Private Debt

as an

Asset Class

REDWOOD
INVESTMENT MANAGEMENT

An Introduction to Private Debt

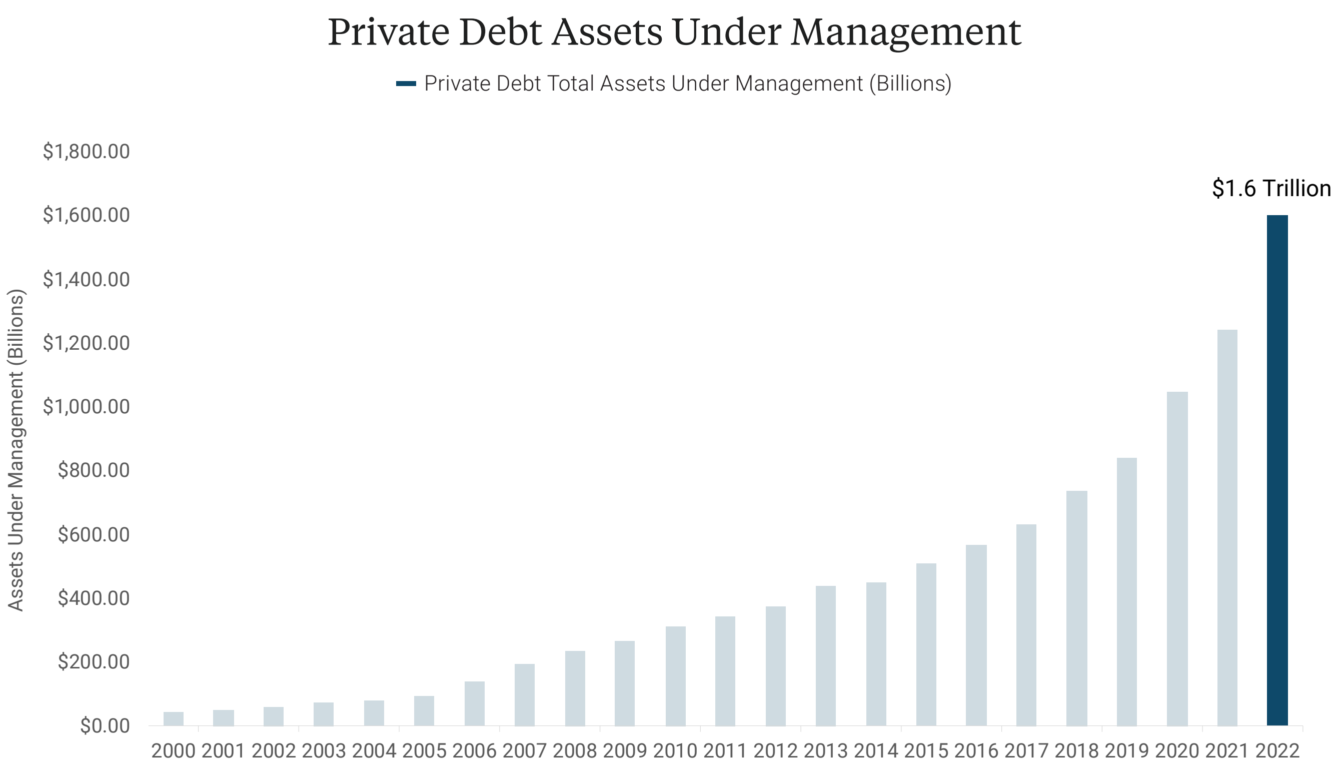
Private Debt, sometimes referred to as Private Credit, is lending provided by non-bank entities to companies and is considered private because these loans are not publicly traded nor generally available to the public. Private debt is related to the traditional bond market, like private equity is related to the traditional stock market.

What Is Private Debt?

Investment Instrument / Type	Investment Objective	Public Markets Asset Classes & Strategies	Private Markets Asset Classes & Strategies
Equity	Capital Growth	Public Equity	Venture Capital Growth Capital Mid-Market Private Equity Leverage Buyouts GP Stakes
Debt	Income	Fixed Income	Real Estate Debt Direct Corporate Lending Senior Loans Specialty Finance
Real Assets	Income	REITS Commodities Infrastructure	Private Real Estate Private Infrastructure

Although private debt has existed for a long time, it didn't become a significant sector until after the implementation of Basel III banking regulations, following the 2008-2009 financial crisis. These regulations called for more stringent balance sheet requirements for banks, causing them to shift away from lending to small and middle-market companies.

