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Opportunities in Private Credit

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In response to the Great Financial Crisis and, more recently, the COVID-19 pandemic, accommodative central bank policies were implemented to help stabilize dislocated credit markets, driving yields to record lows. As the economy healed, a new paradigm emerged, driven by the sharp reversal in monetary policy to counter inflationary pressures. In 2022, the Federal Reserve increased the target fed funds rate at an extraordinary pace, beginning with a 25-basis-point increase in March, followed by an additional six hikes over the course of the year. Fed funds rose by an incredible 425 basis points in 2022—a magnitude not seen in a calendar year since 1980.

With the chapter on low interest rates and easy money definitively closed entering 2023, uncertainty over macroeconomic conditions continues to be an overhang as central banks battle persistent inflation and concerns mount over a potential recession. However, with primary issuance stalled in traditional leveraged finance and higher volatility expected to drive performance dispersion in secondary credits, the next phase of the cycle could present compelling lending and buying

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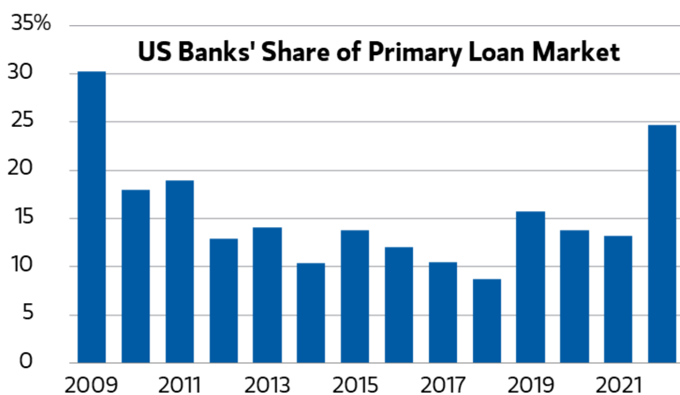
opportunities for experienced managers able to navigate turbulent markets.

Evolution of the Credit Markets

Since the financial crisis, credit markets have undergone structural changes that have significantly altered the banking and investment landscape. Because of more stringent banking oversight and regulations, banks have largely exited the low margin business of lending to small and middle market companies. Notwithstanding the anomalous spike in US banks' share of the primary loan market last year on significantly lower issuance volume, nontraditional lenders have stepped in to fill this void left by bank disintermediation (see Exhibit 1).

Exhibit 1: US Banks' Loan Market Share Down by Two-Thirds in Past Decade



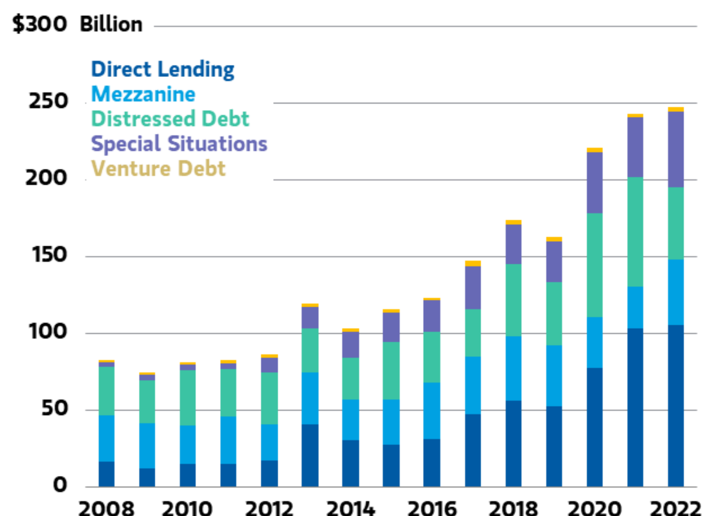
Source: S&P LCD Leveraged Lending Review Q1 2023

In addition to increased regulations and bank deleveraging driving private lending opportunities, elevated market volatility and the cessation of central bank security-purchase programs have further encouraged investors to seek yield away from traditional investments. Along with diversification attributes and the floating-rate nature of certain private credit investments, which may protect from rising rates, private credit strategies may enable investors to capture the illiquidity, or return, premium associated with less-liquid debt.

As investors reassess their need for liquidity and reposition a portion of their traditional fixed income allocations into private debt, many institutional and high net worth investors have adjusted their approach away from the traditional 60%/40% equity/fixed income asset allocation mix. Within the Global Investment Committee's broader asset allocation framework, private debt is categorized as a stand-alone allocation and is no longer grouped with private equity (PE) or liquid debt. This should allow investors to better identify where their allocation to private credit sits in a broader portfolio context.

As institutional acceptance of private credit rises, so do allocations to this asset class. The increased institutional acceptance of private credit can also be seen in the increase in dry powder and fund formation (Exhibit 2).

Exhibit 2: Private Credit Fund Dry Powder Has Risen



Source: Preqin as of December 2022

What Is Private Credit?

Over the past decade, private credit strategies have become a more integral part of alternative investment allocations. They generally come in two categories: those that focus primarily on income generation and those that focus on capital appreciation. Strategies that emphasize income generation mainly invest in privately originated direct corporate loans, asset-based loans or specialty lending opportunities, all of which have typically been higher yielding and have generated attractive current income. Strategies that invest in distressed and special situations credit tend to seek higher total returns through capital appreciation and to focus less on current income.

The private credit space comprises several areas offering different levels of return, risk, income and liquidity. Distinctions among the various strategies place each one at a different point on the risk/return spectrum (see Exhibit 3). We will detail each of these strategies in the following sections while discussing their relative attractiveness in the current environment. We believe investing in private credit may enhance overall portfolio returns either through the illiquidity premium associated with nontraded originated investments or the potential they provide to take advantage of credit market dislocations.

