Muzinich & Co. Public/Private credit roundtable

Chair: Erick, we saw a slight fall in sovereign risk-free yields at the end of 2023, and in 2024, many were predicting a start to the rate cutting cycle by the Federal Reserve. Yet here we are now, and there are even more talks about further rate hikes, from the Federal Reserve in particular, from many commentators. Can you talk us through where Muzinich & Co. think we are in the interest rate cycle, what you think Central Banks can and importantly will do over the rest of the year, and what this means for the outlook for both public and private credit?

Muller: When inflation falls from 10-11% to 3% you must act with interest rates. This is why I don't buy the idea that there will be a further hike. The 5.25% rate in the US and the 4% rate in Europe was the peak of rates, and when they last raised interest rates, it was on purpose in order to have this extra hike as a sort of insurance policy against the uncomfortable development in inflation and rise in commodity prices etc. If we look at the current level of interest rates, it is above what would have been needed already. So, 2024 is a year of rate cuts, not rate hikes.

In the US, vis-à-vis the beginning of the year, we are seeing the US exceptionalism which combines the supply side improvement, but also the very strong demand side, which is much stronger than expected given the fact that all this extra demand we've seen recently was coming from savings. We thought that after the pandemic, all the savings accumulated had been consumed, but this was not the case. A negative evolution of savings has been happening. The strength of the job market was also the big surprise. That is something new in the system, and this gives the Fed time, they don't need to hurry. We never thought that the Fed would cut in the first half of this year as it was much too soon, because what is important for central banks to act is to have less volatility in their modelling exercises. September will probably be the first rate cut. In Europe it is very different. Seventy per cent of corporates go through the banking system – it is floating borrowing. They need to cut rates. We don't have the demand side in Europe, we have negative retail sales. This has to change to really be optimistic for

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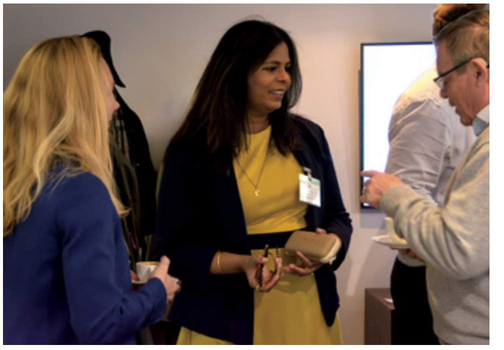
Chair: Paul Whelan, partner, co-head of global fixed income manager research, Aon

Paul serves as a partner and is co-head of global fixed income investment manager research at Aon and is based in London. He is responsible for sourcing, evaluating, conducting due diligence, and monitoring fixed income funds on a global basis and assisting clients globally in effective implementation investment portfolios. Prior to Aon, Paul was a fund manager at UBS, Henderson Global Investors and Aviva Investors.

the eurozone, and for that we need lower rates. That is why the ECB is in more of a hurry than the Fed is to cut rates. Having said that, if we open the dialogue on divergence, between the two regions there is a limit to that. One school of thought of the governing council at the ECB says if the Fed does nothing it reinforces the case for the ECB to do more, because it has an impact on the modelling where if it is a higher interest rate in the US, this applies a negative impact on European growth. Another part of the ECB says it has to be careful with FX because we have been through a long period without FX volatility and a too large or persistent divergence may trigger a weakening of the Euro beyond reasonable limits. Another angle is that it is also very probable that r-star has increased but we have to be very careful. r-star is not observable it is a modellised concept. Depending on the type of model you use, r-star is between -0.5% real terms to 1.5%. It is therefore extremely dangerous to be too fixed by r-star. What is true is that you have pressure on interest rates coming from fiscal deficit financing and fiscal spending that is not being corrected. The second point is the investment you need with climate change. This is putting pressure on real interest rates and that is why we think the terminal rate for the ECB is not 2% in nominal terms it is around 2.5%. In the US it is about 3%-3.25%.

