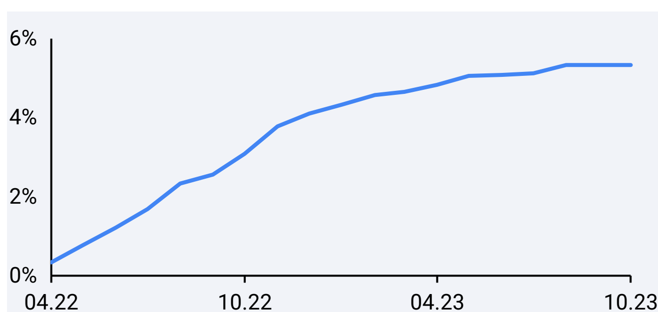
In our November paper, the spotlight was on CRED's attributes as a diversifier for all-weather portfolios. It's crucial to underscore that CRED provides a relatively high floating-rate income. Coupled with a shorter duration, it serves as an ideal complement or substitute for an investment-grade bond portfolio. In this piece, our focus pivots towards highlighting why CRED holds specific appeal in the current investment landscape. Four major factors contribute to making CRED an exceptionally compelling proposition, and we will delve into each of them.

1. The FED has raised rates particulary aggressively

Firstly, we have witnessed a significant number of base rate hikes, entering into a 'higher for longer' scenario.

This marks a dramatic shift in a very short span. The Federal Reserve initiated the first in its series of hikes in the first quarter of 2022, moving from a near-zero level to reaching 5.33% in less than 18 months.

US interest rate hike



Source: Board of Governors of the Federal Reserve System (US)

As the chart above clearly illustrates, the direction of interest rates can shift decisively and materially. And our earlier experience with the Global Financial Crisis shows that these significant moves can take place in either direction.

Nevertheless, we are focusing on the current market environment and highlighting why the recent interest rate increase provides tailwinds for first-lien mortgages in the foreseeable future.

Mortgage lenders now have the opportunity to negotiate interest rate floors set at or near the currently elevated FED discount rate. At Valvest, we are actively implementing measures to introduce a SOFR floor. Our goal is to set this floor at a minimum of 3.5%. This proactive approach emphasizes our efforts to strengthen our position and mitigate interest rate risk in our portfolio.

By adopting this proactive stance, we aim to structure first-lien mortgages with elevated minimum coupon rates. This strategic move not only safeguards lenders from potential fluctuations in official interest rates but also ensures that they stand to benefit from robust downside protection, even in scenarios where the prevailing interest rates dip below their current levels. This approach exemplifies our dedication to navigating the dynamic financial landscape with resilience and prudence.

2. Enhanced principal protection

"If you would like to know the value of money, go and try to borrow some!"

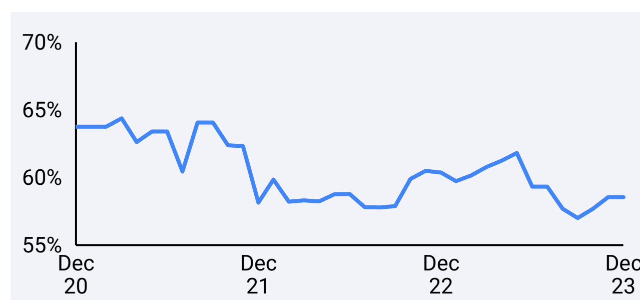
The point regarding Benjamin Franklin's quote about first mortgages is that lower loan-to-value ratios are preferred because they provide greater capital protection for the mortgage lender.

Due to the significant decline in the number of traditional banks in the commercial mortgage sector, alternative mortgage lenders now have the opportunity to negotiate better terms. Consequently, the loan-to-value (LTV) ratios for new loans are significantly lower today compared to similar loans negotiated just two years ago. The lower LTV effectively creates an equity buffer.

This is a crucial aspect of first-lien mortgages, allowing for expected returns even in the face of declining property valuations. With an LTV of 70%, a first-lien mortgage would only potentially incur losses if the corresponding property price drops by more than 30%. Mortgage lenders can benefit from prudent lending practices with lower LTVs, taking advantage of adjusted pricing. This not only establishes the groundwork for more stable returns but also provides better protection against price declines.

