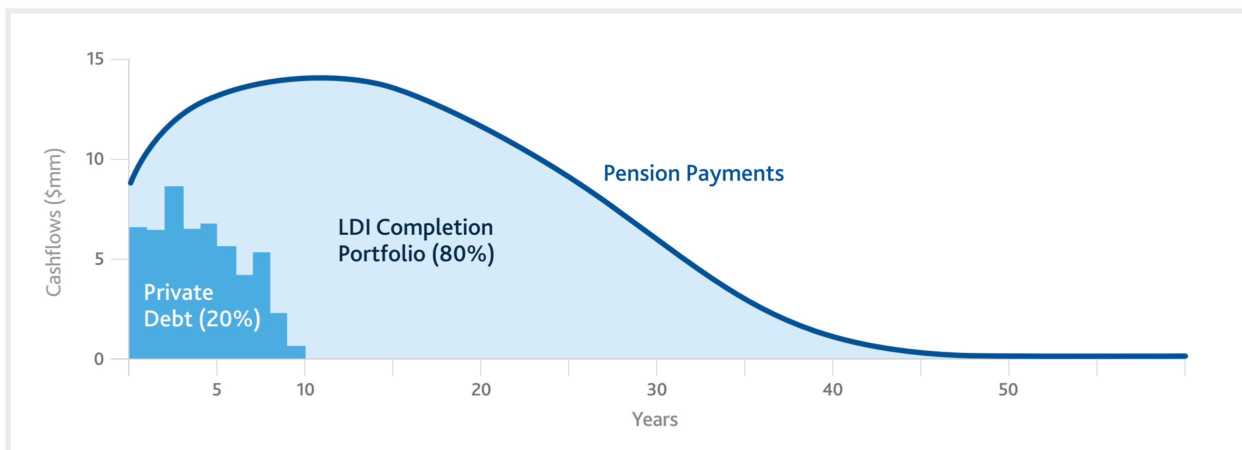
In the context of cash-flow driven investing, certain private debt strategies offer structural liquidity which may help plan sponsors meet short- and medium-term liabilities without sacrificing duration or yield enhancement. This is due to several factors embedded in these types of private debt portfolios.

First, the fixed rate coupons of these loans ensure that income production is not undermined in falling interest rate environments. While floating rate loans can offer attractive income in rising rate environments, they also lose their income production advantage when rates fall. When viewed over a longer time horizon/cycle, fixed rate loans provide a more predictable income stream at a premium to public markets, capitalizing on higher coupons in a rising rate environment, and holding those coupon rates steady on new loans over a longer period of time, irrespective if rates revert to historical levels. Second, these loans are often amortizing, meaning that each payment period includes both a principal and interest payment. This feature may add significant structural liquidity as investors receive higher cash flows versus non-amortizing loans and also systematically de-risks the portfolio over time due to reduced leverage. This cash flow profile may also complement the common "bullet" structure in public market bonds whereby investors receive smaller coupon payments through the life of the bond and a large principal repayment at maturity.

In addition, these strategies may generate additional cash flow through origination and borrower fees that are passed through to investors, further enhancing returns without taking on additional credit risk.

The figure below illustrates a hypothetical Canadian pension plan with a typical liability profile and a $200M liability hedging portfolio. As shown below, a 20% allocation to a private debt strategy with the characteristics described above provides a meaningful contribution to matching cashflows from 1 to 10 years. Combined with an LDI completion portfolio (i.e. duration extension/matching program), an asset owner can produce a cash flow profile which helps meet liabilities at a lower cost than public corporate bonds. Most importantly, this type of cash flow profile is not available through most private debt strategies.

Private Debt Contributing to Matching Cashflows



Source: Fiera Capital & Fiera Private Debt Inc. Assumes liability duration of 12 years on a 4.6% discount rate. Rates of return based on public market yields as of August 2022 and indicative IRR for private debt investment at end of capital raising period. Corporate bonds assume 50% A-rated/50% BBB-rated.

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Conclusion

While there are a wide variety of private debt strategies available, selecting the right one for the right reasons will complement an investor's portfolio. We believe, when viewed through the lens of a liability-aware investor, a long-term fixed rate private debt strategy that focusses on high-grade credit quality can provide enhanced yields and consistent income production over the long term while also reducing credit risk and contributing to duration and cash-flow matching goals.

Aaron Young, CFA

Senior Director, Investor Relations

Fiera Private Debt Inc.

Aaron Young is a Senior Director with Fiera Private Debt Inc. He has extensive experience across fixed income portfolio management, pension/insurance solutions and sustainable finance.

About Fiera Private Debt Inc.

Fiera Private Debt Inc., a subsidiary of Fiera Capital Corporation, provides innovative investment solutions to a wide range of investors through two distinct private debt strategies: corporate debt and infrastructure debt. Fiera Private Debt is focused on providing investors attractive risk-adjusted returns while preserving capital and investing responsibly.

Index Definitions

Long Government: FTSE Canada Long Term Government Bond Index
Long Corporate: FTSE Canada Long Term Corporate Bond Index
Floating Rate Private Debt (PD): Cliffwater Direct Lending Index
Fixed Rate Private Debt (PD): Fiera Private Debt Fund characteristics at initial investment stage
Corp AA: FTSE Canada AA Corporate Bond Index
Corp A: FTSE Canada A Corporate Bond Index
Corp BBB: FTSE Canada BBB Corporate Bond Index
HY FRN: Bloomberg High Yield Floating Rate Note Index
Leveraged Loans: S&P LSTA US Leveraged Loan Index
HY Private Debt: Cliffwater Direct Lending Index
HY BB: Bloomberg Barclays US BB High Yield Bond Index
HY B: Bloomberg Barclays US B High Yield Bond Index
Equities: S&P/TSX Composite Index

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