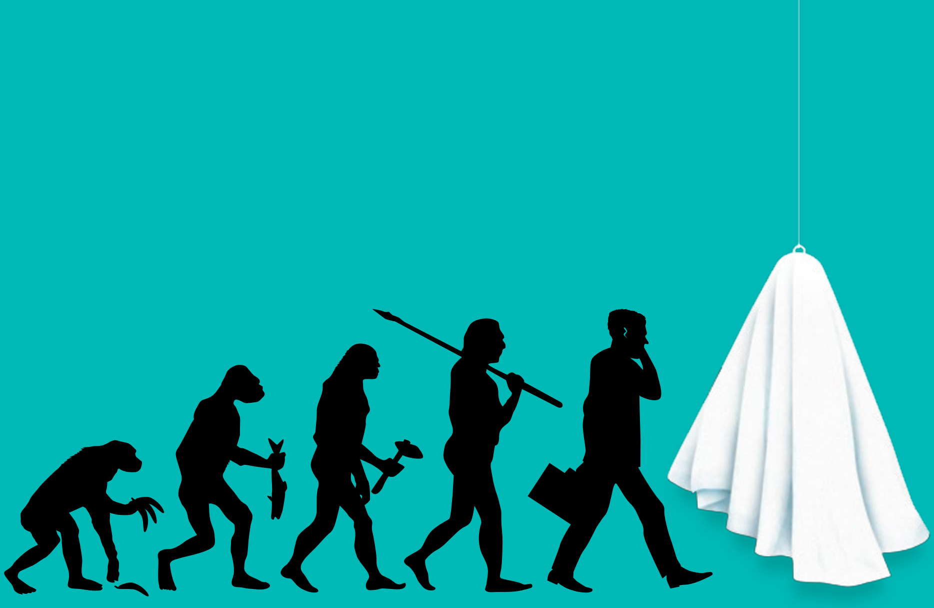


PRIVATE DEBT REFERENCE GUIDE

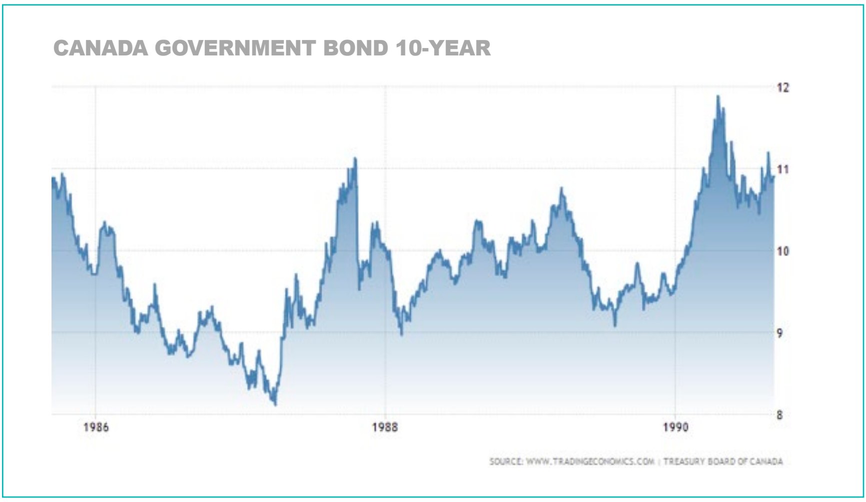
THE NEXT EVOLUTION OF FIXED INCOME

ninepoint PARTNERS

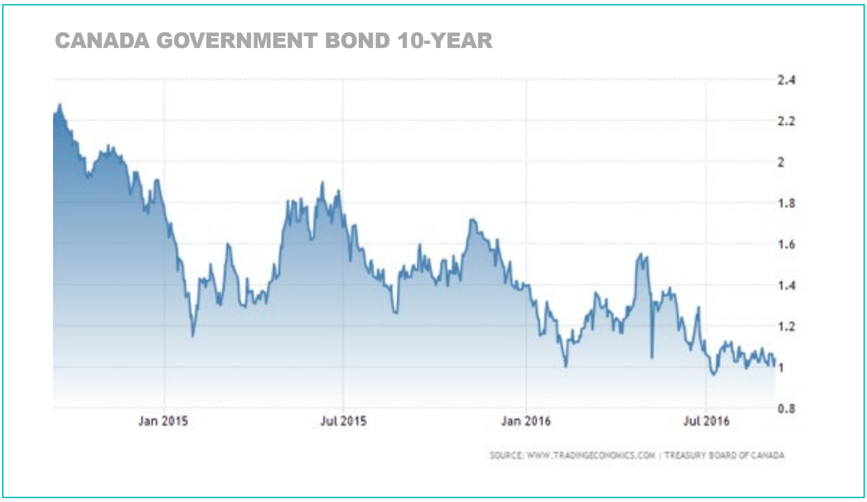
Low-yielding safe assets: The new normal

Government bond yields aren't what they used to be, and investors are in need of new options.

