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A dynamic allocation approach to private credit

Invesco Private Credit

A dynamic allocation approach to private credit: Key points

1. Private credit is made up of unique asset classes with a variety of return, risk, and liquidity profiles that require specialization.

2. Relative value within private credit can be harnessed through a dynamic allocation approach throughout the business cycle.

3. A portfolio utilizing this dynamic approach can improve income and return potential while reducing volatility relative to single private credit sectors and/or traditional assets.

4. Finally, manager selection is a critical decision when allocating within private credit. We provide a checklist for investors to review when selecting private credit managers.

Sources: Invesco Private Credit, as of Dec. 31, 2024

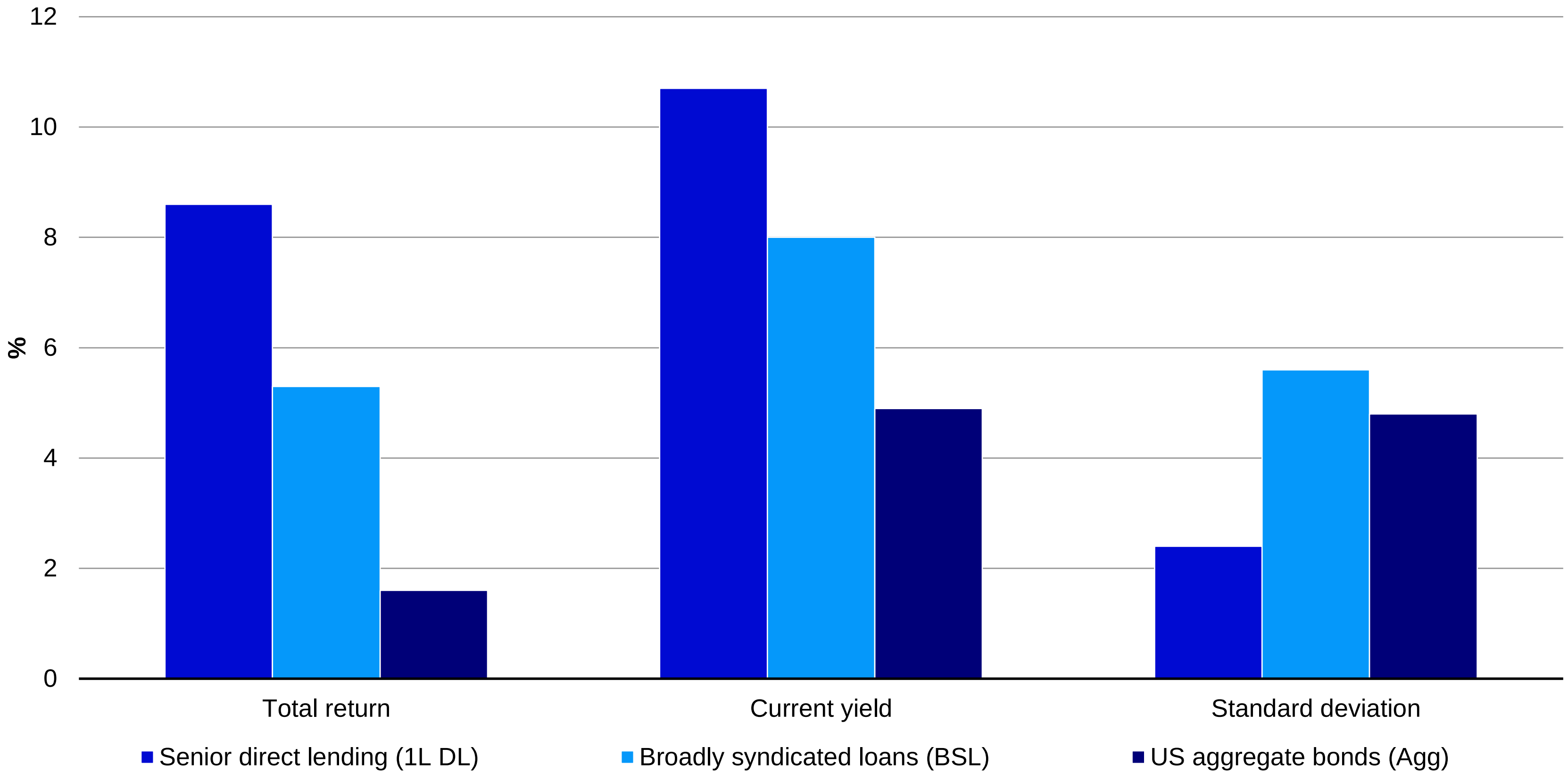
Private credit has produced outsized returns relative to public fixed income

Senior direct lending boasts higher current yields and lower levels of volatility

Private credit as an asset class has performed impressively over the past decade, which included a global pandemic and one of the most aggressive tightening cycles on record from the Federal Reserve. In fact, senior direct lending outperformed aggregate bonds by 700 basis points at half the level of volatility since 2012. Current yields for private credit remain impressive with around 200 basis points of additional yield compared to broadly syndicated loans to compensate for illiquidity.

The years after the Global Financial Crisis were characterized by low and steady interest rates, benefiting equities and stable asset allocations. Today, the environment is quite different, with elevated levels of inflation and interest rates and significant volatility in both credit and equity markets. We believe this environment still favors private credit; however, it requires a dynamic approach to the credit cycle that can capitalize on opportunities and dislocations as they materialize.

Annualized total returns, current yield, and risk of credit assets (1/12 – 12/24)



Source: Invesco Private Credit, Bloomberg, Cliffwater, as of Dec. 31, 2024. Agg is the Bloomberg US aggregate bond index, BSL is the S&P UBS (Credit Suisse) leveraged loan index, DL is the Cliffwater direct lending index – senior. Risk is annualized standard deviation of quarterly returns. Current yield measure is the 3Y takeout yield for 1L DL and yield-to-maturity for both BSL and Agg.

