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Private credit primer

December 2020

Introduction

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Private credit may offer investors a broader opportunity set than public credit, and greater potential for active manager alpha through skilled allocations to less efficient markets. For institutions considering a private credit allocation, this white paper aims to provide an in-depth look at the role the asset class might play, and what investors might expect in terms of behavior. This area of the marketplace is complex, and this paper necessarily uses technical terms throughout – we have attempted to ensure that each new term is explained in a related footnote, to avoid excessive interruptions in the flow of the text. First, we will touch on the different areas of the private credit market and how each might fit alongside other asset classes in the portfolio. Next, we outline the expected behavior of private credit throughout the typical economic cycle and visit its risks. Finally, we review considerations for accessing the private credit marketplace, with an emphasis on the importance of skilled active manager selection.

In summary, private credit is a big tent that offers investors various options for preserving capital, generating yield, and benefiting from capital appreciation. When building private credit portfolios, investors must carefully balance their risk tolerance with their return objectives. Arriving at an optimal allocation requires consideration of the context of the entire portfolio's allocation to broader alternative and traditional long-only assets. Investors will likely be well-served by working with a skilled advisor to properly navigate and understand the different corners of the private credit market and how each of these areas might play a role in achieving the investor's portfolio objectives.

What is private credit?

Private credit fund strategies target higher yielding corporate, asset-based, or financial assets owned through a closed-end, private fund structure. The three primary strategies of private credit are direct lending (inclusive of all performing corporate strategies), opportunistic (primarily backed by the cash flow of securities of non-corporate, non-correlated, or unique and esoteric assets), and distressed debt. A summary representation of the respective strategies is shown below.

GLOBAL PRIVATE CREDIT OPPORTUNITY SET

	Dry Powder ($bn)		Unrealized Value ($bn)		AUM ($bn)	
Date	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**
Corporate / Direct Lending	156	57.8%	338	57.9%	494	57.9%
Opportunistic	46	17.0%	98	16.8%	144	16.9%
Distressed Debt	68	25.2%	148	25.3%	216	25.3%
Total	270	100%	584	100%	854	100%

Source: Preqin Quarterly Update: Private Debt, Q2 2020

Expected Return Profiles

Within each of the three primary strategies there are multiple sub-strategies which offer varying risk and return profiles. The three main strategies and their respective sub-strategies are shown below. Private credit managers typically target a specific expected investment return which is communicated to investors. We show these targeted expected returns below, targeted both on an unlevered investment-level gross-of-fee returns basis, and also on a levered net-of-fee basis. Levered fund-level net returns for the sub-strategies are broken out to illustrate the important role that leverage plays in the asset class.

PRIVATE CREDIT: PRIMARY & SUB-STRATEGIES TARGETED RETURNS

Strategy	Sub-Strategy	Unlevered Gross Yield	Loan-to-Value (LTV)	Target Internal Rate of Return (IRR)
Corporate Debt	Direct Lending - 1st Lien	6.3%	50%	9.0%
	Direct Lending - Unitranche	6.8%	60%	10.0%
	Direct Lending - 2nd Lien	10.5%	65%	11.5%
	Direct Lending - Non-Sponsored	9.0%	55%	11.5%
	Mezzanine	11.0%	70%	13.0%
	Structured Equity	9.0%	70%	14.0%
Opportunistic	Multi-strategy: Low Vol	6.5%	70%	10.0%
	Multi-strategy: High Vol	6.0%	70%	13.0%
	Contingent Fund	7.5%	65%	12.0%
	Consumer Finance	10.0%	80%	14.0%
	Business Finance	10.0%	80%	12.5%
	Shipping	12.0%	75%	10.0%
	Aircraft	8.0%	65%	10.0%
	CLO Equity	12.0%	100%	15.5%
	Drug Royalties	8.0%	35%	12.0%
	Litigation Finance	0.0%	100%	22.5%
	Regulatory Relief	10.0%	85%	11.5%
	Fund Leverage	10.0%	65%	12.0%
Distressed	Rescue Financing / DIP	11.0%	70%	15.0%
	Distressed for Influence	0.0%	65%	17.5%
	Distressed for Control	0.0%	100%	21.3%
	Capital Solutions	6.5%	75%	14.0%

