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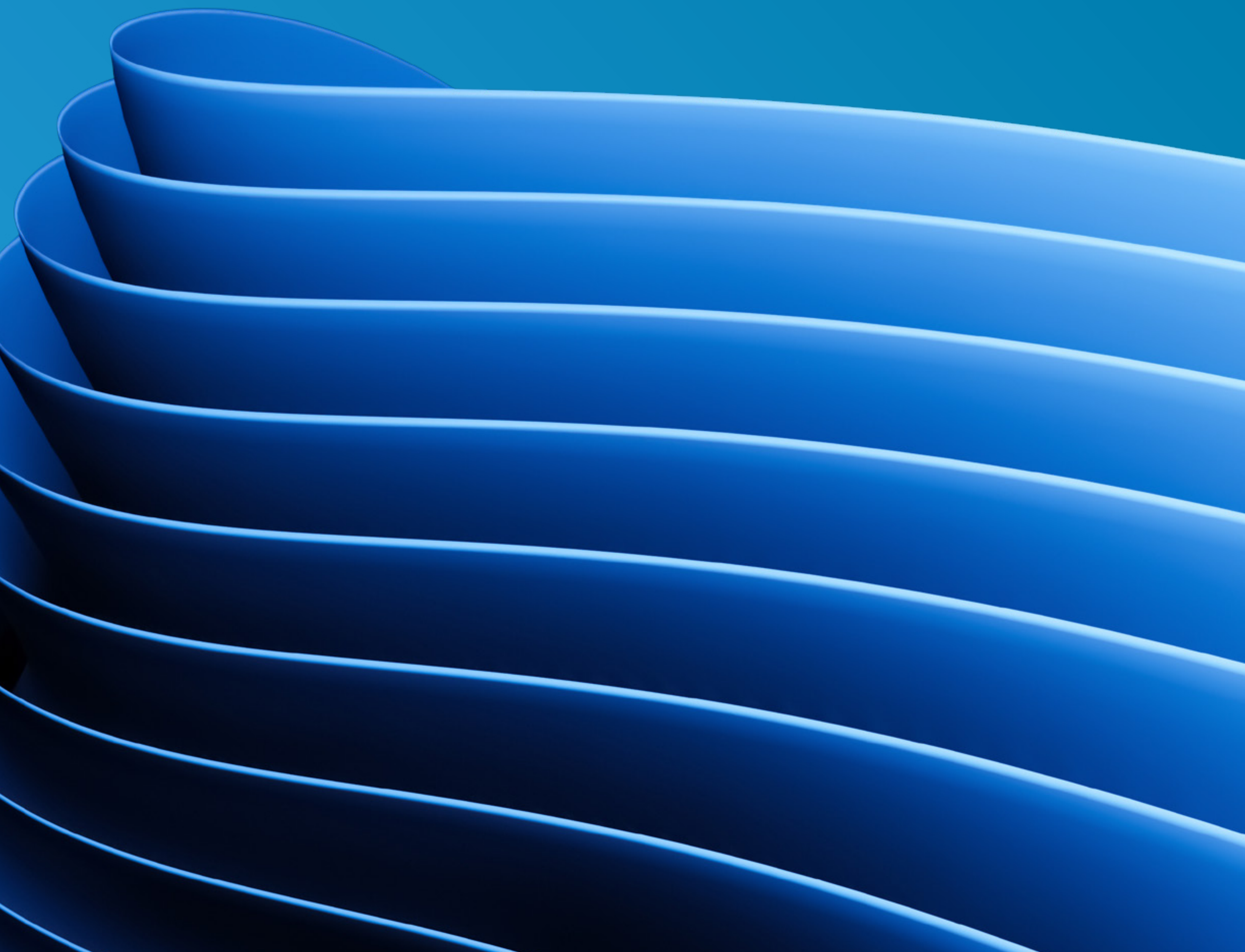
An introduction to private rated secured lending

A guide to private investment grade asset based finance ("Private IG ABF")



Contents

1 Executive Summary Tear Sheet

Asset Class:	Private Investment Grade Asset Based Finance
Objective of Paper:	Introduce an asset class that offers diversification from traditional corporate credit
Client Fit:	Allocators requiring efficient usage of capital (Insurers) Allocators broadly seeking diversification from corporate credit

Highlights

Market volatility and a glut of corporate credit exposure have spurred Allocators across a variety of institutional client types to consider additional avenues for optimizing fixed income allocations. One such tool that may appear on the radar of Allocators is Investment Grade Asset Based Finance ("Private IG ABF"), a subset within private credit. This white paper seeks to provide a broad guide encompassing what Private IG ABF consists of, the drivers of risk and potential return, and to ultimately aid Allocators in thoughtfully weighing key considerations prior to adoption.

Why Consider Private IG ABF?

- Corporate credit diversification
- Favorable RBC treatment specific to insurers
- Potentially enhanced downside protection vs. traditional private credit (middle market loans to sponsor-backed borrowers)
- Sustainable premia over public markets resulting from complexity, illiquidity, and active management
- Implementable solutions currently available

Risks to Consider

- Lower return potential than traditional private credit
- Illiquid, complex, and opaque asset class
- Broad dispersion in underlying lending arrangements and collateral, increasing the difficulty of comparing strategies

Asset Class Snapshot

Return Expectation	150-250+ BPs Spread Over IG Credit
Potential Downside Protection	High
Average Quality	Investment Grade (above BBB-)
Credit Risk	Low to Moderate
Corporate Credit Correlation	Low to Moderate
Liquidity	Illiquid

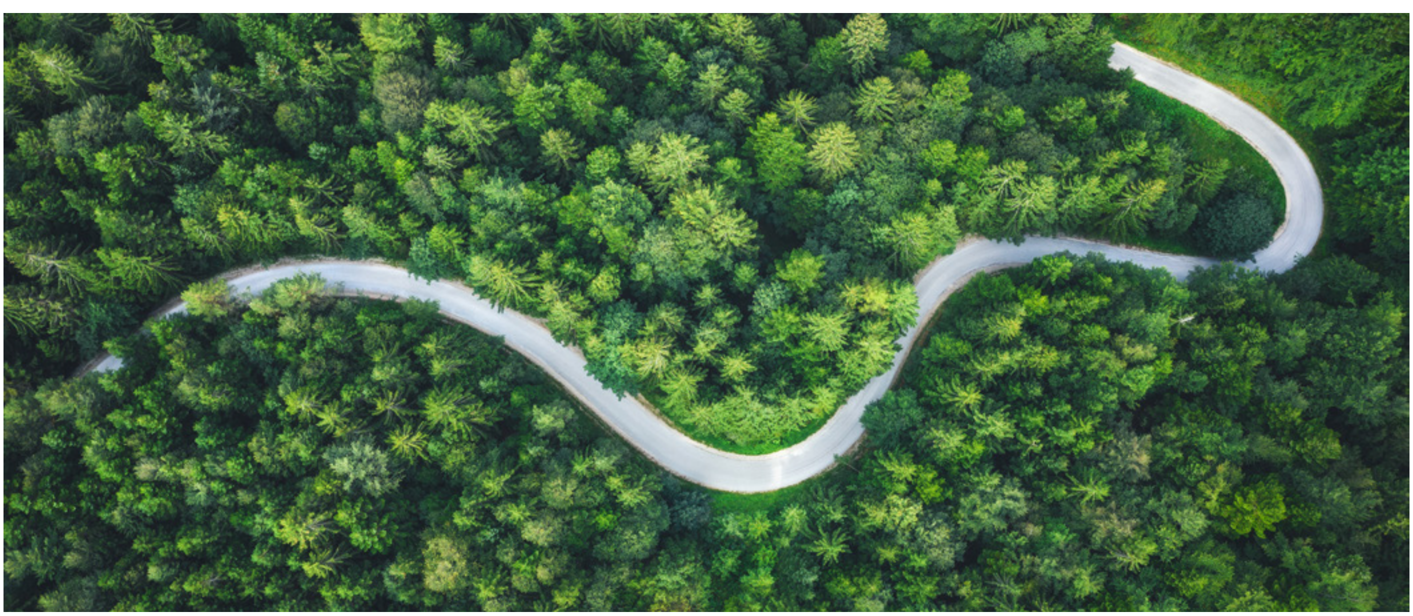
Asset class expected returns are hypothetical, shown only for illustrative purposes the general-market level only. Hypothetical returns shown are based on of Mercer's Capital Market Assumptions. This is not meant to represent Mercer's performance or any illustrative/actual portfolio. It is not a recommendation, offer or solicitation to buy or sell any securities or to adopt the illustrative portfolio. There can be no guaranteed targets will be achieved. Past performance is not a guarantee of future results.

