Understanding Private Credit

Private credit defined[1]

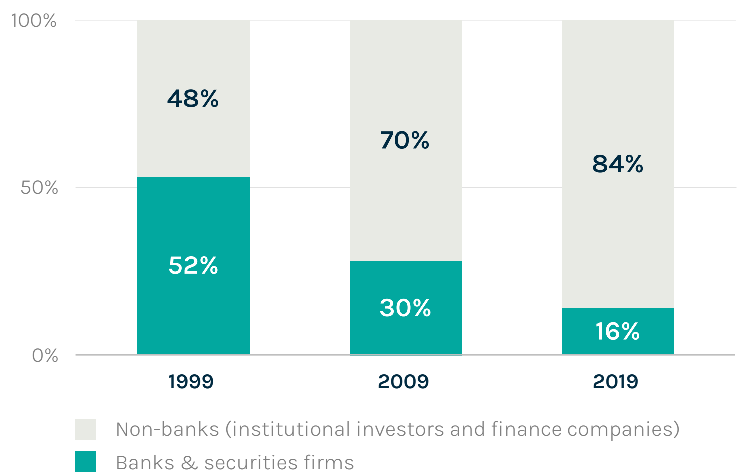
Private credit refers to directly originated debt investments that are illiquid and not actively traded in the debt markets. These investments may be debt to a company or a pool of assets. Private credit provides a way for businesses to access credit and growth capital, often when traditional sources of capital are not available or borrowers are seeking additional flexibility. In many instances, private lenders will bundle a collection of direct loans into a private credit fund. Investors in such funds are typically seeking to achieve consistent income with lower price volatility and lower credit and interest rate risk than public fixed-income investments.

The five realities of private credit

#1 Direct lenders are meeting an important need in the economy.

In recent decades, as a result of the consolidation of the banking industry, traditional banks have significantly reduced the amount of capital they lend to middle market companies, focusing on larger borrowers instead. This has left the middle market, often considered the heartbeat of the U.S. economy, without a steady source of debt funding needed to grow. The private credit markets broadly—and direct lending in particular—have stepped in to fill the gap and have steadily taken market share from traditional bank lenders.

Banks represent a dwindling share of U.S. primary commercial loan issuance



Source: S&P LCD Quarterly Q4-19 Leveraged Lending Review.

#2 Private credit has demonstrated lower credit risk.

Non-bank lenders generally issue loans that they intend to hold to maturity, not repackage and sell to others. Therefore, they are more likely to conduct extensive due diligence before extending credit to a company. This has resulted in historically lower default rates relative to public fixed income.

Long-term average default rates (2004-2022)

2.0%	2.36%	2.43%
Middle Market	High Yield Bonds	Leveraged Loans

Sources: Fitch U.S. Leveraged Loan Default Index, Refinitiv LPC, Bloomberg. Middle market default rates prior to 2008 include Business Development Company year-end non-accruing loan rates for three of the largest BDCs: American Capital, Ltd., Apollo Investment Corp., and Ares Capital Corp. Past performance is no guarantee of future results. High Yield Bonds are represented by the ICE BofA US High Yield Constrained Index ("HUC0"). Leveraged Loans are represented by the Credit Suisse Leveraged Loan Index ("CSLLI").

#3 Private credit has historically provided stronger risk-adjusted yields.

Since 2005, private direct lending has generated a 550bps spread to the leveraged loan market while generating nearly identical annual loss rates.[2] Relative to high yield bonds, private direct lending has yielded 340bps of additional spread with 55% lower annual loss rates.[2]

Asset yield and loss comparisons

Annualized since 2005	Private Direct Lending	Leveraged Loans	High Yield
Gross asset yield	10.9%	5.4%	7.5%
Loss rate	1.03%	0.92%	1.49%
Net asset yield	9.9%	4.5%	6.1%

