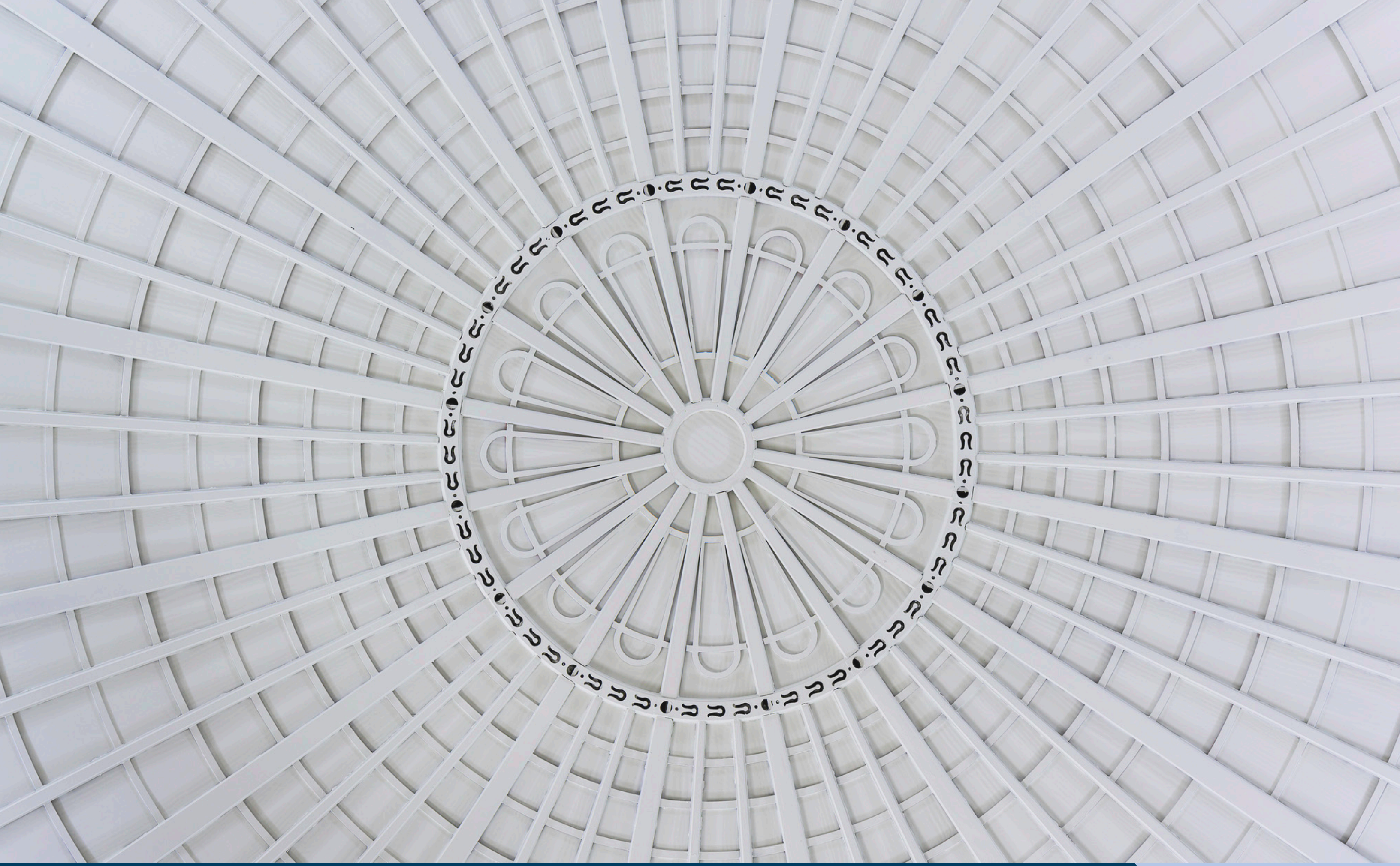

Looking Under the Hood

An Update on Recent Developments in Private Credit

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Revisiting Private Credit

In 2024, we shared our thoughts on private credit in a memo from Richard Pilosof, CEO. Although we did not believe the asset class was inherently flawed, we noted that rapid growth and significant capital inflows had compressed return premiums and, in some cases, weakened underwriting standards.

Recent market developments have reinforced that view. Private credit remains a useful source of flexible financing and can play a role in portfolio diversification. However, as economic uncertainty rises, industry saturation increases, and capital becomes more selective, risks that were previously masked by money inflows and smooth reported returns are becoming increasingly visible.