We see three phases. The first one is removing the insurance policy we've put in September



2023, the second one is when inflation is ok enough to have possibly two more cuts in Europe this year, and then we will have more cuts mid- 2025. This high for longer is a reality and we have to adjust to this. It has meant that floating rate instruments in your portfolio are still attractive. The floating rate instruments can be loans, CLOs and private debt with a different liquidity feature of course If we talk about appetite for duration, in 2024, we feel that the best camp for duration positioning is probably shorter than your benchmark. From our clients, we see the demand for duration vanishing. It was very visible end-2023, still very present in the beginning of 2024 and since March it has gone. Flows are coming back into this 2-5 year part of the yield curve with an increase of the credit beta in compensation for the duration reduction.

Chair: You mentioned the fiscal deterioration that many nations are having. How risk-free are the risk-free markets and where do you think the buyers are likely to come from over the next 2-3 years? Do you think that will make investors more cautious of moving out down the interest rate duration curve?

Muller: It is very clear to me that lending to governments is a risky business and that will not change tomorrow. If we look at how the fiscal trajectory has been managed over the past 10 years, it has been catastrophic everywhere. In Europe, you will see five countries with excessive deficit procedures in the second part of this year. In the UK, it is close to election and of course it will be very surprising if we have a fiscal discipline. Fortunately, rates are low. It is fiscal dominance that we are seeing in the UK. That is

why central banks must cut rates. It is already 3% of GDP being spent in paying the debt. In two years' time it will be 5% or 7% depending on the countries in Europe.

Chair: If we turn our attention to the credit opportunities on the private and public sides, while fiscal positions have deteriorated, many corporate balance sheets especially for larger cap companies, are still looking reasonably healthy. How does this opportunity play out in the way you see the risks and rewards given spreads in public markets are towards the tighter end?

Bode: Let's take a step back to the origins of private debt and direct lending in Europe. In Europe, the market came into existence after the global financial crisis when companies figured out they couldn't rely on the banks. This is when from a regulatory perspective, through Basel 3 and 4, it was made much easier for players on the institutional side to be an alternative to the banking system. That had happened in the US many years earlier, so Europe followed this. It came together where interest rates were very low, so there was not only demand from the corporate side but from the investor perspective. Yields were not obtained in a 0% interest rate environment and investors wanted to create additional yield in their typically fixed income portfolios. A percentage of the fixed income was shifted into direct lending and private credit in various shapes and forms. The pitch from our perspective was the so-called illiquidity premium. At all times through our portfolios, we want to show that we can compensate for the illiquidity. This is not a fixed number; it differentiates by strategy but one would say there should be at least one and a half percentage for a straightforward strategy where you can show this illiquidity premium. This is how direct lending private credit started off in Europe. In more recent times, with the first-time interest rate increase, many investors thought should we stay with this private credit asset class or should we move more into floating rate instruments. We felt there was hesitation to continue increasing allocations in 2022/3, however we saw that during the beginning of the Ukraine crisis, banks were hesitant to conduct bank lending and that is the competition for us. There was a huge demand from corporates, but this has flattened out a bit. Nevertheless, we see our deals being driven by M&A activity, so private equity sponsors wanting to acquire businesses. The lower market segment has been very active here. In 2024, investors have come back to private credit due to the very interesting rate of returns. Private equity has suffered, and private credit has benefited from that. A typical question we have received from our investors over the last 12-18 months, is interest rates have increased, how healthy is your portfolio? It really depends whether you lent in the subordinated space where leverage levels are high, or have you been active on the senior secured level with very conservative leverage structures. For us, the answer is interest rate coverage have reduced a little bit, but it is of no concern. For our new deals, our leverage levels have decreased half a turn to a turn, so we can pass on the increased base rate to the counterparties in a way where we won't increase the risks in the deals we are conducting.

"At all times through our portfolios, we want to show that we can compensate for the illiquidity

Erick Muller, Director of Market and Product Strategy, Muzinich & Co.

Erick joined Muzinich in 2015. His responsibilities cover macro and fixed income markets strategy and product management as well as client relationships across institutions, global distribution platforms and global private banks. Erick has an MBA in finance – marketing from the ESLSCA Business School and a degree in economics from the Universite Pantheon-Assas.

