

Volatility Laundering in Private Credit

When Smooth Returns Hide Real Risk in the Late-Cycle Credit Environment

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Outlook

Returns

The period for significant alpha generation from private credit is behind us. We expect public credit outperformance of private credit, broadly speaking, to continue, particularly on a risk-adjusted basis.

Late-Cycle Principles

Investors should be aware of the risks associated with the low credit quality and highly concentrated nature of private credit at this point in the cycle.

New-Issue Share

The Dec. 5, 2025, decision by the FDIC and OCC to rescind the Interagency Guidance on Leveraged Lending should accelerate public markets regaining share of leveraged finance new issue from private credit.

Key Takeaways – Private vs. Public Credit



History

2020-2022: Period in which private credit outperformed and generated significant alpha relative to public credit, as public credit markets were mostly shut down, and funding rates reset higher.

2023-Present: Fully open public credit markets refinanced many of the opportunities that were in private markets in 2020 to 2022. Short-to-intermediate fixed-rate public credit has also benefited from falling U.S. Treasury rates since late 2023.



Return Convergence & Diminishing Alpha Generation of Private Credit

Broadly syndicated loans (BSLs aka “public loans”) and high yield (HY) corporate bonds have outperformed private credit since October 2022. Notably, in a year of generally strong risk-asset returns, publicly traded business development companies (BDCs) ended 2025 down 4.45%.¹



Lower Credit Quality

92% of private credit rating estimates are B- or below, versus only 30% for public loans.²



Higher Concentration

The top five industries in the private market represent 94% of the market, whereas the top five industries in the public loan market represent 32% of the market. Technology represents 31% of the BDC market versus 16.9% of the public loan market.



Industry Stress

Sectors with the most distress in the public loan market (software, IT services, health care) represent the largest industry weightings in the private market.



More Expensive Financing

Public credit markets have offered cheaper financing for borrowers versus private credit markets since January 2023. This begs the question, why would a borrower choose the more expensive financing option? DoubleLine believes it is because the borrower believes their weaker financial condition might require flexibility.



Market Share

Private credit now represents roughly 30% of the \$4.1 trillion U.S. leveraged finance market.³ However, public credit has regained its share of leveraged finance new issue versus private credit since 2022. This is likely to accelerate in 2026 after the Federal Deposit Insurance Corp. (FDIC) and Office of the Comptroller of the Currency (OCC) rescinded 2013 leveraged lending guidelines that restricted bank activity in the below-investment-grade debt market on Dec. 5, 2025.



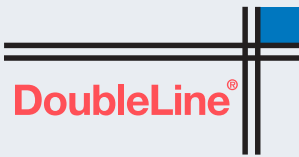
Liquidity

Private credit is less liquid than public credit. Private credit firms, at times, have used liquidity differences and absence of daily mark-to-market pricing to their advantage, marketing superior Sharpe ratios as a result. DoubleLine believes this is a form of “volatility laundering” and a misguided marketing campaign.

¹ MVIS US Business Development Companies Index (TR Gross)

² S&P Capital IQ, Morningstar LSTA Leveraged Loan Index, as of Dec. 31, 2025

³ Pitchbook, ICE, Morgan Stanley Research



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History

Private credit emerged over the past decade as a major “alternative” to public debt markets, offering investors higher yields and borrowers flexible financing. This activity was amplified in 2020 to 2022 when the public markets largely shut down new financing due to the COVID-19 pandemic and subsequent reset higher in the federal funds rate. In 2022, the broadly syndicated bank loan (public loan) market sold off, causing spreads to widen and yields to rise. The yield to maturity (YTM) of the B3/B- segment of the public loan market in this period was comparable to the YTM for transactions in the private credit market. This meant that borrowers did not have an economic incentive to borrow in the public loan market as opposed to the private credit market. Moreover, with many public loans trading at discounts to par, the public loan new-issue market seized up. At the same time, private credit investors were sitting on large pools of uninvested capital, making them ready and willing to step in and provide financing. As a result, the private credit market appropriately filled the void, offering needed financing for borrowers and attractive investments for investors. Thus, during this period, the private credit market took market share from the public loan market.