Below, we present our observations on four aspects of the private debt asset class given today's uncertain environment, and also on the opportunities we are capitalizing on in some of our portfolios.

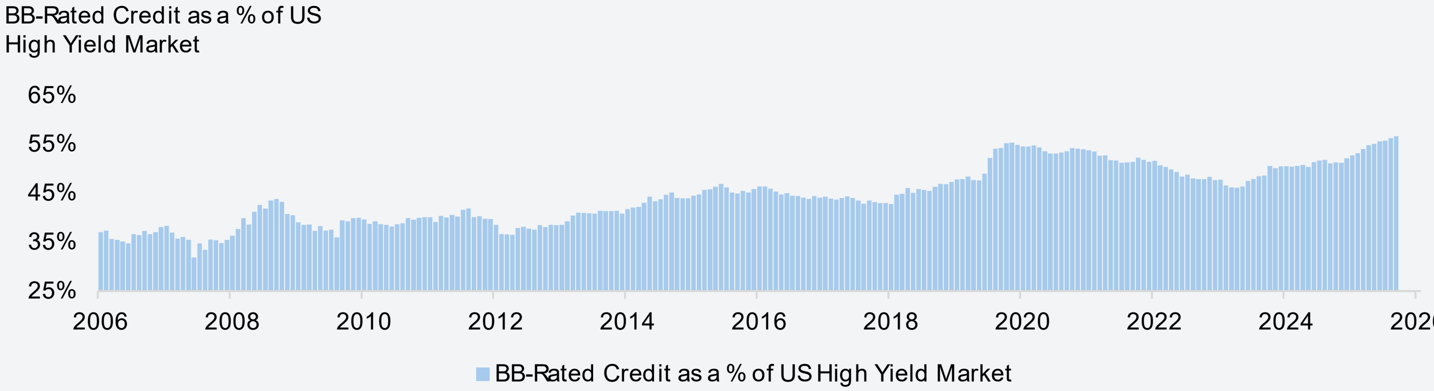
What We Are Seeing

1. Credit Fundamentals

Historically, private credit focused on lending to smaller companies that had limited access to traditional bank financing or public debt markets. As private credit experienced extraordinary growth over the past decade, private managers have faced increasing pressure to deploy capital. In many cases, we believe this has resulted in lending to companies with higher leverage, smaller scale, and/or business models that public markets have been less willing to finance – including certain software businesses and niche sectors.

Meanwhile, the overall credit quality within the public market has improved materially over time, especially within the US high yield segment. 20 years ago, BB-rated issuers, the highest quality tranche of the high yield market, represented ~35% of the US high yield market; today that figure has increased to ~55% (see chart below). Given the size and depth of the public markets, public credit managers like ourselves have a broad and attractive opportunity set for investing.

US High Yield Market Has Shifted Toward Higher Credit Quality



Source: BarclaysLive. Data as of May 31, 2026. US High Yield Market = Bloomberg Barclays US High Yield Corporate Bond Index.

In an environment where there has been deterioration in lending standards in the private credit market, it means that manager selection, underwriting discipline, and borrower quality matter much more today than they did when the space was less crowded. We are already seeing much more divergence across the performance of private debt managers.

Note that credit deterioration can take longer to emerge in private markets than in public markets. Loan amendments, maturity extensions, and the payment-in-kind structure can help preserve loan value and provide borrowers with flexibility, but they can also delay the recognition of underlying credit stress. As a result, we believe investors should look beyond reported default rates and stable headline returns and decide whether they are being adequately compensated for the combination of credit risk, illiquidity, and limited transparency.