Given the various strategies, private credit can fulfill different roles within investor portfolios. Strategies with greater expected upside, such as distressed-for-control or collateralized loan obligation (CLO) equity might also be found in private equity allocations[1]. Strategies expected to return less, such as multi-strategy or drug royalties may sit in an "opportunistic" bucket[2]. The lower-yielding strategies, such as direct lending, may sit within fixed income or alternative credit. Private credit strategies can be used to enhance or diversify traditional fixed income or private market allocations, or they can serve as stand-alone allocations in a portfolio, given their varied risk and return profiles.

Direct Lending (Senior Corporate Debt)

Direct lending is an area of private credit that most closely resembles the public markets—namely the broadly syndicated loan and high yield markets. In direct lending, a general partner (GP) finances a private equity manager's buyouts and company expansions. Direct lending strategies generate most of their returns from interest payments composed of a contractual credit spread and a reference rate (LIBOR or Prime). Direct lending can be even

1 *"Distressed for control" investing involves an investor taking a controlling position in a distressed security with the intent to take control of the underlying company. If/after successfully taking control, the investor would work to increase profitability by restructuring the company, putting it up for sale, or another form of divestment.*

2 *"Drug royalty financing" involves the acquisition of drug royalties from biotechnology companies that seek financing. Investment in drug royalties is often seen as attractive due to return streams that do not correlate to the broader markets.*

further categorized according to the size of the borrower and seniority of the debt instrument. Some sub-asset classes and their typical, unlevered gross-of-fee yields as well as their defining characteristic are shown below.

DIRECT LENDING CATEGORIES

Category[3]	Defining Characteristic	Unlevered Yield
Lower-middle market, 1st Lien	Borrower EBITDA < $25MM	LIBOR + 6.5%
Middle market, 1st Lien	Borrower EBITDA between $25MM & $50MM	LIBOR + 5.5%
Upper-middle market, 1st Lien	Borrower EBITDA > $50MM	LIBOR + 5.0%
Stretch Senior	1st lien, 2nd in order of payment	LIBOR + 5.8%
Unitranche	1st lien leverage above 5x; no 2nd lien or subordinated debt	LIBOR + 6.0%
2nd Lien	2nd lien	LIBOR + 9.5%
Public Credit (for comparison purposes)		
Bank loans		LIBOR + 5.0%
High yield market		LIBOR + 6.0%
High yield B		LIBOR + 5.9%
High yield CCC		LIBOR + 9.0%

Spread expectations for typical market conditions, for illustrative purposes only

Direct lending is traditionally differentiated from the public markets in a variety of ways. Credit spreads tend to be higher relative to broadly syndicated loans, which are often priced at LIBOR + 3-4%. Borrower size is much smaller, at less than $100MM of EBITDA. And the debt terms are different with stronger financial covenants (unlike the covenant-lite deals in broadly syndicated loans), call protections (often non-callable for one year with slight premiums in the second year), and fewer lenders are involved as sole or club lending is the norm (rather than a broad lending group of five or more lenders in broadly syndicated loans)[4]. The lines between the categories in direct lending do become blurred, however, when it comes to unitranche (deals where the lender provides the debt financing through a single facility rather than with separate first- and second-lien facilities).

Senior debt funds can be levered or unlevered at the fund level. Unlevered gross-of-fee returns tend to be around 6.25% for first-lien debt, but GPs can use fund-level leverage to achieve net internal rates of return (IRR) of 10%. The rule of thumb is that the riskier the underlying loans, the less fund-level leverage the fund is able to support (based both on GP risk management and advance rates that commercial banks are willing to provide for financing riskier loans)[5].

3 *Source: The Lead Left, Sept. 7, 2012*

4 *A "sole" lender situation is a deal with a single investor. A "club deal" is a deal that involves two or more investment firms.*

5 *An "advance rate" is the amount a lender is willing to lend in relation to the value of the collateral. For example, if collateral is worth $100,000 and an advance rate of 80% is determined, the loan available would be $80,000.*

Beyond the traditional sponsor-backed market is the non-sponsored market. "Non-sponsored" loans are those which lack a private equity sponsor, meaning the private credit fund manager will typically work directly with the underlying company to negotiate debt terms. Non-sponsored loans command larger spreads due to the sourcing requirements for the fund (calling on a national market of borrowers rather than a cluster of sponsors) and the complexity of the transactions (often unbanked, which requires more difficult due diligence).

