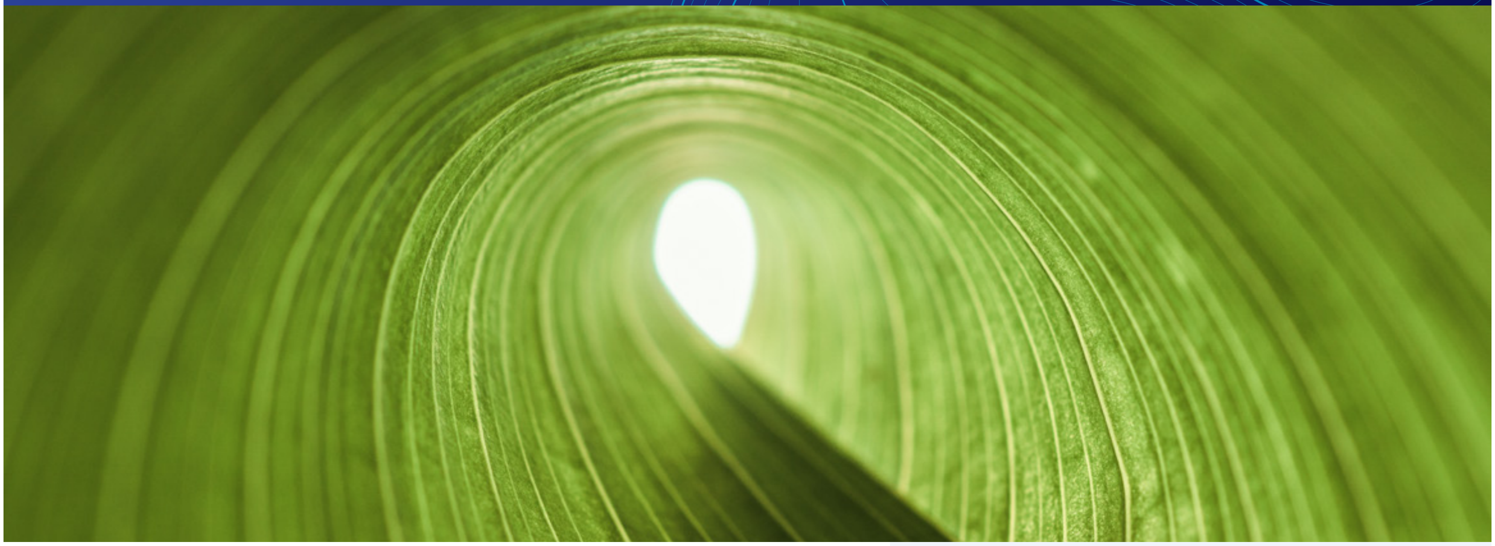


# Giving (Alt) Credit Where (Alt) Credit Is Due

**Alternative credit assets have grown in popularity over the past decade-plus as meager yields prompted investors to expand their search for current income beyond traditional investment grade bond markets.**

Among the beneficiaries of this trend were floating-rate assets like broadly syndicated loans and middle market direct lending, both of which typically offer higher yields than public securities in exchange for reduced liquidity and lack of investment grade ratings.

The inflation pressures that emerged in the aftermath of the Covid-19 recession introduced a novel complication to bond markets, however. The Federal Reserve's aggressive policy response in 2022 left investors with few places to hide, and the contemporaneous bear markets for stocks and bonds that emerged during the year highlighted the challenges of asset allocation in increasingly correlated public markets. Meanwhile, continued uncertainty around the central bank's ongoing efforts to tame inflation has resulted in significant volatility across markets.

While the massive backup in rates during 2022 has some questioning whether alternative credit assets still hold the same appeal, our view is that thoughtfully constructed alternative credit strategies are worthy of a strategic allocation independent of market conditions. Given the current environment of considerable volatility and inadequate spread compensation from traditional bonds, we believe the historically attractive risk-adjusted returns of floating-rate assets like broadly syndicated loans and middle market direct lending may represent a particularly compelling alternative, if appropriate.