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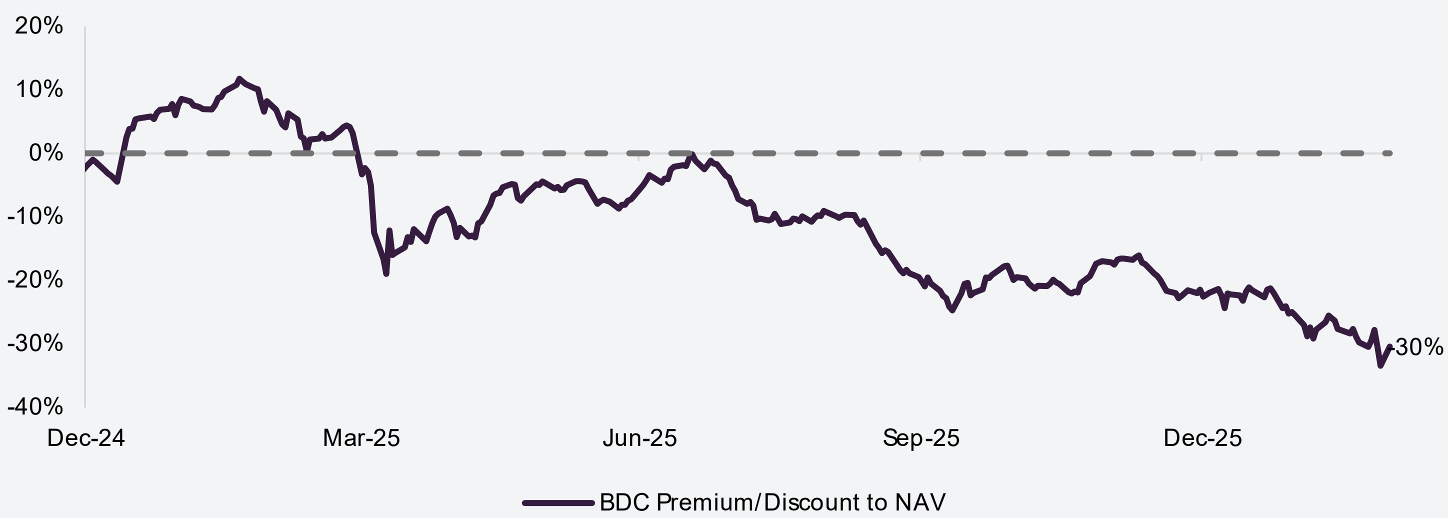
2. Valuations

For many investors, one of the primary attractions of private credit is the smooth return profile compared to public credit markets. However, smoother returns do not necessarily imply lower risk. Public markets provide daily price discovery, which can be uncomfortable during periods of volatility but also offers greater transparency.

Publicly traded Business Development Companies (BDCs), which are vehicles that invest in many of the same private loans held by private credit funds, provide a useful comparison. Many of these vehicles have traded at meaningful discounts to their reported net asset values (NAVs), with discounts reaching as much as 40% among lower-quality BDCs. This suggests that public markets may be assigning lower values to certain private credit assets than those reflected in private fund marks.

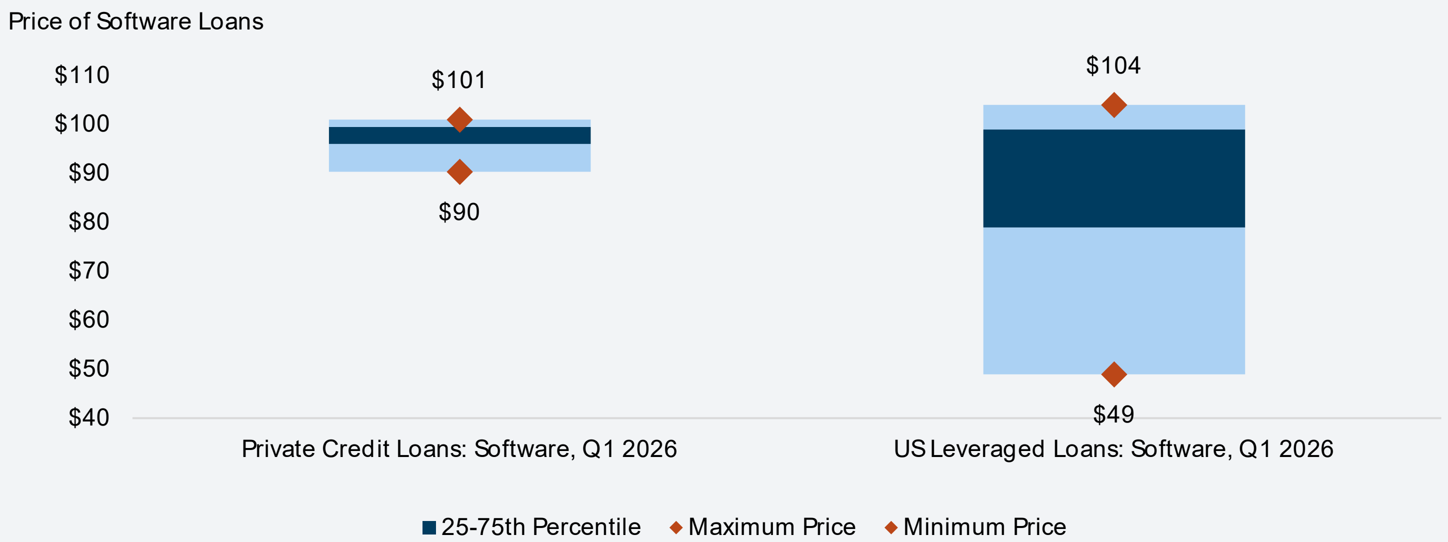
BDCs are Priced at Larger Discounts to NAV Than the Start of 2025



Source: Bloomberg. Data as of May 5, 2026. Aggregated data reflects publicly traded BDC units across leading private credit managers, including Blackstone, BlackRock, Blue Owl, KKR, and Oaktree.

