Yielding Assets: Public vs. Private

Is it possible to get a mid-to high-single digit annual yield in publicly traded fixed income or real estate investments? Yes. Further, are public options less risky compared to private fixed income or real estate? The answer to that second question, at least at a high level, generally appears to be no.

Whether referred to as income or yield, the notion of relying on a portion of a portfolio to generate recurring cash flow has become increasingly unreliable. At its core, yield is a product of an asset's operating income (e.g., a portfolio of rental properties or the coupon payments on loans), which can be modeled with a fair degree of confidence. What is harder to account for, is the ongoing impact of changes in interest rates, the creditworthiness of borrowers, and the relationship an investment has with other assets, particularly if those assets are traded in the public markets. Each of these traits affects the level of investment risk and begs the question of whether seeking yield at the expense of adding what may be disproportionate risk is worth it or necessary.

What distinguishes yield-seeking investments in public markets versus those in private markets?

There are plenty of public debt instruments and real estate investment trusts (REITs) that advertise high yields (in some cases high single- to low-double digit annual yields). However, those yields are often tied to undesirable characteristics such as higher leverage multiples, lower quality borrowers, less secure or unsecured loans, and fixed interest rates at prevailing market rates.

Public yield seeking investments introduce varying levels of exposure to these characteristics while also presenting investors with a related dilemma. As most of these investments are tradeable on the public markets, the impact of changes to interest rates or credit downgrades may make investors uncomfortable and susceptible to abandoning a position. This behavior is all too common in public markets, creating a decision point of whether there is more value in exiting a position to preserve capital, or in being patient so as to realize the potential associated yield over the long term.

By contrast, private market investments seeking yield are not often subject to the same behavioral risks, in large part due to illiquidity. In isolation, illiquidity is a polarizing concept, where some investors view it as a risk and others as a benefit, but it does remove the ability for investors to abandon a position and allows sponsors to build a high yielding portfolio over a long term, which is typically a net benefit to all parties involved. Further, private market debt instruments and real estate typically include investor protections that public markets typically do not, such as conservative leverage multiples, capital stack seniority, collateral, and robust covenant packages. These protections further enhance investment in assets with durable operating cash flows. Collectively, these allow private credit and real estate sponsors to generate attractive yields on an absolute basis (high single- to low-double digit annual yields), as well as on a risk-adjusted basis.

As an investment firm focused on identifying private market investments offering differentiated sources of return in the lower- and lower-middle market, Altera views private yield-producing assets as highly desirable with a risk/return profile that perhaps may be more easily understood.

About the Author

Tim Partridge, FRM®, CAIA
Managing Director

Tim Partridge is a Managing Director at Altera and the Chair of the Firm's Investment Committee, overseeing all investment opportunities. He has worked in the investment and asset management industry since 2002 and has focused exclusively on private market investing since 2013.