Mezzanine

Mezzanine debt is capital that is lower than senior debt in seniority but above equity (it falls in the middle). This type of debt may have equity features which provide upside potential for investors. It is often issued during a business acquisition or buyout with the goal of giving new debt owners priority in the case of bankruptcy. Mezzanine managers tend to make subordinated loans to middle-market borrowers and generate most of their return from current cash pay coupons in excess of 10%[6]. These funds also generate returns from prepayment penalties and paid-in-kind (PIK) interest[7]. Historically, mezzanine managers also captured equity exposure through purchased equity or warrants, as well as penny warrants, but the market has evolved such that equity participation is usually through a direct co-investment rather than warrants[8]. Pricing for mezzanine debt is influenced by the pricing in the first-lien loan marketplace; the junior debt prices 300-500 basis points wider than first-lien loans. Mezzanine portfolios look like a barbell of second-lien loans and equity co-investments.

A primary risk for managers is that credit losses overwhelm gains from equity exposure. In theory, equity gains from the rest of the credit portfolio should compensate the investor for limited credit losses, but this is not always the case. In the current market for mezzanine debt, where equity exposure comes from co-investments rather than penny warrants, funds are increasingly sensitive to both credit and equity losses[9]. Mezzanine funds target a low-teens gross-of-fee return with most of that return coming from the debt component of the investment. Net-of-fee returns for mezzanine had stepped down from the mid-teens after the 2008-2009 Global Financial Crisis to a 10-11% range in the late-cycle environment of 2019. Post-COVID-19, Verus anticipates mezzanine funds will target 12-13% net-of-fee returns.

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6 *"Subordinated debt" refers to debt that is last to be paid back in the case of a bankruptcy. This makes subordinated debt riskier than most other debt. Subordinated debt is also referred to as "junior debt". This compares to senior debt, also known as unsubordinated debt or primary loans, which is among the first to be paid back.*

7 *"Payment-in-kind" is a payment to bondholders in the form of additional debt securities or equity, instead of a traditional cash payment. A payment-in-kind payment option may be attractive to companies that prefer not to make cash outlays to debtholders.*

8 *A "direct co-investment" is an investment made by a private credit or private equity investor directly into equity of an underlying company, alongside an investment made by a private credit or private equity fund itself, but not through the private fund. This type of investment comes with the benefit of avoiding the potentially high fees of the private fund.*

9 *A warrant is a debt feature that allows the holder to purchase a specified number of company securities at a given exercise price. When the exercise price is very low, such as $0.01, this is referred to as a "penny warrant".*

Given the longer hold period and equity component of the returns, mezzanine funds target higher money multiples than direct lending funds with a 1.5x net total value paid-in (TVPI) for Mezzanine versus 1.3x for direct lending[10],[11].

Opportunistic Credit

Opportunistic credit strategies seek to deploy debt capital opportunistically wherever market liquidity is weakest or value is greatest. This might include deeply discounted purchases of public market securities across multiple strategies (investment and non-investment grade corporate debt or structured credit), real estate and infrastructure debt, portfolios of performing and non-performing loans (NPLs), specialty finance, and other unique strategies that may be noncorrelated to the broader market or more esoteric in nature[12]. Frequently, the most attractive opportunities for multi-strategy opportunistic credit strategies arise at the beginning of a distressed cycle, while the non-correlated and asset-backed strategies are typically all-weather strategies[13]. It is important to note that opportunistic credit strategies can be either higher risk in nature, or lower risk in nature. The higher risk opportunistic funds will target either more riskier kinds of credit strategies or will invest in dislocated credit (bonds that are believed to be incorrectly priced) with a thesis that dislocated securities will appreciate in price and return to their true economic value. The lower volatility opportunistic strategies may invest in non-correlated strategies or pools of investments that can be back-levered using non-recourse debt to generate a stream of more stable, lower yielding returns[14].

