AN ALTERNATIVE APPROACH TO CREDIT IN **A RISING RATE ENVIRONMENT**

Traditional fixed-income assets have struggled over the last year. Despite the increase in yields, spiking inflation has meant that income could not keep up with rising consumer prices.

The Federal Reserve has signaled that we are likely to be in a rising rate environment for the next several years, and that it will reduce its balance sheet. This will likely continue to put pressure on bond prices, but rate increases may not bring inflation down quickly enough for the additional yields to be worthwhile.

The potential increase in rates brings to the fore another element of the fixed-income return equation: duration. Traditional fixed-income durations are lengthening, which increases interest rate risk and potential price volatility.

WHAT ELSE IS OUT THERE?

The alternative credit spectrum may offer assets that can provide income without long durations. Private credit is one option. Another option is leveraged loans, which can offer interest rate risk mitigation and yield.

These asset classes generally tend to have floating rates that reset over very short periods, which keep their duration low. One of the few fixed-income asset classes that did well last year – high yield—may also provide opportunity.

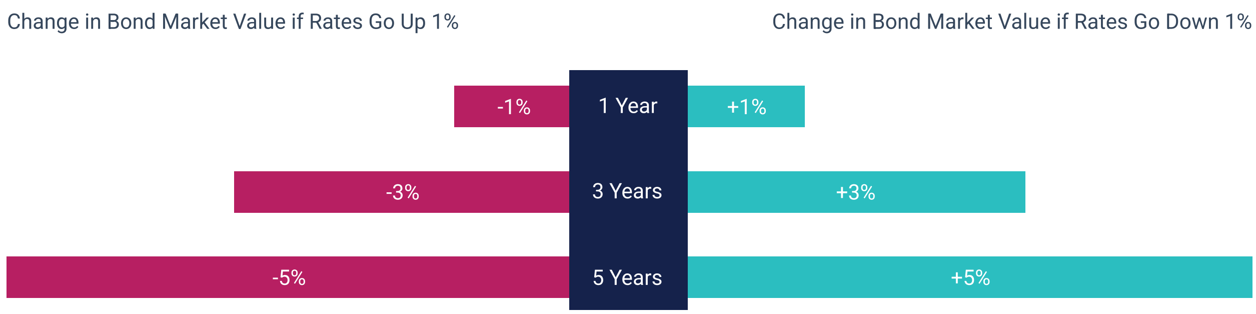
High-yield bonds generally have much lower duration than investment grade corporates, as they have maturities of less than ten years and are often callable after five years.

We look at the Federal Reserve's likely path on interest rates and get into the details on alternative credit.

THE FEDERAL RESERVE IS AGGRESSIVELY RAISING RATES

The Federal Reserve is raising the key short-term interest rate to tighten the money supply. The Fed is attempting to slow economic growth to a level that will bring down inflation to an average of 2%. Given the current level of inflation, the Fed has reiterated that it is committed to a series of rate increases.

Duration, Interest Rates and Bond Prices



AREN'T HIGHER RATES A GOOD THING?

Yes and no. Higher rates reflect long-term confidence in the economy. Higher rates eventually translate into more income, but at the expense of price. Bond yields move inversely to prices.

Duration is a measure of a bond's sensitivity to changes in interest rates. Longer duration creates more interest rate risk.

As interest rates rise, bonds with longer duration will see correspondingly greater decreases in price. In a rising rate environment, for every 1% increase in interest rates, a bond's price will decrease approximately 1% for every year of duration.

Bloomberg U.S. Aggregate Index

Source: Bloomberg

When you factor inflation into the return equation, the outlook for traditional bonds looks grim. The value proposition of traditional credit assets is that they lower portfolio volatility while adding stable income.

Historically low yields over the last decade have meant durations have increased. Even with rate increases, yields struggle to keep up with inflation. Traditional bonds may still have a role to play in smoothing volatility, but it comes at a cost.