Since late 2022, however, conditions have shifted materially. Public credit markets have fully reopened, spreads have tightened, and financing costs in public markets have declined relative to private credit. (Figure 1) Many larger, higher-quality issuers that relied on private credit during the dislocation have since returned to public markets, where they benefit from lower capital costs, greater liquidity and broader investor bases. As a result, public markets have been steadily regaining share of leveraged finance issuance. (Figure 2) These larger companies generally have higher competitive entry, more diverse product offerings, better access to capital markets and often better management than smaller-scale companies still financing through the private credit markets.

This evolution over the past five years merits further analysis when investors are considering expectations for return per unit of risk from private versus public credit.

Cheaper Financing for Borrowers in the Public Markets Since January 2023 | As of December 31, 2025

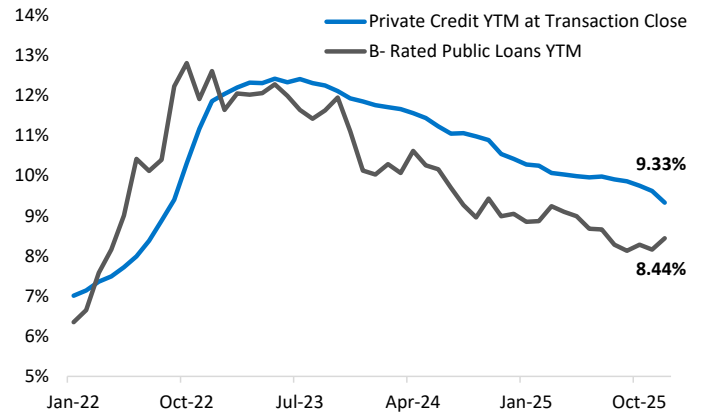


Figure 1
Source: DoubleLine, J.P. Morgan, KBRA DLD

Private Credit’s Declining Share of Leveraged Debt Issuance As of September 30, 2025

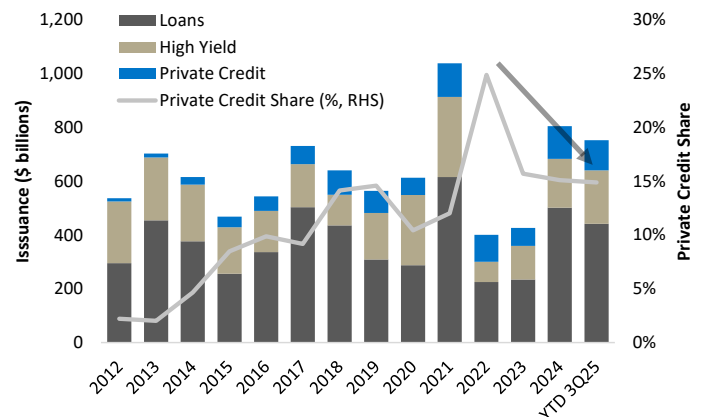
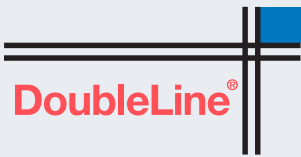


Figure 2
Source: DoubleLine, BofA Global Research, Preqin, Bloomberg, LCD, LSEG, S&P Capital IQ, ICE BofA indices



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Performance

After generating strong returns during the early years of this decade, private credit performance has converged with and subsequently lagged public credit. Since October 2022, both BSLs and HY bonds have outperformed private credit. (Figures 3 and 4) In October 2022, DoubleLine believed there was a strong case for investors to allocate assets to public credit. (See: [The Case for Public Credit in Today's Environment](#))

Private Outperformed Public Credit 2020 - September 2022

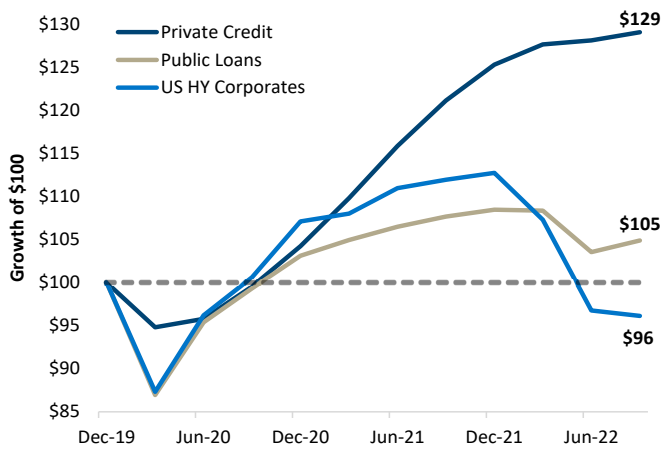


Figure 3

Source: DoubleLine, Bloomberg Finance LP, Pitchbook LCD, Preqin Private Credit: Preqin dataset, Public Loans: Morningstar LSTA Leveraged Loan Index, US HY Corporates: Bloomberg US Corporate High Yield Index