Exhibit 3: Wide Spectrum of Private Credit Strategies

Strategy	Direct Lending				Structured Credit	Distresssed Investing			
Sub-Strategy	Senior Secured	Unitranche	Junior/Mezzanine	Specialty Lending	Active/Non-Control	Active/Non-Control	Control	Restructuring/ Turnaround	Special Situations
Strategy Overview	Privately negotiated loans Senior in the capital structure	Combination of senior and junior debt Typically the only debt in the capital structure	Junior debt in the capital structure Typically combined with equity warrants	Privately negotiated loans often backed by hard assets	Securities backed by loans (RMBS, CMBS, CLO, etc.)	Trading and non-influential positions in debt of distressed companies	Purchasing debt of distressed companies with intention of gaining ownership post reorganization	Investment in bankrupt or defunct companies or their assets at significant discounts	Bespoke capital solution for stressed or transitioning companies

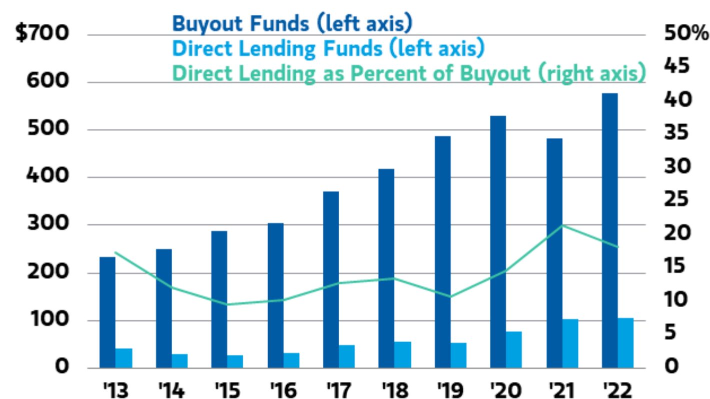
Note: For illustrative purposes only. Past performance is not indicative of future results. Structured Credit encompasses securities with varying levels of risk/return (ex. RMBS, CMBS, CLO). Source: Morgan Stanley Wealth Management GIMA

Direct Lending

Inflation and higher interest rates have led to market uncertainty and bank retrenchment from lending activities, creating a supply/demand imbalance for debt financing and investment opportunities for private lenders. Direct lending has also benefited from investor demand for floating-rate debt due to higher coupons, low interest rate risk, and historically strong performance in rising rate environments.

While US middle market loan volume declined in 2022 after record issuance the prior year, direct lending was still strong with $280 billion in volume, the third highest since 2000[1]. According to Preqin, as of December 2022 approximately $250 billion of dry powder remains in US private debt funds, including $105 billion in direct lending. Dry powder in private equity is approximately $1.3 trillion, including $580 billion in US buyout funds. Since 2013, dry powder in US buyout and direct lending funds has grown by 2.5 and 2.6 times, respectively, which has allowed PE managers to undertake more deal activity (see Exhibit 4).

Exhibit 4: Dry Powder: Private Debt vs. Buyout Funds

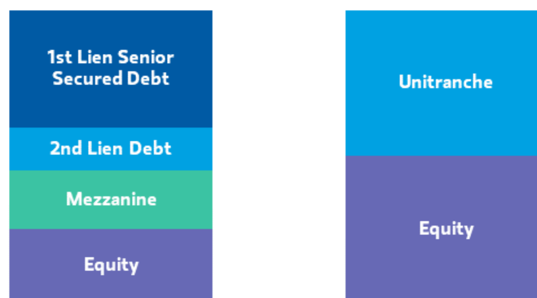


Source: Preqin as of December 2022 (in $ billions)

This is important because a large portion of middle market lending is used to finance leveraged buyouts (LBOs) from PE sponsors.

In the following sections we compare and contrast the various direct lending strategies and their respective risk/return characteristics. Exhibit 5 depicts the typical capital structure of a company, illustrating the various types of financing that can be utilized in the strategies outlined.

Exhibit 5: Typical Capital Structure With Various Investment Entry Points



Source: Morgan Stanley Wealth Management GIMA

Senior Lending

Private senior lending is generally defined as first lien senior secured loans to small- and mid-sized companies generating EBITDAs (earnings before interest, taxes, depreciation and amortization) from $10 million to $100 million. These loans are privately negotiated, have tighter debt covenants and require extensive due diligence relative to public syndicated debt. Many of the loans are to companies owned or backed by PE sponsors who can potentially provide additional capital infusions during periods of stress. Furthermore, middle market loans tend to entail less leverage than large corporate loans.

Middle market senior loans carry a floating-rate coupon often with an interest rate floor, which helps mitigate interest rate risk. Private lenders can also generate additional return through origination fees and prepayment penalties, which are generally absent in the syndicated market. Additionally, as a result of the seniority and built-in risk mitigation of this debt, managers often utilize moderate amounts of leverage in an attempt to boost overall returns.

Junior Debt/Mezzanine

Junior debt, which includes mezzanine, is a form of debt senior to equity but subordinate to senior secured loans and provides credit to small and mid-cap borrowers unable to access the high yield public markets. Mezzanine financing is often utilized for private equity leveraged buyout transactions or acquisitions. Middle market borrowers benefit from mezzanine debt's flexible structure, which does not require public filings or credit ratings. Similar to senior direct lending, mezzanine debt is privately negotiated with extensive due diligence and added maintenance covenants.

Mezzanine debt returns are composed of fixed-rate cash interest payments, "payment in kind" or PIK coupons which are paid by capitalizing the deferred interest payment as additional debt, upfront fees, and call premiums. Call premiums require the issuer to pay a premium to par value in the event the bond is paid off early. Additionally, mezzanine debt often includes an equity warrant, allowing the investors to purchase equity in the company at a later date, providing further upside potential to the investor.