We also observe meaningful discrepancies in how underlying loans are being marked in private vs. public markets. In the software sector, for example, private credit valuations appear to be pricing in only a modest impact from AI disruption on software loans. By contrast, more liquid markets such as leveraged loans – often financing similar businesses – are reflecting a much wider range of potential outcomes and, in many cases, a more cautious outlook. This suggests that investors should be careful not to interpret stable reported valuations as evidence of low risk or high asset quality.

US Leveraged Loans Reflect a Wider Range of Software Valuations vs. Private Credit

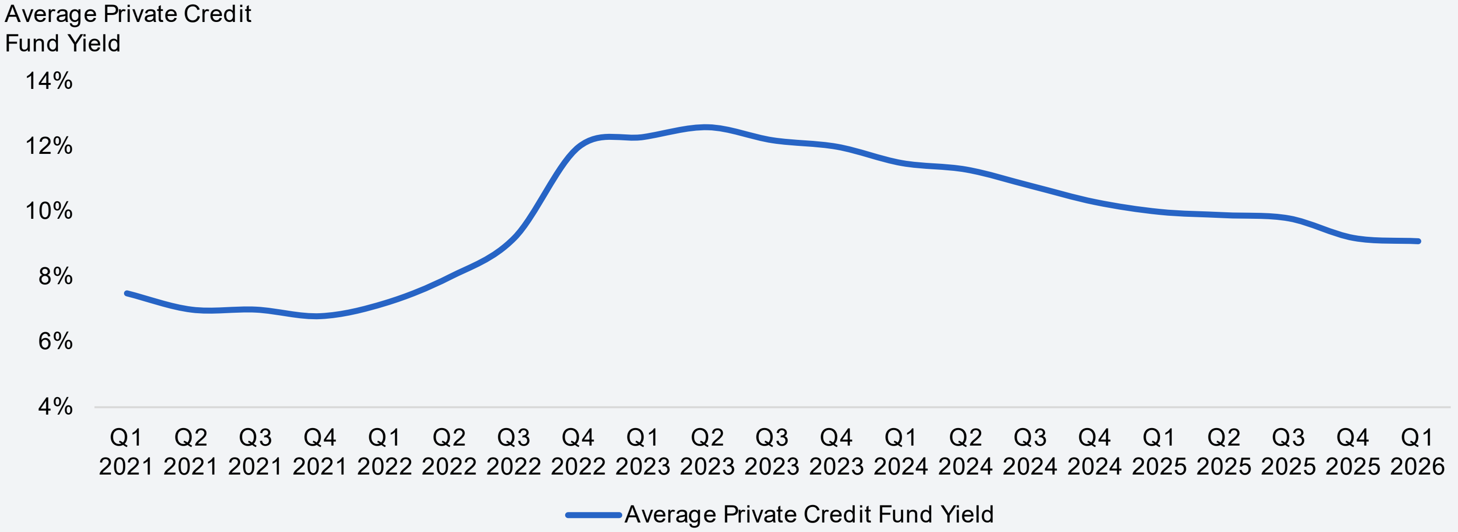


Source: Deutsche Bank. Data as of Jun 11, 2026.

3. Income Distribution Sustainability

Many private credit portfolios consist primarily of floating-rate loans. As interest rates rose in 2022, investors benefited from a substantial increase in portfolio income. However, as policy rates started their decline in 2025, a portion of that income has naturally fallen. Investors who entered the asset class expecting persistent double-digit yields may need to reset their expectations. The reduction in income distribution could be exacerbated by rising defaults among weaker borrowers, particularly those at the lower end of the credit-quality spectrum.