This created an opportunity for alternative lenders, such as private debt funds, to enter the market and provide loans to these companies using investor capital. Since the credit crisis and the subsequent regulatory changes to the banking sector, the private debt market has grown to over $1.6 trillion, fueled by increased capital being allocated to private debt funds.

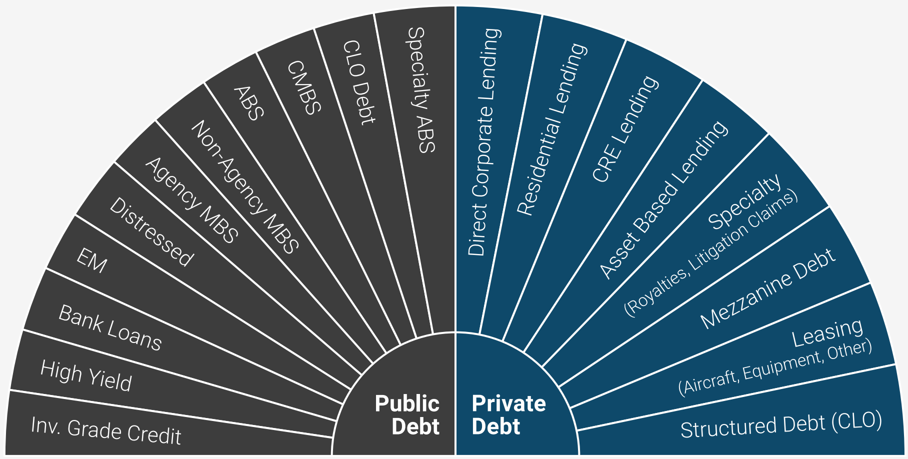


Source: Preqin, Redwood. Data as of 1/20/2023. Please see additional disclosures at the end for more information.

This dramatic growth in private debt AUM has been fueled by increased investor allocations seeking differentiated characteristics from their public debt allocations.

The Case for
Private Debt

The Range of Public and Private Debt Sectors

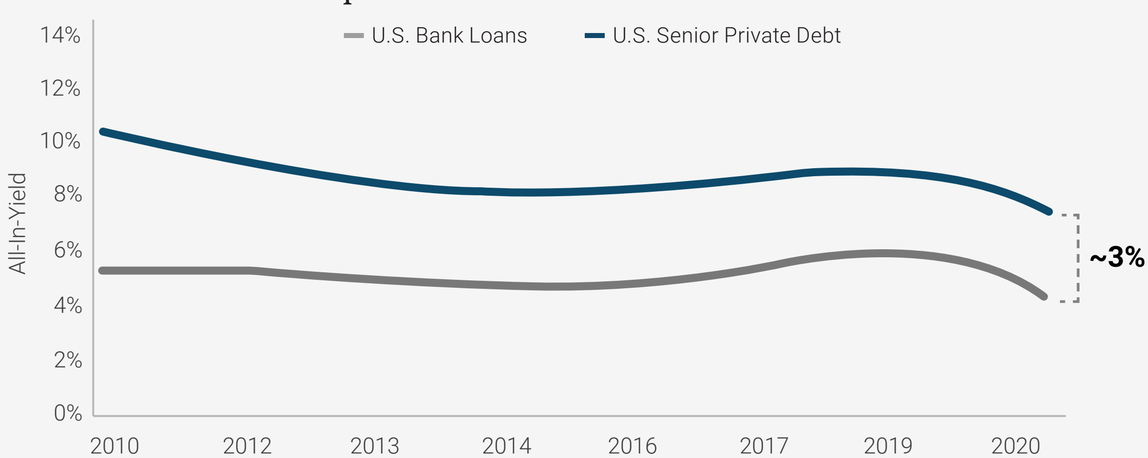


Source: PIMCO, 9/2020. "Across the Spectrum: Understanding Public and Private Debt". For Illustration purposes only.