2 Introduction

Market volatility and a glut of corporate credit exposure have spurred Allocators across a variety of institutional client types to consider additional avenues for optimizing fixed income allocations. One such tool that may appear on the radar of Allocators is Private Investment Grade Asset Based Finance (“Private IG ABF”), a subset within private credit. The suitability of this asset class ultimately hinges on investor-specific investment objectives and risk tolerances. Overall, the mix of attractive yield pickup over investment grade public fixed income, corporate credit diversification, and downside protection may offer an additive supplement to institutional portfolios. Despite the potential benefits, we find the inherent complexity and obscurity of this asset class has resulted in a lack of familiarity among institutional investors.

This white paper therefore seeks to provide a broad guide encompassing what Private IG ABF consists of, the drivers of risk and return, and to ultimately aid Allocators in thoughtfully weighing key considerations prior to adoption.

This makes for a timely introduction, as current market dynamics between specialty lenders and specialty borrowers have created a gap that offers opportunities for those institutional investors who pursue adoption. The fragmented lending landscape with high barriers to entry and informational disadvantages offers the necessary ingredients for repeatable premia harvesting, however, it is certainly not without risks. As a result, Allocators should continue to prioritize a thoughtful long-term strategic approach.



3 What is Investment Grade Asset Based Finance?

Investment Grade Asset Based Finance (synonymous with "secured lending") stands apart from familiar asset classes such as corporate credit or securitized assets. In short, Private IG ABF refers to lending against specified bankruptcy remote collateral. Specifically, lending that is secured by individual contractual cash flows grouped into pools based on shared similar characteristics such as loan type, underlying asset type, or borrower quality.

To draw a contrast against a familiar asset class, in corporate credit, individual corporations borrow for a variety of reasons, but the general structure of the lending arrangement is consistent in that it involves an individual corporation (the borrower) borrowing from either a consortium of lenders (public market broad syndication) or individual lenders (private market direct origination), or something in between (club deals). As long as a company remains willing and able to repay its debt until maturity, the lender will receive full principal and interest.

This compares to Asset Based Finance, which, as we noted, consists of lending arrangements that are **secured by specified collateral rather than a general obligation from a borrower**. The cash flows from the underlying assets in the collateral pool, along with their liquidation value, are what investors are dependent on for the full receipt of expected principal and interest, creating a direct link between the degree of downside protection an investor can expect and the quality of the underlying collateral.

Definition

IG ABF: Lending that is collateralized by distinct bankruptcy-remote pools of assets whose cash flows pay the principal and interest expected by bond holders and whose liquidation value provides a second layer of protection in the case of default. In short, lending against specified and bankruptcy-remote collateral.

Figure 1 | Asset Class Comparison

		IG ABF	IG Public Credit	Private Credit
Return Potential	**Total Return**	Moderate	Low	High
Characteristics	Amortization	✓		
	Differentiated Credit Profile	✓		—
	Inflation Protection	✓		—
	Downside Protection	✓	✓	—
	Overall Diversification	High	Low	Moderate

Legend
✓ Strong
— Moderate

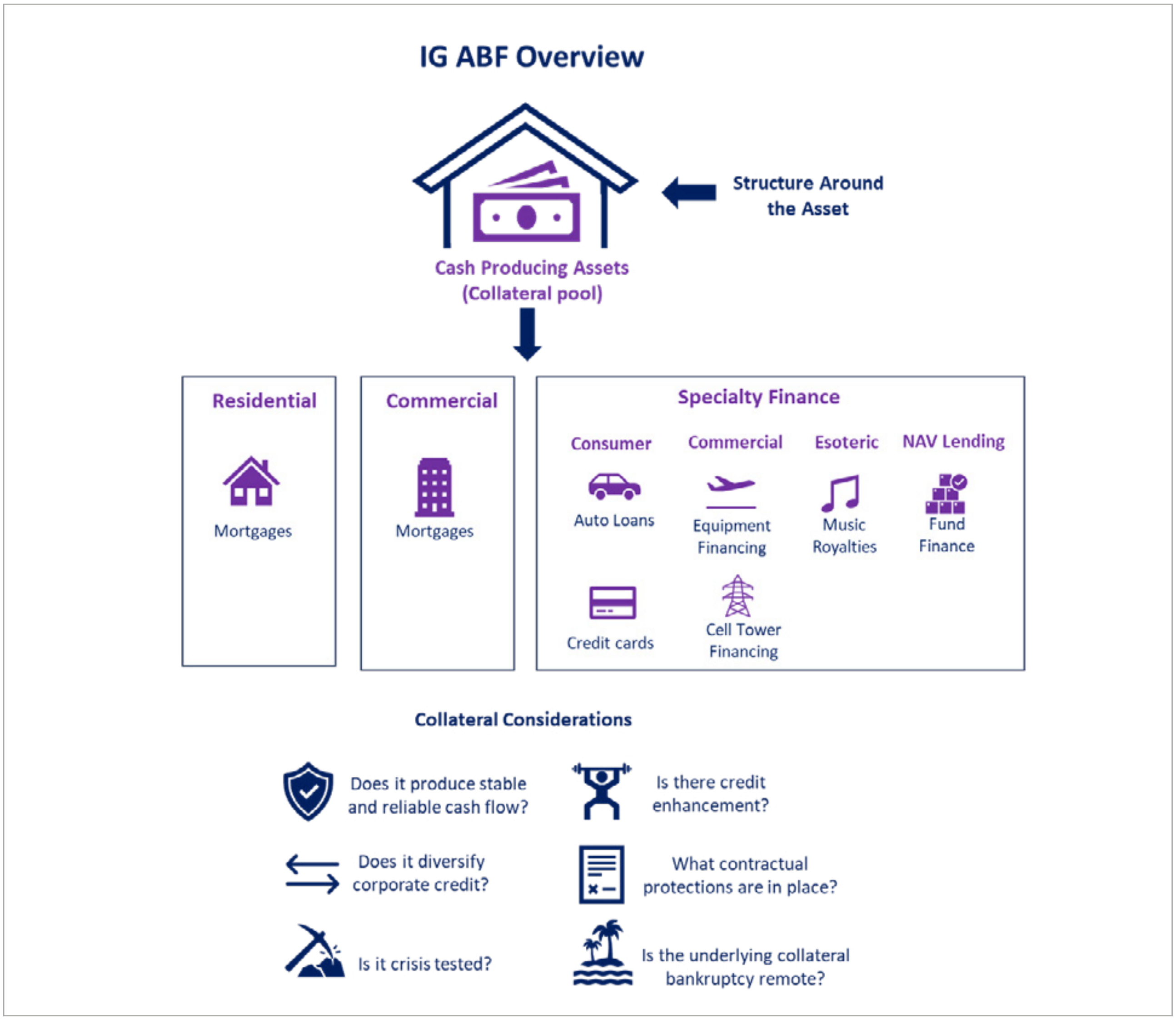
		IG ABF	IG Public Credit	Private Credit
Key Risks	Illiquidity	✓		✓
	Complexity	✓		—
	Leveraged Borrowers			✓
	Credit Risk	✓	—	✓
	Interest Rate Risk		✓	
	Overall Risk	Moderate	Low	High

Legend
✓ Primary Risk
— Secondary Risk

For illustrative purposes only.