It wasn't that long ago that your Canadian government bond portfolio alone could fund a long, prosperous retirement. As the chart below shows, in the mid- to late-1980s and early 1990s, the 10-Year Government of Canada bond was yielding between 8% and 12%.

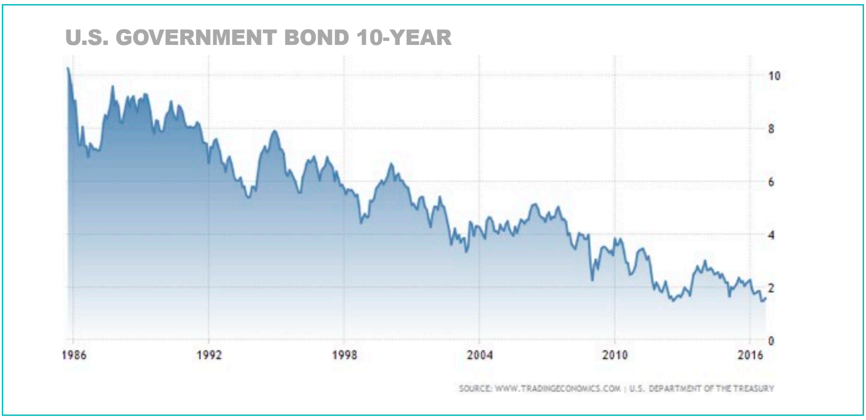


Even within the last 10 to 15 years, Government of Canada 10-Year Bonds offered returns averaging between 4% and 6%. The situation is very different today. Historically low yields put Canadian investors in a position where their government bond yields do little more than maintain the purchasing power of their investments by matching annual inflation (see below).

