No Free Yield: Risk, Return and Expectations in Private Credit

TRANSPARENCY ANALYTICS

I. OVERVIEW

At its core, sponsor-backed direct lending lives largely in the non-investment-grade world. These are generally borrowers with higher leverage, greater operating and execution risk, and less margin for error than their investment-grade peers. That is not a flaw in the asset class. It is part of the reason it exists, and one of the reasons investors earn higher yields.

This is not a new lesson. In the years before 2008, investors who wanted more than AAA yields moved down the capital structure and down the rating scale, and for a long time they were well paid for doing so. When losses arrived, much of the reaction treated them as a betrayal rather than as the realization of risks those investors had been compensated to bear. That episode also exposed real shortcomings in how some risks were evaluated, a point we return to below. But the broader pattern of embracing the yield while disowning the risk is worth remembering.

For a long time, the environment for private credit was highly constructive. Liquidity was abundant, defaults were low, refinancing was readily available and performance across many portfolios appeared remarkably stable. In that environment, higher yields could begin to feel less like compensation for risk and more like excess return.

Everyone grew comfortable: sponsors, arrangers, investors and, in certain cases, those who assess the risk. Prolonged stability creates a tendency to place less emphasis on downside scenarios.

But some of that apparent stability also failed to reflect where private credit risk may be lurking. Loans held to maturity and valued periodically do not exhibit volatility the way publicly traded instruments do. Amendments, maturity extensions, and payment-in-kind (PIK) interest can give borrowers additional runway and postpone the recognition of stress without resolving the underlying credit problem.

Lincoln International estimates that 6.2% of the loans it tracks had no PIK at origination but carry it today, a measure it has characterized as a potential "shadow default rate."[1] Low observed volatility is not the same thing as low underlying risk.

At the same time, the compensation for bearing that risk was declining. Global median spreads over floating base rates (SOFR in the U.S.) on new direct loans fell from a peak of 716 basis points in March 2023 to 544 basis points by the end of 2025, while the covenant-lite share of direct lending transactions rose from 4% to 21%.[2] Investors were accepting

MARKET COMMENT

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narrower compensation and weaker structural protections for risk that remained fundamentally speculative-grade.

Yield is not the same thing as return.

A contractual spread is what an investor is promised for assuming a collection of risks. Some of it compensates for expected credit losses, some for uncertainty around those losses, and some for illiquidity, complexity, and structural risk. What remains after losses, expenses and other frictions is what becomes realized return.

II. WHEN RISK BECOMES VISIBLE

Fast forward to today. Some borrowers are missing projections. Capital structures are being tested. Liquidity is less forgiving, even as base rates have eased.

How much stress depends partly on who is counting. Fitch's U.S. private credit default rate reached a record 6.3% on a trailing 12-month basis in August 2026, a measure that draws on Fitch's credit opinions and privately monitored ratings and captures restructurings and other distressed outcomes as well as missed payments.[3] Proskauer's index of senior secured and unitranche loans showed a default rate of 2.51% for the second quarter.[4] KBRA DLD's trailing default rate reached a high for its series earlier this year, and KBRA expects it to rise further.[5]

The gap between those figures is itself instructive. In private credit, default is not one universally defined event, and differences in definition, sample, and weighting matter. What the measures share is direction.

Those developments deserve attention, but they also need context. Periods of benign performance can lead investors to confuse the absence of realized losses with the absence of underlying risk. When stress emerges, outcomes that were always possible can suddenly feel exceptional. More often, they are the realization of risks that were present, but dormant, throughout the investment.

Defaults matter, but they do not determine investor outcomes on their own. Recoveries, collateral, documentation, and seniority matter. So do restructuring outcomes, the income earned before impairment, and the timing and severity of losses. Default is not the same thing as loss.

Over roughly two decades that include the global financial crisis, U.S. middle-market direct loans in the Cliffwater Direct Lending Index have experienced realized credit losses after recoveries of approximately 1% annually. Through mid-2026, realized losses were running at about half that long-term average.[6] That is a meaningful record.

But realized losses are a lagging measure. They are recognized when loans are restructured, sold, or written off, often well after stress has appeared in non-accruals, PIK interest and valuation marks. Much of today's portfolio was underwritten in the low-rate years of 2020 to 2022, or in the more competitive and more loosely documented market that followed. Historical loss experience is a reference point, not a forecast.

Higher spreads exist in part because losses are expected to occur. The relevant question is not whether a portfolio ever experiences defaults. It is whether investors were adequately compensated for the frequency and severity of the losses that ultimately emerge, and whether risks were appropriately differentiated when the investments were made.

Periods of stress reveal whether markets priced risk adequately in the first place. That is when dispersion becomes especially important. As the cycle turns, weaker credits distinguish themselves from stronger ones, and capital structures that appeared sustainable under optimistic assumptions become constrained under more realistic ones.

Refinancing options narrow, amendments become more frequent, PIK interest increases and non-accruals rise.

That dispersion is already visible. In Fitch's data, borrowers with less than $25 million of EBITDA defaulted at a 12.0% trailing rate through August, and healthcare and industrial borrowers at 9.9%. Software, despite intense concern about AI disruption, has so far defaulted at among the lowest rates of any major sector.[3] Averages obscure where risk is concentrated.

None of these means the asset class has failed. It is the credit cycle doing what credit cycles do: exposing differences that are hard to see when liquidity is plentiful and almost everything is performing.

III. STRUCTURE MATTERS, BUT IT DOES NOT MANUFACTURE CREDIT QUALITY

Complexity and bespoke structuring do not fundamentally change this equation. Strong documentation, covenants, collateral, and lender protections matter. They influence lender behavior, recovery prospects, and outcomes when a borrower encounters stress. But they are not substitutes for fundamentally sound credit.