While target returns for junior debt is higher than the expected returns for senior secured lending, the debt's position in the capital structure represents the first loss piece above equity with greater risk of loss of capital.

Unitranche

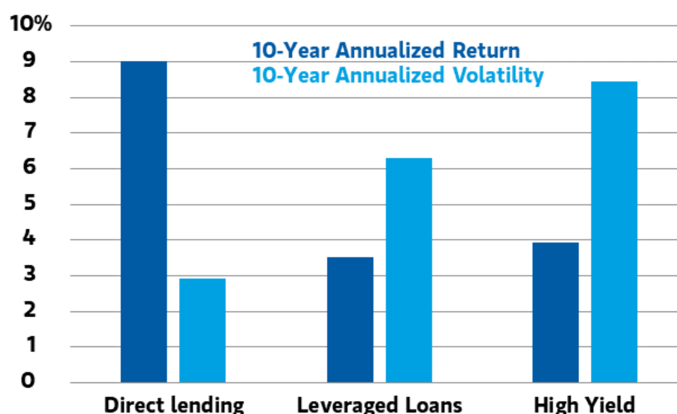
In recent years, we have also seen a rise in unitranche financings, or more solutions-based single loan facilities for borrowers that combine senior and junior debt and serve as the only debt on a company's balance sheet. These financings are typically extended to companies that have limited alternatives for obtaining credit. Over the last few years the traditional unitranche borrowing base has expanded with larger companies now opting out of the syndicated loan markets and pivoting to private credit given the enhanced ability and willingness of direct lenders to allocate to larger deal sizes. Direct lending unitranche structures are an attractive one-stop financing tool for all-sized companies with the additional value-add proposition of certainty of execution, which is often valued by many borrowers. The target returns generally fall in between senior and junior debt.

Performance

Over the past 10 years, direct lending, which includes both senior and mezzanine/junior debt, outperformed leveraged loans and high yield bonds, with lower volatility (see Exhibit 6). Moreover, the outperformance was not associated with higher credit losses, as direct lending loss rates were in line with the leveraged loan and high yield markets over the same period. The appealing risk/return attributes further underscore the opportunity direct lending strategies may offer investors.

The higher returns over the past decade may be partly explained by the illiquidity premium. Investors typically lend to these companies through illiquid investment vehicles such as closed-end drawdown funds or private business development companies (BDC), which allows managers to invest with minimal redemption pressures. Experience is critical to obtaining attractive risk/return characteristics, and we favor managers with deep expertise in loan structuring and analysis with disciplined credit underwriting. Also, managers should have a wide-reaching network of PE sponsors for sourcing capabilities.

Exhibit 6: Direct Lending Has Generated Higher Returns and Lower Volatility



Note: The returns illustrated are gross of all fees, and actual investor returns would be lower if these fees were deducted. Past performance is not indicative of future returns. Source: Cliffwater Research, S&P/LSTA Leveraged Loan Index, Bloomberg US Corporate High Yield Index as of September 2022

Potential Risks

While the opportunity set appears rich for direct lending, there are potential risks associated with the strategy. Credit quality and illiquidity are key risk factors for the asset class. Typical borrowers for privately originated loans are smaller with narrower product mixes and could have greater balance sheet leverage than public debt issuers. They generate lower cash flows which could limit the company's ability to navigate economic or industry downturns, and the debt is illiquid with no established secondary market which could subject investors to extended holding periods. The ability to source, underwrite and manage the risks noted above is essential given the buy-and-hold nature of the asset class.

Fund managers may use leverage to enhance the yield for

direct lending given its seniority in the capital structure, which can exacerbate the impact of adverse macroeconomic conditions. Credit quality also declined during the period of low rates and accommodative monetary policy due to a general deterioration in loan documentation and covenant protection, and more loans being made with adjustments to financial forecasts.

Lastly, investors should be aware of the lag effect for floating rate debt. Middle market loans usually have floating-rate coupons comprised of a fixed credit spread over a variable reference rate. The reference rate, which is typically the Secured Overnight Financing Rate (SOFR), resets on a quarterly basis and during periods of elevated rate volatility the impact of sharply higher or lower rates may be lagged.

Implementation

As private credit markets have matured, direct lending has become a standard allocation across many client portfolios through a variety of vehicles that can deliver stable income while offering greater flexibility regarding deployment and return of investor capital. Managers have continued to build out their direct lending platforms, which offer a number of liquidity options.

These include public BDCs, with daily liquidity; perpetual BDCs, which offer flexible deployment of capital into fully ramped portfolios and can return capital through quarterly tenders if desired; and private-to-public BDCs, which may seek a liquidity option in the public markets after capital is fully deployed. In addition, we continue to see finite private BDCs that invest over a number of years and then harvest according to stated fund terms until the portfolio is wound down in full.

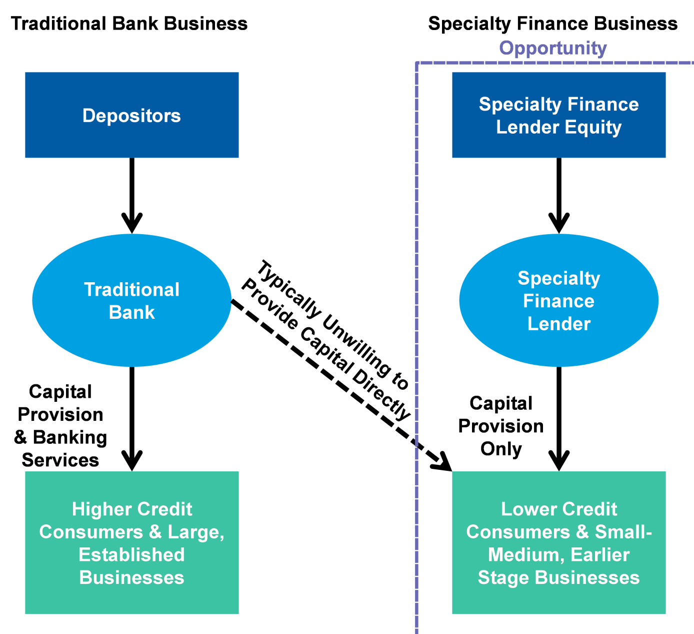
With the evolution of private lending, we have seen the emergence of more opportunistic capital solutions strategies, as well as sector-focused products targeting essential businesses in areas such as technology, health care and life sciences. Although these strategies may exhibit greater performance volatility due to exposure to complex businesses or corporate situations, they can provide a premium over core direct lending strategies and deliver attractive risk-adjusted returns.