The chief risk for narrower-mandate managers is that their target niche may attract increased attention, encounter a decreased opportunity set, or both. Broader-mandate managers, on the other hand, are at risk of miscalculating the true value of a new and unfamiliar opportunity.

Specialty Finance

Specialty finance managers pursue a very broad array of niche strategies. These managers tend to target one small industry, requiring highly specialized expertise. Traditionally, specialty finance lenders had lent to non-bank financial lenders that targeted either the consumer or small and medium-sized enterprise (SME) borrowers. The specialty lending fund would set the underwriting standards for the loans that the non-banking financing company would originate. Given the high cost of borrowing for the consumer or SME (~20%), the specialty finance funds could charge coupons in the mid-teens. More recently, pharmaceutical and music royalties, rediscount lenders, and funds specializing in life

10 *Total Value Paid-in (TVPI) is a ratio of the current value of the remaining investment value in a fund plus the total distributions that have already been paid to the investor, divided by total capital that has been invested into the fund.*

11 *According to a Cambridge Associates report for 2013 vintage mezzanine and senior debt*

12 *A "non-performing loan (NPL)" is a loan which the borrower has defaulted on its obligations and has not made payments for an extended period of time.*

13 *"All-weather" strategies aim to generate positive returns in all environments, with less sensitivity to economic or market cycles.*

14 *"Back leverage" is a transaction in which the lender finances their equity investment into a target company using loans from a third party.*

settlements, catastrophe bonds, and trade finance have come to market[15]. Similar to the original specialty finance lenders, these newer entrants are lending against an over-collateralized pool of financial assets[16]. The highly specialized nature of these strategies makes them among the most difficult to perform due diligence on because each strategy requires unique lines of inquiry or an ability to assess the validity of a "black box" pricing model[17]. As such, many lenders will generate exposure to the strategies by investing in multi-strategy funds which include individual unique asset classes, each making up 5-25% of a fund.

Distressed Credit

Distressed corporate credit managers typically target middle- to large-capitalization companies and purchase deeply discounted debt securities. What actions they take with these securities helps differentiate each manager. Most managers endeavor to generate returns through negotiation, using whatever leverage is afforded to them as creditors under the governing document and the prevailing bankruptcy code. A minority of managers tend to be "pull-to-par" or "distressed-for-trading" investors, basing returns on their view of a company's fundamental valuation. Pull-to-par distressed investments are based on the premise that the instruments are "cheap" to intrinsic value—these investors are not relying on external forces to generate returns. The thesis for pull-to-par investments is that the debt will generate an attractive coupon and will experience price appreciation as secondary markets return to normal. "Negotiator" or "distressed-for-influence" investors tend to create their own catalysts through restructurings or tailored financings to extract value.

Distressed-for-influence credit managers generate returns from the accurate assessment of borrower enterprise value, an ability to form creditor groups and craft constructive outcomes, and a thorough understanding of the rights and protections afforded by a borrower's credit documents. Returns are frequently generated through a combination of contractual yield component (interest accruing debt purchased at a discount), underwriting fees (for refinancing, debtor-in-possession or exit purposes), and capital gains (repayment of debt principal at a haircut, at par or at a premium or back-ended equity instruments)[18]. Targeted gross IRRs typically exceed the mid-teens.

The primary risks attending these strategies lie in the complexity of the restructuring process as well as the financial performance of the borrower. Investments can pay off handsomely if negotiations go as planned. Alternatively, they can quickly underperform if other creditors, company management, ownership, or even a local bankruptcy court judge becomes.

15 "Rediscount lending" is the act of reducing the offered value of debt for a second time, without changing par value, to increase the attractiveness of the debt and hopefully lead to heightened investor demand. Rediscount lending typically occurs when a debt issuer initially offers bonds at a discount, but investor interest is low, so the bank discounts the debt for a second time to increase demand.

16 An "overcollateralized" loan is one which the pledged collateral is worth more than the value of the loan.

17 A "black box" model is one which the creator does not disclose the inner workings of the model, due to its proprietary nature.