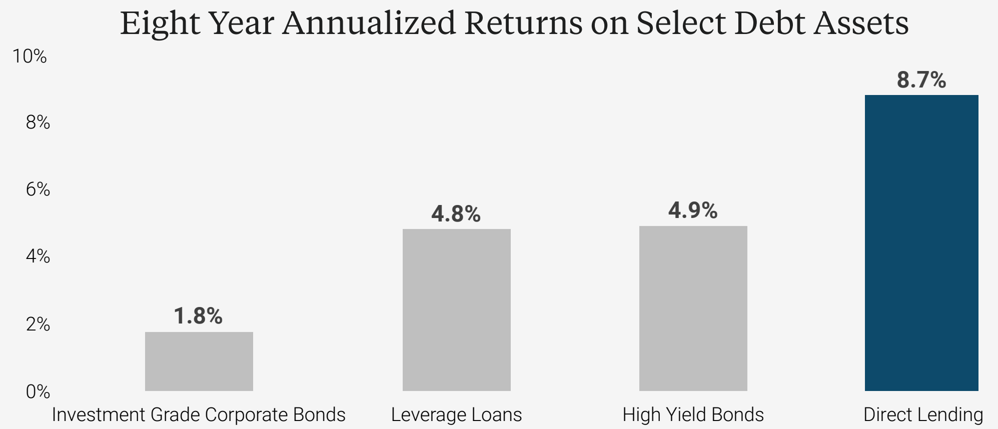
What Makes Private Debt Attractive Versus Public Debt?

Institutional investors have been growing their allocations to private debt due to its unique characteristics, which typically include higher yields, lower drawdowns, and attractive diversification benefits compared to traditional publicly traded fixed income.

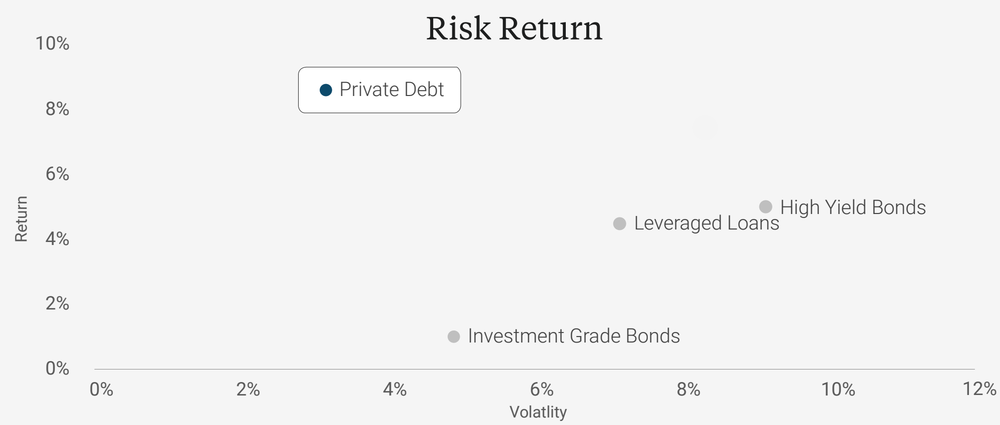
Yield Spread of Private vs. Public Senior Debt



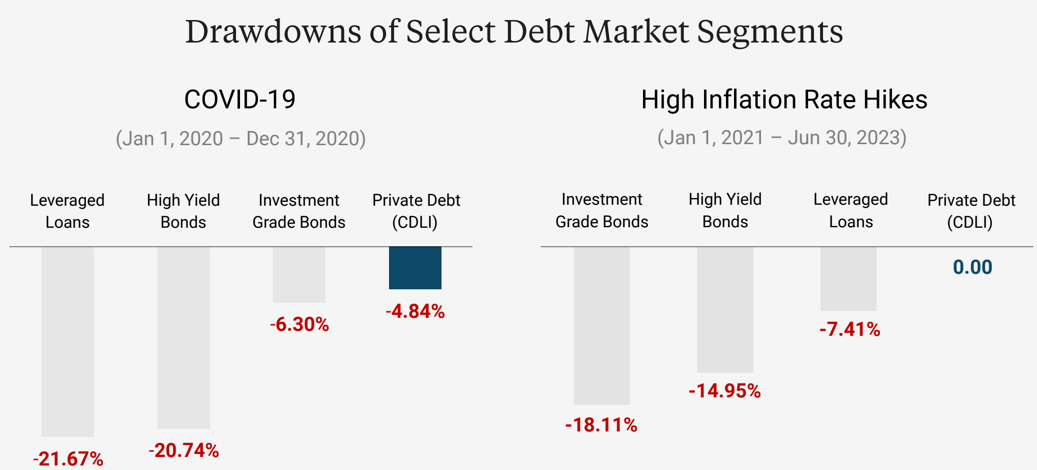
Source: Mercer, 6/2021. "Private Debt". For Illustration purposes only.