### KEY TAKEAWAYS

- Floating-rate assets like syndicated loans and direct lending served as a relative port in the storm as sharply rising interest rates in 2022 resulted in a historically bad year for investment grade fixed income markets.
- Due to their combination of higher yields and senior position in borrowers' capital structures, alternative credit assets have a history of delivering higher income and lower losses than other fixed income sectors.[1]
- Alternative credit historically has had a low to negative correlation to public fixed income markets, giving the assets attractive diversification potential.
- We believe interval fund structures are well-suited to strategies that invest in less-liquid alternative credit assets and can help reduce the volatility that may accompany daily inflows and outflows of investor assets.

1. Source: Bloomberg, JPMorgan; data as of March 31, 2023.

## Floating Coupons Have Helped Alternative Credit Weather the Spike in Rates

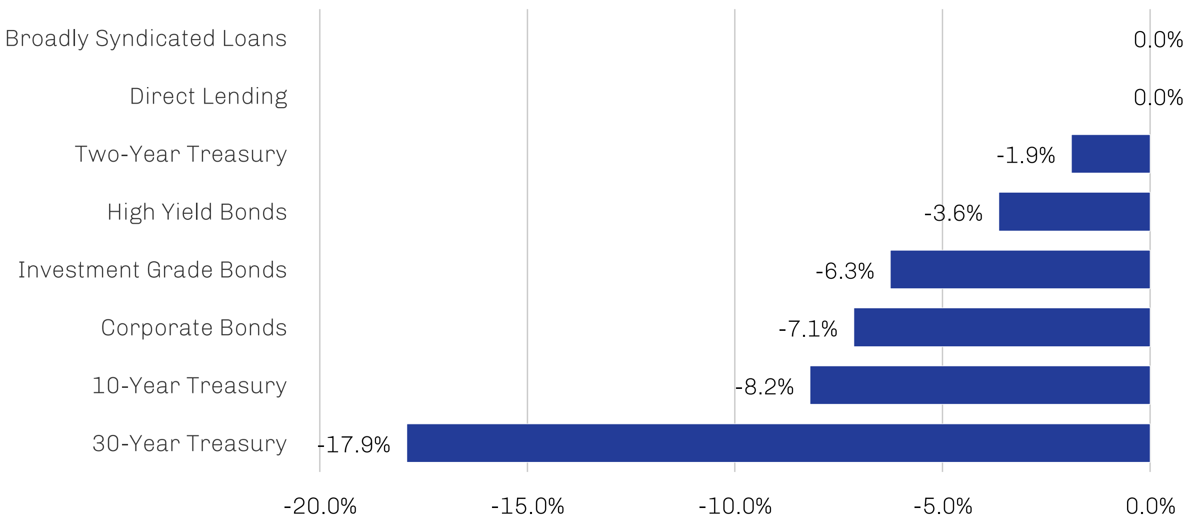
Coming out of the economic dislocations of Covid-19, high inflation prints thought to be transitory by many—including the Fed—have proved quite persistent. Inflation packs a one-two punch against traditional fixed-rate bonds, eroding the purchasing power of coupon payments and often presaging higher interest rates, both of which weigh on market prices. Thus, the battering of investment grade fixed income markets in 2022 came as little surprise. From March through December, the Fed hiked its target fed funds rate by 425 basis points, and yields across the Treasury curve followed suit, causing the Bloomberg US Aggregate Bond Index to crater a record 13% for the year; its previous worst annual decline was less than 3%.[2]

With coupons that reset on a periodic basis to maintain a fixed spread over a reference rate, alternative credit assets like syndicated loans and private debt have very limited duration—and thus, as depicted in Exhibit 1, limited sensitivity to the interest rate increases that punished an array of fixed-rate assets in 2022. The Credit Suisse Leveraged Loan Index fell only 1.1% last year, while the Cliffwater Direct Lending Index, which tracks the quarterly performance of middle-market loans, gained 6.3%.[3]

> Given very limited duration, alternative credit outperformed in the rising-rate environment of 2022.

**Exhibit 1. Extended Durations Leave Some Assets More Susceptible to Rising Rates than Others**

Potential Price Impact of a 1% Increase in Interest Rates




Note: Broadly Syndicated Loans = Credit Suisse Leveraged Loan Index; Direct Lending = Cliffwater Direct Lending Index; High Yield Bonds = Bloomberg US Corporate High Yield Bond Index; Investment Grade Bonds = Bloomberg US Aggregate Bond Index; Corporate Bonds = Bloomberg US Corporate Bond Index.

Source: Bloomberg; data as of March 31, 2023.