18 "Debtor-in-possession" is an entity that has filed for Chapter 11 bankruptcy protection while still owning the property to which creditors hold a legal claim against.

uncooperative. Additionally, the borrower's financial performance which led to the restructuring can continue to deteriorate in the case of a prolonged process, leaving distressed investors with a less valuable enterprise. Liquidity can vary, and some managers pursue similar distressed strategies through liquid hedge funds as well as lock-up vehicles.

Investment process

All private credit managers first identify the party requiring financing. Each strategy has a unique set of asset owners that require a differentiated set of credit solutions. Sponsor-backed direct lenders, for instance, may call on 300 or more private equity firms, while a litigation claims fund might source from corporate entities, brokers, individual policy holders or aggregators. The more esoteric the underlying asset is, the more differentiated the sourcing network becomes.

Private credit managers then enter a due diligence phase during which they evaluate the risks involved in the financing. This phase includes the structuring of the security. Private credit managers must consider interest rates (cash or paid-in-kind), instrument tenor, seniority, collateral, advance rates, amortization, and covenants, among other items. Strategies based on secondary market purchases of existing debt instruments (distressed debt, NPLs, life settlements) cannot re-negotiate the debt; the initial price incorporates the strength of the creditor's rights.

Once the loan is funded or the asset purchased, the process begins to diverge even more dramatically. Direct lending and mezzanine managers take a "monitor and manage" approach to portfolio management, whereby monthly or quarterly financial reports are reviewed by the managers for both covenant compliance, liquidity, and financial performance. During episodes of financial uncertainty, direct lenders work closely with their borrowers and their sponsors to triage the situation. They identify the appropriate liquidity levers and apply the right balance of investment protection (higher coupon, amendment fees, equity investment from the sponsor) and borrower preservation (interest or amortization waiver, covenant holiday, principal reduction). Distressed credit managers specializing in negotiated solutions embark on a series of long discussions with other lenders and company management to arrive at a profitable outcome. Non-performing loan (NPL) managers as well as lenders in asset intensive segments like specialty finance, royalties or leasing employ either their own or third-party servicers that manage the assets.

The final step in the private credit process is realization. The three primary forms of repayment are refinancing, self-liquidation and secondary market sale. Refinancing is the most frequent source of repayment for private credit instruments. Direct lending originates 5- to- 7-year loans, but the average loan refinances within 3 years. Self-liquidation applies mostly to asset intensive credit where the physical asset or intellectual property has a finite life. Under these circumstances, the borrower will face an amortization schedule to repay the debt and the owner will retain the equity value once the debt is paid down. For multi-strategy opportunistic credit and distressed debt, the primary form of repayment is the secondary market sale of the investments.

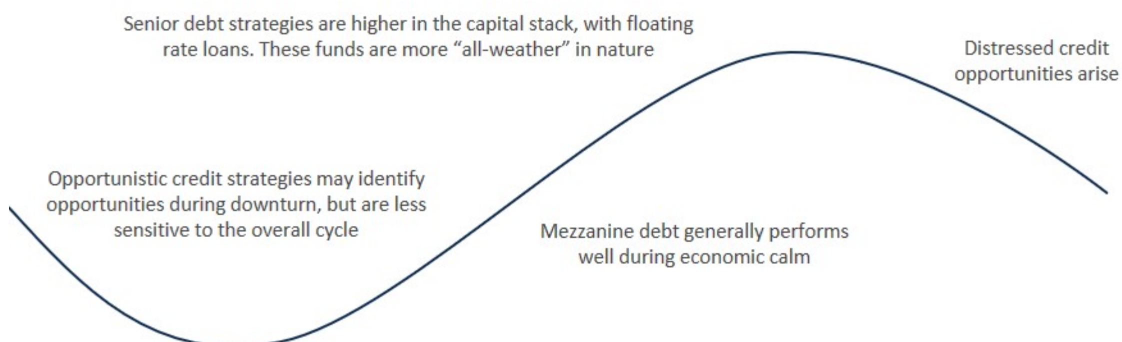
Private credit and the economic cycle

No analysis of private credit strategies would be complete without a reference to the economic cycle. The strategy most sensitive to the economic cycle is distressed credit because opportunities arise due to financial distress, either localized or widespread. Similarly, credit opportunities strategies that frequently allocate to distressed assets are also well-served during a credit crunch. Their broader mandate, however, makes them less sensitive to the cycle than their cousins in the distressed space.