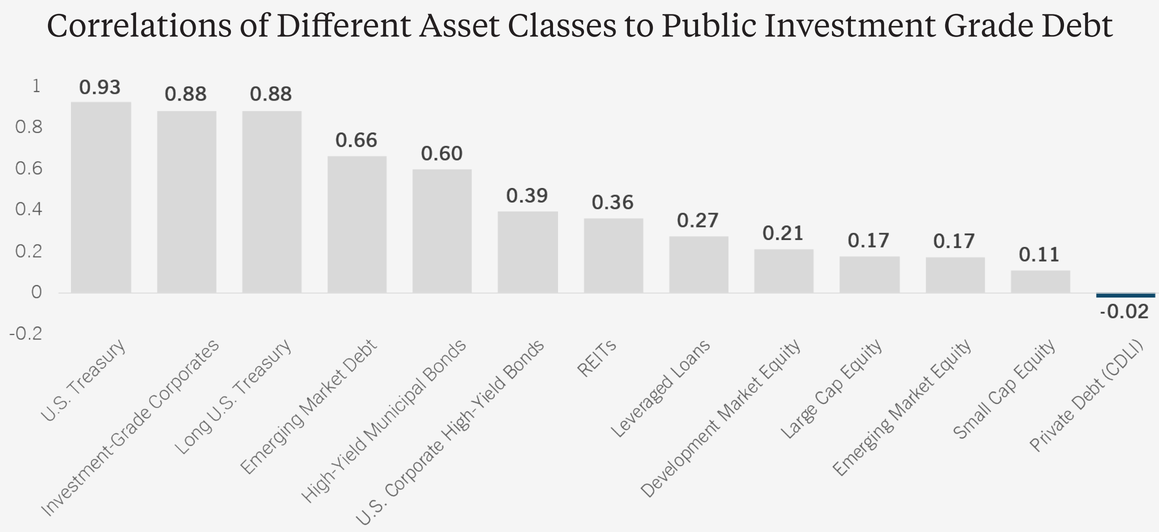
Source: Ares. Data as of 1/25/2024. Date Range 9/30/2015 - 9/30/2023. "Private Credit: Differentiated Performance in the Midst of Rising Interest Rates".



Source: Bloomberg, Redwood. Data as of 10/24/2023. Date Range from 10/2015 - 6/2023. Please see additional disclosures at the end for more information.



Source: Bloomberg, Redwood. Data as of 6/30/2023. See important information including indices information in the disclosures section at the end.



Source: Bloomberg, Redwood. Data as of 10/24/2023. Date range 10/1/2015 - 6/30/2023. Please see additional disclosures at the end for more information.

Why Does Private Debt Have These Attractive Attributes

There are structural reasons that private debt exhibits these attractive risk-return characteristics. First, because private debt is generally not traded, there is little to no secondary market for these loans, so they are categorized as Level III assets and do not have the daily price variance that publicly traded (Level I) securities have. Second, most of these private loans are senior loans secured by the borrower's collateral, which provides a margin of safety of the principal loan value in the event of a default. Third, assets in private debt funds generally have lock-up periods and/or have other limitations on the pools of capital that prevent forced sales that can negatively impact the value of loans and securities.

Level III Asset Valuation

All assets in co-mingled investment funds, whether private funds or public mutual funds are required to be fairly valued. Fair valuation of assets follows a process based on the "type" of assets being valued.

- Level I assets are those that have quoted prices in active markets, such as publicly traded stocks and bonds.
- Level II assets are those that have observable inputs other than quoted prices within Level I.
- Level III assets are those that have no observable inputs and, therefore, follow a different valuation methodology.