Any contractual cash flow can be collateralized: royalty payments, personal loans, auto loans, mortgages, accounts receivable, and credit card receivables are all examples of individual contractual cash flows that can be bundled together and lent against. Some borrowers may be incentivized to proactively tap the ABF market in a bid to lower borrowing costs or to manage their balance sheets, while other market participants restricted from traditional lending (banks) or from traditional borrowing (specialty finance companies) may be forced to use the ABF market to pledge assets in exchange for access to capital from lenders willing to lend against esoteric assets.

Figure 2 | Investment Grade ABF Components Overview



Further, it should be noted that there are variations across types of collateral, across pools of the same collateral type, and even among the lending arrangements structured around underlying collateral. To illustrate how collateral that consists of different types of contractual cash flows influences the Private IG ABF opportunity set, we provide some snapshots below of various Private IG ABF sub-sectors as defined by asset managers. While hardly comprehensive, these snapshots illustrate how characteristics (fixed to floating interest rates, amortization, maturity, etc.) vary depending on the underlying collateral profile. It is also clear that there is a lack of synchronization in sub-sector classification, adding to the complexity of this asset class. **Thus, the profile of a given Private IG ABF opportunity set varies dramatically depending on the collateral that is referenced.**

Figure 3 | Private IG ABF Sub-Sectors - Manager Defined

(As of September 2023)

Manager 1	Commercial Finance	Fund Finance	Physical Assets	Consumer Assets	Infrastructure
YTM	6.5%	7.5%	7.4%	8.3%	6.4%
Average Maturity (WAL)	9	4	3	4	11
% Floating Rate Securities	0%	100%	32%	0%	0%
%IG	100%	100%	100%	91%	100%
% Amortizing	100%	100%	100%	100%	27%

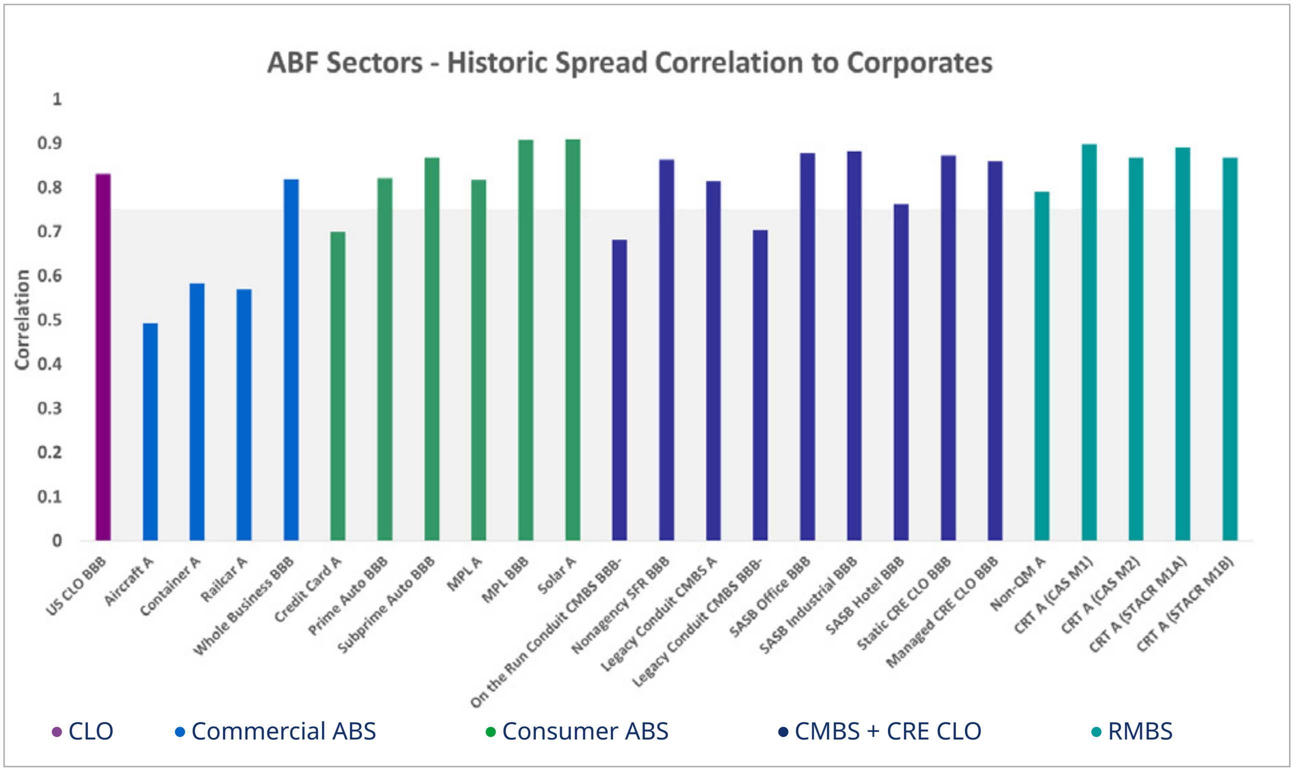
Manager 2	Mortgage	Commercial	Hard/Physical Assets	Consumer	Infrastructure
YTM	8.0%	8.0%	8.0%	7.7%	7.9%
Average Maturity (WAL)	3	3	3	4	5
% Floating Rate Securities	0%	70%	0%	40%	100%
%IG	100%	100%	100%	100%	100%
% Amortizing	18%	0%	0%	50%	0%

Manager 3	Speciality Assets	Financial Assets	Real Assets
YTM	High	High	High
Average Maturity (Yrs)	3-5 Yrs	3-7 Yrs	3-8 Yrs
% Floating Rate Securities	>50%	>50%	>50%
%IG	Not Provided	Not Provided	Not Provided
% Amortizing	100%	100%	100%

Source: Mercer's Asset Backed Finance Survey, January 2024.