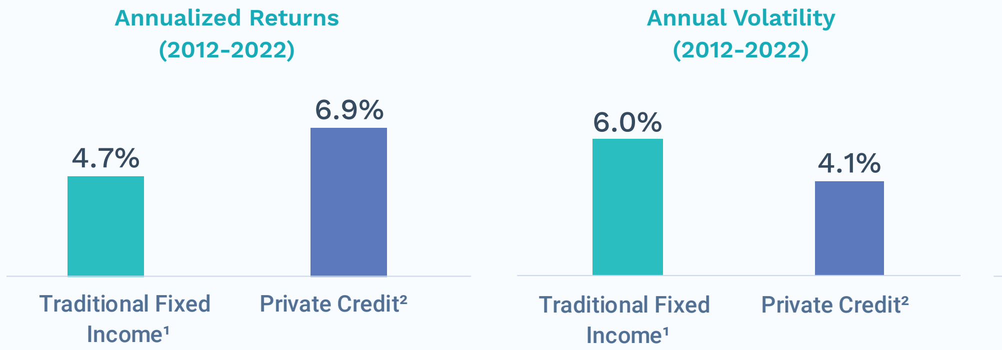
THE RESILIENCY OF PRIVATE CREDIT

Demand for private credit has grown over the last decade. The structure of these types of loans and the illiquidity premium they provide can create enhanced yield.

In addition, the resiliency of the asset class became apparent throughout the market dislocations and recovery over the last several years.

This has refocused demand on the value of the lower volatility that private credit assets can bring.

Comparison of risk/return between traditional fixed income and private credit



1. ½ Bloomberg U.S. Corporate Bond Index and ½ Bloomberg U.S. Corporate High Yield Bond Index
2. ½ Cliffwater Direct Lending Index and ½ Credit Suisse Leveraged Loan Index.
All data as of March 31, 2022.

The lower volatility of the asset class is related to the structure of the loans. Private credit direct lending is a way for middle market companies (those between $10 million and $1 billion in revenue) to fund operations, expansion, or other business priorities.

These companies often cannot access the public capital markets, and the banking industry's consolidation into large players that make very big loans has left them underserved.

To attract private lenders, companies offer enhanced yield and structure the loans to be senior in the capital stack, and they are secured with the assets of the company. This puts lenders in a position to recover their investment in the event of a default.

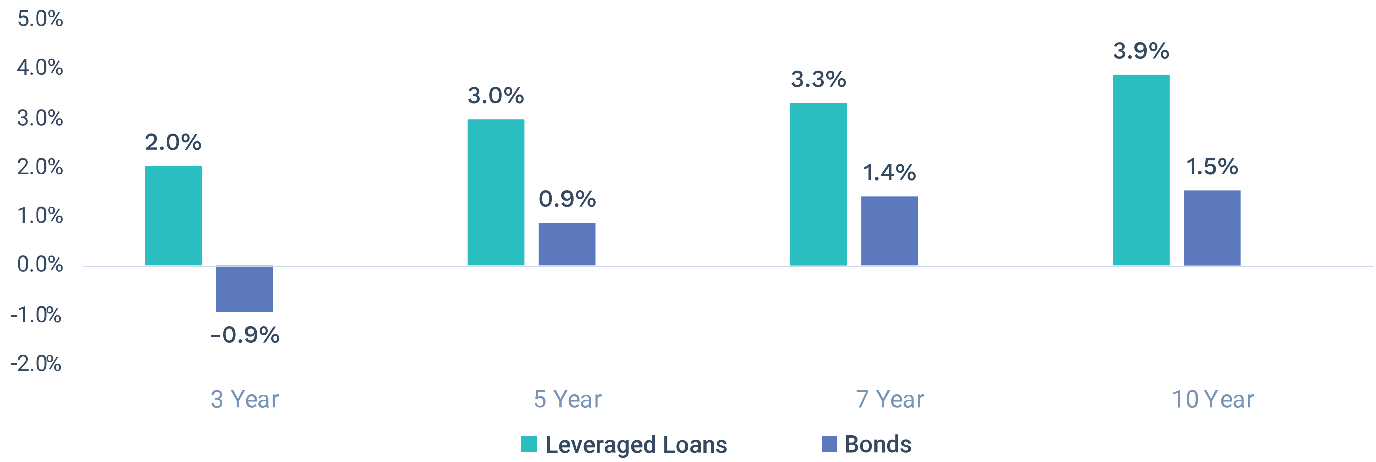
The loans are typically floating rate instruments. As rates go up, lenders can benefit from increased yields. Fixed-rate bonds in environments with rising interest rates lose value.