A review of private credit

Return and liquidity spectrum for private credit investment strategies

Private credit is inclusive of direct lending, opportunistic credit, structured credit and broadly syndicated loans (BSLs). We define each in the accompanying appendix of this paper.

Common traits of private credit include high income and total returns due to illiquidity, seniority in the capital structure to recoup value, a secured claim on company assets to support capital preservation, and floating rate coupons with low interest rate sensitivity.

Where these assets differ is their underlying liquidity and risk profiles, resulting in vastly different investor experiences and potential levels of expected returns.

Common traits of private credit	
High income and total return potential	Due to less liquid nature of assets
Senior claim in capital structure	First in line to recoup value
Secured claim on company assets	Can further support capital preservation
Floating rate coupons	Low interest rate duration risk

Liquidity spectrum and characteristics of private credit investment strategies

	Direct lending	Opportunistic credit	Structured credit	Broadly syndicated loans
Role	Attractive income potential above public market levels	Attractive return potential with credit-like risk	Potentially offering attractive returns during dislocations	Attractive yield potential with liquidity
Description	Directly originated loans issued to middle market companies	Investing in the senior debt of companies at significant discounts to par due to disconnect between market's perceived risk and actual risk	CLO note investments in CLO BB debt tranches that can be indiscriminately punished without fundamental cause during periods of market volatility	Investments in floating-rate senior secured loans of non-investment grade companies around the globe
Return profile	9-12% expected return	11-15% expected return	8-10% expected return	6-9% expected return

← Less liquid — Liquidity levels — More liquid →

Source: Invesco Private Credit as of Dec. 31, 2024. Net returns. There is no guarantee these targets will be achieved or expectations will be met.

Credit sectors display a level of cyclicality

Difficult to predict how an asset class will perform any given year

It is difficult to predict the returns of an asset class in any given year. When isolating the annual performance of these credit assets over the business cycle, a few patterns become clear;

1. Full cycle returns of an asset class have been commensurate to the level of risk assumed, with structured credit and opportunistic the top performers.
2. Senior direct lending is a standout without a single negative year and averages high single digit returns with low volatility.
3. Interest rate risk has become a critical issue for long duration fixed income, namely HY; specifically in a world where yields have been low and rising to levels not seen in decades.

Returns of public and private fixed income assets by calendar year

Total return (%)	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
High	**DL** 7.8%	**DL** 6.6%	**Opp** 25.6%	**Opp** 8.0%	**DL** 7.6%	**DL** 8.4%	**DL** 6.7%	**Opp** 15. 0%	**DL** 5.9%	**Opp** 16.1%	**Opp** 18.0%
	Opp 4.4%	**BSL** -0.4%	**BSL** 9.9%	**DL** 7.4%	**Opp** 4.4%	**BSL** 8.2%	**Opp** 5.4%	**DL** 9.9%	**BSL** -1.1%	**BSL** 13.0%	**DL** 12.2%
Low	**BSL** 2.1%	**Opp** -6.1%	**DL** 8.6%	**BSL** 4.2%	**BSL** 1.1%	**Opp** 2.7%	**BSL** 2.8%	**BSL** 5.4%	**Opp** -13.3%	**DL** 12.3%	**BSL** 9.3%
Public market comparisons	HY 2.5%	HY -4.5%	HY 17.1%	HY 7.5%	HY -2.1%	HY 14.3%	HY 7.1%	HY 5.3%	HY -11.2%	HY 13.4%	HY 7.7%
	Agg 6.0%	Agg 0.5%	Agg 2.6%	Agg 3.5%	Agg 0.0%	Agg 8.7%	Agg 7.5%	Agg -1.5%	Agg -13.0%	Agg 5.5%	Agg 4.8%

Sources: HY Corp is the Bloomberg high yield bond index, Agg is the Bloomberg US aggregate bond index, BSL is the S&P UBS (Credit Suisse) leveraged loan index, DL is the Cliffwater direct lending index – senior, and Opportunistic Credit is the S&P UBS Leveraged Loan Index (CCC/Split CCC) , all as of Dec. 31, 2024. **Past performance does not guarantee future results.** An investment cannot be made in an index.

Single-strategy approach to private credit compared to a full-cycle approach

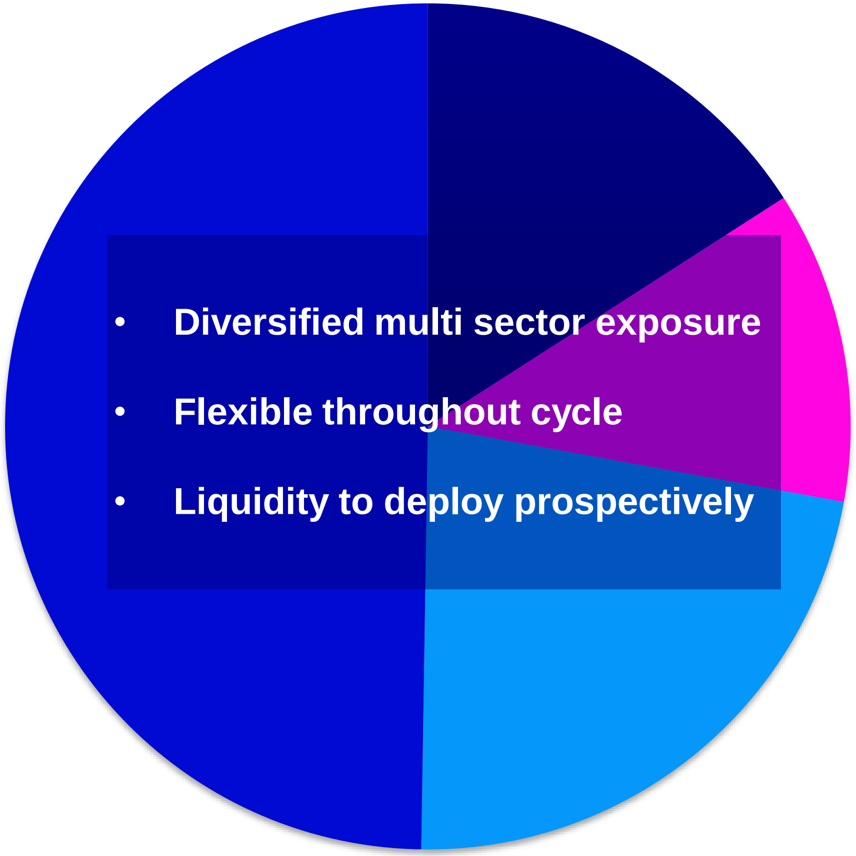
Reacting to the business cycle may be challenging when factoring in illiquidity