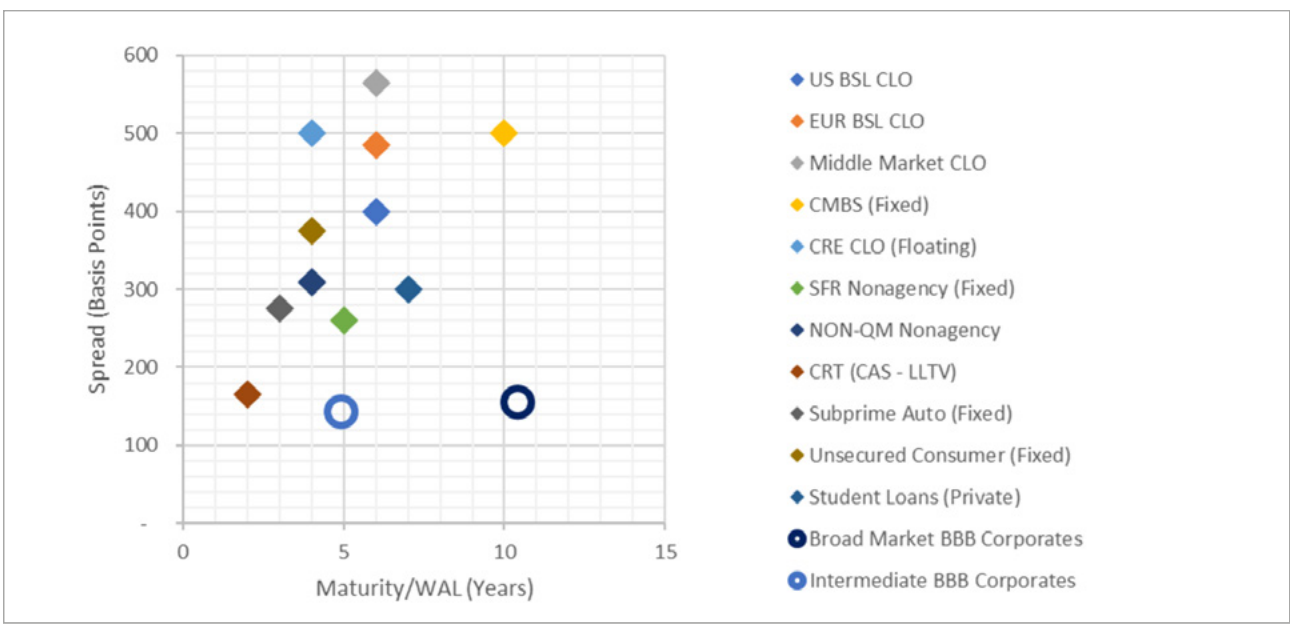
A natural question might be to what degree does the variety of profiles inherent in Private IG ABF manifest in diversification benefits? While the actual degree of diversification in private markets is difficult to quantify, public market ABS spread correlation (see below, provided by Apollo) provides a rough approximation by measuring the correlation in credit spreads between public securitized and public corporate credit. This demonstrates that diversification can be material but also varies meaningfully depending on the collateral and structure of a particular sub-sector. The second image (also sourced from Apollo) again uses public securitized sectors to approximate differentials in yield for secured lending arrangements to equivalent maturity corporate bonds.

Figure 4 | Correlation Between Public ABS (Private IG ABF Proxy) vs Public Corporate Credit



Source: Apollo. Data dates back to 2015 earlier, spread correlation is matched to rating and duration versus corporates.

Figure 5 | Yield for Equivalent Maturity – Public ABS (Private IG ABF Proxy) vs Public Corporate Credit



Sources: Apollo and Barclays Live, as of September 2023.

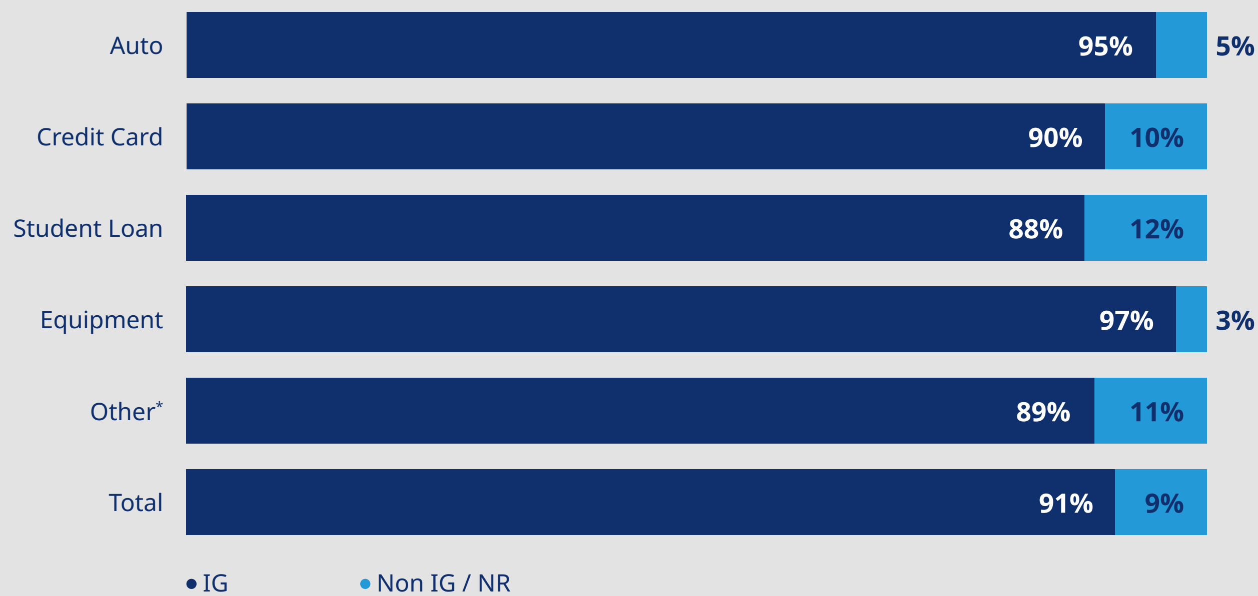
The next logical question might be, why not instead use public securitized if it offers yield enhancement and a degree of corporate credit diversification? It should be noted that the yield enhancement is often lower, less predictable and dependent on market conditions. Private IG ABF in particular is a credit diversifier that offers broader diversification, greater yield enhancement, greater RBC capital efficiency for regulatory - constrained institutions, and superior degrees of downside protection by leveraging control over covenants and collateral. Ultimately, both public securitized and private ABF are useful tools often underutilized in institutional portfolios, however, while both have a role to play, we believe that Private IG ABF is a currently overlooked diversifier against corporate credit that offers sustainable yield enhancement over public markets without sacrificing credit quality.

4 Underneath the Hood — Breaking Private IG ABF into its Components

Breaking the Private IG ABF asset class down, the asset-based market can and should be first sub-divided into two broad umbrellas, “Investment Grade” and “Non-Rated”.

The existence of these universes extends to the pioneering work of life insurers. These early investors realized that through secured lending, they could build lending arrangements with attractive yield which third-party rating agencies were willing to rate favorably due to the loss-remote nature of such assets. As a result, heavily regulated investors could achieve favorable capital treatment reserved for investment grade rated securities along with attractive returns. **Therefore, early capital was directed primarily towards investments achieving an investment grade rating, which today constitutes the majority of the asset-based finance market.**

Figure 6 | Quality Decomposition — Public Securitized Sectors



*Other consists of various esoteric or niche categories
Source: KKR, Bank of America. Data as of November 30, 2023

As the asset-based finance market has developed, client capital has increasingly pursued both rated and non-rated lending opportunities. Institutional investors should therefore note that there is an important distinction between investment grade and non-rated lending in the secured lending space. The investment grade portion of the market represents a longer track record and experienced teams, while non-rated remains a nascent asset class that offers increased returns in exchange for increased credit risk, usually in the form of subordination or reduced credit enhancement. Non-rated ABF remains a pure alpha-seeking opportunity with an emphasis on total return that is beyond the scope of this paper. Suffice it to say, clients should be aware of the notable difference in risk profile between the rated Private IG ABF and non-rated ABF opportunity set.