Public Outperforming Private Credit Since October 2022

As of September 2025

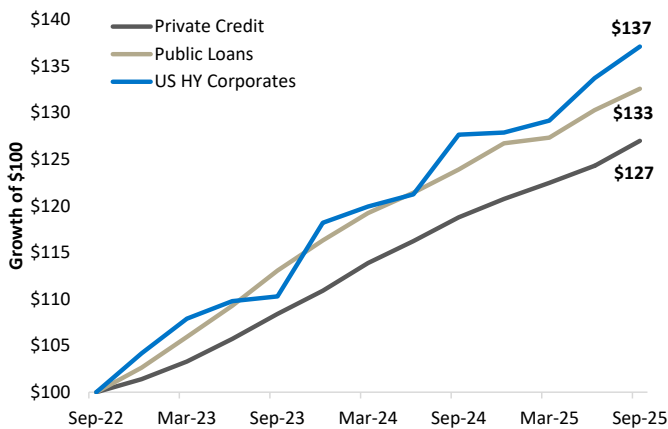


Figure 4

Source: DoubleLine, Bloomberg Finance LP, Pitchbook LCD, Preqin Private Credit: Preqin dataset, Public Loans: Morningstar LSTA Leveraged Loan Index, US HY Corporates: Bloomberg US Corporate High Yield Index

Notably, publicly traded stocks of BDCs, which provide a market-based signal of private credit sentiment, have declined 8.5% since the start of 2025⁴ despite broadly strong risk-asset performance. While BDC equity returns are not a direct proxy for private credit fund returns, the divergence is instructive. This decline is not merely a reflection of cyclical weakness, it underscores structural vulnerabilities that have long been embedded in the private credit model. Concerning headlines, rising nonaccruals, weaker income streams and competition from syndicated markets are eroding confidence. Conversely, publicly traded small-capitalization companies, many of which comprise the public loan and HY market, are up 22.3% since the start of 2025.⁵

Credit Quality

The divergence in credit quality between private and public credit markets is substantial. Private credit portfolios are heavily skewed toward lower-rated issuers, with an estimated 92% rated B- or below. In contrast, only about 30% of the public loan market falls into this category. (Figure 5)

Public Loans vs. Private Credit Ratings Estimates

As of December 31, 2025

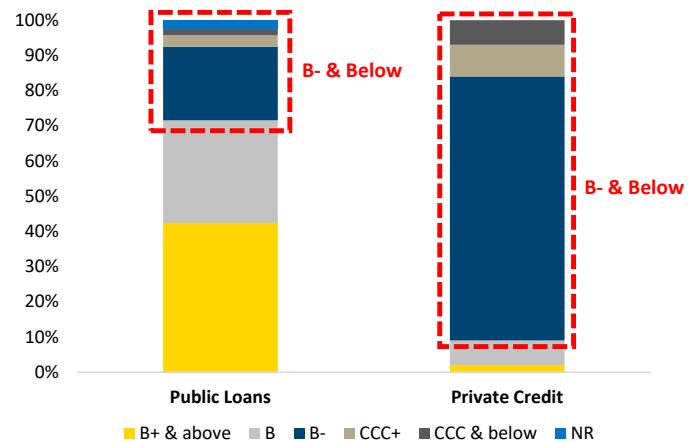


Figure 5

Source: DoubleLine, Deutsche Bank, Pitchbook LCD, S&P Capital IQ Public Loans: Morningstar LSTA Leveraged Loan Index, Private Credit: Credit rating estimates by S&P Capital IQ

⁴ As of February 9, 2026

⁵ As of February 9, 2026

The U.S. HY public market has experienced significant credit quality improvement over the past 20 years, with credits rated BB now representing over 56% of the Bloomberg US Corporate High Yield Index and CCC and below exposure representing less than 12%. (Figure 6)

Since 2023, when financing in public markets became cheaper than private markets and the public markets opened back up, many companies have switched from private to public funding. DoubleLine believes that the companies that chose to remain in the private markets tend to be riskier credits. Why else would they be willing to finance through the more expensive option if not for needing the flexibility that comes with having a one-on-one borrower relationship? Thus, it is not surprising that the U.S. HY credit market has improved in quality, because much of the tail risk has been taken out by private credit.