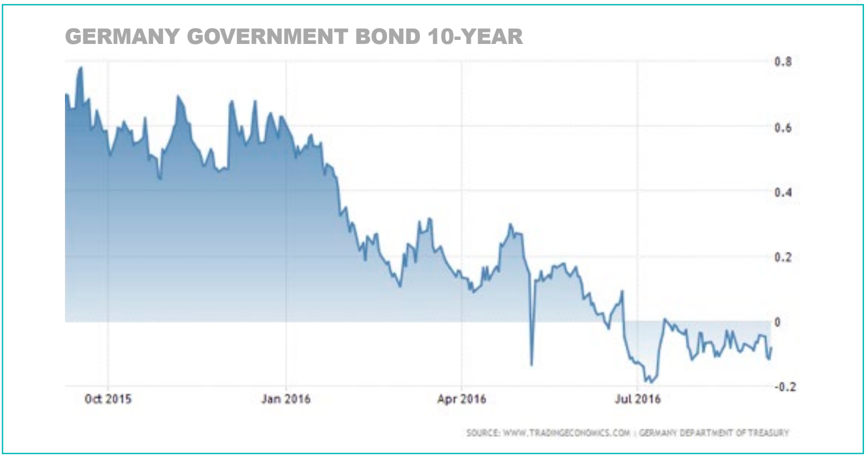


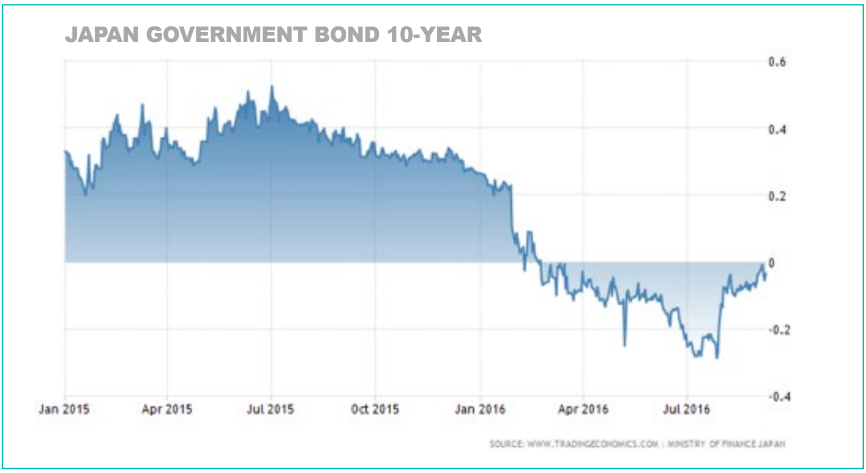
Low yields: A global phenomenon

Other developed countries' government bonds are in a similar predicament. The chart below shows the extremely low yields of U.S. government bonds.



The situation in Europe and elsewhere in the developed world is even more pronounced. Yields in Germany and Japan, for instance, have fallen into negative territory. This means that instead of receiving a return for buying the government's debt, investors are paying the government to keep their money safe.



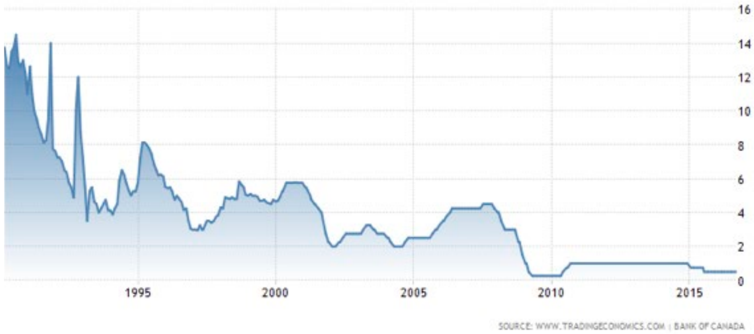


Central Banks

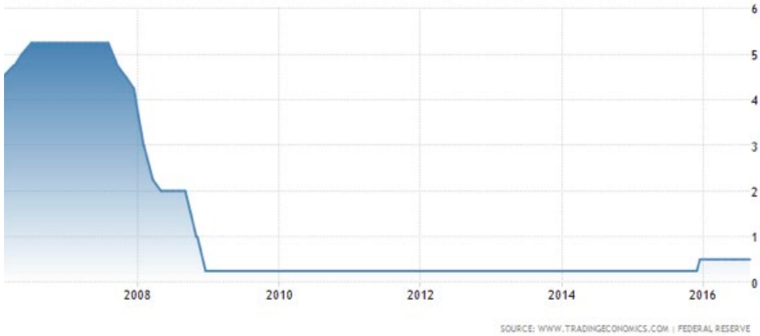
Central bank interest rate policy, which regulates the supply of money and its value, is an important consideration for anyone concerned about the direction of government bond yields. While the relationship between central bank interest rate policy and government bond yields can be complex, the actions of central banks provide a window into the yield environment.

Constrained by weak economic conditions, central banks in Canada and the U.S. are effectively stuck in a very low-rate or even zero-rate predicament for the foreseeable future.

BANK OF CANADA OVERNIGHT INTEREST RATE



U.S. FEDERAL RESERVE FEDERAL FUNDS RATE



Interest rates in European countries are similarly hovering just above 0%, while Japan's rates are negative.

Low yields and low rates: The challenge to investors

The “new normal” of historically low yields and interest rates poses unprecedented challenges for both institutional investors (e.g., pension funds, endowment funds, family offices) and individual retail investors.

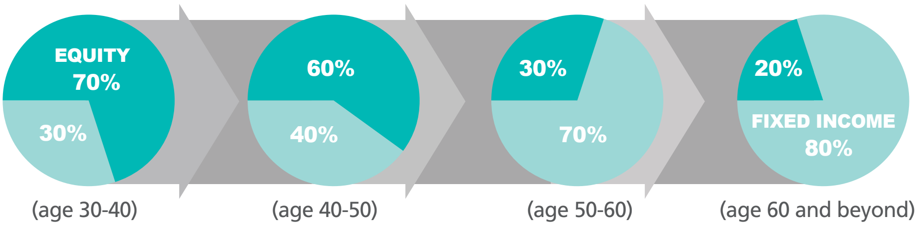
INSTITUTIONAL INVESTORS

To control risk, many institutional investors are required by their investment mandates to allocate a percentage of their assets to fixed income, such as government bonds. This worked well when government bond yields were high, as even the conservative portions of their portfolios were generating meaningful returns.