Structure can mitigate credit risk. It cannot manufacture credit quality.

The borrower's capacity to generate cash flow, manage leverage and meet its obligations remains fundamental. Structural protections shape how creditors move through a period of stress. They do not eliminate the possibility of stress itself.

Structure also matters most when it is tested, and much of it was given away when it seemed least necessary. During the benign years, competition for transactions led lenders to accept covenant-lite terms, more generous EBITDA definitions and documentation that left room for liability-management transactions. Those concessions cost little while borrowers performed.

In a stressed environment, those same terms determine how early lenders can act and how much value remains when they do. Recovery expectations formed in a more protective era should be lowered accordingly.

That is why spread compression, and weaker documentation should be considered together. The question for investors is not simply how much yield they are receiving. It is what risks they are being paid to accept, and what protections they have if those risks materialize.

IV. LIQUIDITY HAS ITS OWN TRADEOFF

The same logic applies to liquidity. Semi-liquid investment vehicles give investors periodic access to portfolios of fundamentally illiquid loans. But a redemption mechanism does not change the liquidity of the underlying assets.

In the second quarter of 2026, repurchase requests at non-traded BDCs reached 12.4% of net asset value, against typical quarterly limits of approximately 5%.[7] Those limits are not a malfunction. They are features designed to reconcile redemption requests with assets that cannot always be sold quickly without affecting value.

And where leverage is added above the loans themselves, through fund-level borrowing, NAV facilities or rated feeder structures, the gap between promised liquidity and underlying liquidity can widen further.

Liquidity access is not the same thing as liquidity.

Illiquidity is another risk for which investors are compensated. Like credit risk, it stays largely invisible when few investors seek liquidity at the same time and becomes very visible when many do. The tradeoff did not suddenly appear. The environment has simply exposed it.

V. WHAT THIS MEANS FOR CREDIT RATINGS

The same discipline applies to us.

A credit rating is an opinion about relative credit risk. It is not a guarantee and was never designed to be one. A speculative-grade rating says a borrower is more likely to default, and creditors more likely to lose money, than at higher rating levels.

When speculative-grade credits default at higher rates during a downturn, the rating scale is doing what it is meant to do. Rising defaults among lower-rated borrowers, standing alone, do not show that ratings have failed.

That argument holds only if it can be demonstrated, and the burden of demonstrating it is ours.

Rating agencies operated in the same environment as everyone else. Low defaults, ready refinancing, and sponsor support can make credits look sturdier than they are. The question is not whether ratings will be tested in this cycle. They will be. The question is whether they hold up.

We think the test has three parts:

- **Rank-ordering.** Do lower-rated credits default more often and lose more than higher-rated ones, consistently and across cycles?
- **Consistency.** Does a given rating category carry similar risk whether the exposure is public or private, widely held or privately rated?
- **Responsiveness.** When the evidence changes, through covenant breaches, PIK elections, maturity extensions, amendments or liability-management transactions, do ratings move, and do they move in time?

Private ratings carry a particular responsibility. Many are not publicly disclosed, yet institutional investors, including insurers, rely on them for investment and capital decisions. Questions about incentives in that market are legitimate.

The answer to those questions is evidence: disciplined surveillance, clear criteria, and published performance data that let market participants judge ratings on their record.

A through-the-cycle view does not mean an anchored one. It means distinguishing temporary volatility from changes that materially alter a borrower's credit profile and acting when they do.

VI. THE LESSON IS ABOUT EXPECTATIONS

So where are the lessons in the current environment?

An investment cannot be underwritten, assuming favorable conditions and then be treated as misunderstood when a downside scenario occurs. Accepting non-investment-grade returns requires being financially and analytically prepared for non-investment-grade outcomes.

That means stress-testing portfolios with downside assumptions rather than relying on base cases alone. It means looking through fund structures to the liquidity of the assets underneath them. It means monitoring non-accruals, PIK migration, amendments, maturity extensions, and liability-management activity, not only headline default rates.

And it means asking whether investors are being paid for weaker covenants, greater leverage, and reduced liquidity, rather than accepting those characteristics as the price of admission to the asset class.

None of this makes private credit unattractive. For investors who understand the risks, price them appropriately, diversify thoughtfully and maintain discipline across the cycle, private credit will continue to play an important role in the capital markets. But generating attractive returns requires intellectual honesty about where those returns come from.

> **There is a crucial difference between risk that has disappeared and risk that simply has not yet manifested.**

Periods of benign performance make that distinction easy to miss. Periods of stress make it impossible to ignore.

The discipline of credit investing is not to eliminate every default or avoid every loss. It is to understand the risks embedded in the return; ensure investors are adequately compensated for bearing them, differentiate among credits, and be prepared when those risks materialize.

> **There is no free yield. The return exists because the risk exists.**

NOTES AND DATA SOURCES

1. Lincoln International, private market index commentary, Q2 2026.
2. McKinsey Global Private Markets Report 2026, citing Kroll StepStone and Proskauer data.
3. Fitch Ratings, U.S. Private Credit Default Rate, August 2026. Blends model-implied credit opinions and privately monitored ratings. Includes sector and borrower-size detail. Report coverage
4. Proskauer, Private Credit Default Index, Q2 2026. Release
5. KBRA DLD, Direct Lending Default Report, 2026. Coverage
6. Cliffwater Direct Lending Index, mid-year 2026 release. Release
7. Robert A. Stanger & Co., non-traded BDC repurchase data, Q2 2026.