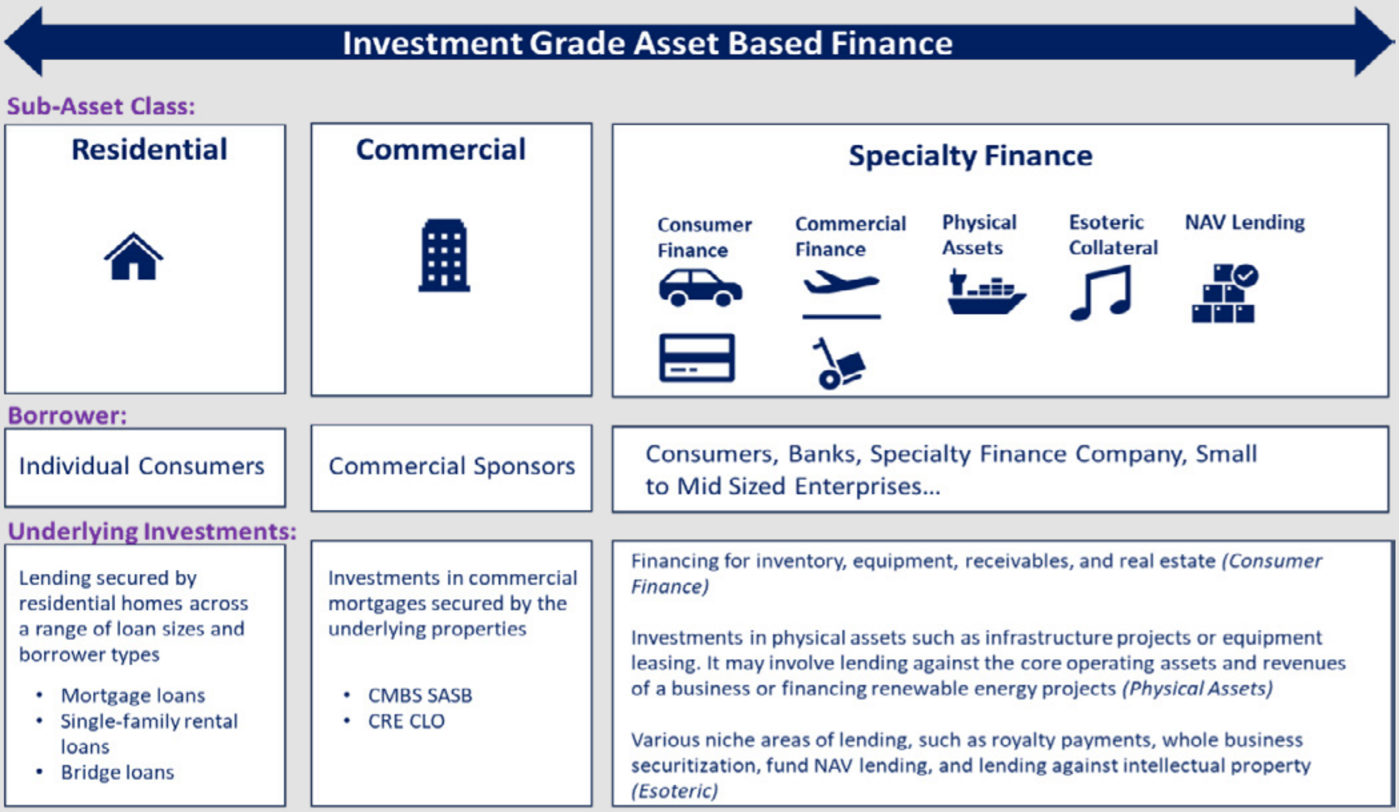
Figure 7 | Key Characteristics Comparison: Rated vs Non-Rated ABF

	IG ABF	Non-Rated ABF
Yield Premium	150-250+ bps over Public IG Corp	300-500+ over Public IG Corp
Source of Spread	Illiquidity, Complexity, Private Origination	Illiquidity, Complexity, Subordination
Income	High	Very High
Liquidity	Illiquid	Illiquid
Credit Risk	Low to Moderate	High
Interest Rate Risk	Low	Low
Diversification vs Corp Credit	High	Moderate to High
Diversification vs Alternatives	Moderate to High	High

Source: Mercer, 2024 Survey. Figures and values represent estimates based on survey responses and discussions with research partners and are subject to change.

Narrowing our focus on Private IG ABF, the first notable feature is the tremendous diversity in capital needs, lending structures, collateral employed, and actors actively tapping and lending in this marketplace. **The majority of lending arrangements fall into three broad buckets: residential, commercial, and specialty finance (a catch-all term for a wide array of collateral profiles)**. These pillars together comprise the opportunity set referred to as Investment Grade Asset Based Finance. Recent estimates of the size of the specialty finance market (excludes residential and commercial assets) place the market size at $5.5 Trillion (Oliver Wyman) while estimates for the broad ABF market range from $7.7 Trillion (KKR) to $20 Trillion (Apollo).

Figure 8 | Private IG ABF Sub-Sectors Profile



Source: Mercer's Asset Backed Finance Survey, January 2024.

5 Private IG ABF Market Participants

To further pull back the curtain on the inherent complexity of the private secured lending market, it is necessary to understand the dynamics of the borrowers, lenders, and lending arrangements that make up this market.

As with any fixed income market, Private IG ABF consists of arrangements between willing lenders and borrowers. In this case, the role of lenders is filled by an assortment of alternative lenders (non-banks) lending to a variety of counterparties or deal sponsors. Secured lending is dominated by these alternative lenders, who source capital from private investors rather than an underlying deposit base. These lenders are willing and able to underwrite esoteric or complex collateral that banks are either unwilling or unable to underwrite.

On the borrower side, this can refer to “specialty finance companies” who specialize in a specific type of asset such as consumer, residential, commercial, or equipment lending. Other borrowers who tap the secured lending market for capital include banks and corporations, including small and medium-sized enterprises, with a variety of assets to be offered as collateral such as accounts receivable, inventory, equipment, or real estate, which serve as the foundation for the financing arrangement. A specific example would be a mortgage originator (sponsor) that makes loans to individuals (homeowners). To obtain favorable lending terms, the sponsor may securitize or sell pools of originated loans (residential mortgages) to alternative lenders or other investors. **Overall, borrowers in the ABF market primarily consist of underbanked borrowers whose complex or esoteric assets are rejected by public markets, or who find they can obtain surety of execution at scale, for which they are willing to pay favorable yields.**

The lending structures in the Private IG ABF market primarily consist of bilaterally negotiated (negotiated between two counterparties) and privately held lending arrangements. This has produced numerous financing arrangements, differentiated by their degree of subordination and the collateral supporting them. As a result, the associated degree of risk and return varies widely depending on the lending terms and collateral at play. Specifically, lending arrangements may consist of whole loans, delayed draw term loans, hard assets, and other structured financial lending arrangements.

Figure 9 | ABF Lending Arrangements

Lending Style	Description	Universe
Tranche Lending	Lending where pooled collateral is sold to a special-purpose entity, and that entity then issues various tranches of debt along with a residual piece. Each tranche can receive a rating from a third-party rating agency and offers varying degrees of protection. Payment is made in a waterfall structure.	Public Securitized, Private IG ABF, Non-Rated ABF
Core Loans	Senior Investment Grade lending, secured by physical or financial collateral rated by a third-party rating agency	Private IG ABF, Non-Rated ABF
Whole Loans	Diversified pools of loans that are securitized into a private label ABS where investors own both rated tranches and non-rated residual equity. Whole loans can be entirely unrated.	Private IG ABF, Non-Rated ABF
High Yield	Junior liabilities and non-rated residuals.	Non-Rated ABF
Platform investments	Yield-oriented equity investments in consumer or commercial finance origination platforms.	Non-Rated ABF

6 How Did This Asset Class Develop? — A Brief History of Private IG ABF

A wave of bank consolidations between 1990 and 2005 evaporated nearly 500 banks per year*, increasing the dominance of large banks with a preference for stable lending to large companies. During this secular shift in banking preferences and availability, the Great Financial Crisis ("GFC") exacerbated banking consolidation as a wave of regulatory reform raised regulatory requirements for banks. As a result, a gray space in lending to small to middle-market companies coincided with a low-yield environment post-GFC, creating the conditions for institutional investor acceptance of a burgeoning asset class known as private credit.