In the current environment, these institutional investors find it increasingly difficult to meet their return targets and long-dated liabilities. In the case of pension funds, this may force them to reduce promised payments to employee plan members, creating further strain on individual investors.

INDIVIDUAL RETAIL INVESTORS

Investors approaching retirement typically shift their asset allocations to include more fixed income and less equities.



In a low-yield environment, this approach no longer generates the returns needed to fund retirement. Accordingly, investors of all kinds have been looking for ways to enhance returns to cover the shortfall.

Antidotes to low yields?

Many of the solutions investors have used to counteract the problem of low-yielding government bonds have inherent problems that can make them less than optimal. These include higher allocations to:

- Longer-duration bonds – Bonds with longer maturities (e.g., 10 years), which offer higher coupons (interest payments) in exchange for the longer maturity.

- Investment-grade and high-yield corporate bonds – Investment-grade bonds have credit ratings of BBB or higher and have a low risk of default; high-yield bonds have a credit rating below BBB and offer higher yields than investment-grade corporates.

- Preferred shares and/or dividend-paying stocks – Preferred shares are a class of equity ownership that typically pay a dividend, but do not carry voting rights. Owners of *preferred shares* have a higher claim on dividends and earnings than holders of common shares. *Dividend-paying stocks* are common shares that pay a dividend at specific intervals (e.g., quarterly).

- Common shares/equities – Common shares represent equity ownership of a company.

While all of these options have benefits, there is growing consensus that their disadvantages as income replacements become more pronounced the longer they are used to substitute for traditional fixed income.

Let's look at the **pros and cons** of each.

Pros and cons of common attempts to solve the problem of low yields

Longer-duration bonds	
PROS • Higher yields	**CONS** • Interest rate risk. As duration increases (the length of time before a bond matures), so too does the risk and probability of an impairment of principal. For example, if interest rates move up 1%, a 7 year duration bond fund would lose 7%, less any income that the fund had generated.

Investment grade and high-yield corporate bonds

PROS	CONS
• Higher yields than government bonds • Typically less risky than stocks	• Risk of default (e.g., financial failure of the issuing company) • Tend to exhibit higher correlations to stocks, representing a less diversified portfolio • Interest income is taxed at highest marginal rate

Preferred and/or dividend-paying shares

PROS	CONS
• Provide the income that bonds used to produce and have a higher claim on a company's assets and earnings than common shares • Steady stream of income potentially above currently low-yielding government bonds • Dividend income is taxed at a lower rate than interest income	• Higher correlation to broader equity market, reducing diversification and increasing risk profile of the overall portfolio • Dividends can be arbitrarily cut or eliminated by the issuing company

Common shares/equities

PROS	CONS
• Potentially higher returns from price movements • Capital gains are taxed at a lower rate than interest income	• Lower claim on the company's assets than the bonds they replace • Higher level of volatility • Higher equity allocation increases the overall risk profile of the portfolio (diversification risk)

INVESTORS NEED INNOVATIVE SOLUTIONS TO THE LOW-YIELD ENVIRONMENT

THAT OFFER:

- reliable income streams;
- enhanced risk management; and
- low or even non-correlation to broader markets.

Let's look at one such solution.

PRIVATE DEBT

A TIMELY SOLUTION FOR THE LOW-YIELD ENVIRONMENT

Private debt, also referred to as private credit or private lending, has emerged as one of the most promising opportunities in the face of lackluster yields from traditional fixed income.

Private debt involves making privately negotiated loans or extending financing primarily to mid-market companies that are unable to obtain credit from conventional bank channels – not because they aren't creditworthy, but because, post-2008, regulatory reforms tightened banks' capital requirements, further reducing their ability to provide loans to these companies.

This perfect storm of cash-hungry mid-market firms, unavailability of conventional loans, and institutional investors searching for alternatives to low-yielding government bonds has injected tremendous energy into the private debt space. Private debt investing has more than tripled since 2006 as pension funds and other investors have stepped in to meet the demand for credit.

PRIVATE CREDIT

Source: The 2016 Preqin Global Private Debt Report

What the smart money is saying

Top institutional investors are embracing private debt – and indications are they're pleased with the results, according to a recent Preqin poll:

86%

of global institutional investors polled said their private debt investments met or exceeded their expectations in 2015.