Level III asset valuation methodology utilizes "unobservable" inputs to measure fair value to the extent that relevant observable inputs are unavailable. These valuations are usually based on the following methodologies: discounted cash flow method, comparable company analysis, comparable transaction method, asset-based valuation method, the sum of parts valuation method, prior transaction method, net recovery approach, liquidation approach, and income approach using yield analysis. In the case of private debt, which is usually categorized as Level 3, the valuation processes often lead to fair value prices being the same as the original par value of the debt. This consistency of valuations is a major differentiator to publicly traded Level 1 debt.

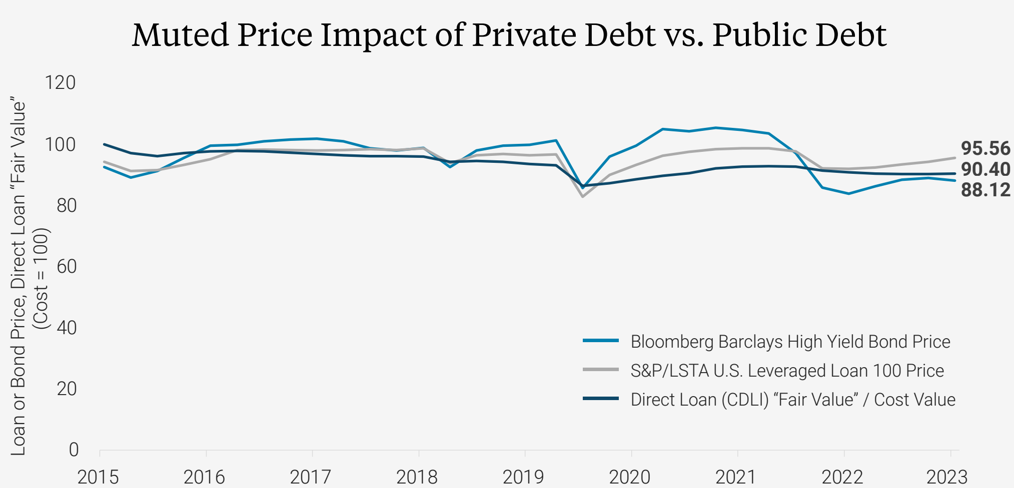
Secured By Collateral

As discussed above, the value of underlying assets (or collateral) backing the private debt plays a critical role in determining the fair value of such debt. Net recovery approach, liquidation approach, asset-based valuation method, and sum-of-parts valuation methods all rely on the value of the underlying collateral. When private debt is senior and secured by tangible assets such as real estate, and the value of the collateral does not decline to be less than the par value of the debt, then the value of the private debt remains consistently at par. This is because, in the event of a borrower default, the lender can recover the original par loan amount through the value of the underlying collateral. In contrast, unsecured loans have no tangible backing, relying solely on the faith that the borrower will be able to make interest and principal payments on time. It is important to understand that the key attribute is not the notion of being "secured by collateral" but the value of the underlying collateral relative to the par value of the outstanding debt.

Illiquidity Premia

Due to the lack of liquidity in the underlying private debt in the private debt funds, the funds generally have lock-up periods and limited liquidity provisions for their investors. A benefit stemming from the lock-up and periodic withdrawal provisions of private debt funds is managers/lenders are not forced sellers of fund holdings. Specifically, the lack of large redemption requests means that fund managers do not have to prematurely exit positions to fund withdrawals during short-term dislocations.

In contrast, open-end mutual funds or ETFs that hold publicly traded debt may be impacted by market fluctuations. In times of crisis, individual bonds in the funds may be trading well below par, and demand for cash from investors could cause managers of these funds to sell assets to fund withdrawals. As a result, bonds may be sold at a significant discount to par, even though most bonds do not default. This can cause managers to lock in losses on loans that would have otherwise matured at par. When the market eventually recovers, and investors pile back into the funds, managers must buy back the previously sold bonds at higher prices. Due to the reduced demand for withdrawals, loans in private debt funds are usually held to maturity or refinanced, rather than traded in the secondary markets. This helps preserve the value of the investment and protect the fund from market-driven losses. As a result, private debt fund managers are typically able to avoid being held hostage to market fluctuations.



Source: Cliffwater. Data as of 1/23/2024. Date range 9/30/2015 - 9/30/2023. "The Valuation of Private Middle Market Corporate Loans."

