Most public and private defined benefit pension plan sponsors aim to design an effective liability driven investment (LDI) strategy that balances several objectives – achieving the desired funded status for the plan, managing return-seeking assets in the portfolio against relevant benchmarks, and effectively de-risking and hedging future liabilities. LDI portfolios traditionally rely on a combination of Treasury securities and long and medium duration corporate bonds as hedging instruments. Today, sponsors are challenged with the implications of a low interest rate environment as well as the potential for negative credit migration within their investment grade corporate holdings.

Core commercial mortgage loans represent an asset class that merits additional consideration within LDI portfolios for three key reasons:

(i) they offer access to a large and scalable asset class with a variety of duration options;
(ii) they provide a persistent spread premium to public investment grade (IG) corporate bonds; and
(iii) they provide diversification and have demonstrated superior risk-adjusted performance with low correlation to IG corporate bonds.

Core commercial mortgage loans (CMLs) are senior debt instruments secured by real estate assets such as office buildings, multifamily apartment complexes, industrial warehouses, and retail centers. Rental income from a property’s tenants is used to service the senior mortgage debt ahead of any other interest and prior to any return of capital to the property’s owners. Because of its first payment priority, CML debt provides cash flow and principal stability as well as downside protection against property value declines.
Commercial Mortgage Loans: An Alternative Asset in LDI Portfolios?

Large and Scalable Market

In seeking a large market of high-quality credit exposure, many investors turn to public IG corporate credit. This is not without merit as the market is perceived as liquid and allows for large-scale deployment of capital. A common misconception is that the CML market lacks this scale but the empirical data proves otherwise (Figure 1).

Figure 1: Large and Scalable Market

New originations of CMLs have been consistently robust and provide exposure to collateralized loans with diversified rate structures and durations. The market’s total size is significant – by our measure, it is 124% the size of the IG corporate bond market, excluding financials – which means that managers can deploy large sums of capital in the market sectors which are most appropriate for their investors without simply “buying the market.”

Further, for investors in LDI strategies, CMLs offer an attractive alternative to long duration bonds when matching long-dated liabilities. Newly originated CMLs generally range in tenor from 2 to 25 years. PGIM Real Estate is one of the largest non-bank lenders globally with over $70 billion of total originations from 2010 through 2019. Over 60% of those originations carried an average life of 10 years or longer, and 23% of 12 years or longer. By contrast, only 33% of comparably-rated public bonds have an average life profile of 10 years or longer.

1As of December 31, 2018; CRE Debt Source: Mortgage Bankers Association; IG Corp Source: SIFMA. IG corporate bond amount outstanding excludes the financial sector and is as of December 31, 2019; Source: Bloomberg Barclays. Multifamily and non-residential mortgage debt represents the average quarterly outstanding figures as of September 30, 2019 and excludes one-to-four family residences and farm volume; Source: Federal Reserve (Mortgage Debt Outstanding, Table 1.54)
As is generally the case with many private assets, CMLs have less liquidity than public bonds and have historically been difficult to access because they require an infrastructure to source and privately negotiate each investment. The origination market has been dominated globally by banks and insurance companies, though more recently, investors have been able to gain exposure to these assets in a commingled format through open-end, evergreen vehicles.

### Persistent Yield Premium to IG Bonds

Core CML strategies focus on delivering and maximizing a yield premium over comparably-rated corporate credit. This premium is attributable to the inherent complexity of the market’s direct origination model (which creates meaningful barriers to entry), as well as a manager’s specific value-add through investment selection, loan document negotiation, avoidance of credit losses, and active asset management.

This premium has proven real and persistent across cycles (Figure 2) and has averaged 88 basis points since 2009.

#### Figure 2 : Persistent Yield Premium

<table>
<thead>
<tr>
<th>PGIM Real Estate Quality Rating</th>
<th>Average Life (5yr)</th>
<th>Average Life (7yr)</th>
<th>Average Life (10yr)</th>
<th>Average Life (15yr)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A+</td>
<td>139</td>
<td>111</td>
<td>85</td>
<td>62</td>
</tr>
<tr>
<td>A</td>
<td>139</td>
<td>111</td>
<td>85</td>
<td>70</td>
</tr>
<tr>
<td>A-</td>
<td>139</td>
<td>111</td>
<td>85</td>
<td>91</td>
</tr>
<tr>
<td>BBB+</td>
<td>139</td>
<td>132</td>
<td>134</td>
<td>142</td>
</tr>
<tr>
<td>BBB</td>
<td>175</td>
<td>173</td>
<td>177</td>
<td>185</td>
</tr>
<tr>
<td>BBB-</td>
<td>223</td>
<td>231</td>
<td>245</td>
<td>257</td>
</tr>
</tbody>
</table>

Actual performance returns may differ significantly from market spread information presented here. Past performance is not a guarantee or an accurate indicator of future results. 

1. U.S. Mortgage market spreads as maintained by PGIM Real Estate for investment grade, fixed rate loans. Corporate bond data represented by the Bloomberg Barclays U.S. Corporate Bond Index, isolated to bonds rated A. Data as of March 31, 2020. 
**Superior Risk-Adjusted Performance**

In addition to this persistent yield premium relative to IG bonds, core CMLs deliver superior risk-adjusted returns. This is in large part due to the structural advantages offered by these loans, including collateralization by real property, direct access to borrowers and primary due diligence, call protection, and a “seat at the table” in downside scenarios which helps to drive work-out and recovery. Downside protection as experienced by a lower default rate, lower principal losses, and lower mark-to-market fluctuations has outperformed IG corporate credit over the long-term (Figure 3).