46%

plan to invest more capital in private debt in 2016 compared to the previous year.

92%

Longer term, 92% intend to maintain or increase their allocation to private debt.

Preqin Investor Outlook: Alternative Assets, H1 2016

DEMOCRATIZING ACCESS TO PRIVATE DEBT

While private debt investing is currently restricted to institutional and accredited investors (generally defined as high-net-worth individual investors), Canada's securities regulators are presently considering reforms that would give retail investors greater access to these investment strategies.

Private debt and other alternative investment strategies may soon be distributed very much like conventional mutual funds – with a simplified prospectus, and available through MFDA *and* IIROC dealers. Regulators are also considering easing restrictions on conventional mutual funds, potentially enabling them to take advantage of alternative strategies such as private debt.* *Stay tuned!*

*Alternative Investment Management Association of Canada press release (September 22, 2016).

Long-term results

One reason institutional investors are so enthusiastic about private debt is that it has performed strongly over the long term.

A recent TIAA Global Asset Management report breaks down the key figures for mid-market private debt (that would be, loans of $200 million or less to companies worth $50 million or less; these loans fall between traditional bank loans and public market debt). Here are the key performance numbers:

MID-MARKET LOAN INVESTMENT PERFORMANCE

Yield			1998-2015		
ASSET CLASS	CURRENT[1]	HISTORICAL (1998-2015)	DEFAULT RATE	LOSS RATE	RECOVERY RATE
Mid-Market Loans[2]	6.82%	7.47%	3.42%	0.67%	80.39%
High-Yield Debt[3]	7.61%	9.43%	4.45%	2.84%	42.24%

[1]As of June 30, 2016.

[2]Defined as loans of $200 million or less, based on S&P LSTA Leveraged Loan Index.

[3]BoA Merrill Lynch US High Yield Index. Average default, loss, and recovery rates are based on trailing 12-month time frames. Sources: S&P LCD, S&P Credit Pro, BoA Merrill Lynch.

PERFORMANCE OF PRIVATE DEBT AND PUBLIC ASSETS: 1999-2015

ANNUALIZED	CORPORATE BONDS	HIGH-YIELD BONDS	MID-MARKET LOANS[1]	10 YR. TREASURY BONDS	S&P 500 INDEX
Mean Return	5.63%	6.27%	6.21%	4.17%	4.99%
Standard Deviation[2]	5.31	10.65	7.42	3.58	16.67
Sharp Ratio[3]	1.06	0.59	0.84	1.16	0.30

[1]Loans to companies with EBITDA of $50 million or less within the S&P/LSTA Leveraged Loan Index. Data reflect performance, volatility, and Sharpe Ratios for the following indexes: S&P 500 index, BoA Merrill Lynch US High Yield Index, BoA Merrill Lynch US Corporate Bond Index, BoA Merrill Lynch 10yr US Treasury Index, S&P/LSTA Leveraged Loan Index. Performance is based on quarterly returns for the period January 1, 1999 through December 31, 2015. Sources: S&P LCD, Morningstar, TIAA Global Asset Management.

[2]Measure of volatility – lower is better.

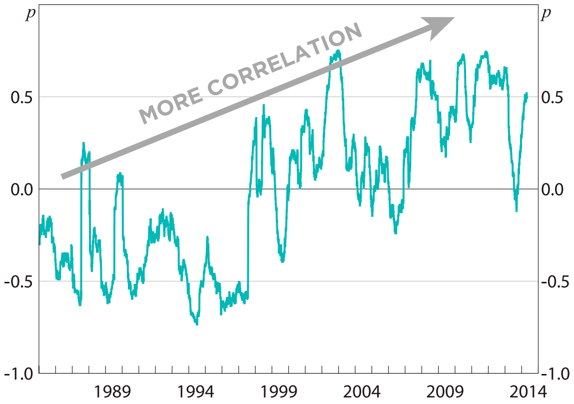
[3]Measure of risk-adjusted return – does the return justify the risk taken by the investor – higher is better.

The holy grail of asset allocation: low correlations

Investors have traditionally held securities from multiple asset classes, in part for their non-correlation benefits: when one asset class was doing poorly, the other would be stable or even moving upwards. This is the hallmark of a well-diversified portfolio.