The Average Yield on Private Credit Funds Have Declined to Pre-2023 Levels

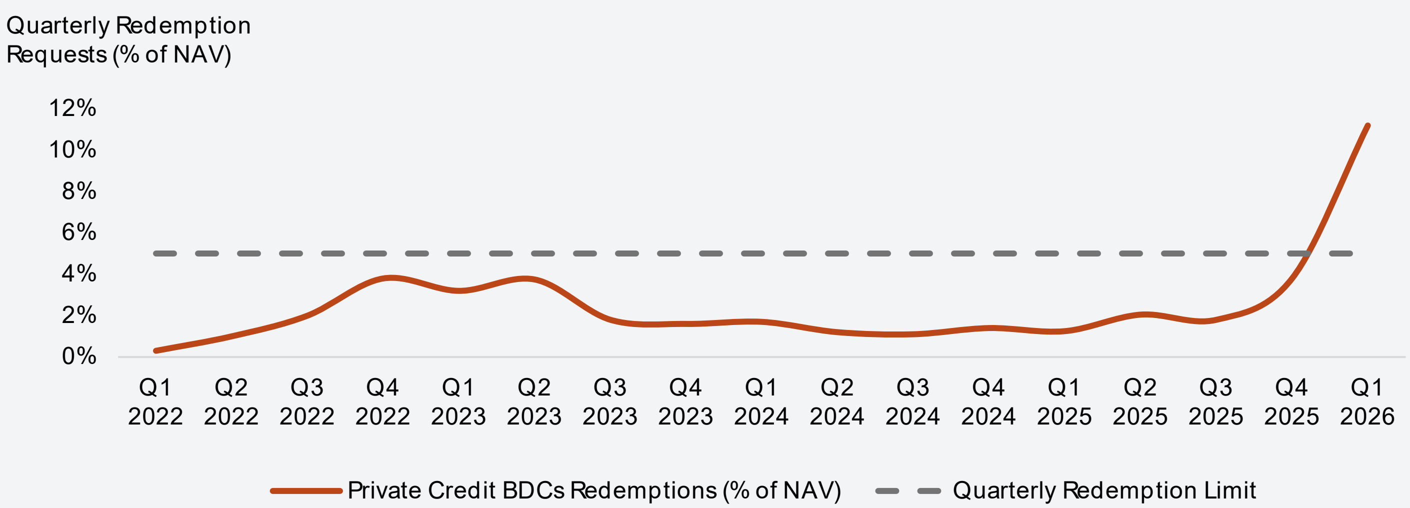


Source: Cliffwater. Data as of April 30, 2026. Average private credit fund yield is proxied by the yield on newly originated first-lien loans to private companies.

4. Liquidity

As a result of factors mentioned above, several large private credit vehicles have recently received higher-than-normal redemption requests. In simpler terms, more investors are asking for their money back. Given the BDC NAV discount mentioned earlier, private credit investors are realizing that this is an opportune time to redeem at reported private fund NAV and invest instead in BDC units.

Private Credit BDC Redemption Requests Exceed Limits for the First Time in Q1 2026



Source: Cliffwater. Data as of March 31, 2026.

The challenge with private credit redemptions is that the underlying loans are not easy to sell quickly. During stable market conditions, this is rarely an issue. However, when many investors want liquidity at the same time, it can matter a great deal.

Most private credit funds are designed with limits on how much can be redeemed at one time, so this does not necessarily create an immediate and systemic problem. But as the redemption queues grow longer in the following months, even strong managers may need to hold more cash, slow new lending activity, or manage their portfolios more defensively.

How We Are Positioned in Our Portfolios

While some warning signs are emerging in private credit, we continue to see some attractive opportunities following the recent repricing across the sector. Within some of our portfolios, we are selectively investing in the debt of high-quality companies and platforms involved in private credit. In some cases, public bonds issued by leading managers currently offer attractive yields while sitting higher in the capital structure than the underlying equity, creating a more favorable risk-reward profile. We remain highly focused on manager quality. We prefer larger platforms with strong sponsorship, diversified portfolios, permanent capital bases, and proven experience managing through difficult credit environments.

For example, recent market weakness created opportunities for us to purchase investment-grade rated bonds issued by publicly traded BDC managers at spread levels similar to a B-rated issuer. Certain bonds offer yields of ~7.5%, with credit spreads in excess of 250-300 basis points. In our view, this represents compelling relative value.

Equity holders in these same vehicles are often looking to receive yields of ~10%, a modest premium over the (senior) bonds – but with substantially higher risk. Bondholders benefit from significant equity cushion and a more senior position in the capital structure. If one were to apply leverage to these securities, one would be able to generate an equity-like return while maintaining a preferential position in the capital structure.

Author Takeaways

- Recent market developments have brought private credit funds back under the microscope, reinforcing our cautious outlook regarding that space.
- Lower credit quality, pricing discrepancies, reduced income distribution, and gating concerns have all led to a shaky picture for investors who are in search of transparency and liquidity amid uncertainty.
- Public credit can offer some balance as a complement to private allocations. We continue to see compelling opportunities where compensation for risk is attractive.
- Choosing the right manager is more important than ever as market pressures require careful security selection and greater flexibility.

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