We do not necessarily view the significantly lower credit quality of the private credit market as inherently positive or negative. However, investors need to be aware of it, along with their own risk appetite, when considering private markets as an alternative to public markets late cycle. For perspective, since 1981 in the public markets, global corporate bonds rated CCC or below had a weighted long-term average default rate of approximately 26%. Low credit quality combined with high sector concentrations creates a risk profile that is likely to perform poorly when defaults increase materially. Notably in 2025, nonaccrual rates for private credit increased.

HY Index Market Share by Rating

As of December 31, 2025

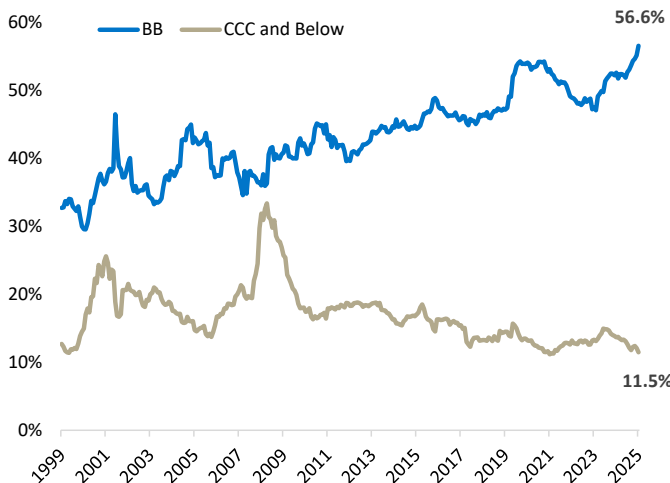


Figure 6
Source: DoubleLine, BofA Global Research

Industry Concentration & Distress

In addition to having lower credit quality, private credit is less diversified with higher industry concentration compared to public markets. The top five industries in the private market represent 94% of the market, whereas the top five industries in the public loan market represent 32% of the market. Technology represents 31% of the BDC market versus 16.9% weighting to software and IT in the public loan market. (Figures 7 and 8)

BDC Loans Industry Weighting

As of March 31, 2025

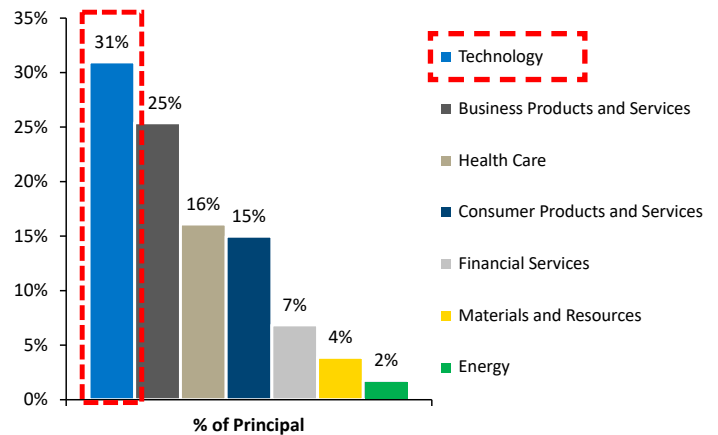


Figure 7
Source: DoubleLine, Deutsche Bank, Pitchbook LCD

Technology Weighting in Public Loan Market

As of December 31, 2025

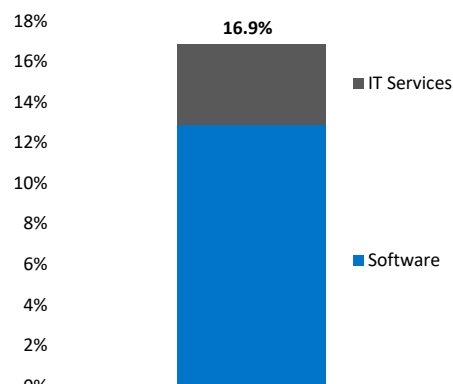


Figure 8
Source: DoubleLine, Pitchbook, Morningstar LSTA Leveraged Loan TR Index

Furthermore, the sectors with the highest share of distressed leveraged loans in the public loan market represent some of the largest industries in the private market. Software and IT represent almost one-third of all the loans that trade below \$80 in the Morningstar LSTA Leveraged Loan Index. (Figure 9)