How the story plays out from here remains highly uncertain. Policy actions tend to transmit through the real economy with a lag, and the oscillation in market sentiment we have seen thus far in 2023 seems to suggest participants are struggling to develop a consensus view on the trajectory of inflation, interest rates and economic growth. Meanwhile, recent tumult in the banking system introduced another complication. The high-profile failures of two midsized US banks in mid-March was followed by a spike in the credit-default swaps of several European megabanks, leaving many observers questioning the Fed's ability to maintain its hawkish bias amid a seemingly shaky global financial system. Of course, the struggles of traditional lending institutions may result in tighter liquidity conditions and continue to send borrowers in search of alternative sources of capital, such as loans through nonbank institutions.

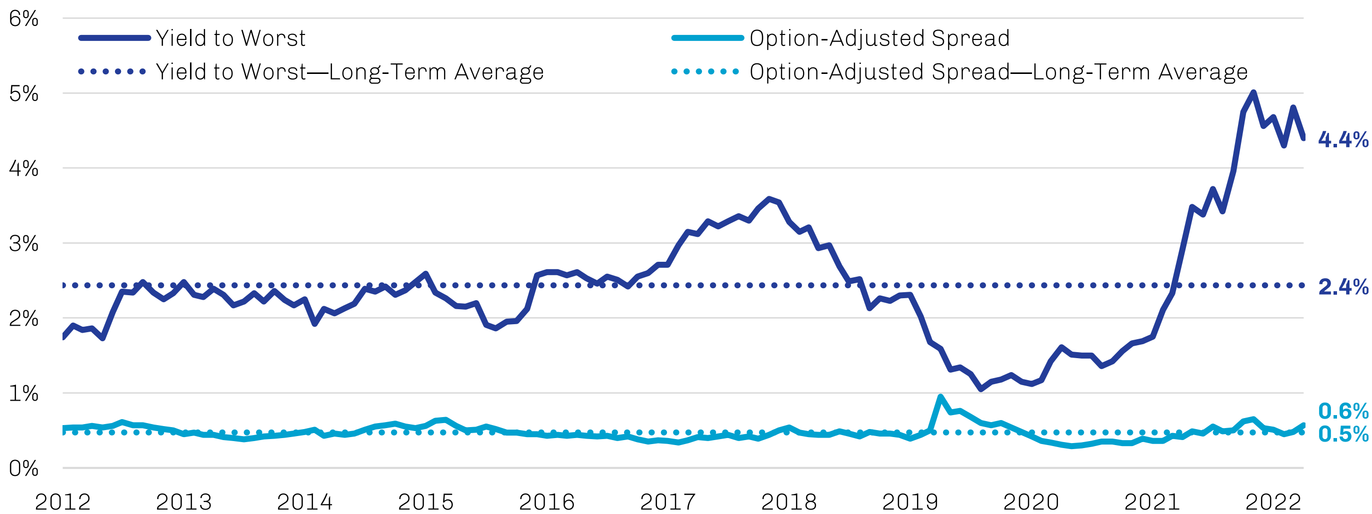
2. Source: FactSet; data as of December 31, 2022.
3. Source: Credit Suisse, Cliffwater; data as of December 31, 2022.

## While Higher Coupons Belie Pronounced Risk in Core Fixed Income...

Yields across the fixed income complex have risen as the Fed continues to battle inflation through tighter monetary policy, but don't be fooled by the five-handle on the Bloomberg US Corporate Bond Index. While traditional fixed income securities currently appear to offer investors reasonable coupons, the improvement largely can be traced to rising base rates rather than increased spread compensation. As shown in Exhibit 2, option-adjusted spreads on investment grade corporate credit are consistent with their five-year average, suggesting that the compensation for credit risk has remained relatively stingy even as the economic backdrop—and thus future credit fundamentals—deteriorated.

**Exhibit 2. Investment Grade Yields Have Risen, but Spreads Remain Tight**

Bloomberg US Aggregate Bond Index, January 2012 through March 2023




Source: Federal Reserve Bank of St. Louis; data as of March 31, 2023.