FLOATING RATE LOANS CAN HEDGE AGAINST RISING RATES

Rising rate environments are ideal for floating rate bank loans. These loans, also called leveraged loans or syndicated loans, offer higher levels of yield as interest rates increase.

Leveraged loans aren't just valuable in rising rate environments. Over the long-term, they have a history of outperforming bonds. Careful credit selection is necessary, as rising rates may increase default risk.

Historical Returns



Leveraged loans are represented by the Credit Suisse Leveraged Loan Index; Bonds are represented by the Bloomberg U.S. Aggregate Bond Index. It is not possible to invest directly in an index. Past performance is not indicative of future results. As of June 30, 2022.

HIGH-YIELD BONDS AREN'T JUST ABOUT YIELD. RETURN PLAYS A ROLE

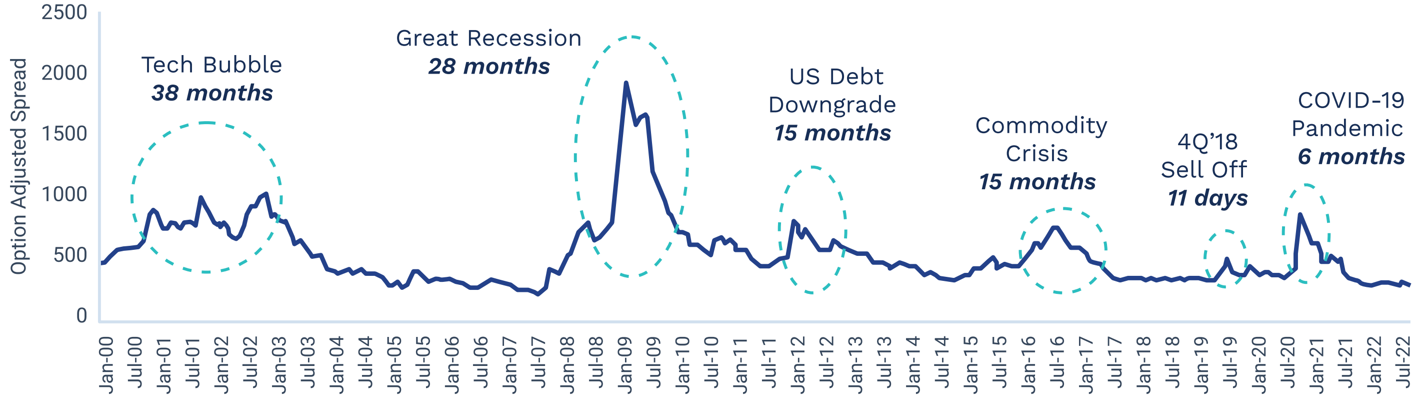
High-yield bonds are publicly traded non-investment grade corporate or municipal bonds. They offer higher yields to compensate for the greater credit risk associated with these securities.

They are often used to help diversify credit exposure, as these bonds are relatively more correlated to equities than fixed income.

However, maintaining a consistent, high allocation to high-yield bonds can increase risk substantially. High-yield bonds tend to be more volatile than other credit instruments, and the opportunity window they present – usually related to a dislocation in the market – tends to be very short.

A managed exposure to high-yield bonds could potentially offer both yield and return opportunities while managing risk.

2000 - Present Day: Market Dislocations



Dislocation defined as periods when high yield OAS increased above ~700 before returning to historical median of ~500.
Source: The BofA US High Yield Master II Constrained Index ("HUC0") OAS from January 1, 2000 through July 1, 2022.

A TURN OF THE ECONOMIC CYCLE

Traditional fixed income may continue to struggle as the Federal Reserve works to contain inflation. Against this backdrop, demand for income alternatives continues to increase.

Asset classes that can offer enhanced yield along with lower volatility and the ability to mitigate interest rate risk are well-positioned in these environments.

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