When distressed managers are most excited, mezzanine managers will probably be very worried. Rising defaults, higher leverage, and the economic malaise that set distressed managers' pulses racing usually spell bad news for holders of junior obligations issued at par. Similarly, equity-style gains targeted by capital appreciation managers can come under pressure during a cyclical downturn. However, those with sufficient dry powder at the beginning of a cycle can likely invest profitably by providing liquidity to struggling companies or even growth capital in the very early stages of a recovery when lenders are still rationing capital.

Senior debt funds are not immune to a downturn in the economic cycle. They do have, however, seniority, security, and enforcement mechanisms (like financial covenants) which allow creditors to protect their downside. Beyond that, senior lenders have the benevolent hand of the U.S. bankruptcy code behind them to support their recovery efforts. Moreover, their loans are usually floating rate, insulating them in a rising rate environment. The ability of senior debt funds to protect the downside makes them the closest to an all-weather strategy in corporate credit. Credit opportunities funds come in at a close second—not because of their ability to mitigate losses, but because of their ability to capitalize on distress.

PRIVATE CREDIT & THE ECONOMIC CYCLE



Risks

Investors should consider the business risks of different private credit strategies, many of which we discussed earlier. Of the many risks to consider, we highlight three: liquidity, leverage, and volatility.

Liquidity

"You break it, you buy it" is a mantra that lends itself well to private credit, because once an investment is made there is not often a secondary market in which to sell the investment. Private credit differs from broadly syndicated loans or corporate bonds, which typically have more than 50 investors, a lead underwriter, and three to four co-agents along with their trading desks involved. Middle market direct lenders are either the sole participant or among a group of fewer than five lenders in the deal. There is no quoted bid or offer for the debt. Any effort to generate a secondary market sale would require a broker to collect confidentiality agreements from third parties, conduct due diligence, execute a successful negotiation, and then close the trade. Exiting these loans is much more involved than for loans in liquid markets.

Two strategies where there is generally greater liquidity to underlying assets are distressed debt and multi-strategy opportunistic credit. Within these strategies, there is a significant weighting to assets that are regularly marked-to-market and generally have an observable price. Within distressed debt, however, holders may be restricted from selling their holdings. During periods of restriction due to possessing material non-public information, potential sellers are effectively prohibited from selling their holdings to anyone other than their peers on the committee who face the same level of restriction.

Within broadly syndicated and high yield markets, it is important to note that "quoted" and "traded" are two different realities. As commercial and investment banks scaled back their trading efforts after the 2008-2009 global financial crisis, liquid instruments became less liquid. In periods of market volatility, traders are unwilling to bid for even the most liquid of loans. This phenomenon was most recently seen when BB-rated bank debt traded into the high 70's in the COVID-19 meltdown on little volume. The takeaway for investors is not that private credit is more liquid than labelled, it is that broadly syndicated loans are less liquid than advertised during market volatility.

An ongoing debate across the investor community is whether the excess returns of private credit above public credit are due to an "illiquidity premium", or instead perhaps generated by other variables. We believe that rather than illiquidity alone, these excess returns in many cases are a function of smaller issuer size, lack of issuer credit rating, a "valuation" premium (relying on the sponsor's valuation committee and a third party valuation service to provide mark-to-model valuations), and/or leverage. Fewer lenders competing for deals gives rise to higher premiums. Illiquidity may also play a part at times, but we do not believe it is the primary driver in most cases.

Leverage

Leverage is another operating risk that investors must analyze. Although subscription lines to bridge capital calls have been around for years, some managers now use them to enhance fund returns[19]. More permanent fund-level leverage is used primarily by senior debt funds originating senior secured loans, as few leverage providers have the willingness to finance subordinated, uncollateralized loans (and certainly not at a reasonable borrowing rate to the fund manager).