Implementing a dynamic credit strategy within private credit is not so simple. There are numerous frictions within opaque and illiquid private markets. It takes time to pick the right manager for an asset allocation and for them to source deals that match their investment strategy. Further, the average maturity of private credit funds is around 5 years. This illiquidity is statistically likely to span multiple phases of the business cycle with limited room to maneuver or exit, regardless of macroeconomic or credit conditions.

A diversified full-cycle approach to private credit may be able to navigate the business cycle in a way that single-strategy allocations cannot. This approach can add to potential total returns by dynamically allocating to opportunistic or structured credit, all the while maintaining a core holding within direct lending. The liquidity component from broadly syndicated loans acts as a lever to deploy capital for positioning and fund shareholder liquidity.

Single-strategy approach

Full-cycle approach



Sources: Invesco Private Credit, NBER as of Dec. 31, 2024.

A dynamic allocation approach to private credit

Navigating the business cycle within a credit portfolio

The combination of multiple private credit strategies within a full-cycle, dynamic approach may help provide an opportunity for higher returns and lower volatility versus the individual components, as the consistent coupon from high-quality liquid assets historically has mitigated the J-curve while preserving the ability to react to changing market conditions in “real-time.”

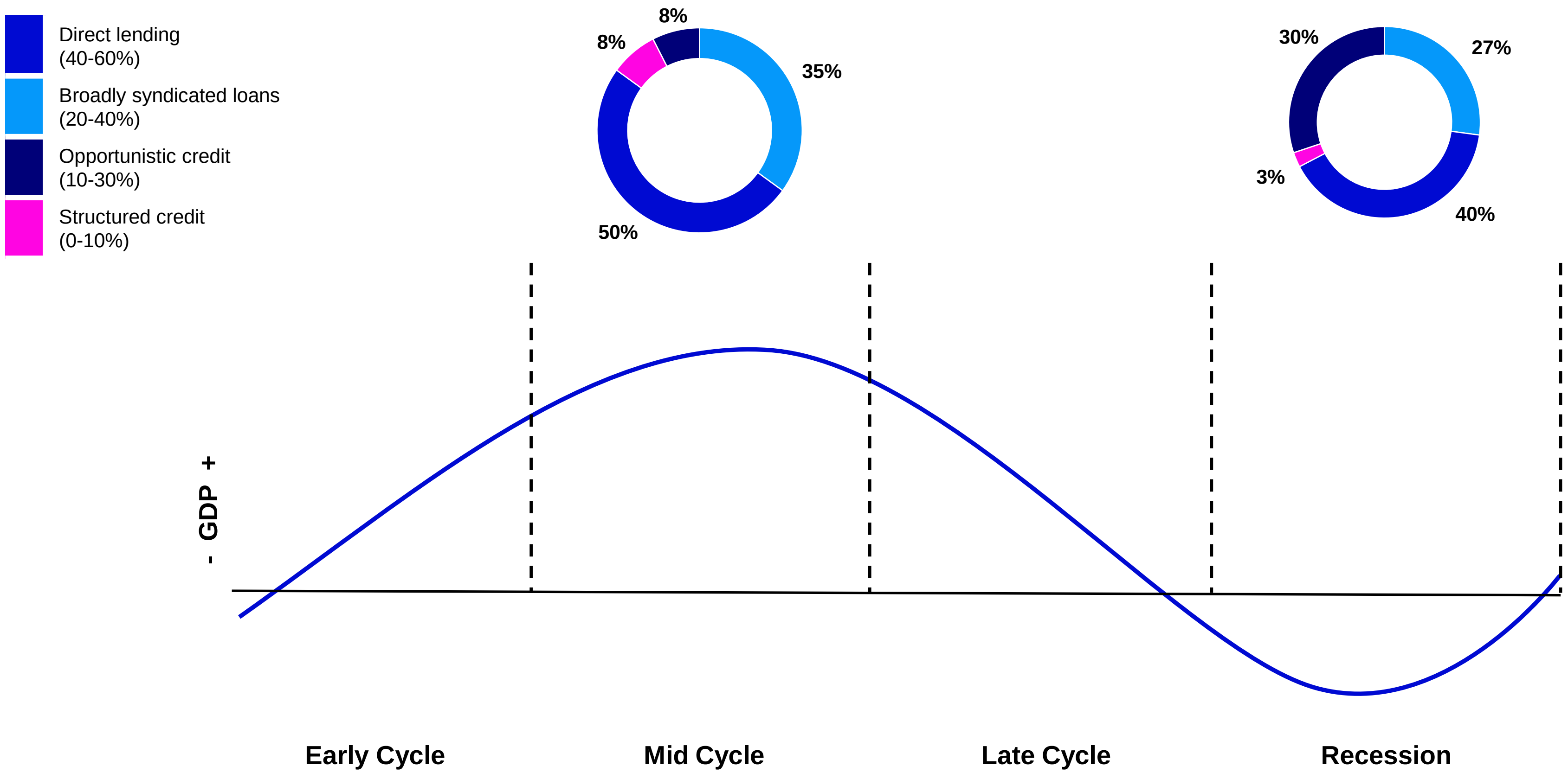
Early cycle: Default rates drop and credit spreads tighten. Higher exposure to opportunistic credit to capture spread tightening.