Chris Price, Director, Insurance Solutions, Muzinich & Co.

Chris joined Muzinich in 2023 following his previous roles as an adviser to asset management, private equity and fintech firms. Prior to that, he was head of insurance solutions UK at AXA IM, where he led the UK insurance strategy as well as provided asset allocation modelling and accounting, regulation and other expertise.

Kirsten Bode, Co-Head Private Debt – Pan Europe, Muzinich & Co.

Kirsten joined Muzinich in 2015 following six years as a managing director in the principal debt investing team at Macquarie, responsible for sourcing and executing transactions ranging from leveraged senior, unitranche and mezzanine debt to equity in the UK, Germany and Benelux. Kirsten graduated from ESB Reutlingen and Middlesex University London with a BA (Hons) in European business administration.

Andrew Douglas, Head of Institutional Sales, UK and Ireland, Muzinich & Co.

Andrew joined Muzinich in 2021 from AXA Investment Managers where he was director of the institutional business. Prior to that, Andrew worked for two other asset managers in similar positions after starting his career as a fixed income analyst. Andrew has a BA (Hons) in industrial economics and is an IMC and ESG CFA holder.

Chair: Looking at the asset owners, on the public IG credit portfolios that you invest in, what is the tolerance for active portfolios with high turnover or are you looking at buy and hold?

Malharkar: As one of UK's leading Retirement and Savings business, Phoenix has a significant allocation to credit across both Shareholder and Policyholder portfolios. With gilt yields rising, and credit looking expensive on a relative basis, we have allocated more to gilts in the recent past for our shareholder book. We will opportunistically look to deploy that back into credit when conditions become more favourable with wider spreads. We have opportunistically deployed into private credit as well during this period, but that is more on the Solvency II MA eligible debt front, depending on where we have appetite in terms of our liability buckets on a relative value basis. On the policy holder side, we have signed the Mansion House Compact last October and, we are keen to allocate to private markets for our DC Defaults - both debt and equity. We will be looking to start with a 5% allocation to private markets and this will be part of our multi asset portfolios.

Whitfield: Being a Lloyd's insurer, we are constrained with the amount of appetite we can take on for our Syndicate assets. Given the fact that we carry a relatively short duration portfolio of assets, we do benefit wherever we can to maximise our asset allocation across the IG space. In terms of our private allocation, we have had for some time an allocation to private credit through a senior secured credit fund. This has been a great diversifier for us and helped a lot through the period of rising rates being a floating rate exposure. We are also actively looking to increase our capacity to a broader asset base within the group overall.

Muller: By broader do you mean the equity side or on the fixed income side?

Whitfield: Both. We are currently running two searches on an EMD debt strategy that would complement our long term FAL capital, as well as looking at a more active equity strategy. Through one of our syndicates, we have a long tail PPO exposure and match it through an allocation to equities but are exploring a more active strategy to maximise long term returns.

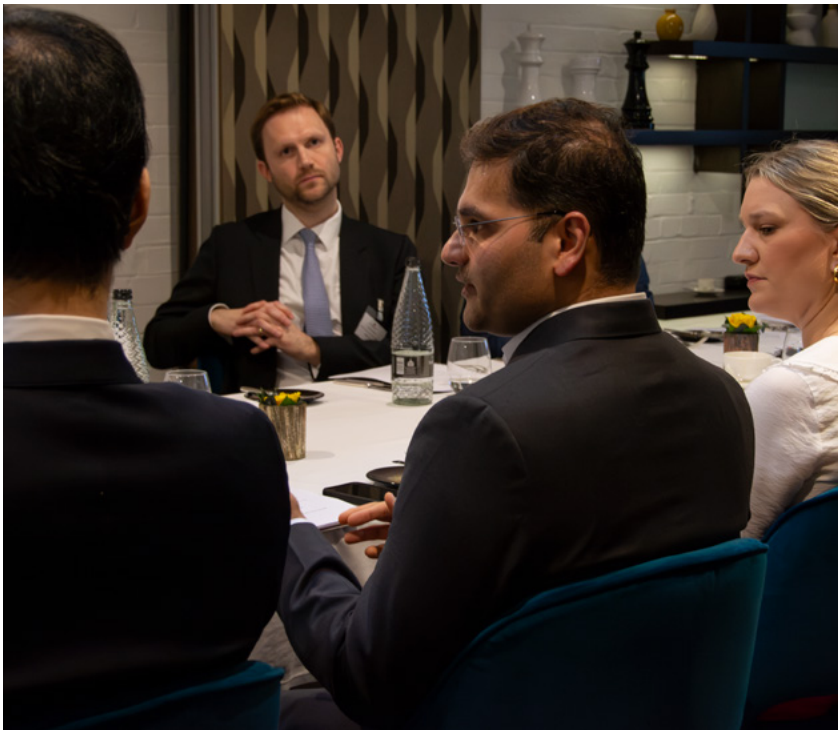
Staunton: Focusing on the P&C side of Zurich UK, we have an allocation to private debt. We look across more traditional private debt and then also syndicated loans. On our life side, the