Increasingly, conventional bonds and equities – once regarded as the textbook case of non-correlated assets – have been exhibiting tighter correlations than ever.

US STOCK BOND CORRELATIONS: S&P 500 VS 10-YR GOVERNMENT



Source: Bloomberg - Six-month rolling centered correlation of daily changes

One of private debt's most appealing features is low or even negative correlation to traditional asset classes, providing the portfolio-protecting benefits of true diversification. Data compiled by TIAA Global Asset Management breaks down the key correlation figures. In the table below, "1.00" represents complete correlation. The lower the number presented, the lower the correlation between asset classes.

CORRELATIONS OF PRIVATE DEBT AND PUBLIC ASSETS: 1999-2015

ANNUALIZED	CORPORATE BONDS	HIGH-YIELD BONDS	MID-MARKET LOANS[1]	10 YR. TREASURY BONDS	S&P 500 INDEX
Corporate Bonds	1.00				
High-Yield Bonds	0.52	1.00			
Mid-market Loans	0.30	0.75	1.00		
10 Yr. Treasury Bonds	0.37	-0.46	-0.48	1.00	
S&P 500 Index	0.12	0.69	0.52	-0.64	1.00

[1]Loans to companies with EBITDA of $50 million or less within the S&P/LSTA Leveraged Loan Index. Based on quarterly returns for the period January 1, 1999 through December 31, 2015. Sources: S&P LCD, Morningstar, TIAA Global Asset Management.

Under the hood

Now that we have a sense of what private debt is and why professional money managers are so drawn to it, let's take a closer look at some specific strategies which, like so many other alternative investment strategies, are now increasingly available to accredited retail investors.

Private debt is a highly diverse category with many different strategic approaches. Typically, these strategies are divided into four main categories:

DIRECT LENDING	Private loans to companies secured by real assets (accounts receivable, inventory, real estate, plants and equipment, etc.). Typically first lien senior debt, this includes structures such as asset-based lending, equipment finance, supply-chain finance, invoice discounting and factoring.
MEZZANINE	A hybrid debt and equity financing that gives the lender the right to convert debt into equity interest in the company, if the company defaults on the loan. Ranks junior to senior debt but higher than equity.
DISTRESSED DEBT	Private loans to companies that have defaulted on their loans; these companies are going through operational or financial restructuring, or are under bankruptcy protection.
VENTURE DEBT	Private loans to promising start-up companies that have minimal available capital.
SPECIAL SITUATIONS	Opportunistic investments using a combination of debt and/or equity to finance company spin-offs, restructurings, share purchases, etc.

LOWER RISK

HIGHER RISK

Private debt in action

The most accessible and lowest-risk form of private debt is direct lending. For the balance of this discussion, we'll look at two of the more popular forms of direct lending.

APPROACH 1: FACTORING

In a factoring strategy, the fund managers raise a pool of capital from accredited investors. The fund managers then deploy this capital through a factor (e.g. a sub-advisor) to buy accounts receivables, at a discount (e.g., 80 cents on the dollar), from interested companies. The reason mid-market companies may be willing to sell their receivables at a discount is that they may need the cash sooner than the 30, 60, or even 90 days that some of the companies they sell to pay their invoices.

The fund then holds the receivable until it is paid by the buyer, collecting the difference between the full invoice value and the discount the fund paid for the invoice. This represents the income to the fund.

To illustrate, consider the following example.

An electronics wholesaler sells $1 million worth of product to each of three retailers on March 1, with payment due within 90 days. The problem is that the wholesaler has a need for that money before the payments come in.

Factoring solves this problem. The factor will give the wholesaler the cash value of the receivables – minus a percentage, which represents the source of the fund's returns – in exchange for legal ownership of those receivables with the original purchasing company.

The factor's main risk is non-payment by the company's creditors. To reduce this risk, the factor will conduct thorough due diligence on their creditworthiness, including confirming that invoices are valid and collectible.

APPROACH 2:
PRIVATELY NEGOTIATED SECURED LOANS

In this strategy, the fund manager invests the pool of investor capital in loans secured by senior liens on key company assets, with visible potential cash flows or realizable value in the event of the company's liquidation.