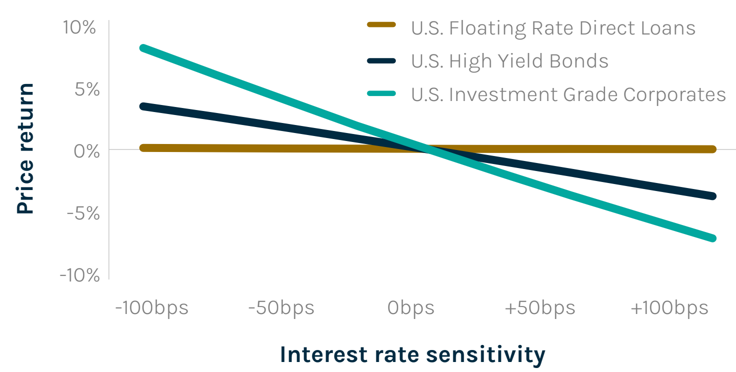
As of December 31, 2022. For illustrative purposes only. Portfolio yields are representative of a gross portfolio at each data point in time and do not represent a return to investors. Private direct lending is represented by the Cliffwater Direct Lending Index ("CDLI"). The CDLI seeks to measure the unlevered, gross-of-fees performance of U.S. middle market corporate loans, as represented by the underlying assets of Business Development Companies ("BDCs"), including both exchange-traded and non-traded BDCs, subject to certain eligibility requirements. The CDLI is asset-weighted by reported fair value. High Yield Bonds are represented by the ICE BofA US High Yield Constrained Index ("HUC0"). Leveraged Loans are represented by the Credit Suisse Leveraged Loan Index ("CSLLI").

#4 Private credit has provided protection against interest rate risk.

Due to the largely floating rate nature of private credit investments, they are typically less sensitive to changes in interest rates than public fixed income. Floating interest payments are reset to a reference interest rate every 30 to 90 days. As rates rise, investors receive more income while prices stay stable.

Other variables may impact loan and bond pricing, including changes in credit spreads to base interest rates. U.S. High Yield Bond per the HUC0 index. U.S. Investment Grade Corporate per the C0A0 index. U.S. Floating Rate Direct Loans assume an asset with a 90bps LIBOR floor, L+450 with a 5-year contractual maturity.

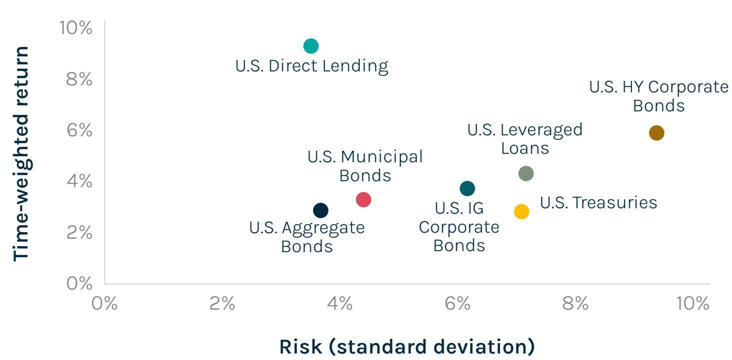
Floating rate debt demonstrates less price sensitivity than public fixed income



#5 Private credit has typically exhibited greater price stability.

Direct loans tend to be held by investors who originate the debt as a longer-term investment, rather than trading it frequently. As a result, private credit has typically exhibited greater price stability than public market equivalents while maintaining similar levels of return. This reduced mark-to-market volatility can induce less perceived need to trade and can make these investments easier to hold for the long term.

U.S. floating rate direct loans have been less volatile than public fixed income



For illustrative purposes only. Information included herein is not an indicator of actual results. Past performance is not a guarantee of future results. All data 09/30/2004 – 12/31/2022. U.S. Direct Lending is represented by the CDLI Index. The CDLI Index does not reflect the impact of fees and expenses of the Fund. Investors cannot invest directly in the index. U.S. Leveraged Loans is represented by Morningstar LSTA US Leveraged Loan Index. U.S. Treasuries is represented by ICE BofA Current 10-Year US Treasury Index. U.S. Aggregate Bond Index is represented by Bloomberg Barclays US Agg Total Return Value Unhedged USD Index. U.S. Municipal Bonds is represented by Bloomberg Barclays Municipal Bond Index. U.S. IG Corporate Bonds is represented by Bloomberg Barclays U.S. Corporate Bond Index. U.S. HY Corporate Bonds is represented by Bloomberg Barclays U.S. Corporate HY Bond Index. An investment in private credit is significantly less liquid than an investment in public fixed income and is not immune to fluctuations, including downward fluctuations.

