

Private Debt: Where Do Mortgages Fit In?

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Over the past six months, investors have faced heightened uncertainty, as a result of shifting trade and tariff policies of the US government. Market volatility has remained elevated, and no single traditional asset class has provided consistent protection against the resulting swings. Traditionally, institutional investors relied on the inverse correlation between equities and bonds to stabilize their portfolios. However, in recent years, that relationship has weakened - equity and bond markets now often move in tandem, in times of stress, reducing the effectiveness of traditional diversification strategies.

In response, institutional investors are increasingly exploring alternative asset classes to enhance portfolio resilience. One such alternative is private debt. While private debt has been part of the strategies of pension funds and insurance companies, now, mid-sized plans and even high-net-worth individuals are following suit, drawn by the attractive risk-adjusted returns and income stability these strategies can offer.

This article is focused on institutional investors, including pension funds, endowments, and foundations, who are evaluating the role of mortgage investments within a diversified private credit portfolio. We'll examine how mortgage strategies differ from other forms of private credit and outline the specific

benefits they can bring to institutional portfolios—particularly in today's uncertain economic environment.

Many institutional asset allocators are actively reviewing their portfolios in search of strategies that can reduce risk and volatility, without sacrificing returns. In this context, Canadian commercial mortgages deserve serious consideration. Historically, this asset class has delivered strong performance—offering yields above those of most traditional fixed-income strategies, while maintaining relatively low risk.

The past few years have provided a real-world stress test for both the asset class and its managers. With interest rates at historic lows and property valuations at all-time highs, the investment landscape was unusually fragile for mortgage Portfolio Managers. When interest rates began to rise rapidly, the underlying risk profile of nearly every loan increased dramatically. The impact of U.S. tariffs on the asset class has been minimal. Even in the event of an economic slowdown, commercial real estate values are expected to remain relatively stable. Despite this challenging environment, the vast majority of Canadian commercial mortgage loans have continued to perform, and top-tier managers were able to navigate the changing market conditions and deliver strong risk-adjusted returns.

Today, with inflation largely under control in Canada, most economists expect interest rates to remain stable or decline modestly over the next few years. This expected stability is positive for commercial real estate owners, as it provides greater clarity for budgeting, refinancing, and planning new development or capital improvements. In turn, this fuels market activity, expanding the pipeline of potential mortgage deals - a key benefit for active mortgage managers. Canada's population growth also serves as a tailwind for the mortgage asset class, driving increased demand for real estate across all sectors. While the impact is most evident in the multi-residential space, it also extends to commercial properties, as a growing population supports greater need for workplaces, retail, and services.

Over the past five years, many investors seeking diversification within private debt have turned to private credit strategies. A McKinsey report published in September 2024 noted: "Private credit has been one of the fastest-growing segments of the financial system over the past 15 years. The asset class, as commonly measured, totaled nearly \$2 trillion by the end of 2023, roughly ten times larger than it did in 2009."¹ This rapid growth has led to concerns about overcrowding in

certain segments of the private credit market, making it increasingly challenging for portfolio managers to source accretive investment opportunities.

While private corporate credit and mortgages share certain characteristics—they are both fixed income strategies with shorter loan terms, often floating rate structures, and limited mark-to-market volatility—they differ in fundamental ways. The key distinction lies in the nature of the collateral backing the loans.

Private credit loans are typically secured by corporate revenues, receivables or inventory, which tend to be less secure than real estate, especially in stressed markets. Success depends on the Portfolio Manager's ability to select companies with strong fundamentals and reliable cash flows capable of meeting interest and principal payments. In contrast, mortgage loans are secured by tangible real estate assets. Managers assess the property's ability to generate sufficient cash flow to service the loan, offering more predictable income streams that are generally less sensitive to market volatility or geopolitical risks.

Another notable advantage of Canadian commercial mortgages is the lender's recourse in the event of default. In most cases, Canadian lenders have the legal right to pursue the personal or corporate guarantors for repayment—even beyond the value of the underlying asset. This legal framework strongly incentivizes borrowers to cooperate with lenders and avoid default, contributing to the historically low loss rates observed in the Canadian market.

In November 2023, Business Wire, a Berkshire Hathaway news outlet, quoted a report from Kroll Bond Rating Agency (KBRA) analyzing Canadian CMBS loans. The study examined 3,599 loans originated between 1998 and 2022, providing valuable insight into the long-term credit performance of Canadian commercial mortgages. The findings underscore the asset class's strong credit profile: the cumulative loss rate was remarkably low at just 0.2%. These figures highlight the resilience and stability of Canadian mortgage investments over the past 25 years.²

Historically, institutional investors have allocated assets to mortgage strategies primarily to enhance the yield of their fixed income portfolios. While this remains a key objective, an increasing number of investors now view mortgages as a tool for risk mitigation, given their low volatility and low default rates. They provide a way to insulate a portion of the portfolio from broader market disruptions.

Core mortgage portfolios typically provide a meaningful spread over government bonds while maintaining conservative credit profiles, with loan-to-value ratios often below 65%. Another useful lens for evaluating the asset class is by comparing historical returns from mortgage portfolios to those of traditional real estate equity investments. A review of Canada's largest pension plans shows that the long-term performance of select active mortgage funds has been comparable to real estate equity portfolios—yet with significantly lower volatility and the added benefit of consistent cash flow.

Looking ahead, we expect more institutional investors to explore the benefits of reallocating a portion of their core real estate exposure into value-add mortgage strategies. When managed by experienced portfolio managers, these strategies can deliver yields in excess of 10%, while offering low volatility and strong downside protection, since they tend to be backed by high-quality real estate assets and well-capitalized borrowers.

In an environment marked by persistent volatility and macroeconomic uncertainty, institutional investors are increasingly focused on resilience and predictability within their portfolios. Mortgage investments - particularly those secured by cash-flowing, income-generating real estate - offer a compelling solution.

The ability of a real asset to generate steady cash flow plays a critical role in preserving loan performance, especially during periods of economic stress. Unlike corporate-backed private credit, where repayment depends on a company's operational success, mortgages are underpinned by tangible assets with stable, contract-based income in the form of rent. This foundational difference not only enhances downside protection but also provides greater visibility into risk. For those looking for stability, it is important to look for mortgage managers focused on stable cash flowing properties, with an underwriting process focused on the stability of those cashflows.

As institutions re-evaluate their fixed income and real estate allocations, the appeal of mortgage strategies lies not only in their attractive yield profile, but in the strength and reliability of the underlying collateral. In uncertain times, there is real value in holding assets where income generation is directly tied to physical, cash-flowing properties. For long-term investors, that stability is more than a defensive play—it's a strategic advantage.