ramp up of private debt has been challenging for the investment grade side of things. The spread compression above publics has been a challenge to then get the ramp up that you want at the right price. We are quite stable on the P&C side and not looking to allocate any more.

Kansagra: We are mostly US dollar denominated investors, because in the Lloyd's market two thirds of the premiums are US dollars. Over the past two years or more, we have started to introduce allocations to private assets in the Lloyd's Central Fund which we manage and have opened up these options to the Lloyd's market via the Lloyd's Investment Platform. The capital layer or the Funds at Lloyd's has investment restrictions driven by the rules that we have, but we have been creating solutions which are not only compatible with the rules, but which also gives Lloyd's market access to private markets. We have already launched a USD US direct lending private debt fund investing in the lower to mid-market sponsor backed loans, usually not in the syndicated part of the market. The other solution we have launched and invested as a seed investor in an ESG focused article 9 private equity fund, which is open to the Lloyd's market as well.

Huang: Our approach to asset allocations follows both top-down bottom-up perspectives. We have five balance sheets across different regions, with investment strategies tailored to the business strategy and capital efficiency of each entity balance sheet. There are three main pillars - on our IG public credit side, they tend to be multi-currency multi-sector portfolios driven by key characteristics of the liability profile. We mostly have our IG credit denominated in USD but we also have exposures to the Canadian and sterling credit markets. The second pillar is more in structured credit in our Bermuda/US balance sheet. This currently benefits from the higher for longer narrative theme. The third

> We have started to introduce allocations to private assets in the Lloyd's Central Fund



pillar is more on the private credit side, and that is quite a widely diversified portfolio across IG rated private placements, as well as large cap and middle market loans and small exposures on the commercial mortgage loan side as well.

Chair: And do Aspen invest in the public sub-IG space?

Huang: We have very small exposures to high-yield bonds and leveraged loans.

Bray: On the public side, we wanted to increase our EMD allocation but with spreads tight at the moment, we have shelved that. We were also interested in adding a strategic allocation to CLOs and high yield, but it all looks quite expensive now. An area of greater focus has been on private markets, and this has been our first tiptoe into it. Historically Hiscox has been very conservative, very liquid, very short dated, with low duration liabilities and so on. We are starting with private debt, looking at the highest quality, senior secured side with a mixture of dollars, pounds and euros whilst setting up a fund structure so that all the different entities can invest - more secondaries in dollars, and

Angel Kansagra, Head of ALM and investment solutions, Lloyd's

Angel heads the asset liability management and investment solutions team at Lloyd's. He is responsible for investment strategy, asset allocation and investment risk. He also leads the design and implementation of public asset investment solutions on the Lloyd's Investment Platform to provide customised solutions to insurers and capital providers in the Lloyd's market. Angel is a qualified actuary.

Kedi Huang, Chief Investment Officer UK, Aspen

Kedi is currently a UK chief investment officer with principal responsibilities of overseeing UK investment activities, and leading group investment initiatives to ensure UK entities would benefit from these. Prior to this, he was an investment banker at Nomura, and has also worked at LGIM.

more primaries in pounds and euros. We may look beyond direct lending to corporates but maybe also at other areas like real estate lending or asset backed.