When vetting potential loan opportunities, fund managers look at a number of key attributes, including:

VALUABLE ASSET COLLATERAL	Senior liens on self-liquidating working capital assets and critical business assets with predictable realization values
PROVEN BUSINESS MODEL	Sound business strategy with visible product demand and capacity for cash flow generation to limit default risk
STRONG MANAGEMENT	Experienced management teams committed to business and aligned through personal risk and ownership
STAKEHOLDER SUPPORT	Strong customer, supplier, employee, junior creditor, and/or shareholder relationships
MULTIPLE EXITS	Wide range of deleveraging options independent of refinancing markets or collateral realization and liquidation

LET'S LOOK AT AN EXAMPLE.

An Ontario-based software developer whose primary business is the design, development, distribution and service of online games needed a $40-million term loan for acquisition of a successful and fast-growing developer of online social casino games. Here's how it meets each key test:

VALUABLE ASSET COLLATERAL ✓	Senior liens on self-liquidating working capital assets and critical business assets with realizable liquidation values
PROVEN BUSINESS MODEL ✓	Sound business strategy with visible product demand and capacity for cash flow generation to limit default risk
STRONG MANAGEMENT ✓	Experienced management teams committed to business and aligned through personal risk and ownership
STAKEHOLDER SUPPORT ✓	Strong customer, supplier, employee, junior creditor, and/or shareholder relationships
MULTIPLE EXITS ✓	New contracted cash flows from acquired company, potential acquisition by larger industry player

The case for private debt

In summary, many investors have begun to explore allocating private debt to their portfolios because of the advantages that have been discussed here:

✓ An innovative way to generate income
✓ Low volatility
✓ Equity-like returns
✓ Collateralized by assets
✓ Non-correlated to traditional asset classes
✓ Lower historical default and loss rates than high-yield bonds
✓ Capital preservation with strong long-term performance

Challenges of private debt

When institutional investors Invest in private debt, there are challenges which make the asset class more difficult for some retail investors to access:

- **Less liquidity**
  Unlike stocks and bonds, there is no active secondary or listed public market for private debt. Private debt is intended to be a medium to long-term investment for buy-and-hold investors.

- **Term to Maturity**
  The typical maturity of a private debt investment can run from one to three or more years. To realize the full yield on a private debt investment, an investor may have to hold the investment to maturity.

- **Possible concentration risk**
  When fewer loans exist in a loan portfolio, there is greater the potential for one loan default to affect overall returns.

- **Possible cash drag**
  Cash raised cannot always be fully deployed as there are a finite number of mid-market borrowers available at any one time. Timing issues between cash inflow and outflow (investment) may produce lower returns.

How retail investors can access private debt

At this time, private debt investments are only available to accredited investors (that is, an investor who owns net financial assets worth more than $1 million before taxes, or who has net income before taxes exceeding $200,000 in both of the last two years*).

*For a full definition of “accredited investor”, please visit http://www.osc.gov.on.ca/en/21943.htm

To address some of the private debt investment challenges identified above, several innovative investment products have been developed that typically feature the following:

	PURE-PLAY DIRECT LENDING FUNDS	MULTI-STRATEGY DIRECT LENDING FUNDS
Risk-Return Relationship	Higher potential risk Higher potential return	Lower potential risk Lower potential return
Risk Oversight	• Strict covenants • Active management oversight • Team of 20+ credit experts	Same oversight as Pure Play Funds plus additional layer of oversight at the portfolio level
Example Strategies	Asset-Based Lending or Accounts Receivable Factoring	Asset-Based Lending *and* Accounts Receivable Factoring *plus* additional fixed income strategies that provide greater liquidity for entrance and exit from the fund
Concentration Risk	>10 private loans, but risk but can be mitigated by manager talent	>30 private loans *plus* inclusion of >50 more traditional fixed income positions
Cash Drag	Possible, but can be mitigated by manager talent	Multiple strategies permit greater optimization of uninvested cash

Conclusions / Next Steps

- Private debt is an emerging asset class that has the potential to provide a portfolio with superior risk-adjusted returns versus traditional fixed income investments, while contributing to portfolio diversification and volatility mitigation.

- In a persistent, low-yield environment, private debt investments have the potential to provide meaningful income to a portfolio.

- Private debt investments can be complex and less transparent than investments in traditional securities. As a result, it is critical to select a manager who possesses deep expertise in private debt investments and who has shown a track record of success.

- To that end, the best first step is to talk with your financial advisor about whether investing in private debt can better help you meet your investment objectives.

THE NEXT EVOLUTION OF FIXED INCOME

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