Leverage is a very effective tool to turn a loan with a 6% current pay coupon into a 10% yielding asset. As a result, virtually every senior debt fund currently in the market offers a levered option, with many eschewing unlevered portfolios altogether. The challenge with assessing the risk of leverage lies in its permanence. The four types of fund-level leverage include: syndicated facilities, bilateral facilities, swaps/repos, and CLOs[20]. Syndicated facilities and CLOs provide the greatest maturity match but force more stringent terms (less flexibility) on the manager. Swaps and bilateral agreements are cheaper and more flexible but shift greater enforcement mechanisms to the lender. Investors in leveraged funds are accepting the risk that the provider of leverage (loans) to the fund could put pressure on the fund to repay fund-level loans. This pressure could result in adverse behavior by the fund, such as the forced selling of loans to cover the financing arrangements. Also, leverage cuts both ways. While leverage will magnify gains in instances of repayment, leverage exacerbates losses in times of increased defaults.

Volatility

As evidenced in the first half of 2020, private markets tend to appear to exhibit lower volatility than the public markets. While the average broadly syndicated loan fund was down 14% at the end of Q1 2020, direct lending funds were down 6-7%. At the end of the second quarter, private credit funds were down 3-4% YTD, while broadly syndicated loans were down 6-7%. The difference between these pricing mechanisms is that broadly syndicated loans were largely marked down based on market observations, while direct lending investments were marked down based on conversations among valuation agents and valuation committees. Given the lack of transparency in the valuation process in private credit, we do not believe it is appropriate to include "less volatile" as a tangible benefit of private credit relative to the public markets. While lower volatility of private credit was reported across strategies, this was not tested by actual transactions. In short, while private credit may give the appearance

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19 *A capital call facility (or "subscription" facility) is a line of credit that allows a private fund to access cash immediately while that private fund is waiting for investor capital to come in after a capital call has been made.*

20 *A "collateralized loan obligation" (CLO) is a pool of loans that is offered to investors. Investors may invest in different "tranches" with different risk levels that are determined by that investor's priority in receiving loan payment.*

of lower volatility than similar publicly traded credit, this is due to data problems and the true volatility will typically be higher[21].

Active manager selection is key

Active manager selection in private markets is typically essential to success, and private credit is no exception. First, there is not a market "beta" for private credit. In other words, investors do not have a way to passively invest in the asset class. Second, performance outcomes in most areas of private credit are much wider than in the public markets, which creates opportunities for investors to more significantly outperform (or underperform) their peers. Third, navigating this complex asset class can be difficult: best-in-class managers can often only be accessed by investors with deep relationships in the private marketplace; the operational burden during and after the due diligence process can be much greater than in public markets; and active management fee structures can vary considerably, leading to more or less alignment of interests between the manager and the investor.

We recommend that investors work with an experienced advisor to properly identify and construct a portfolio of skilled private credit managers.

Conclusion

Private credit is a big tent that offers investors various options for preserving capital, generating yield, and benefiting from capital appreciation. Private credit strategies can range considerably in size, scale, and the role that they might fulfill. When building private credit portfolios, investors must balance their risk tolerance with their return objectives. Arriving at an optimal allocation requires consideration of the context of the entire portfolio's allocation to broader alternative and traditional long-only assets.

Navigating this complex asset class can be difficult, as performance of managers with very similar strategies can vary widely. Best-in-class managers can often only be accessed by investors with deep relationships in the private marketplace. Investors may be well-served by working with a skilled advisor to properly navigate and understand the different corners of the private credit market and how each of these areas might play a role in achieving the investor's portfolio objectives. For questions or further information regarding the role which private credit might play in your portfolio, please reach out to your Verus consultant.

21 *Private investments often give the appearance of lower volatility (lower risk) than similar publicly traded assets, but this is for the most part due to well-acknowledged issues with appraisal-based pricing and data lag effects. There is no reason to believe that taking a publicly traded asset off the market should reduce the investment risks of that asset. Certain investors might argue that the inability to see the true market price of their investments is a type of psychological benefit because the investor does not personally witness the volatility. However, not being able to see the true price of an investment does not mean that the volatility goes away.*

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