However, lesser known but no less material, another gray space formed in the wake of reduced bank lending as specialty finance companies grew in number. Recent estimates (Source: Ares) indicate more than 1,000 specialty finance companies operate across the US and Canada alone, with more than half formed post-GFC. This represents a broad and fragmented specialty lending marketplace with diverse financing needs. However, banks today are unable or unwilling to meet the needs of these originators who specialize in complex assets that have failed to gain acceptance in the public securitized market. Alternative lenders have stepped into this gap to customize loans and provide certainty of execution against specified assets. **As institutional acceptance increases, alternative lenders have grown and achieved a sufficient capital base to offer specialty finance issuers certainty of execution at scale in the private markets.**

In 2023, volatility in the banking sector among mid-sized banks has once again tightened lending standards and reduced bank risk appetite, discouraging loans to the specialty finance market. A broader set of borrowers have therefore increasingly tapped into the private asset-based financing market.

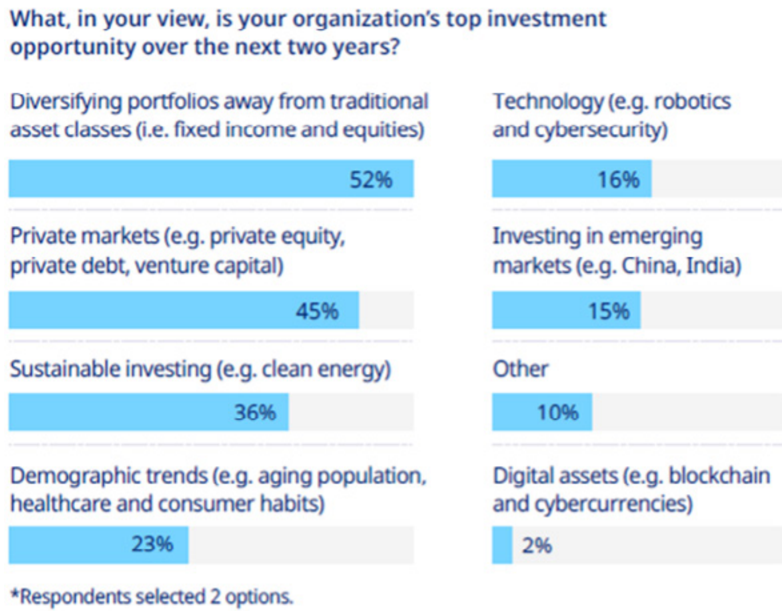
*Source: Ares

7 The Relevance of Private IG ABF to Institutional Investors — Corporate Credit Diversification

Increasing fluctuations in capital markets and a rapid change in interest rate regimes globally have fed Allocators appetite for diversification from traditional risk exposures. Across institutional investors corporate credit continues to represent an outsized portion of the asset allocation pie. While risk may be diversified by borrower, industry, geography, liquidity, or loan structure (fixed vs floating rates, secured vs unsecured), there remains a concentrated exposure to corporate credit. Private IG ABF may offer a source of diversification beyond simply introducing illiquidity by also introducing lending that is secured by esoteric collateral, whose differentiated cash flow and risk profile varies from the risk and payout profile of corporate credit.

Figure 10 | Past Mercer Client Surveys

Mercer 2023 Global Wealth Management Survey



Wealth management survey participants have highlighted diversification from traditional asset classes and evaluating private markets is top of mind

Mercer 2023 Global Insurance Investment Survey

	Percentage of organizations
Optimizing the core (fixed income) portfolio	60%
Diversifying portfolios away from traditional asset classes (i.e. domestic fixed income and equities)	51%
Enhanced cash management	40%
Increasing private markets allocation	39%
Utilizing illiquidity as a return driver	37%
Further embedding ESG criteria	25%
Diversifying credit exposure to include high yield, emerging market debt, structured credit, etc.	20%
Sustainability, impact and climate solutions	18%
Other	8%

For regulatory-constrained insurance clients, diversifying away from traditional asset classes and increasing private markets and illiquidity is top of mind

8 Employing Active Management to Help Add Value and Mitigate Risk

Given the complexity inherent in the illiquid Private IG ABF market and to justify a strategic allocation, it is important to closely examine how value can be sustainably added over the long term as well as how risk can be prudently managed.

Certain structural factors contribute to sustainable premiums in Private IG ABF, namely inherent complexity, illiquidity, and the lack of "forced flow" to the asset class from index-aware investors. These risks require that borrowers "pay up" to attract lenders' interest and assume increased investment risks. However, any potential yield enhancement will not be realized if poor underwriting leads to defaults or if attractive investments are not regularly identified. For this reason, quality active management is crucial to translate potential returns into a realized track record. The ingredients for success in Private IG ABF are sourcing, underwriting, structuring, and monitoring. We elaborate on each of the active management levers in further detail below.

First, sourcing investments can be a key contributor to generating alpha. Alternative lenders may use a broad funnel to find investments, such as reverse inquiry with potential issuers, source pools of loans from third-party or affiliated aggregators, forming exclusive forward flow arrangements with banks or specialty finance companies, or engage in risk transfer arrangements with traditional lenders (banks). However, many ABF sourcing cuts out intermediaries and therefore favors managers that have built proprietary pipelines for attractive investments through relationships with sponsors, borrowers, banks, specialty finance companies, and by building credibility and relationships in industry verticals. The length of a team's track record and their relationships with the street are therefore also an important consideration when determining the probability of a firm to consistently source value-adding opportunities.

Once an opportunity is identified, underwriting the collateral is a second important source of alpha. Any payments to lenders (principal and interest) are derived from the underlying collateral, making collateral analysis central to achieving desired results. Furthermore, while collateral types can include assets also found in public markets, Private IG ABF favors specialty assets that traditional lending markets struggle to adopt due to their size, complexity, or credit risk. As a result, alternative lenders can benefit from employing industry specialists with niche expertise. Lenders are also provided upfront with large quantities of granular information on each loan they are lending against and can use this information to exercise greater degrees of control over what collateral is included in a deal. Therefore, investing in technology and data infrastructure to help price and monitor risk based on this information enhances the ability to build loss-remote collateral structures. Overall, in Private IG ABF, lenders can tailor acceptable credit risk by underwriting and exerting control over the collateral used in a loan.

Finally, the structure around collateral (covenants, loan terms, servicer arrangements, bankruptcy remote protection, subordination, credit enhancement, etc.) is central to achieving performance expectations once a lending opportunity is identified. Bilaterally negotiated deals offer lenders control over terms and covenants to protect investors' interests and negotiate a yield premium. Direct negotiations also allow managers to charge fees that would otherwise be paid to intermediaries in public markets.

With respect to risk mitigation, aside from underwriting to avoid unintended risks, monitoring is important to continue to evaluate performance and address concerns in a timely manner, as well as using portfolio construction to manage industry, issuer, and collateral concentration risk and enhance diversification within a portfolio. It is also necessary for managing reinvestment risk as amortizing structures may force reinvestment at inopportune times.