Asset-Based Lending

A more niche subclass of private lending that has been on the rise is asset-based lending, which seeks to achieve similar investment outcomes as corporate direct lending but through exposure to different kinds of underlying credits and risks. Asset-based lending sits at the intersection of private credit and real assets strategies, and can provide high levels of current income uncorrelated to broader corporate credit markets. Asset-based lending can be attractive as a counter-cyclical strategy, serving as a source for liquidity for companies during periods of declining demand and inventory buildup. The strategy also differs from corporate direct lending in that asset-based loans are underwritten against specifically identified collateral that can be held away from the borrowing company's balance sheet.

Asset-based lending spans a broad range of asset types that can serve as collateral. Loans can encompass small-balance commercial real estate mortgages, mortgage transitions, infrastructure debt, shipping and aircraft, litigation finance, intellectual property, health care royalties, regulatory capital relief, small-ticket equipment and auto loans. Strategy attributes include high levels of current income, floating-rate coupons, amortization, and shorter maturities, which can make asset-based lending attractive as a defensive allocation during the later stages of the business cycle (see Exhibit 7).

Exhibit 7: Specialty Finance Lenders Fill Gaps of Traditional Lenders



Source: Fortress Investment Group

Asset-based lending is broadly defined; however, it is typically identified with loans that are secured by hard assets or with pools of consumer, corporate and commercial loans, and receivables, which typically fall outside of the scope of corporate direct lending. Given that asset-based lending is less standardized, investors can earn a premium as compensation for complexity without giving up covenants or structural enhancements. From a competitive standpoint, there are fewer large-market participants in this asset class compared to middle market direct lending.

Managers for asset-based lending strategies are often partnered with origination and servicer platforms to help facilitate sourcing, servicing and asset management throughout the investment life cycle. Loans can be structured as revolving warehouse facilities or term debt facilities secured by assets that may eventually be securitized, and in some instances managers may also provide equity capital.

Most asset-based lending investments are structured with conservative advance rates and overcollateralization to ensure borrowers have first loss equity and strong alignment of interests with their lenders (see Exhibit 8).

Exhibit 8: Typical Attributes of Privately Negotiated Asset-Based Loans

Attribute	Description
Cash Flows	Durable cash flows can shorten investment duration, enhance price stability and reduce severities
Structure	Investments are designed to feature stable performance, especially during times of stress
Control/Seniority	For credit investors, seniority and other forms of control can lead to greater probability of outcomes
Asset Security	Investments secured by assets, when combined with proper structure, can mitigate downside risk
Covenants	Covenants are designed to secure a lender's rights and priority over the assets and cash flows that support the investment

Source: Ares Management

Potential Risks

Asset-based loans are similar to direct lending in that they are illiquid and there is no active secondary market; however, unlike direct lending, asset-based loans typically have traits such as amortization, which drives principal recapture over shorter time horizons and helps mitigate the illiquidity risk.

Complexity is another risk prevalent in asset-based lending, with loans requiring strong documentation to provide protection against tax, accounting and legal issues and complications that can arise with both the underlying collateral and borrower. Manager experience and sector expertise is necessary to constraining complexity risk, particularly in operationally intensive deals.

Managers that employ asset-based lending strategies generally do not employ leverage at the fund level; however, underlying investments may have high structural leverage such as loans collateralized against financial assets or real estate, or deals that provide advanced funding against secured assets. While structural leverage can work well when debt is applied to assets with stable cash flows, it can also potentially lead to larger downside risk during periods of economic stress.

And lastly, while we view the current environment as late cycle and potentially optimal for the strategy, the opportunity set could be limited should the cycle be short-lived.

Structured Credit

The next area of private credit we highlight is structured credit, an asset class that encompasses a wide range of products. Structured products may be backed by various types of loans, from residential, commercial and bank loans to auto and student loans. These structures are broken into different tranches that have varying risk and return profiles; the most senior tranche is the first to receive contractual interest payments from the underlying loans but generally with the lowest relative return, and the most junior tranche receives interest payments last while generally being compensated with higher potential return.

While many of these securities rebounded strongly in 2021 amid broad economic recovery, primary markets declined in 2022, with US CLO issuance down over 30% from 2021's record-breaking level due to stiff technical headwinds, inflation and fears of a potential recession. Origination in commercial mortgage-backed securities (CMBS), residential mortgage-backed securities (RMBS) and ABS markets was also impacted, experiencing steep declines in 2022. However, in the secondary market, liquidity pressure and forced selling by institutional and other holders of structured credit have created opportunities for managers to invest higher in the capital structure. We believe bouts of market volatility and dislocations across the various sectors will continue to present these types of opportunities, which can generate attractive yield with a relatively wide margin of safety.

Given the complexity of structured credit, investors should focus on managers that have the appropriate credit expertise to evaluate these securities and invest up and down the capital stack. For managers, the investment decision may not be simply whether one prefers RMBS over CMBS but rather which tranche within RMBS provides the most attractive relative value. Many structured credit funds also provide a current distribution yield as part of their overall return. As with the strategies previously discussed, we believe that illiquid fund structures are best aligned to take advantage of dislocations in these markets.