Chair: So, looking at your private market allocation, the capital sourced for that is in short dated IG, or gilts for example?

Bray: It is coming from short-dated IG. We have also changed the benchmarks to have a bit more government weight, and also to try and bring our duration a bit closer to liability duration.

Muller: You mentioned secondaries. Why specifically are you interested?

Bray: Price and transparency. It is also better capital efficiency to buy shorter dated loans. Having this diversification is beneficial.

Muller: From what the panel has said, it believes credit spreads are very tight and that this is a problem for increasing your allocations to credit. I would like to say that if we look at spreads over time, so let's say 10 years, I'm not so sure that the spreads are as tight as people are saying, and this doesn't mean the asset class isn't attractive. There are a lot of things you can do in tight spreads with active management of course, with picking the right region, the right type of credit. Secondly, if you expect the spreads to widen by 100-150bps in high yield before investing you may be disappointed. I think right now it is more interesting to look at the level of yield rather than the level of spread and how that matches your liability. Being obsessed by the spreads might make you miss the opportunity of interesting at the proper level of yield. I understand the constraints of high yield from a capital perspective versus IG however. We are seeing more and more demand from clients to enter the high yield space, removing the tension about the entry point. Clients want solutions where you can manage through derivatives exposure and overlay portfolios to reduce the risk of buying too expensive, because you can hedge and be short.

Chair: Looking at the asset owners, on the public IG credit portfolios that you invest in, what is that tolerance for active portfolios as long as you get that look through or are you looking at buy and hold?

Malharkar: For us on the annuities side our approach is very much buy and hold. However, it

Alastair Whitfield, Investments and Treasury management, IQUW

Alastair joined IQUW in 2023 to lead the build-out of the company's investment & treasury management function. With over 20 years of experience on both the buyside and sellside, Alastair also oversees group assets in excess of $1.5bn and is responsible for optimising the overall strategic asset allocation and setting the investment strategy of the company.

is 'buy and hold' and not 'buy and forget' so we are actively optimising the portfolio for capital as well as spreads.
Huang: Our portfolio management style is active and selective at a granular level. We incorporate SAA into the customised benchmark for each account to reflect our strategic views, and overlay with tactical allocations via actively positioning across sectors, duration and credit risk weightings versus the benchmark within the risk appetite. .
Price: On the private market side, there are some theoretical benefits which include access to less price volatile assets, the investors are closer to work out process if things do go wrong and obviously you get diversification. But how do people quantify those benefits, if at all?

Chair: That's a good question. There are many private credit managers out there who have only invested in a zero or negative interest rate cycle and that's how their businesses were setup. It is only recently that they are in that non zero cycle so it is a combination of those different dynamics. At Aon, we see private credit as a great area to support the just transition as well as societal impacts. So, you have a Rubiks cube approach of assessment within that.
Malharkar: Yes, we do pay attention to performance durability across cycles and ability to influence ESG and that plays into the conversation. We invest across a range of private credit sectors including infra, real estate, corporate private placement, structured credit across different managers and we look at both the illiquidity pick up as well as the complexity premiums involved in structuring.

Chair: Lizzie, you mentioned the challenge of deploying into private markets and finding the opportunities. Now that you are looking to invest with that more sustainable lens, does that add another 'wrinkle' into the difficulty of originating and sourcing those assets?
Staunton: It does, but I think private credit also has a real role to play in that ESG journey. It might increase the complexity of trying to find the right deal to meet Zurich's ambitions, but

Chris Bray, Investment Analyst, Hiscox

Chris has been an analyst in Hiscox Group's investment team since 2019, having previously worked in financial consulting and equity fund management. He focuses on quantitative analytics relating to the group's investments, including asset-liability matching, strategic asset allocation and risk modelling. On the responsible investment side he develops and maintains the group's internal ESG investment dashboard, researches new fund investments and monitors ongoing policy/regulatory developments.