Percent Share of Loans Priced Below \$80 in the Leveraged Loan Index | As of December 31, 2025

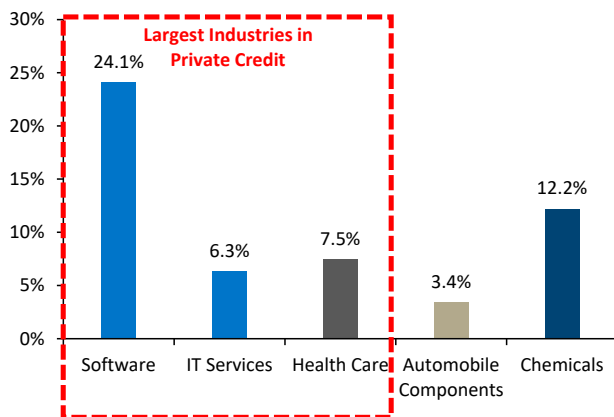


Figure 9
Source: DoubleLine, Pitchbook

Fundamentals

While headline default rates appear benign despite ticking up in public loans and HY, private credit fragility reflects deeper risks. We urge caution in extrapolating HY public corporate bond resilience to private credit, as the latter's structure vulnerabilities and lower credit quality could amplify stress in the next downturn.

The income profile of private credit is deteriorating in multiple dimensions. Falling spreads reduce cash returns while the growing prevalence of payment-in-kind (PIK) loans and rising nonaccruals undermine the quality of cash flow. PIK structures, which allow borrowers to defer interest payments by issuing more debt, are particularly problematic. They mask immediate stress but increase leverage, reduce transparency and can be a signal of a stress in cash-flow generation. At nearly 9% of BDC loans currently PIK, the share of PIK loans is close to pandemic highs, signaling that many borrowers are struggling to generate sufficient cash to service debt. (Figure 10) This dynamic erodes investor confidence and raises questions about the sustainability of private credit's yield advantage.

By contrast, public HY bonds have enjoyed a period of relative resilience. Lower Treasury volatility has been a critical driver, allowing investors to re-engage with risk assets. Since midsummer 2025, flows into HY ETFs and mutual funds have remained consistently strong, buoyed by redemptions and coupon reinvestments. Technical conditions remain favorable, even

% of Payment-in-Kind BDC Loans

As of September 30, 2025

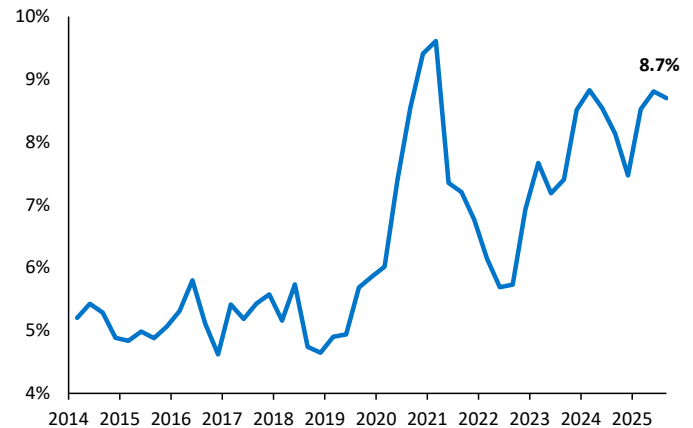


Figure 10
Source: DoubleLine, Pitchbook

as net supply rises. BSLs have also attracted refinancing flows, trading cheap relative to HY bonds and prompting sponsors to switch from loans to bonds.

Default and downgrade dynamics further illustrate the public-private divergence. Private credit nonaccrual rates rose in 2025, though they remain understated relative to leveraged loan defaults. Net downgrade rates in the public loan market are accelerating in the B3 and CCC cohorts, which generally dominate private credit portfolios. Unsurprisingly, lower-rated highly leveraged syndicated loans underperformed in 2025, particular B3 and below. (Figure 11) This type of behavior is analogous to prior late-cycle dynamics where return divergence across cohorts widen, and weaker credits do not participate in a risk-on market as one would normally expect.