Potential Risks

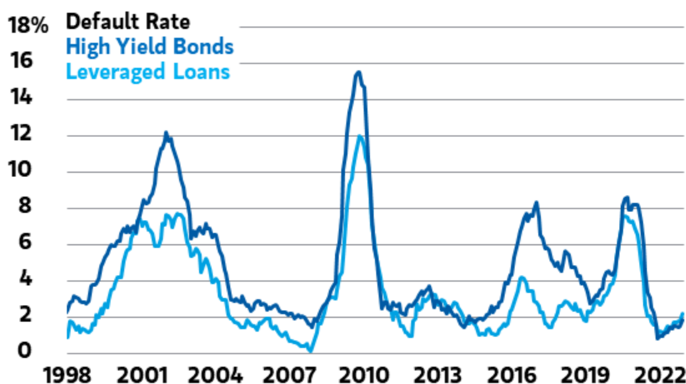
As with the strategies outlined previously, experience in underwriting and managing risk is paramount as structured products tend to be highly complex, requiring deep due diligence and understanding of the underlying collateral and risk profiles of the structure's tranches. Structured credit funds can also utilize leverage to enhance returns and may provide little or no client liquidity, as the asset class is generally not actively traded due to each structure's bespoke nature. As such, during periods of severe market dislocation, funds that employ more leverage or focus more on junior tranches may experience extreme volatility or even become forced sellers to meet margin requirements.

Distressed Investing

The last area of private credit we dive into is distressed investing. While direct lending and asset-based lending focus on providing credit to performing companies and those with discrete asset pools or cash flows, distressed investing generally focuses on investing in stressed or distressed companies at a significant discount to par, with the intention of generating profit post-company turnaround.

In past years, we have highlighted several trends emerging in the leveraged credit market, including greater amounts of leverage, more "covenant lite" loans and an increase in the ratio of downgrades to upgrades. We saw the culmination of these factors in the aftershock of the pandemic, which resulted in the quickest repricing of risk to the downside since the Great Financial Crisis. Over a short period of time, public and private credit markets, driven by significant volatility and risk-off sentiment, became dislocated, with credit rating agencies quickly implementing downgrades. This was accompanied by a significant spike in defaults, resulting in one of the largest and, in retrospect, briefest distressed debt investment opportunities ever witnessed. Ultimately, default activity topped out well below worst-case expectations, as unfettered access to liquidity helped lower-rated and stressed companies secure financing (see Exhibit 9).

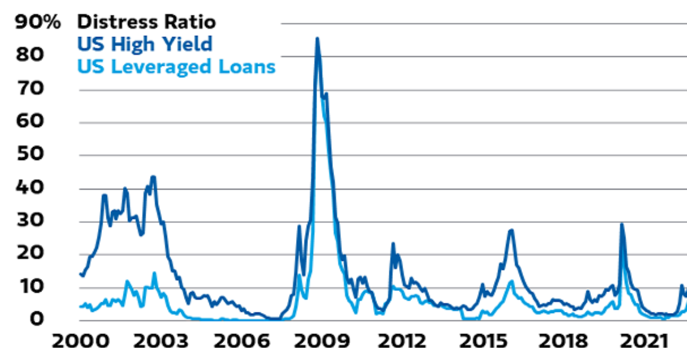
Exhibit 9: Credit Default Rates Retraced in 2021 to Pre-Pandemic Levels



Source: Moody's, Morgan Stanley & Co. Research as of December 2022

Fast forwarding to today, the Fed has raised rates to counter inflation, which is likely to foster slower economic growth and may pressure overleveraged companies challenged to refinance their businesses. While the distress ratio remains relatively low (see Exhibit 10), distressed investing in 2023 will be predicated on identifying more idiosyncratic situations.

Exhibit 10: Corporate Distress Ratios Remain Low



Source: Bloomberg, S&P LCD, Morgan Stanley & Co. Research as of December 2022

Opportunities for large-scale distressed investing has historically been correlated with the credit cycle[2], with the best often coming during periods of market turmoil or recession. We believe the best positioned distressed managers will adapt to the evolving environment by expanding their traditional playbook to include opportunistic and situational investing, including bespoke financing solutions (e.g., debt with warrants, preferred equity) for situations that have an element of distress or complexity. Targeted companies could have severely inflation-impacted business models and be facing headwinds from limited working capital while experiencing reduced revenue streams, higher fixed expenses and limited balance sheet flexibility.

Non-control, Control and Restructurings/Turnarounds

Investors may attempt to take advantage of market dislocations through distressed investment strategies which includes control, non-control, restructuring/turnaround, and special situations.

Distressed for control is based on building controlling positions in a distressed company by identifying the fulcrum security, which is the tier of debt that receives only a partial payout in a bankruptcy proceeding. This tier of claims will typically receive the equity of the newly reorganized company and gain control over operations, with the goal of steering the company toward growth and profitability and ultimately monetizing the equity. Managers may also pursue minority, influential positions, with the goal of active participation in a restructuring process. The typical holding period for this type of investing ranges from 1 to 4 years.

Managers may also pursue restructuring/turnaround investments by acquiring assets at significant discounts with the intent to reposition loss-making businesses. Investments tend to be complex as the companies are typically in the midst of bankruptcy proceedings. Given the added risks, restructurings and turnarounds generally target slightly higher returns than distressed for control investments.

Non-control distressed investing is typically utilized by hedge funds as a trading strategy to take advantage of temporary dislocations in credit markets. Managers do not seek control of the company, nor do they attempt to exert influence over operations. The holding period for this strategy can be 6 months to 2 years, with target returns slightly below the expected performance for distressed for control investing. Unlike the aforementioned distressed strategies, managers may also employ leverage in non-control distressed to enhance returns.