Meanwhile, the risk profile of today's investment grade bond market differs markedly from its historical reputation. The high volume of long-dated low-rate paper issued over the past decade-plus, particularly in the aftermath of the Covid-19 outbreak, pushed interest rate risk markedly higher. At 6.3 years, the US Aggregate's duration remains well above its long-term average of 5.0 years even after easing somewhat in 2022, suggesting potential for additional downside should base rates continue to rise. In addition, credit risk in the index has marched steadily higher as its composition became more skewed toward bonds rated BBB, which now account for about half of the US corporate investment grade market compared to around 30% a decade ago.[4] As inflation and the higher cost of capital continue to weigh on corporate fundamentals, it seems likely that credit profiles should weaken further before they get better, especially if the economy slips into recession.

> The risk profile of today's investment grade bond market differs markedly from its historical reputation.

4. Source: Bloomberg; data as of March 31, 2023.

## ...We See Durable Advantages in Alternative Credit

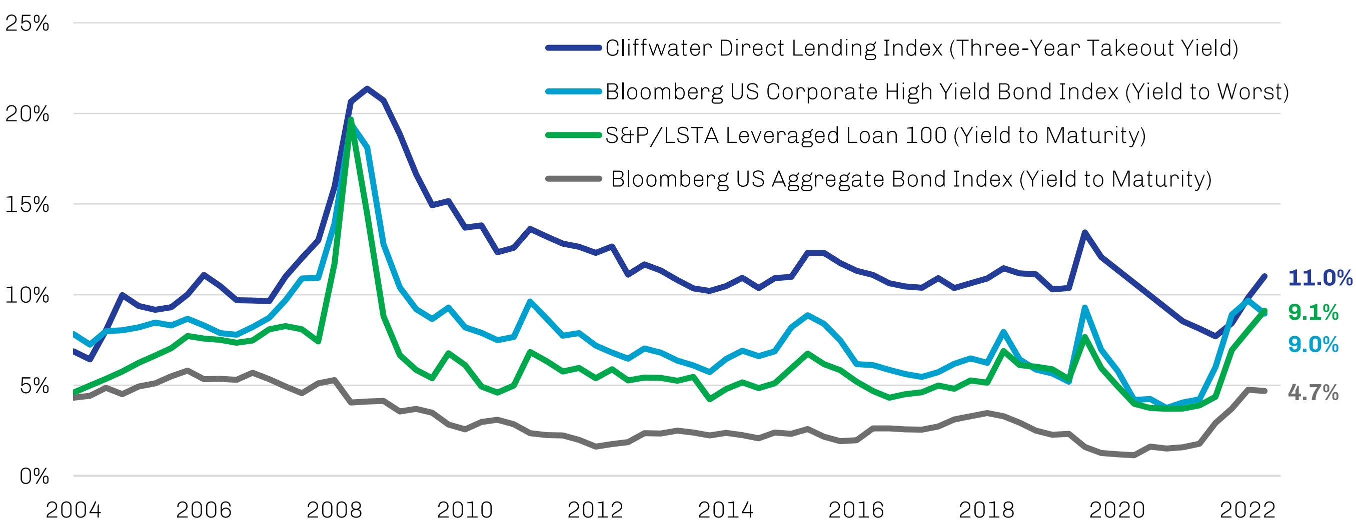
Non-investment grade and less liquid in nature, alternative credit assets like bank syndicated loans and direct lending may represent an attractive solution to the challenges facing traditional fixed income investments, offering a range of potential benefits to diversified portfolios.

**Compelling risk-adjusted returns over time.** Due to their combination of higher yields and senior position in borrowers' capital structures, alternative credit assets have a history of delivering attractive risk-adjusted returns over time relative to core fixed income asset classes.

> Alternative credit assets have a history of delivering attractive risk-adjusted returns over time relative to core fixed income asset classes.

As shown in Exhibit 3, syndicated loans and direct lending historically have offered a consistent and healthy premium to core fixed income assets as compensation for their more limited liquidity and lack of investment grade ratings. And while credit spreads remain tight in the investment grade space, spreads in the alt credit space are well off cyclical lows.