Against the backdrop of the current market environment, especially considering the highs and lows of the past two years, it is likely that first-lien mortgages will yield better returns due to their risk structure. At Valvest, our borrowers are in a strong position. Mortgages are structured based on a robust capital structure, ensured through high equity participation and top-tier collateral. This leads to increased interest income compared to earlier times, concurrently reducing risk. In our portfolio, we adhere to cautious lending processes. The weighted LTV is between 50% and 60%, highlighting our commitment to balancing returns and risks.

Loan-to-Value Development in the Valvest Steady Income Fund



3. Credit spreads are widening

Since the Global Financial Crisis, traditional banks have faced significant pressure to restructure their balance sheets. However, this challenge was somewhat mitigated by an unprecedented decade or more of near-zero interest rates and asset purchase programs.

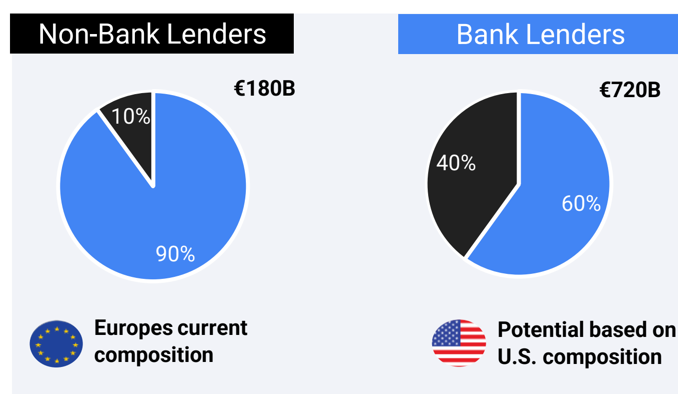
Now, the landscape has shifted, and traditional banks find themselves navigating the dual challenge of normalizing monetary policy while confronting increasingly stringent demands for liquidity and capital. This combination has effectively created a funding gap in the market, necessitating the exploration of alternative sources. Consequently, the potential benefits of taking advantage of improved economic conditions for new mortgage lending should not be underestimated.

Hence, the opportunity to capitalize on improved economics from new CRED loan originations should not be underestimated. In the United States alone, it is estimated that approximately 450–500 billion USD of CRED will mature annually from 2024 to 2027. Over the last 12 months, US credit spreads have widened by around 75 to 100 basis points, excluding more and more participants from an increasingly compelling opportunity.

4. Increasing market share for non-bank CRED lenders

As highlighted in the section titled 'Credit spreads are widening,' traditional banks are facing challenges in the CRED space due to a combination of factors, including the normalization of monetary policy and increasingly stringent regulatory requirements concerning balance-sheet quality and liquidity. We anticipate that this trend will persist, leading to enduring structural changes in the CRED lending market and creating a growing opportunity for non-bank CRED lenders.

It is noteworthy that non-bank lenders already constitute 40% of the real estate market in the US, making it a more mature and significantly larger market compared to both the UK (25%) and Europe (10%). The maturity of the US market implies that borrowers are already more accustomed to a non-bank lending environment.



Source: ARES, Increasing Market Share for Non-Bank CRE Lenders. P. 6, 2023

Reasons for first lien mortgages

In summary, as previously noted, CRED stands out as a potential all-weather component in a diversified investment portfolio, and the argument for allocating in the current environment is particularly compelling.

This is underscored by the ongoing structural changes within the space, favoring non-bank lenders over traditional banks. From a pure investment standpoint, it's crucial to highlight the following:

- High and sustainable coupon income
- Downside protection
- More favorable deal structuring terms
- Portfolio diversification

At Valvest, we proudly present a running yield of 11%, coupled with a robust downside protection of 58% Loan-to-Value (LTV) and a low volatility of 0.6%. Consequently, we highly recommend considering the inclusion of the Valvest Steady Income Fund as an alternative to conventional instruments, providing a stable source of interest income in lieu of traditional fixed-income investments.

Opting for the Valvest Steady Income Fund offers an alternative to traditional investment instruments, presenting investors with a stable income source compared to conventional fixed-income options. The fund's unique proposition lies not only in its attractive returns but also in its role as a valuable addition to a diversified investment portfolio. The inclusion of first-lien mortgages adds a layer of diversification, contributing to a well-rounded and resilient investment strategy.

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