Figure 11 | Historical Public Securitized Average Default Rates

Sector	GFC High	Post GFC Low	2019 Average	2023 Average	Current
Auto Loans					
Prime	2.08%	0.06%	0.49%	0.40%	0.46%
Subprime	11.25%	2.10%	7.57%	7.59%	7.96%
Personal Loans					
Marketplace / Online		2.49%	7.80%	12.22%x	12.95%
Traditional		3.89%	7.84%	8.45%	7.48%
Personal Loans	10.84%	0.87%	2.29%	1.61%	1.79%
Student Loans					
Stafford/PLUS	9.83%	1.74%	4.51%	9.29%	9.78%
Consolidation	2.31%	1.16%	2.28%	3.88%	3.44%
Private (Refi)			0.04%	0.20%	0.23%
Private (In-School)	2.67%	0.47%	1.89%	1.30%	1.23%

Source: Loomis, BofA Global Research. Auto rates are seasonally adjusted. Data as of 11/10/2023.

9 Looking Forward: How ABF May Continue to Develop

The ABF market has developed rapidly post-GFC, influenced by banking regulations and disintermediation, investors' search for capital-efficient yield, and the growth of large alternative lenders. These factors are likely to continue shaping the landscape for the foreseeable future.

Short to Intermediate Term

In the short to medium term, two themes have emerged – an expansion in borrowers using the ABF market along with forced flow arrangements. The vast scale and size of the ABF market is unlikely to diminish in the near term as regulatory and capital constraints on banks, paired with bank consolidation, have decreased traditional lender's appetite for market making. As a result, alternative lenders are likely to continue serving the increasingly fragmented and expanding universe of specialty finance companies with diverse lending requirements. Regarding forward flow arrangements, a trend has emerged whereby asset managers agree to take future delivery of loans that meet pre-determined specifications. Loans originally destined for syndication in the public ABS markets are increasingly diverted to private ABF as a result. This dynamic may also encourage negative selection, where the securities offered by an originator are those the originator does not wish to hold themselves. The development of the forward flow market and its importance to sourcing in ABF is a factor to monitor.

Long Term

In the long term, regulation as it relates to insurers, increasing competition among alternative lenders to attract deal flow, and climate risk are factors to monitor.

Regarding regulation, it should be noted that regulatory capital treatment by the NAIC within ABF is constantly evolving. At a high level, the key themes to be aware of are twofold. First, there has been elevated regulatory activity as it relates to insurance investments over the last few years. Second, while the Private IG ABF asset class is currently expected to provide capital efficiency, that is subject to change if the NAIC and respective regulators adopt changes to the current framework or rules in place.

With increasing adoption of Private IG ABF rising, competition is another factor to monitor. Likewise, asset managers in search of increased scale have partnered with or acquired insurers to gain access to vast pools of fee-paying capital that can be poured into secured lending.

However, we do not yet see the same trend of “dry powder” build-up as we do in traditional private credit due to a variety of factors, including the size of the ABF market and the still under-allocated nature of this asset class amongst institutional investors. Likewise, the barriers to entry for this market remain prohibitive for many potential new entrants. Therefore, increasing competition should be monitored, but is not yet a limiting factor.

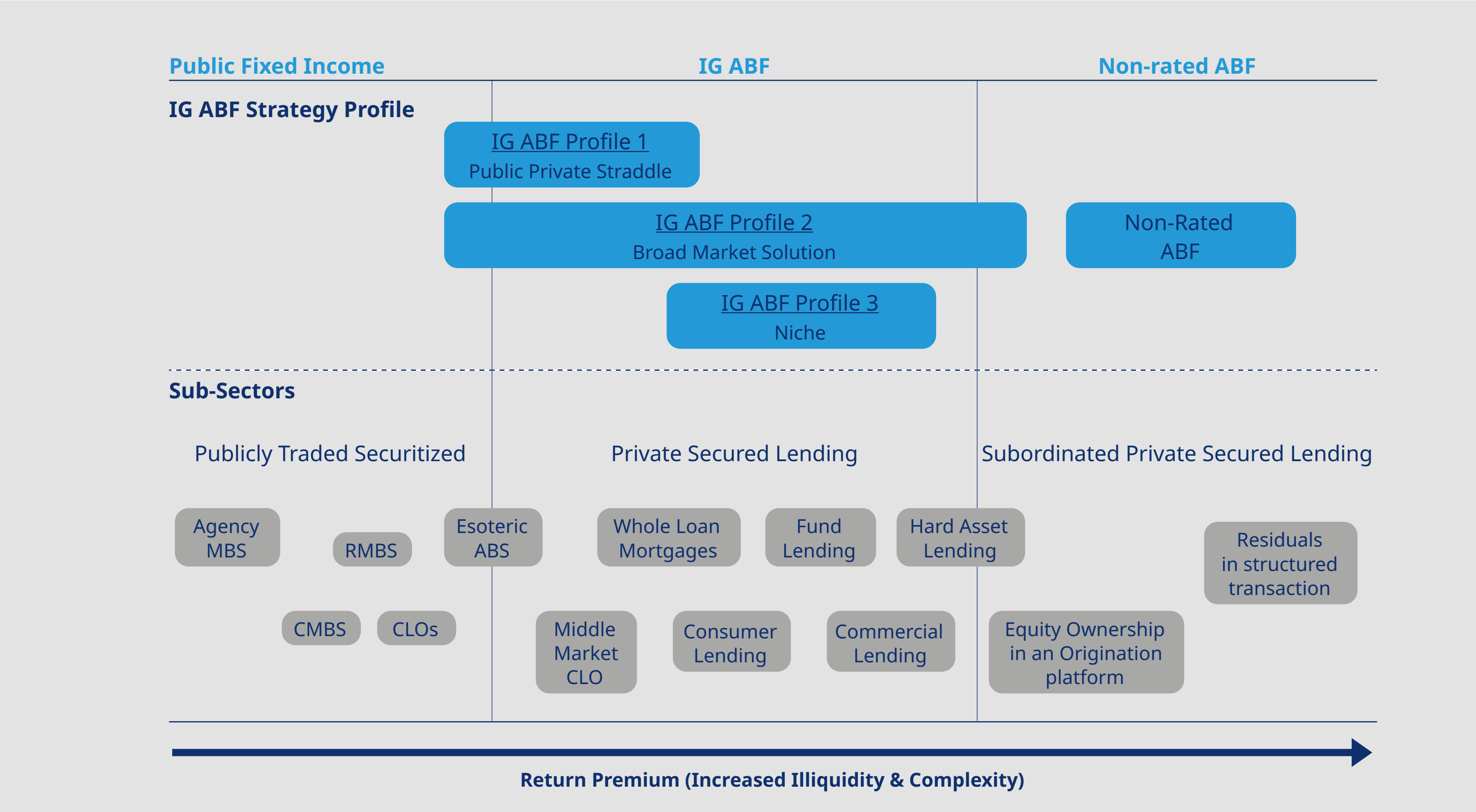
Finally, climate risk (including transition and physical risk) are factors that may influence the Private IG ABF asset class. Considering the importance of assets as the underlying collateral in ABF lending, transition risk may become an increasingly important lens through which to evaluate relative value, or long-term return prospects for particular assets. Climate change can pose physical risk and transition risk to particular businesses or investments. Therefore, whether assets will become obsolete or fall in or out of favor over the long term as a result of climate change or regulation related to climate change is an important factor to consider.

10 Portfolio Construction and Client Considerations

Portfolio construction within Private IG ABF is complicated by varying opportunity sets that lead to disparate risk and return profiles. Some strategies are dedicated to Private IG ABF, while some choose to also invest in public markets or non-rated ABF. The majority of strategies we have reviewed are centered on Private IG ABF as discussed in this paper with a degree of tolerance for public market securitized or non-rated ABF. These strategies are referred to as broad market solutions. A minority of the ABF managers are focused on a very constrained subset of the universe — these are referred to as niche strategies.