An enduring shift toward private credit

Many of today's highest-growth businesses are seeking non-bank lenders to provide the capital they need for continued success. Middle market companies, most of which are private, are fundamental to economic growth. The owners of these businesses appreciate the long-term focus of direct lenders as well as the closer alignment of interests between their company and its creditors. The structural shift from public to private capital is expected to continue, fueled by the increased reliance of private equity sponsors on direct lending.

Why is private credit playing an increasingly important role in individual investors' portfolios?

Durable income

With a focus on current income and regular distributions, private credit can help investors seek enhanced yields while diversifying their sources of income.[3]

Reduced credit and interest rate risk opportunity

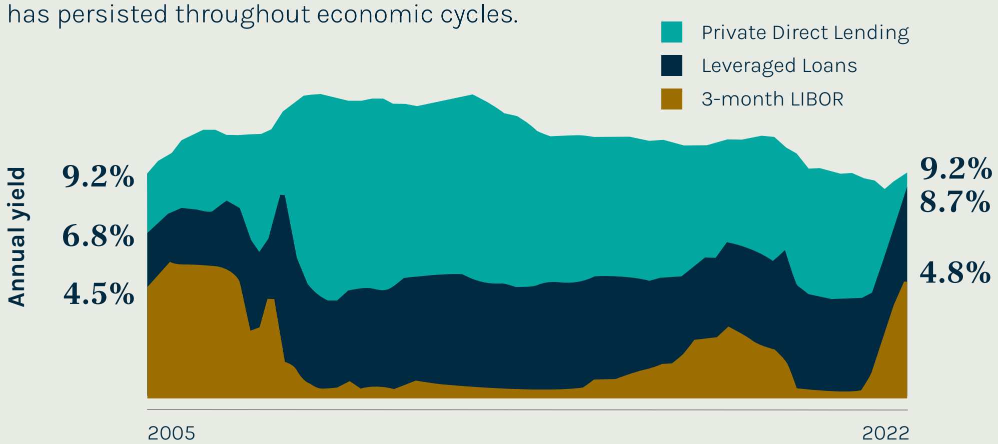
Private credit investments have demonstrated lower sensitivity to changes in interest rates and reduced credit risk relative to traditional public fixed income.

Expanding opportunity set

The long-term trends for growth in direct lending are evident as competitive dynamics and bank regulation continue to shift the market in favor of private credit. Direct lending is expanding to meet the growing need for capital and the reduced competition from banks, which may lead to a continuation of attractive risk-adjusted returns for the asset class.

Private credit has delivered superior yields over time

Private credit has historically provided a yield premium to publicly traded debt that has persisted throughout economic cycles.



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Ready to learn more?

AccessAres is your resource for education and information about the private markets. Talk to us to learn more about these important asset classes.

[1] Private credit can encompass direct lending, alternative credit, infrastructure debt, real estate debt, and/or distressed debt/special situations. An investment in private credit is significantly less liquid than an investment in public fixed income and is not immune to fluctuations, including downward fluctuations.

[2] Source: Private direct lending represented by the Cliffwater Direct Lending Index ("CDLI"). The CDLI seeks to measure the unlevered, gross-of-fees performance of U.S. middle market corporate loans, as represented by the underlying assets of Business Development Companies (BDCs"), including both exchange-traded and non-traded BDCs, subject to certain eligibility requirements. The CDLI is asset-weighted by reported fair value. High Yield Bonds are represented by the ICE BofA US High Yield Constrained Index ("HUC0"). Leveraged Loans are represented by the Credit Suisse Leveraged Loan Index ("CSLLI").

[3] Distribution payments are not guaranteed and diversification does not guarantee against the risk of loss of investment capital or value.

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