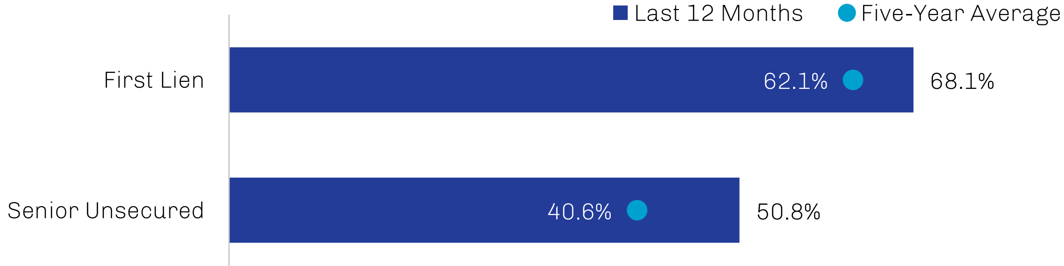
**Exhibit 3. Alternative Credit Assets Have Paid Attractive Yield Premiums Across Interest Rate Regimes**
January 2004 through December 2022




Source: Bloomberg, Cliffwater; data as of December 31, 2022.

Further, the majority of syndicated loans and direct lending assets are secured by the borrower's assets and senior in its capital structure. As illustrated in Exhibit 4, this advantaged position historically has resulted in lower default rates and higher recovery rates compared to bonds, which are unsecured and subordinated. The downside risk mitigation potential inherent in these structures may prove all the more important in light of the economic uncertainty facing investors today.

**Exhibit 4. Position at Top of Capital Stack Historically Has Provided Better Outcomes in Default**
Non-Investment Grade Corporate Debt Recovery Rates




Source: Moody's; data as of March 31, 2023.

**Diversification does not guarantee investment returns and does not eliminate the risk of loss.**

**Rate-agnostic credit exposure.** As suggested by the considerable volatility prevalent since early 2022, markets have been struggling to ascertain the direction and magnitude of interest rate movements. With their floating rates and thus minimal duration, alternative credit assets like syndicated loans and direct lending can relieve investors of this usually fruitless task. With interest rate risk not a primary concern, investment success instead depends primarily on fundamental credit analysis.

> The diversified exposures available in the alternative credit market may help smooth the market value of multi-asset portfolios over time.

**Diversification potential.** A thoughtfully constructed portfolio of alternative credit assets may serve as a diversifying complement to holdings in traditional fixed income markets. Alternative credit—which by definition entails exposure to less accessible segments of US credit markets and to companies underrepresented in public bond and equity markets—historically has had a low to negative correlation to core fixed income investments, and the performance of syndicated loans and direct lending also have exhibited only moderate correlation to equities. The diversified exposures available in the alternative credit market—particularly in the large and varied middle market segment of borrowers—may help smooth the market value of multi-asset portfolios over time.

## Interval Fund Structure Opens Door to Retail Market

**While syndicated loans have been widely available in the retail space through mutual funds and exchange-traded funds, access to private credit strategies historically has been limited to institutional investors through high-minimum private funds or separately managed accounts.**

More recently, however, investment managers have turned to the interval fund structure to offer retail investors differentiated investment solutions that leverage the spectrum of unique risk/return profiles across the alternative credit markets.

Like an open-end mutual fund, an interval fund is a pooled investment vehicle that is available for purchase continuously at net asset value. Unlike the daily liquidity of mutual funds, however, interval fund redemption windows are open only periodically at predetermined intervals (monthly, quarterly, semiannually or annually), a structure generally well-suited for strategies that invest in less-liquid assets like private debt. For strategies that include exposure to assets like syndicated loans with secondary market liquidity, it typically dampens the performance volatility that can result from the daily inflows and outflows of client assets.

## An Alternative Approach to Income Across Market Cycles

While the hawkish shift in Fed policy during 2022 drove base rates markedly higher, the risks inherent in core fixed income markets remain pronounced. The interest-rate sensitivity and slim coupons of core bond assets, in our view, continue to represent an unfavorably asymmetric risk-return profile for those seeking current income in an environment characterized by persistently high inflation, rising interest rates, tightening financial conditions and an uncertain macroeconomic trajectory. There are alternatives, however.

Alternative credit assets like syndicated loans and direct lending typically offer higher yields than investment grade debt alongside 1) floating-rate coupons that help mitigate the impact of rising interest rates, and 2) seniority in the capital stack that historically has contributed to better outcomes in the event of default. While alternative credit appears particularly well-suited to the current environment, both retail and institutional investors may benefit from a strategic allocation to the assets given the unique risk-return profiles that can be found in less-liquid corners of the credit markets.