![Figure 3: Diversification to Corporate Bonds (Total Return and Volatility, 1999 – Q1 2020)](chart)

Past performance is not a guarantee or an accurate indicator of future results. Giliberto-Levy Commercial Mortgage Performance Index tracks the income and price performance of U.S. core commercial real estate loans; A Corporate Bonds represented by the A-rated subset of the Bloomberg Barclays U.S. Investment Grade Corporate Bond Index; BBB Corporate Bonds represented by the BBB-rated subset of the Bloomberg Barclays U.S. Investment Grade Corporate Bond Index. Sharpe Ratio calculated by subtracting the average 1 Mo Libor rate from Q1 1999 – Q1 2020 from annualized index performance over that period, divided by the standard deviation of index returns.

Over the past 20 years, core CMLs, as measured by the Giliberto-Levy Commercial Mortgage Performance Index (G-L Index), have outperformed A-rated and BBB-rated corporate bonds from a total return perspective inclusive of income and changes in market value. This outperformance was recently driven by Q1 2020 performance, during which time core mortgages positively performed and corporate credit declined steeply over pandemic-related economic concerns. Further, the relative stability of core CMLs is evidenced by their substantially lower standard deviation of returns over this same period, the product of lower mark-to-market volatility on an ongoing basis. The result is a historically higher risk-adjusted return and low correlation to public corporate credit across both the A and BBB ratings.
Conclusion

Core commercial mortgage loans, such as those originated by life company lenders, represent a large and scalable market and offer attractive risk-adjusted returns due to a strong yield profile and downside protection through the structural protections afforded by direct origination. In addition, these loans have proven to be an effective asset class within the LDI space due to their variety of duration profiles, including those greater than 10 years. All these factors contribute to our strong conviction that core commercial mortgage loans serve as an attractive diversifier and fundamental allocation within an institutional credit portfolio.

About PGIM Real Estate

As one of the largest real estate managers in the world with $179.4 billion in gross assets under management and administration, PGIM Real Estate strives to deliver exceptional outcomes for investors and borrowers through a range of real estate equity and debt solutions across the risk-return spectrum. PGIM Real Estate is a business of PGIM, the $1.3 trillion global asset management business of Prudential Financial, Inc. (NYSE: PRU).

PGIM Real Estate's rigorous risk management, seamless execution, and extensive industry insights are backed by a 50-year legacy of investing in commercial real estate, a 140-year history of real estate financing, and the deep local expertise of professionals in 31 cities globally. Through its investment, financing, asset management, and talent management approach, PGIM Real Estate engages in practices that ignite positive environmental and social impact, while pursuing activities that strengthen communities around the world. For more information visit www.pgimrealestate.com.

1As of March 30, 2020. Includes US$37.9 billion in AUA.
2Includes legacy lending through PGIM's parent company, PFI.
Commercial Mortgage Loans: An Alternative Asset in LDI Portfolios?

Important Information

PGIM is the primary asset management business of Prudential Financial, Inc (PFI). PGIM Real Estate is PGIM’s real estate investment advisory business and operates through PGIM, Inc., a registered investment advisor. PGIM, their respective logos as well as the Rock symbol are service marks of PFI and its related entities, registered in many jurisdictions worldwide. PFI of the United States is not affiliated in any manner with Prudential plc, incorporated in the United Kingdom or with Prudential Assurance Company, a subsidiary of M&G plc, incorporated in the United Kingdom. In the United Kingdom and various other jurisdictions in Europe, certain investment activities are carried out by representatives of PGIM Limited, which is authorised and regulated by the Financial Conduct Authority of the United Kingdom (registration number 193418). PGIM Real Estate, which is affiliated to PGIM Limited, is the real estate investment management business of PGIM, Inc. the principal asset management business of Prudential Financial, Inc. (‘PFI’) of the United States. PGIM Limited is registered in England No. 3809476 VAT no. 447 1835 36, Registered Office, Grand Buildings, 1-3 Strand, Trafalgar Square, London WC2N 5HR. The information provided in the document is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager that is registered with, and licensed by the Monetary Authority of Singapore. In Hong Kong, this material is distributed by PGIM Real Estate Luxembourg S.A., a regulated entity by the Commission de Surveillance du Secteur Financier (CSSF). In Germany, this material is distributed by PGIM Real Estate Germany AG, a regulated entity by the Bundesanstalt für Finanzdienstleistungen (BaFin).

These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM is not acting as your fiduciary.

These materials represent the views, opinions and recommendations of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person’s advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM Real Estate is prohibited. Certain information contained herein has been obtained from sources that PGIM Real Estate believes to be reliable as of the date presented; however, PGIM Real Estate cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM Real Estate has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. Past performance is no guarantee or reliable indicator of future results. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PGIM Real Estate and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM Real Estate or its affiliates.

The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

Conflicts of Interest: Key research team staff may be participating voting members of certain PGIM Real Estate fund and/or product investment committees with respect to decisions made on underlying investments or transactions. In addition, research personnel may receive incentive compensation based upon the overall performance of the organization itself and certain investment funds or products. At the date of issue, PGIM Real Estate and/or affiliates may be buying, selling, or holding significant positions in real estate, including publicly traded real estate securities. PGIM Real Estate affiliates may develop and publish research that is independent of, and different than, the recommendations contained herein. PGIM Real Estate personnel other than the author(s), such as sales, marketing and trading personnel, may provide oral or written market commentary or ideas to PGIM Real Estate’s clients or prospects or proprietary investment ideas that differ from the views expressed herein. Additional information regarding actual and potential conflicts of interest is available in Part 2 of PGIM’s Form ADV.

© 2020 PFI and its related entities.