Mid cycle: Default rates bottom and credit spreads remain tight. Target higher yielding assets that justify overweight positions. Exposure to opportunistic credit begins to moderate in favor of direct lending.

Late cycle: Credit spreads begin to widen. Risk-adjusted return for opportunistic credit is less attractive. Strategy tactically shifts into more “defensive” positioning.

Recession: During the first half of the recession, the strategy favors a defensive posture. Once there is a decrease in forecasted volatility, the strategy will begin to rebalance toward opportunistic credit and structured credit. The rebalancing toward the end of the cycle is critical to capture “early-cycle” tailwinds.

An illustrative example of optimal business cycle dependent allocation to private credit



Source: Invesco Private Credit as of Dec. 31, 2024. For illustrative purposes only.

Applying a full-cycle dynamic private credit strategy to a traditional portfolio

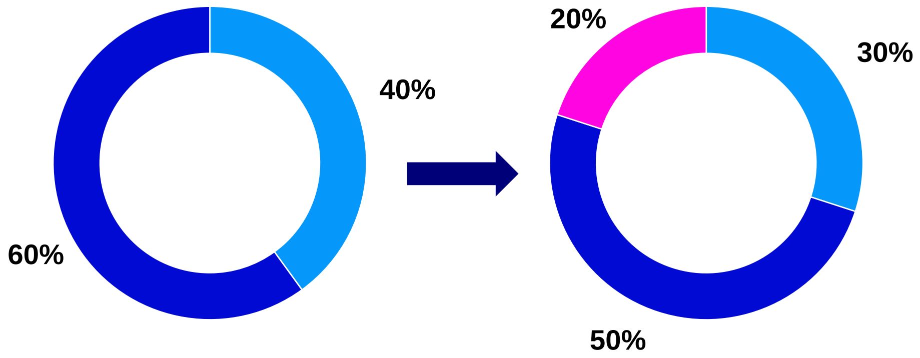
Improvements in risk and yield while historically maintaining returns

Starting with a traditional moderate portfolio of 60% US equities and 40% US aggregate bonds and adding 20% of a dynamic credit strategy funded equally by equity and fixed income, reduces risk and improves yield through high levels of current income, all while maintaining total return over the cycle.

Private credit assets individually have little to no correlation to traditional assets and have exhibited impressive risk-return ratios.

It is worth noting that it has been an incredibly favorable time for equity risk assets post-GFC with equities experiencing above average returns (~15% p.a.) relative to their long-term history (~8% p.a.) and limited recessionary periods (just 2020). There are reasonable arguments to be made that the next cycle will look different with higher interest rates, wider credit spreads and slower growth due to higher debt burdens. Credit assets may outperform in such a future.

Applying a dynamic credit strategy to a US 60/40 portfolio (1/12 – 12/24)



	Traditional 60/40	+20% Dynamic credit strategy
Return	9.8%	9.7%
Risk	9.4%	8.4%
Return/ Risk	1.04	1.13
Yield	2.2%	3.6%

Asset class returns and correlations

Asset	Ret. (%)	Risk (%)	Corr. to dynamic
Dynamic credit strategy	7.8	5.4	
US Agg.	1.6	4.8	0.02
US Eq.	14.7	14.3	0.73

Sources: Invesco Private Credit, as of Dec. 31, 2024. January 2012 is the maximum amount of common history available. US Agg and US eq. proxies the Bloomberg US aggregate bond index and S&P 500 index, respectively. The dynamic credit strategy proxy is a hypothetical, illustrative portfolio, formed by cycling through four, regime-based portfolios, in sample, and dependent on phase of the business cycle as defined by the trend and level of nominal US GDP growth. Further explanation of the methodology and underlying assets is in the disclosures. These portfolio characteristics are gross of fees. **Past performance does not guarantee future results.**