A weakening macroeconomic backdrop is always unsettling for lenders, but the lenders who should be most nervous, in our view, are those that have never experienced difficult market conditions before and/or those that were positioned too aggressively into the downturn.

First Eagle Alternative Credit has decades of experience providing capital across the US alternative credit space, and our credit selection and risk management processes have been honed across multiple macroeconomic regimes. Moreover, as market conditions grow more complicated and pricing more idiosyncratic across what is a massive investment opportunity set, we believe the strong underwriting and due diligence capabilities of our platform—fueled by both qualitative assessments and quantitative analysis, from the top down and the bottom up—will be essential to determining whether the yield on an individual loan or bond represents adequate compensation for its risks. Further, as one of the largest alternative lenders in the US, First Eagle Alternative Credit has broad access to public markets and proprietary private market deal flow as well as the lending capacity to commit more capital to borrowers, advantages of scale that facilitate the efficient deployment of investor capital into resource-intensive investments like syndicated loans and direct lending.

> First Eagle Alternative Credit has decades of experience providing capital across the US alternative credit space.

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**Past performance is not indicative of future results.**

**Risk Disclosures**

All investments involve the risk of loss of principal.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

A credit rating as represented here is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of credit worthiness of an issuer with respect to debt obligations, including specific securities, money market instruments, or other bonds. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. Not Rated (NR) indicates that the debtor was not rated and should not be interpreted as indicating low quality. For more information on the Standard & Poor's rating methodology, please visit standardandpoors.com and select "Understanding Ratings" under Ratings Resources.

Alternative investments can be speculative and are not suitable for all investors. Investing in alternative investments is only intended for experienced and sophisticated investors who are willing and able to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks include:

- Loss of all or a substantial portion of the investment;
- Lack of liquidity in that there may be no secondary market or interest in the strategy and none is expected to develop;
- Volatility of returns;
- Interest rate risk;
- Restrictions on transferring interests in a private investment strategy;
- Potential lack of diversification and resulting higher risk due to concentration within one of more sectors, industries, countries or regions;
- Absence of information regarding valuations and pricing;
- Complex tax structures and delays in tax reporting;
- Less regulation and higher fees than mutual funds;
- Use of leverage, which magnifies the potential for gain or loss on amounts invested and is generally considered a speculative investment technique and increases the risks associated with investing in the strategy;
- Carried interest, which may cause the strategy to make more speculative, higher risk investments than would be the case in absence of such arrangements; and
- Below-investment-grade loans, which may default and adversely affect returns.

**Broadly syndicated loans** are loans extended by a group of financial institutions (a loan syndicate) to a single borrower. Syndicates often include both banks and non-bank financial institutions, such as collateralized loan obligation structures, insurance companies, pension funds or mutual funds.

**Duration** is a measure of a fixed income security's price sensitivity to changes in interest rates.

**Exchange-traded funds** are pooled investment vehicles that are listed on a stock exchange and can be bought and sold throughout the trading day.

**Federal funds rate** is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis.

**Option-adjusted spread** is a measure of a fixed income security's yield relative to that of a comparable risk-free rate (e.g., a US Treasury) adjusted for any options embedded in the security.

**Private funds** are pooled investment vehicles that are not required to be registered or regulated as investment companies under federal securities laws.

**Separately managed account** is a portfolio of securities managed on behalf of a client by a professional asset manager.

**Yield to worst** is the lowest possible yield that can be earned on a fixed income security absent default.

**Two-year Treasury note** is a fixed-rate US government debt security that matures two years after issuance.

**10-year Treasury note** is a fixed-rate US government debt security that matures 10 years after issuance.

**30-year Treasury bond** is a fixed-rate US government debt security that matures 30 years after issuance.

**Bloomberg US Aggregate Bond Index** is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, fixed-rate agency MBS, ABS and CMBS (agency and non-agency).

**Bloomberg US Corporate Bond Index** measures the performance of investment grade, fixed-rate, taxable corporate bond market. It includes US dollar-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

**Bloomberg US Corporate High Yield Bond Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

**Cliffwater Direct Lending Index** is an asset-weighted index of more than 8,000 directly originated middle-market loans.

**Credit Suisse Leveraged Loan Index** is a monthly rebalanced index designed to mirror the investable universe of the USD-denominated leveraged loan market.

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