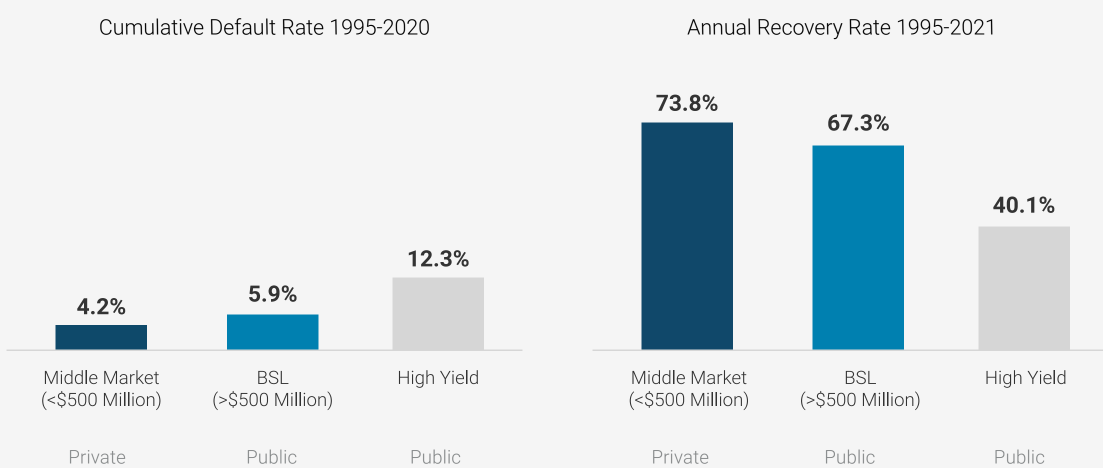
In exchange for giving up liquidity with their invested capital, investors must receive a benefit versus liquid investment options available. This compensation for the illiquid nature of an asset is known as the illiquidity premium. It is the extra yield and/or reduced risk characteristics investors expect to earn for giving up the ability to liquidate their capital for a set period of time. Investors who are willing to accept a lower level of immediate access to their capital historically have been well rewarded through the illiquidity premium.

Favorable Terms and Lower Default Rates

In addition to the illiquidity premium, private debt investments have other distinct features that help improve the overall risk and return of the asset class. The bespoke nature of private debt offers investors more control over the terms of the loans, including the interest rate, duration, repayment schedule, and Loan-to-Value ratio (LTV), which can help to mitigate risk and increase the chances of repayment.

These contractual limitations and covenants in the private debt markets create enhanced protection for the private debt investor and result in lower default rates and higher recovery rates compared to other investment options, such as the high-yield bond space. For example, the cumulative default rate from 1995 to 2020 for private middle-market loans was 4.2%, compared to 12.3% for high-yield bonds. Additionally, the average annualized recovery rate from 1995 to 2021 for private debt was 73.8%, compared to 40.1% in the high-yield market.

Default Rates and Recovery Rates: Private vs. Public



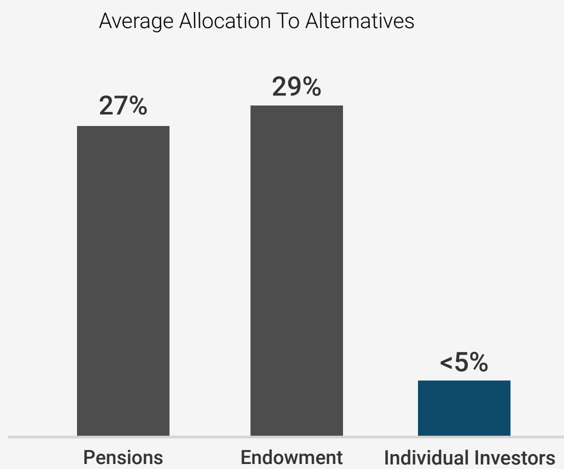
Source: Mercer, 6/2021. "Private Debt." Please see additional disclosures at the end of this commentary for more information.

Historically Reserved for Only the Top

Because private debt offers many unique characteristics in comparison to other investments, institutional investors, who are aware of this, have capitalized on this sector over the past decade. However, individual investors, through no fault of their own, have rarely invested in this sector as the opportunity to do so has historically not been available.

Historically, access to private debt funds was limited to accredited investors, those institutions or affluent individuals that could satisfy significant net worth and investable asset criteria. Barriers to entry included large investment minimums, minimum net worth requirements, complex tax reporting, and liquidity constraints. Additionally, many investors did not have access to the necessary data to research managers or the resources to perform the needed due diligence to directly lend to a company.