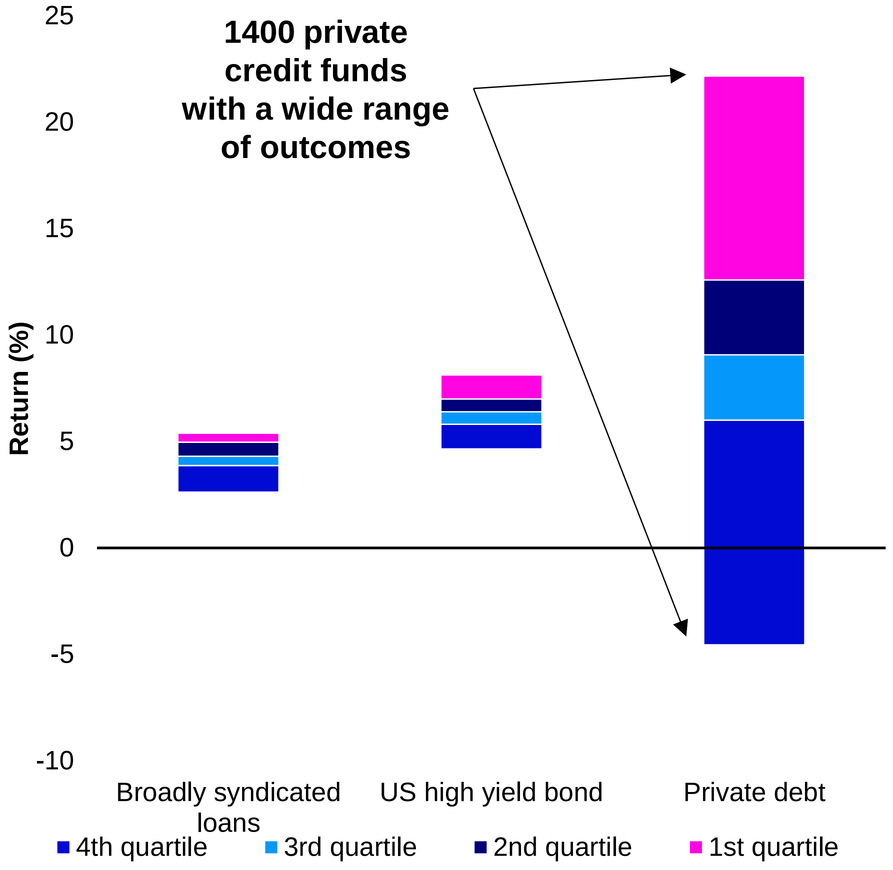
Manager selection within private credit

A common set of items to review when searching for a private credit manager

Manager selection is of critical importance when investing in private credit as the range of outcomes varies significantly when compared to that of comparable liquid credit asset classes like broadly syndicated loans or high yield bonds. It has been true that the median private credit funds outperform even the best funds within public credit, however an underperforming manager within private credit could be disastrous.

Picking a “good” manager requires significant due diligence before committing capital to their fund. To aid in deciding on a private credit fund, we provide a few common items to review when selecting a manager or team.

Private credit versus public credit return dispersion (5Y)



Manager selection checklist

- ❑ Does the manager have a large platform with in-house capabilities providing unique insight across private credit?
- ❑ How will the manager react to changing market conditions? Standalone private credit allocations have limited liquidity and therefore lack flexibility for end investors to shift.
- ❑ Does the manager have proprietary sourcing and diligence for credit investments?
- ❑ What is the manager’s history of performance?

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Sources: Invesco Private Credit as of Dec. 31, 2023, latest data available. Morningstar, Burgiss. Private Debt return data provided by Burgiss. Broadly syndicated loans are represented by the Morningstar US Bank Loans category; US high yield bond is represented by the Morningstar US High Yield category. Data is based on 5-year annualized total returns for public assets and IRR to date for private assets. All fund returns are net of fees. Past performance is not indicative of future results.

Appendix

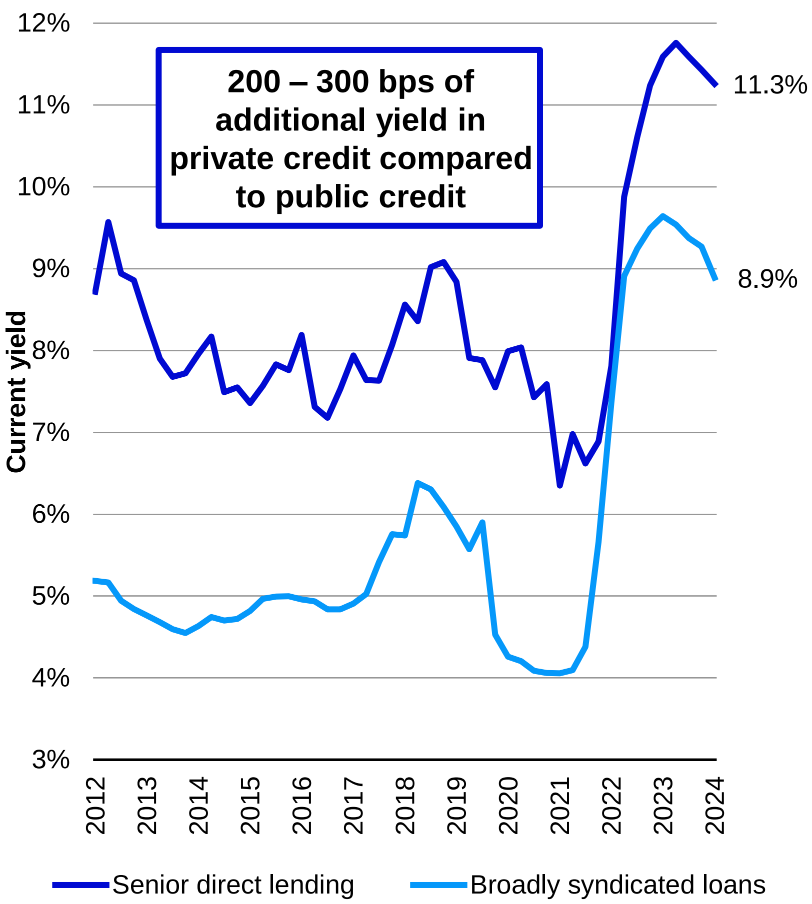
Private credit asset class primers and case studies