Special situations can encompass a variety of strategies, but mainly refers to bespoke, capital solutions in situations that have an element of distress, are in transition, or fall outside of the scope of traditional direct lending due to complexity. Target companies generally have sound businesses but may be challenged by factors such as overlevered balance sheets or poor management. Tailored capital solutions could take the form of structured equity, debt with warrants, or preferred equity, often requiring expertise in both credit and equity, and can provide returns in the form of income or capital gains. Given the nimble nature of special situations investing, managers can identify opportunities across various market environments and investors should consider special situations investing as an all-weather approach.

While the opportunity set in distressed investing is generally greater in times of higher corporate defaults, there are episodic micro cycles in the credit markets, and managers can employ special situations investing during benign periods by seeking idiosyncratic stressed opportunities. Therefore, it is crucial to partner with fund managers who possess the required expertise in bankruptcy law and restructuring, as well as investing experience through previous default cycles.

Given the longer investment horizon, distressed investing is best aligned with fund structures that are illiquid. Managers who pursue a hybrid approach with distressed and special situation strategies often have funds with flexible mandates that can lean or pivot to the most compelling situations whether they're in distressed or performing businesses and in public or private markets.

Potential Risks

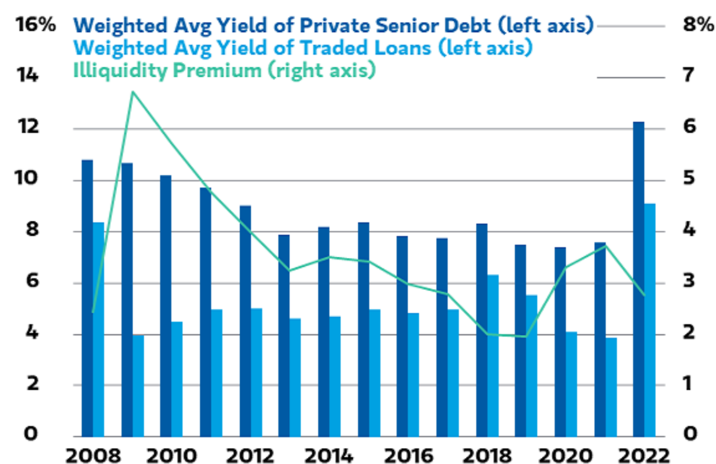
Distressed strategies focus on issuers that tend to be stressed or distressed companies and may be in bankruptcy. Distressed debt is typically less liquid, limiting the fund manager's ability to obtain liquidity in the secondary markets at a favorable price. As such, funds pursuing these strategies generally do not provide liquidity to the limited partners. Significant improvement in the macroeconomic environment could also limit the investment opportunity set for distressed credit managers.

Illiquidity Premium

The illiquidity premium is defined as the extra return or yield investors earn for giving up control over liquidating their capital for a period of time. Quantifying the illiquidity premium is difficult given the idiosyncratic nature of private investments; however, we can gain some perspective on the premium investors can earn in private credit by comparing direct lending to public syndicated loans.

To value the illiquidity premium for private credit as represented by direct lending, we compared the yield of actively traded, broadly syndicated loans to the yield of privately originated first-lien senior secured middle market loans. This yield differential is the market's valuation of the illiquidity premium at a point in time and will vary depending on the economic environment. As illustrated in Exhibit 11, the post-crisis spread of privately originated senior term debt over leveraged loans has been consistent and attractive.

Exhibit 11: Privately Originated Senior Debt Has Provided an Illiquidity Premium



Note: For illustrative purposes only. Source: Ares Management, Credit Suisse Leveraged Loan Index as of December 2022

Private credit can be compelling especially in an environment where traditional investments may not be able to provide expected liquidity. During the financial crisis, COVID pandemic, and last year's Fed rate-hiking cycle, investors in publicly traded assets such as leveraged loans and high yield bonds encountered unexpected illiquidity. Strategies in more liquid fund structures, such as distressed debt hedge funds, were also constrained in deploying capital given the lack of dry powder or fear of potential investor redemptions.

We believe private credit, particularly in fund structures with delineated investment and harvesting periods, can deliver excess return to investors through a manager's ability to be a liquidity provider during market downturns when liquid funds

struggle to meet redemptions.

It should be noted that while many factors contribute to a fund's performance, all funds have some degree of market risk that influences returns and liquidity. Market factors that are either strategy-specific or broad can impact longer-dated funds just as they do more conventional liquid funds, resulting in an illiquidity premium that is not always constant.

Potential Risks

Illiquidity may also pose certain risks to investors, such as the inability to liquidate a portfolio at a time when the individual investor may need the liquidity as secondary markets often do not exist for these investments. If a secondary market does exist, the investor may only be able to sell the investments at a significant discount.

Current Opportunities in Private Credit

The private credit market is broad and offers wide-ranging investment opportunities across the various sub-strategies; however, not all opportunities will be rich at a given point in time. While we believe the strategies discussed offer potential performance and diversification benefits, certain strategies may be more attractive than others based on the prevailing phase in the credit cycle.

Direct lending continues to offer compelling yields in a private lender-friendly environment. The return advantage of direct lending over traditional fixed income, along with lower volatility and limited credit losses can be an appealing complement to fixed income allocations. Despite an overall decline in LBO volume in 2022, we continued to see private credit managers gain market share from syndicated lenders, particularly in middle market buyouts. According to Refinitiv LPC, direct lending middle market LBO volume ended the year at $44.6 billion, well ahead of the $10.9 billion that was syndicated. This was driven by the significant amount of dry powder held by private credit funds and lack of risk appetite and credit availability from banks.