Institutional vs. Individual Allocations to Alternatives



Source: For investable assets, 2018 CapGemini World Wealth Report. For allocations: 2016 Willis Towers Watson Global Pension Assets Study; 2016 National Association of College and University Business Officers; Money Management Institute, "Distribution of Alternative Investments through Wirehouses." Allocations shown are for U.S. Pensions and U.S. University Endowments.

However, expanding retail investor access to private companies has been developing, and the SEC has been exploring how to increase access, recognizing the key role that pooled investment vehicles, including private and regulated funds, can play in providing a more level playing field for ***ALL*** investors. As the financial markets continue to evolve and information becomes more widely available, individual investors may soon be able to follow in the footsteps of accredited investors and access the benefits that were previously unattainable.

Conclusion

The discussion above illustrates that private debt has historically offered many attractive attributes to other asset classes. It provides stable income, low volatility, reduced drawdowns, and diversification benefits when included within a larger portfolio. For years, institutional investors have been taking advantage of private debt for these qualities, and it is only natural that individual investors start considering the inclusion of private debt in their own portfolios, especially considering the recent improved access.

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Past performance is not indicative of future results. Volatility is measured by standard deviation. "Private Debt" is represented by the Cliffwater Direct Lending index (CDLI). "Leveraged loans is represented by the S&P/LSTA leveraged loan index. "High-yield bonds" is represented by the Bloomberg US high yield index. "Investment grade bonds" is represented by the Bloomberg US aggregate bond index. For information purposes only. An investor can not invest directly in an index. For investment professionals only. Not for retail public distribution. There is no guarantee that any objective can be met.

Volatility is measured by standard deviation. Drawdown is a measure of peak to trough loss in a given period. An investor cannot invest directly in an index. While the indices were chosen to represent the broad market performance of each asset class, there are limitations as to available indices and blends which can be selected and how they are presented. Cliffwater Direct Lending Index (CDLI) provides only quarterly pricing and data reflects latest available information.

Indices Information

"U.S. Treasury" - The Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index. STRIPS are excluded from the index because their inclusion would result in double-counting.

"Investment Grade Corporates" - The Bloomberg US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility, and financial issuers.

"Long U.S. Treasury" - The Bloomberg US Treasury: Long Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with 10 years or more to maturity.

"High Yield Municipal Bonds" - The Bloomberg U.S. Municipal High Yield Index covers the USD-denominated long-term tax-exempt high yield bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

"Emerging Market Debt" - The Bloomberg Emerging Markets Hard Currency Aggregate Index is a flagship hard currency Emerging Markets debt benchmark that includes USD, EUR, and GBP-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers.

"High Yield Corporate Bonds" - The 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.

"Leveraged Loans" - The Morningstar LSTA US Leveraged Loan Index is a market-value weighted index designed to measure the performance of the US leveraged loan market.

"REITs" - Dow Jones EQUITY REIT Total Return Index. This index is comprised of REITs that directly own all or part of the properties in their portfolios.

"Developed Market Equity" - The MSCI ACWI ex USA Index captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries (excluding the US) and 24 Emerging Markets (EM) countries. With 2,308 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.*

"Emerging Market Equity" - The MSCI Em (Emerging Markets) Index is a free-float weighted equity index that captures large and mid-cap representation across Emerging Markets (EM) countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

"Large Cap Equity" - The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

"Small Cap Equity" - The Russell 2000 Index is comprised of the smallest 2000 companies in the Russell 3000 Index, representing approximately 8% of the Russell 3000 total market capitalization. The real-time value is calculated with a base value of 135.00 as of December 31, 1986.

"Commodities" - The S&P GSCI Total Return Index in USD is widely recognized as the leading measure of general commodity price movements and inflation in the world economy. The index is calculated primarily on a world production weighted basis, comprised of the principal physical commodities futures contracts.

"Private Credit/Lending" - The Cliffwater Direct Lending Index seeks to measure the unlevered, gross of fee performance of US middle market corporate loans, as represented by the asset-weighted performance of the underlying assets of Business Development Companies that satisfy certain eligibility criteria. The CDLI Total Return Index includes three components: Income Return, Realized Gain/Loss, and Unrealized Gain/Loss.

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