2025 Broadly Syndicated Loan Return by Rating Cohort

As of December 31, 2025

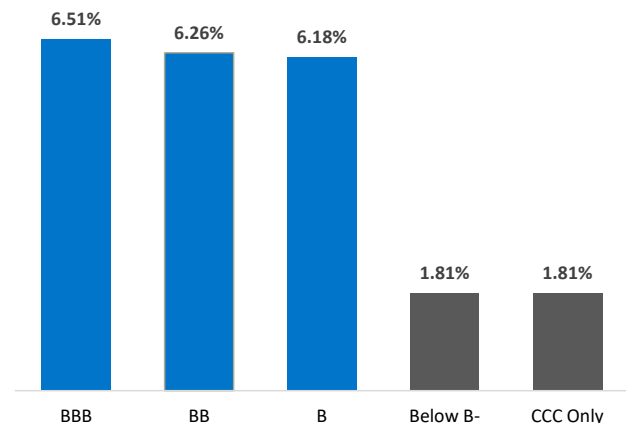
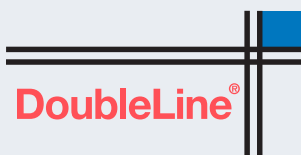


Figure 11
Source: DoubleLine, Pitchbook, Morningstar LSTA Leveraged Loan Index



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Liquidity

Perhaps the most defining characteristic of private credit – and one of its greatest risks – is illiquidity. Unlike public HY bonds or syndicated loans, which trade in transparent markets with daily pricing and established secondary liquidity, private credit positions are largely buy-and-hold. Investors cannot easily exit these loans, and valuations are often based on internal models rather than observable market prices. This opacity creates a lag in recognizing losses and can lead to sudden repricing when defaults rise.

We have witnessed private credit shops marketing illiquidity as a feature, with managers arguing that it allows investors to capture an “illiquidity premium.” By not marking-to-market daily, it allows private credit shops to “volatility launder,” as coined by AQR’s Cliff Asness, and market strong Sharpe ratios as return volatility is artificially lower. DoubleLine believes this argument is fundamentally flawed. In practice, it means investors must be prepared to hold through cycles without the ability to rebalance or exit. During periods of stress, illiquidity magnifies risk because investors cannot sell deteriorating positions or shift into safer assets. Public credit markets, by contrast, provide transparency and flexibility. Even if spreads widen, investors can trade daily, mark portfolios to market and adjust exposures. Private credit investors must rely on quarterly reports and manager valuations, which might understate risk until defaults are realized. Recent headlines have exposed the discrepancy among private credit managers and the marks used on the same security. (Figure 12)

Even more concerning are near-par marks shortly before a borrower declares bankruptcy. For allocators, this difference is critical: The “illiquidity premium” of private credit might still exist, but the value of the premium has diminished. Additionally, it comes with significant tradeoffs in flexibility, transparency and risk management.

Fair Value Assigned to Medallia’s Private Credit Loan

(cents on the \$)

	June 30, 2024	September 30, 2024	December 31, 2024	March 31, 2025	June 30, 2025	September 30, 2025
Blackstone	98	95	94	89	87	82
Apollo	100	100	87	87	87	77
FS KKR	100	100	98	95	91	91
Monroe	100	99	99	98	89	84
Onex	100	99	96	96	92	81
HPS	100	99	94	91	89	–
Antares	–	–	98	98	97	–

Figure 12

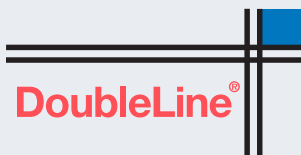
Source: SEC filings, Bloomberg

Conclusion

The evolution of leveraged finance credit markets over the past five years should prompt investors to recalibrate their expectations when assessing private versus public credit today, particularly from an alpha-generation and late-cycle perspective.

At a broad level, private credit portfolios relative to public credit portfolios have underperformed since 2022, are less liquid, have lower credit quality, higher industry concentration and are the more expensive financing option for borrowers. Admittedly, painting the idiosyncratic nature of private credit or direct lending market with a broad brush has its difficulties. Notably, while the averages seem healthy, there is significant dispersion in performance across private credit managers. Nonaccrual rates and the share of PIK interest vary widely, with smaller companies bearing the brunt of the troubles, as they are less equipped to absorb shocks than larger firms.