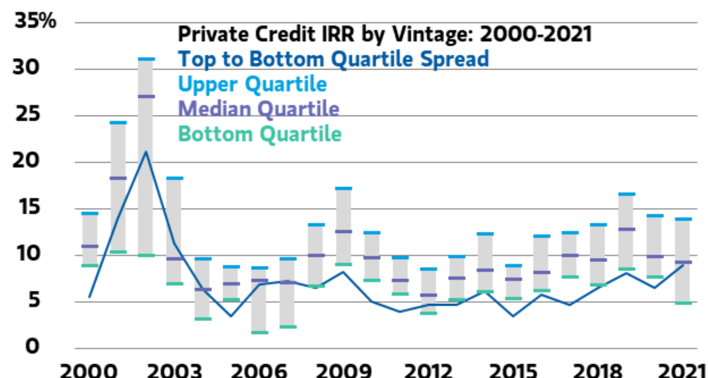
Managers continue to look for creative ways to structure deals with strong downside protection while targeting new, nontraditional borrowers that may not have previously viewed direct lending as a viable option. Direct lenders are well-positioned to negotiate higher spreads, more covenants and better call protection relative to broadly syndicated loans. As direct lending matured as an asset class, it has become a standardized allocation across many client portfolios, with the potential to provide diversification benefits through opportunistic lending mandates as well as products focused on single sectors such as technology, health care or life sciences. Innovative structures like perpetually offered nontraded BDCs have also become popular given their ability to deliver stable income while offering more flexible options for the deployment and return of capital.

As we have noted, asset-based lending strategies tend to be less crowded than traditional middle market lending and may provide comparable yields with better structural enhancements and lower fund-level leverage. Asset-based lending tends to be resilient in rising-rate environments, given amortizing deal structures that can reduce extension risk. Lending facilities used in asset-based finance are often structured with covenants that shorten the tenor during periods of stress, making the strategy complementary to traditional and other types of alternative investments. Asset-based lending has become increasingly sought-after as an alternative income solution given the idiosyncratic returns and low correlation to more broadly held risk assets, and we believe the strategy can be an effective supplement to fixed income portfolios.

With the Fed winding down its stimulus programs and tightening monetary policy, investors allocated to distressed investing and patient with capital deployment stand to benefit should there be attractive new entry points driven by market volatility. Acquisitions of distressed or underperforming businesses by stronger companies can create opportunities for bespoke financing solutions[3], and we favor managers who have the skillset and experience to invest across both public and private markets.

Lastly, given the wide dispersion in private credit returns, we are strong believers in the importance of manager selection. With the average difference between top and bottom quartile returns at 7.3% from 2000 to 2021 (Exhibit 12), we believe sourcing and conducting comprehensive due diligence on managers with extensive experience navigating market cycles can provide a meaningful difference in investor returns.

Exhibit 12: Private Credit Returns Have Exhibited Significant Dispersion



Note: Internal rate of return (IRR) is the interest rate at which the net present value of all the cash flows (both positive and negative) from a project or investment equal zero. Internal rate of return is used to evaluate the attractiveness of a project or investment. Source: Hamilton Lane Data via Cobalt, Bloomberg as of December 2021

Endnotes

[1]Refinitiv LPC, "4Q22 Sponsored Middle Market Private Deal Analysis”, January 2023.

[2]Oaktree, "Global Opportunity Knocks: The Evolution of Distressed Investing”, November 2021.

[3]BlackRock, "Private Credit: Evolution and Opportunity in Direct Lending", November 2022.

Disclosure Section

Glossary of Terms

LIBOR London Interbank Offered Rate (LIBOR) is an interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The LIBOR is fixed on a daily basis by the British Bankers' Association and is calculated from filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year.

Index Definitions

Bloomberg Capital U.S. Corporate High Yield Bond Index is an unmanaged index of prices of U.S. dollar-denominated non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

S&P/LSTA (Loan Syndications and Trading Association) Leveraged Loan Index covers more than 1,100 loan facilities and reflects the market-value-weighted performance of U.S. dollar denominated institutional leveraged loans.

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Alternative investments often are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are appropriate only for eligible, long-term investors who are willing to forgo liquidity and put capital at risk for an indefinite period of time. They may be highly illiquid and can engage in leverage and other speculative practices that may increase the volatility and risk of loss. Alternative Investments typically have higher fees than traditional investments. Investors should carefully review and consider potential risks before investing. Certain of these risks may include but are not limited to:

- Loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices;
- Lack of liquidity in that there may be no secondary market for a fund;
- Volatility of returns;
- Restrictions on transferring interests in a fund;
- Potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- Absence of information regarding valuations and pricing;
- Complex tax structures and delays in tax reporting;
- Less regulation and higher fees than mutual funds; and
- Risks associated with the operations, personnel, and processes of the manager.

In addition, the primary risks of investing in private credit include:

- Illiquidity risk – investments in private lending are typically highly illiquid and may require capital to be committed for an extended period of time, i.e. several years;
- Credit / default risk – non-payment of interest and/or or principal payments;
- Interest rate risk – changes in market interest rates are reflected as a change in the spread which loans in a portfolio pay over the base rate (U.S. Treasuries), which in turn impacts the perceived value of the loans in the portfolio and thus the value of the portfolio itself;
- Prepayment risk – loans which are originated with relatively high interest rates may be paid off early if more attractive financing rates can be found; and
- Credit rating analysis risk – many borrowers have not issued other debt which has been rated by a recognized rating organization (e.g. Moody's, S&P, Fitch), as such the determination of the credit worthiness of such borrowers is dependent on the analysis performed by a portfolios' managers or advisors.

Asset Class and Other Risks

Investing in ***stocks***, ***mutual funds*** and ***exchange-traded funds ("ETFs")*** entails the risks of market volatility. The value of all types of investments may increase or decrease over varying time periods. Besides the general risk of holding securities that may decline in value, ***closed-end funds*** may have additional risks related to declining market prices relative to net asset values (NAVs), active manager underperformance, and potential leverage. Some funds also invest in foreign securities, which may involve currency risk.