Direct lending
Attractive income potential above public market levels

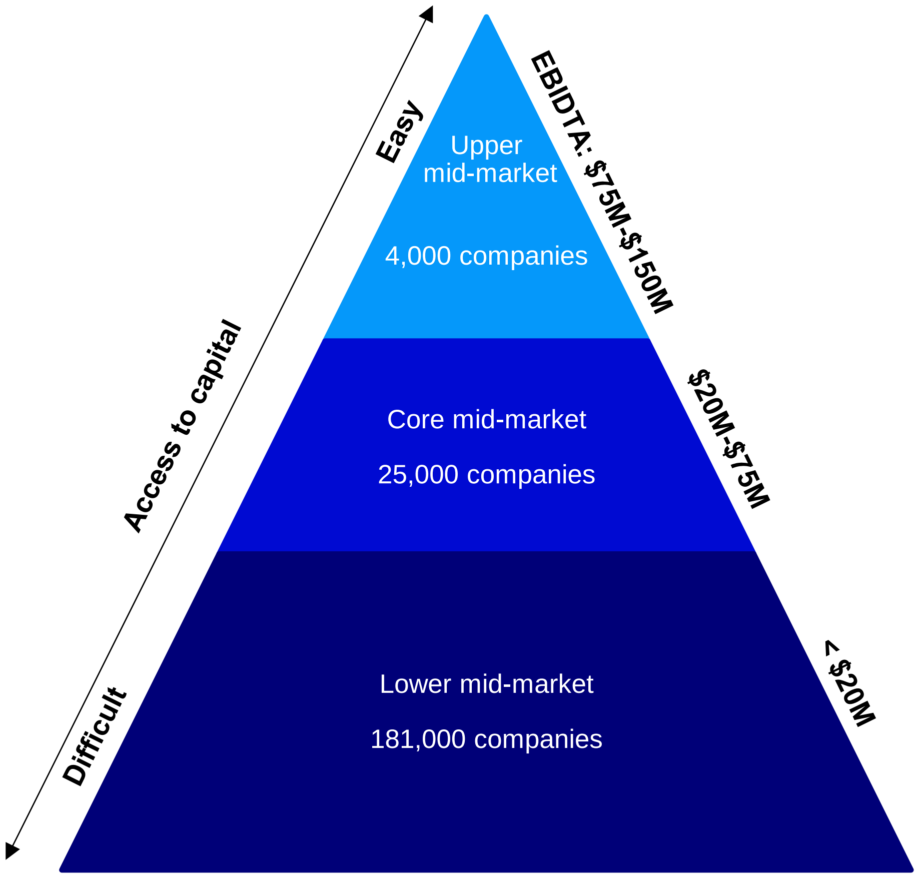
General description:

- Directly originated, senior secured loans to middle market companies. It’s important to note that there are vast differences between the segments of the middle market, with core being a relatively stable universe of borrowers with around $20 - $75M in annual EBITDA.
- Less liquid and typically held by a small group of lenders (<5).
- Investors are typically compensated with an illiquidity premium of 200-300 basis points above syndicated loans.

Current yield of public and private credit



Direct lending middle market opportunity set



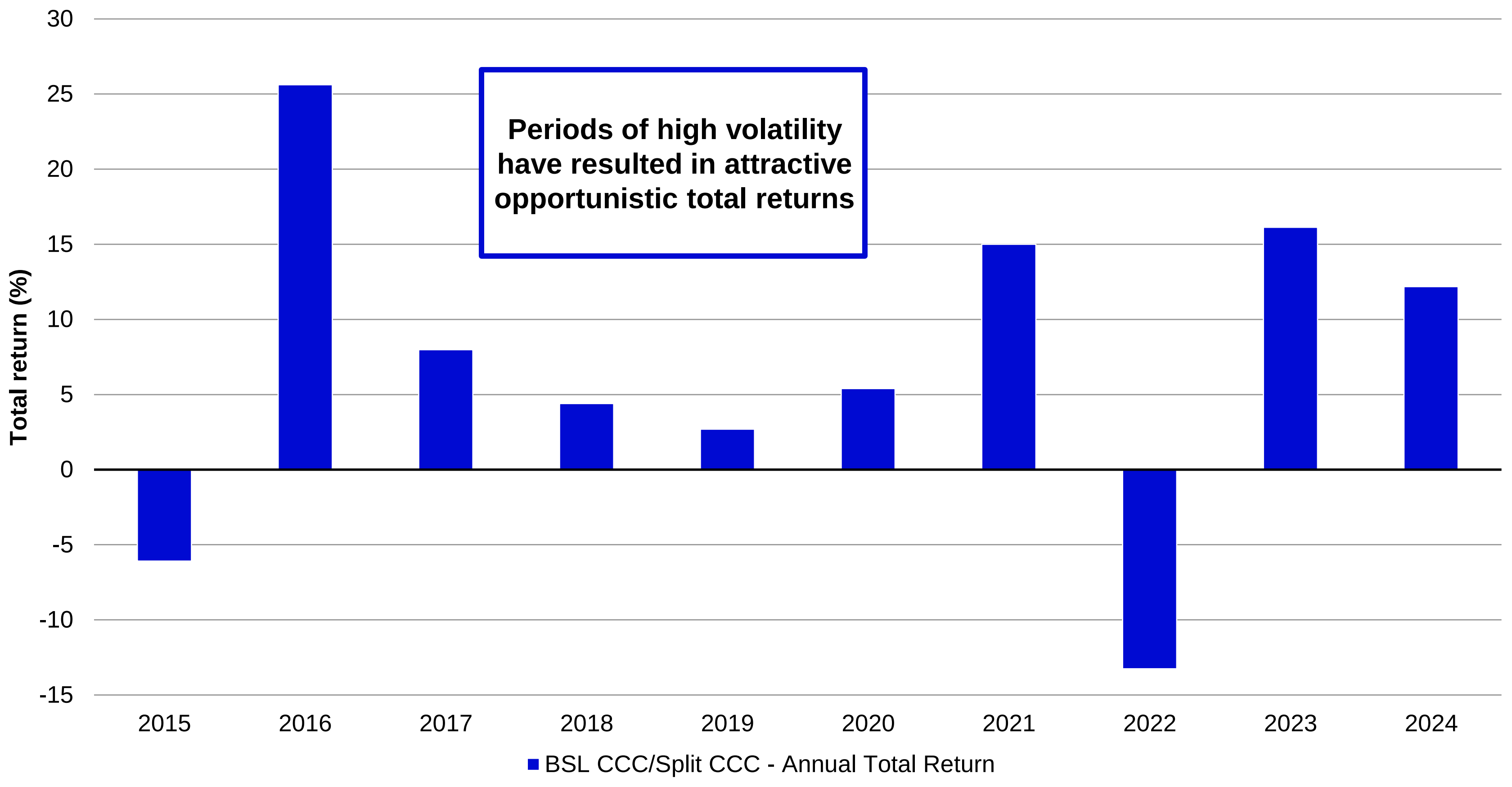
Sources: Invesco Private Credit, Bloomberg high yield bond index, Credit Suisse leveraged loan index, Cliffwater direct lending index – senior, as of Dec. 31, 2024. National center for the middle market, “Year-End 2024 Middle Market Index Report”. These yields are gross of fees and expenses.