For clients seeking a conservative approach to Private IG ABF, we recommend strategies that may allow some degree of public market flexibility but that approach non-rated ABF cautiously or avoid it entirely. For clients with more risk tolerance, the broad market solutions offer comprehensive exposure. For clients seeking to further diversify an already diversified composite, niche strategies may add value as a satellite exposure but would not be our preference as the core exposure to Private IG ABF.

Figure 12 | Private IG ABF Investment Strategy Profiles and Ecosystem



For illustrative purposes only, examples are not comprehensive.

One aspect that should be top of mind for clients considering the Private IG ABF asset class is its ability to withstand credit stress or deterioration. The opaque, complex, and illiquid nature of the asset class limits data availability and therefore analysis of metrics such as historical defaults or recovery rates across collateral types and sub-sectors on an apples-to-apples basis. Caution is therefore warranted, and as such, we focus on the investment grade portion of the universe which has received a third-party assessment of the underlying credit risk.

Other aspects that contribute to enhanced downside protection include structural features such as amortization which reduces risk exposure by paying back principal over time, active management features such as asset manager's ability to source and control collateral, and allocation decisions such as avoiding Private IG ABF strategies that include excessive subordination or first-loss positions. These features when combined contribute to a resilient portfolio better suited to weathering a downturn. Prospective investors should carefully consider the types of collateral employed and evaluate public market proxies (where available) as well as a given manager's track record in avoiding realized losses.

When delving into Private IG ABF, Allocators should also be prepared to consider selecting an appropriate benchmark, identifying a profile that aligns with their investment objectives, tolerating higher fees than public markets, and identify an appropriate investment vehicle or customized account. It is also important to consider whether the fund liquidity terms are aligned with the underlying liquidity in a proposed fund offering. There may also be client-specific considerations, some of which we highlight below:

Insurers

Efficient Capital Treatment: Clients for whom regulatory constraints dictate the efficient use of capital may benefit from the combination of a yield pickup over public markets with an investment grade rating.

Enhanced Cash Yield: Within Private IG ABF, the periodic cash payout of coupons plus principal (amortization) creates a stabilized and higher cash yield than experienced in a bulleted payment structure with periodic interest payments and large principal lump sum at maturity. As a result, the book yield profile may demonstrate enhanced stability.

FHLB Lending Program: For clients participating in an FHLB program or considering regulatory constraints, certain ABF investments can be highly capital-efficient, such as residential whole loans, and are typically managed in a separate account as a result. These loans can be utilized as collateral in an FHLB lending program, freeing up current collateral for other uses.

Pension Plans

Diversification: Pension plans seeking diversification paired with a tolerance for illiquidity may find value in the ABF space. However, due to the short-duration nature of the asset class, clients may require a duration adjustment at the portfolio level to ensure duration is in line with targets, either via an overlay or some other method.

11 Summary

Following a volatile period over the last few years, risk factor concentration is front of mind for many clients. Likewise, fluctuations in interest rates have broken the mold for yield expectations within fixed income, prompting clients to re-evaluate and optimize asset allocation. For clients who remain heavily concentrated in corporate credit, valuable diversification and attractive return potential can be sourced from Private IG ABF, due to the underlying esoteric collateral and multiple avenues for sourcing alpha. However, the complexity and still-developing nature of the asset class requires intensive and thorough due diligence to identify the appropriate investment profile and partner.

Today, despite daunting complexity and an array of solutions, the viability of Private IG ABF adds another tool to investors' tool kit to optimize portfolio outcomes and therefore warrants consideration.

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Glossary

Asset Backed Security (ABS): A type of financial security that is backed by a pool of assets, such as loans or receivables, which generate cash flows for investors.

Allocator: An entity or individual responsible for allocating or distributing investment funds to different asset classes or investment strategies.

Amortization: The process of gradually paying off a debt or loan through regular payments over a specified period of time.

Asset Backed Securitization (ABS): A process of pooling and repackaging of cash-flow producing financial assets into securities that can be sold to investors.

Broadly Syndicated Loan (BSL): Large loans provided by a group of lenders to a single borrower, typically a large corporate entity.

Capital treatment: The regulatory treatment of a financial institution's capital, which determines the amount of capital required to support its activities.

Climate transition risk: The risk that a company or investment portfolio may face due to the transition to a low-carbon economy and the impact of climate change.

Commercial Mortgage-Backed Securities (CMBS): A type of asset-backed security that is backed by a pool of commercial mortgage loans, which generate cash flows for investors.

Collateral: An asset or property that is pledged as security for a loan or debt, which can be seized by the lender if the borrower defaults.

Collateralized Loan Obligation (CLO): A type of structured financial product that pools together a portfolio of loans and issues different tranches of securities backed by those loans.

Credit risk: The risk that a borrower or debtor will fail to meet their financial obligations, resulting in a loss for the lender or investor.

Commercial Real Estate (CRE): Property used for commercial purposes, such as office buildings, retail spaces, or industrial properties.

Credit Risk Transfer (CRT): A financial instrument that transfers the credit risk associated with a pool of loans or other assets from the originator to investors.

Duration: A measure of the sensitivity of the price of a fixed-income investment to changes in interest rates.

FHLB lending program: The Federal Home Loan Bank (FHLB) lending program that provides low-cost funding to member financial institutions.

GFC: Great Financial Crisis of 2008

Illiquidity: The condition of an asset or investment that cannot be easily converted into cash without a significant loss in value.

Investment Grade: A credit rating assigned to a bond or debt instrument indicating a relatively low risk of default by the issuer.

Leveraged borrower: A borrower or entity that has a high level of debt relative to its equity or assets, which increases the risk of default.

Mortgage-Backed Securities (MBS): A type of asset-backed security that is backed by a pool of mortgage loans, which generate cash flows for investors.

Marketplace Lending (MPL): The practice of using online platforms to connect borrowers with lenders, bypassing traditional financial intermediaries.

National Association of Insurance Commissioners (NAIC): Abbreviation for the National Association of Insurance Commissioners, a standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia, and U.S. territories.

Non-Qualified Mortgage (Non-QM): A type of mortgage loan that does not meet the qualified mortgage standards set by regulatory authorities.

Option adjusted spread (OAS): A measure of the spread or difference in yield between a fixed-income security and a risk-free benchmark, adjusted for embedded options.

Risk-Based Capital (RBC): Abbreviation for Risk-Based Capital, a regulatory framework that determines the minimum capital requirements for financial institutions.

Single Family Rental (SFR): Securities backed by residential property that is rented out to a single tenant or family for residential purposes.

Single Asset Single Borrower (SASB: A type of commercial real estate loan where the loan is secured by a single property and the borrower is a single entity.

Weighted Average Life (WAL): A measure used in finance to calculate the average time it takes to receive the present value of all future cash flows of a financial instrument.

Contributors:

Elijah McGowen
Senior Investment Researcher
elijah.mcgowen@mercer.com

Nolan O'Neill
Head of US Fixed Income Manager Research
nolan.o'neill@mercer.com

For additional information, please contact:

Eryn Bacewich
Chair of Insurance Strategic Research Team
eryn.bacewich@mercer.com

Chris Tschida
Head of US Insurance
christopher.tschida@mercer.com

Gary Sems
Commercial Strategy and Business Development – US Insurance
gary.sems@mercer.com

Appendix

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Asset Manager Survey and Discussions

We would like to thank the industry contacts who we had the benefit of meeting with and who provided valuable insights into this opaque asset class for the benefit of our clients:

Apollo	Blackstone	KKR	PIMCO
Ares	Blackrock	Loomis	Wellington

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