Value and ***growth investing*** also carry risks. Value investing involves the risk that the market may not recognize that securities are undervalued and they may not appreciate as anticipated. Growth investing does not guarantee a profit or eliminate risk. The stocks of these companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be more risky than an investment in a company with more modest growth expectations.

International securities may carry additional risks, including foreign economic, political, monetary and/or legal factors, changing currency exchange rates, foreign taxes and differences in financial and accounting standards. International investing may not be for everyone. These risks may be magnified in ***emerging markets and frontier markets***.

Small- and mid- capitalization companies may lack the financial resources, product diversification and competitive strengths of larger

companies. The securities of small capitalization companies may not trade as readily as, and be subject to higher volatility than, those of larger, more established companies.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which allows the issuer to retain the right to redeem the debt, fully or partially, before the scheduled maturity date. Proceeds from sales prior to maturity may be more or less than originally invested due to changes in market conditions or changes in the credit quality of the issuer.

High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

The current yield of *preferred securities* is calculated by multiplying the coupon by par value divided by the market price. The majority of $25 and $1000 par preferred securities are "callable" meaning that the issuer may retire the securities at specific prices and dates prior to maturity. Interest/dividend payments on certain preferred issues may be deferred by the issuer for periods of up to 5 to 10 years, depending on the particular issue. The investor would still have income tax liability even though payments would not have been received. Price quoted is per $25 or $1,000 share, unless otherwise specified. The initial rate on a floating rate or index-linked preferred security may be lower than that of a fixed-rate security of the same maturity because investors expect to receive additional income due to future increases in the floating/linked index. However, there can be no assurance that these increases will occur.

Mortgage-backed securities ("MBS"), which include collateralized mortgage obligations ("CMOs"), also referred to as real estate mortgage investment conduits ("REMICs"), may not be appropriate for all investors. There is the possibility of early return of principal due to mortgage prepayments, which can reduce expected yield and result in reinvestment risk. Conversely, return of principal may be slower than initial prepayment speed assumptions, extending the average life of the security up to its listed maturity date (also referred to as extension risk). Additionally, the underlying collateral supporting MBS may default on principal and interest payments. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements.

Asset-backed securities generally decrease in value as a result of interest rate increases, but may benefit less than other fixed-income securities from declining interest rates, principally because of prepayments.

Bank loans are generally rated below investment-grade by rating agencies, and entail greater credit risk than higher quality, investment-grade securities such as U.S. Treasuries. In the event a borrower stops paying interest or principal on a loan, the collateral used to secure the loan may not be entirely sufficient to satisfy the borrower's obligations and, in some cases, may be difficult to liquidate on a timely basis. While bank loans offer higher interest income when interest rates rise, they also will generate less income when interest rates decline.

Senior loans are generally rated below investment-grade by rating agencies, and entail greater credit risk than higher quality, investment-grade securities such as U.S. Treasuries. In the event a borrower stops paying interest or principal on a loan, the collateral used to secure the loan may not be entirely sufficient to satisfy the borrower's obligations and, in some cases, may be difficult to liquidate on a timely basis. While senior loans offer higher interest income when interest rates rise, they also will generate less income when interest rates decline. The initial interest rate on a *floating-rate security* may be lower than that of a fixed-rate security of the same maturity because investors expect to receive additional income due to future increases in the floating security's underlying reference rate. The reference rate could be an index or an interest rate. However, there can be no assurance that the reference rate will increase. Some floating-rate securities may be subject to call risk. Many floating rate securities specify rate minimums (floors) and maximums (caps). Floaters are not protected against interest rate risk. In a declining interest rate environment, floaters will not appreciate as much as fixed rate bonds. A decline in the applicable benchmark rate will result in a lower interest payment, negatively affecting the regular income stream from the floater.

The returns on a portfolio consisting primarily of *environmental, social, and governance-aware investments (ESG)* may be lower or higher than a portfolio that is more diversified or where decisions are based solely on investment considerations. Because ESG criteria exclude some investments, investors may not be able to take advantage of the same opportunities or market trends as investors that do not use such criteria. The companies identified and investment examples are for illustrative purposes only and should not be deemed a recommendation to purchase, hold or sell any securities or investment products. They are intended to demonstrate the approaches taken by managers who focus on ESG criteria in their investment strategy. There can be no guarantee that a client's account will be managed as described herein.

Derivatives and Leverage. Derivatives are financial contracts whose value depends on the value of underlying assets, reference rates or indices. The use of derivatives involves risks that are in addition to, and potentially greater than, the risks associated with investing directly in securities and other more traditional assets. These include imperfect correlation between the value of the derivative and the underlying asset, risks of default by the counterparty to certain transactions, magnification of losses incurred due to changes in the market value of the underlying asset, and risks that the transactions may not be liquid. Certain derivative transactions may give rise to a form of leverage, which can magnify the potential for gain and/or the risk of loss and could thus have a disproportionate impact on the performance of the fund. Leverage associated with derivative transactions may cause a fund to liquidate portfolio positions to satisfy its obligations when it may not be advantageous to do so, or may cause a fund to be more volatile than if it had not been leveraged. Commonly used derivative instruments and techniques include:

Structured Investments. A structured investment is designed to offer a return linked to a particular underlying security, currency, commodity or market. Structured investments may come in various forms including notes, warrants and options to purchase securities. Holders of structured investments bear risks of the underlying investment as well as market risk, and are subject to issuer or counterparty risk because the fund is relying on the creditworthiness of such issuer or counterparty and has no rights with respect to the issuer of the underlying investment. Certain structured investments may be thinly traded or have a limited trading market and may have the effect of increasing a fund's illiquidity to the extent that the fund, at a particular point in time, may be unable to find qualified buyers for these investments.

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