Opportunistic credit
Attractive return potential with credit-like risk

General description:

- Typically involves investing in the senior debt of companies at significant discounts to par due to disconnect between market's perceived risk and actual risk.
- Usually less liquid in nature but can offer higher potential returns (with incremental risk). Inefficient markets can offer idiosyncratic opportunities throughout the economic cycle.

Opportunistic credit annual return (represented by CCC/Split CCC broadly syndicated loans)



Sources: Invesco Private Credit, Opportunistic Credit is S&P UBS Leveraged Loan Index (CCC/Split CCC) as of Dec. 31, 2024. **Past performance does not guarantee future results.** An investment cannot be made in an index.

Structured credit (CLO notes)
Potentially offering attractive returns during dislocations

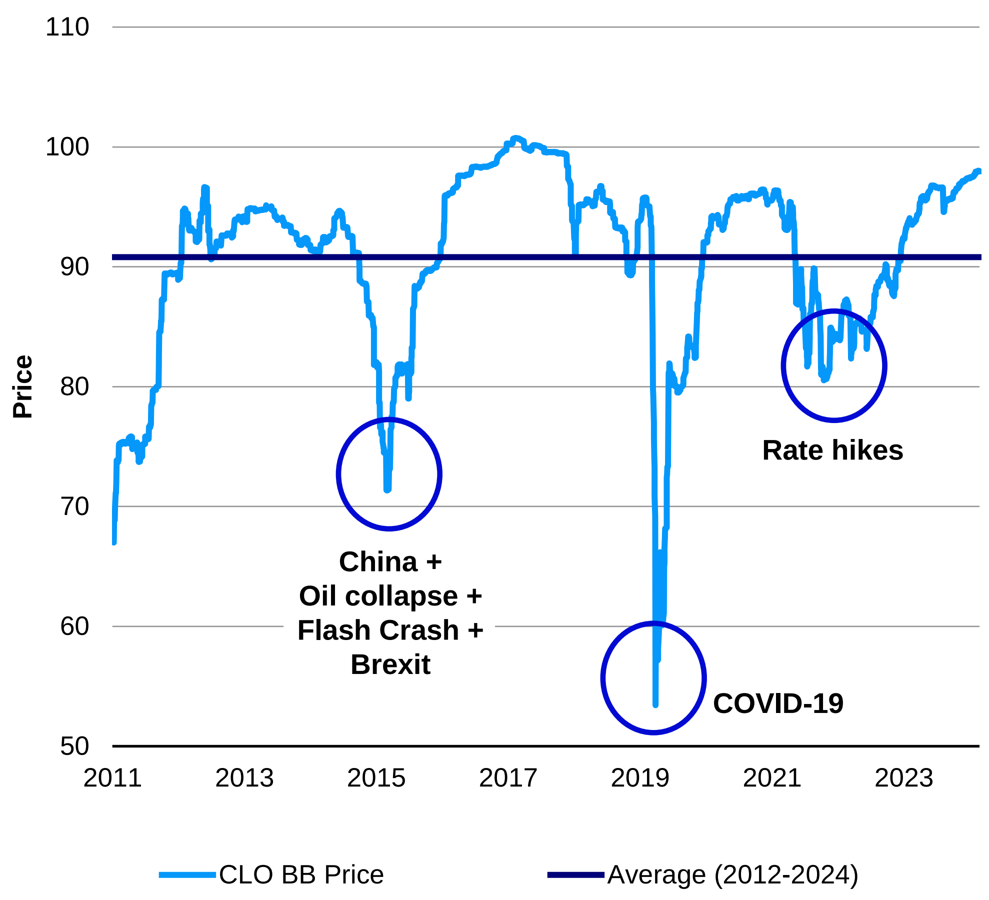
General description:

- CLOs are a securitized product, backed by a portfolio of syndicated loans and broken up into rated tranches.
- Can be indiscriminately punished without fundamental cause during periods of market volatility.
- These dislocations can result in attractive return potential within relatively short time horizons.

Default history and rates by security

Security type & rating	5-year cumulative default history	Annual default rate	Time period covered
Corporate A	0.64%	0.13%	1981-2022
US CLO BB	1.08%	0.22%	1997-2022
Corporate BBB	1.79%	0.36%	1981-2022
Corporate BB	7.26%	1.45%	1981-2022