> I think private credit also has a real role to play in that ESG journey

equally those ESG assets have a crucial part to play in meeting those ambitions. At the same time, they may also have even further spread compressions because everyone wants to have those ESG and social bonds in their portfolios.
Muller: How do you frame your ESG constraints?
Staunton: So, the Zurich Group ambition for us is putting £5bn into impact investment with a target to avoid 5 million metric tonnes of CO_2e emissions and to benefit 5 million people from a positive contribution to their lives and livelihood; this will be achieved through both the public and private space across the whole Group by the end of the 2024. This is a specific Zurich target.
Douglas: So that is the 'E' and the 'S' then for the impact investments. It is around how many lives have been affected and around job creation. This goes back to Reena's point and the Mansion House Compact. All these elements are very aligned. Impact can mean climate and biodiversity, but it can also mean education, job creation, etc.
Price: When you are making ESG investments, do those investments have to compete directly

with non-ESG investments, on price, spread and other factors or do you take a different view?

Malharkar: We look at ESG on a deal-by-deal basis for every borrower/issuer. Our shareholder mandates are set up as non-discretionary mandates where we approve investments, and we approve any changes to the private credit investments. ESG criteria are very much part of the decision-making process. We have a clear exclusions policy, look at impact, think about climate (given our NZ objectives) and social as part of that decision, and have invested in hospitals, universities, social housing etc. We also actively look at transition finance opportunities to ensure we do not exclude investments which may currently not adhere to our ESG standards but may be on a path to achieving them.

Price: Carrying on this theme of ESG, it is clear you can have more impact in global terms in emerging markets than you can have in developed markets. Obviously from an insurance point of view, however, there is some reluctance to invest in the emerging market side. Do people see this as something that is likely to change?

Huang: From my perspective, if you were to build an emerging market mandate for an insurance investment portfolio from scratch, overlaid with the key constraints of IG rated and short to medium term duration, it may be challenging to build a diversified portfolio whilst adding attractive risk-adjusted yield on a relative value basis versus DM market, in the heighted geopolitical risk environment.

Bray: We have made some changes over time where we have excluded China from the hard currency debt mandate and that is arguably for return reasons but also from a tail risk related to Taiwan. It's interesting to see that even the manager we work with has some of its own internal screens and exclusions for some countries e.g. Saudi Arabia on a human rights basis.

Malharkar: From our perspective we have looked to lend to EM's directly through DFI's. The challenge then comes back to making it Solvency II and MA eligible. So, we can maybe achieve this through a guarantee or a wrap.

Price: Erick, going back to the macro material you started with, it seems to me there is a tug of war going on between some governments and their own central banks. This is in two senses. Firstly, governments want interest rates to be low because they have debt to service but central banks don't want rates to be too low because they want some dry powder for the next crisis. Also, you see central banks increasing rates to bring inflation under control while governments are being fiscally incontinent. Do you see this tug of war ever going away?

Muller: No. The problem will continue to exist as long as you don't have a change in the fiscal trajectory in the public finances. The point is, is that it has taken so much effort to gain independence from central banks, and the UK is one case, that you don't want to throw that out the window. I am however very happy to see that we have been through five years of crisis, whilst not putting euro existence into question, not putting central banks independence into question, and not putting the authority of an external body like the OBR into question. At least the institutional framework is stable and that is the good news from the past five years. Otherwise it would have shocked everything.

Lizzie Staunton, Head of Investments, Zurich UK

Lizzie is Zurich UK's head of investments and responsible for setting and implementing the investment strategy and day-to-day management of both the life and P&C balance sheets. Lizzie has been with Zurich for five years and previously worked at Deloitte and Prudential UK. She is a fully qualified actuary.

Reena Malharkar, Senior manager-strategic partnerships & research, Phoenix Group

Reena has over 20 years' experience in asset management and insurance. She was head of portfolio management at Legal & General Assurance before joining the Phoenix Group in 2020. She is now a senior member of the strategic partnerships & research team in Phoenix Asset Management, responsible for strategic relationships and supports the execution of the policyholder and shareholder investment strategy across public and private assets.