CLO BB price



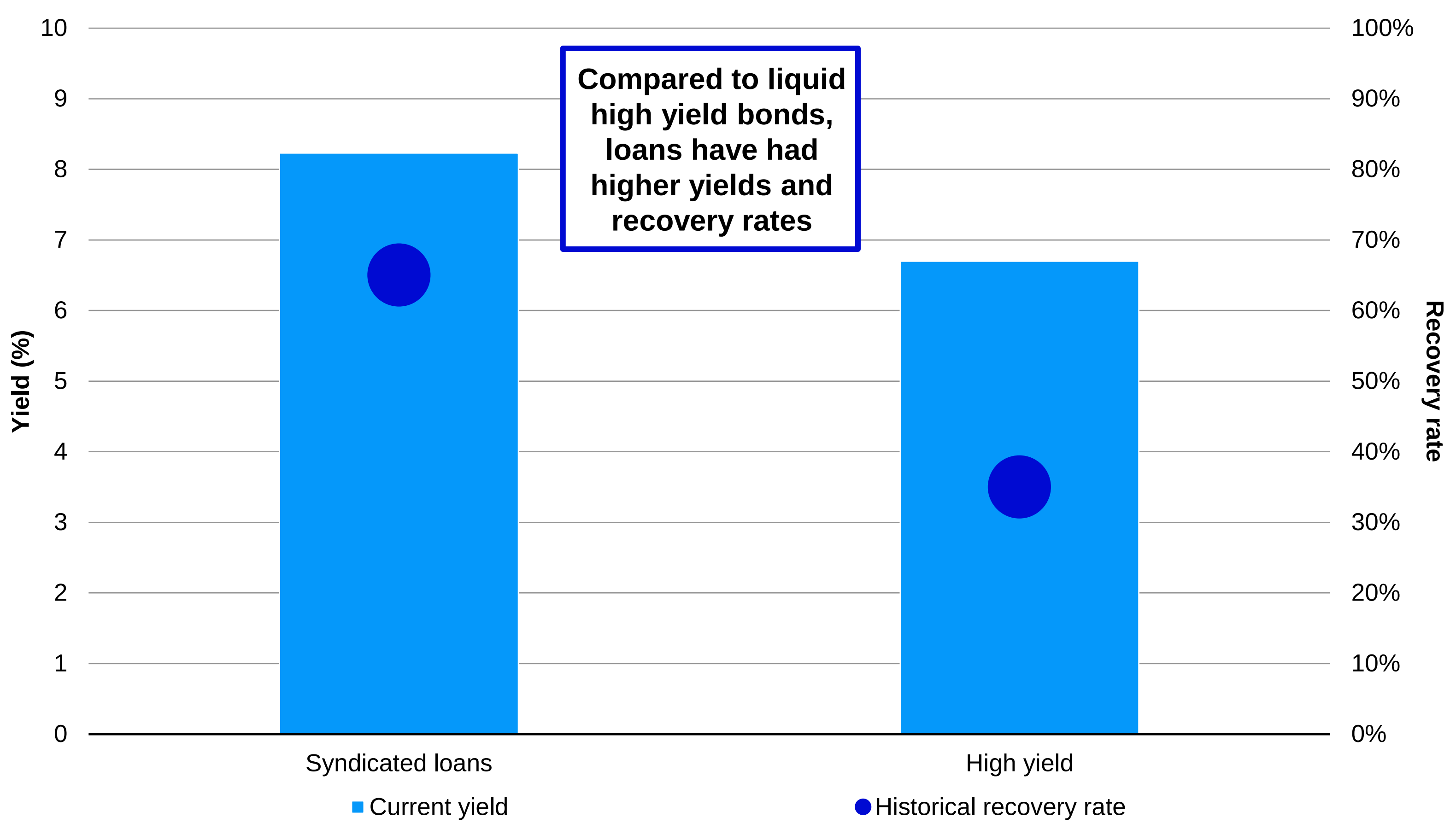
Sources: Invesco Private Credit, JPM CLOIE US BB index, as of Dec. 31, 2024.

Broadly syndicated loans
Attractive yield potential with daily liquidity

General description:

- Senior secured and floating rate loans syndicated by bank intermediaries to multiple institutional investors.
- Actively traded with daily mark-to-market pricing.
- Attractive yield potential with downside insulation.

Comparing yield and recovery rates of broadly syndicated loans and high yield bonds



Sources: Invesco Private Credit, Bloomberg high yield bond index, Credit Suisse leveraged loan index, as of Dec. 31, 2024.

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Our credit process has been continuously tested and refined, but it's always centered on deep due diligence, disciplined underwriting, and risk mitigation to help preserve capital while targeting attractive risk-adjusted returns. This process is employed across all private credit investment strategies managed by the team.

Market presence and scale – As one of the largest loan managers in the world, ISSM has access to virtually all loan issuances and serves as an important counterparty in the loan market. Our top trading counterparty status results in "early looks" at new loan transactions. In exchange for feedback, arrangers will often provide ISSM with preferred allocations.

Information advantage – As a private-side investor, ISSM is afforded deeper access to management teams and private projections than public-side investors.

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Disclosures

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations), and investors may not get back the full amount invested.

Alternative strategies may include investments in private equity, private credit, private real estate and infrastructure, which may involve additional risks such as lack of liquidity and concentrated ownership. These types of investments may result in greater fluctuation in the value of a portfolio. Private Market investments are exposed to risk, which is the risk that a counterpart is unable to deal with counterparty obligations. Changes in interest rates, rental yields and general economic conditions may result in fluctuations in the value of any underlying strategies. These types of strategies may carry a significant risk of capital loss and other market risks.

Dynamic credit strategy methodology

We define the private credit strategy using four distinct portfolios, cycling through dependent on the phase of the business cycle. Business cycle switching model is a purely illustrative and hypothetical to showcase the phases of the business cycle and is built in-sample; in real time, data can be lagged or limited. This is not representative of any of any model used to manage an Invesco product or strategy. Business cycle dependent portfolio weights are also hypothetical, subject to discretion, and will likely vary widely from these ranges when implemented. HY Corp is Bloomberg high yield bond index, BSL is S&P UBS (Credit Suisse) leveraged loan index, DL is Cliffwater direct lending index – senior, Opportunistic Credit is S&P UBS Leveraged Loan Index (CCC/Split CCC) , covering the full period of common available data starting Jan. 1, 2012, as of Dec. 31, 2024. **Past performance does not guarantee future results.** An investment cannot be made in an index.

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