It is our opinion we are late cycle and, as such, currently prefer higher-quality, highly liquid, diversified credit exposure. The landscape has changed, and we urge investors to know what they own and be highly aware of the distinct differences when assessing the different trades that are: Private vs. Public Credit. ■



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About the Authors



Robert Cohen, CFA

Director, Global Developed Credit

Mr. Cohen joined DoubleLine in 2012. He is a Portfolio Manager and Director of the Global Developed Credit Group. Mr. Cohen oversees the group's investment activities in investment grade, high yield (HY) and bank loan corporate credit markets. He also leads the collateralized loan obligation (CLO) issuance effort at the firm. Mr. Cohen is a Portfolio Manager for the Opportunistic Income, Income Solutions, Low Duration, CLO and Floating Rate strategies. Mr. Cohen is a permanent member of the Fixed Income Asset Allocation Committee. Prior to DoubleLine, Mr. Cohen was a Senior Credit Analyst at West Gate Horizons Advisors (and its predecessor, ING Capital Advisors), where he worked as an Analyst covering bank loans and HY bonds. Prior to ING, he was an Assistant Vice President in the Asset Management Group of Union Bank, where he managed CLO and bank loan portfolios. Prior to Union Bank, he was an Associate Director of Corporate and Investment Banking at the Bank of Montreal in its Natural Resources Group. Mr. Cohen holds a B.A. in Economics from the University of Arizona and an MBA from the University of Southern California. He is a CFA® charterholder.



Chris Stegemann

Manager, Client Portfolio Management

Mr. Stegemann joined DoubleLine in 2017. He is a Client Portfolio Manager and Manager of the Client Portfolio Management team. In this capacity, Mr. Stegemann is responsible for communicating DoubleLine's macroeconomic views and portfolio positioning via client engagement, published market commentary and dedicated strategy content, with a focus on DoubleLine's Fixed Income Asset Allocation strategies. Prior to DoubleLine, Mr. Stegemann was in mutual fund distribution for Putnam Investments. He holds a B.S. in Finance and minors in Accounting and Economics from Elon University's Martha & Spencer Love School of Business. Mr. Stegemann holds the FINRA Series 3, 6, 7 and 63 licenses.

Alpha – Term used in investing to describe a strategy's ability to beat the market, or its "edge." Alpha is thus also often referred to as "excess return" or "abnormal rate of return," which refers to the idea that markets are efficient, and so there is no way to systematically earn returns that exceed the broad market as a whole.

Below Investment Grade (IG)/Non-Investment Grade (Non-IG) – Term indicating a security is rated below investment grade (IG). These securities are seen as having higher default risk or being prone to other adverse credit events. They typically pay higher yields than higher-quality bonds in order to make them attractive. They are less likely than IG bonds to pay back 100 cents on the dollar.

Bloomberg US Corporate High Yield (HY) Index – This index measures the U.S. dollar-denominated, HY, fixed-rate corporate bond market. Securities are classified as HY if the respective middle ratings of Moody's, Fitch and S&P are Ba1, BB+ or BB+ or below. The Bloomberg US HY Long Bond Index, including bonds with maturities of 10 years or greater, and the Bloomberg US HY Intermediate Bond Index, including bonds with maturities of 1 to 9.999 years, are subindices of the Bloomberg US Corporate HY Index.

Broadly Syndicated Loan (BSL) – Any loan to an obligor issued as part of a loan facility with an original loan size (including any first and second lien loans in the facility) greater than \$250 million.

Business Development Company (BDC) – Specialized, closed-end investment vehicle, created by Congress in 1980, to provide capital (debt or equity) to small, mid-sized and financially distressed U.S. businesses. Often publicly traded, BDCs allow individual investors to access private-market investments, offering high yield (HY), high-risk opportunities while aiding corporate growth.

Federal Funds Rate – Target interest rate, set by the Federal Reserve at its Federal Open Market Committee (FOMC) meetings, at which commercial banks borrow and lend their excess reserves to each other overnight. The Fed sets a target federal funds rate eight times a year, based on prevailing economic conditions.

High Yield (HY) – Bonds that pay higher interest rates because they have lower credit ratings than investment grade (IG) bonds. HY bonds are more likely to default, so they must pay a higher yield than IG bonds to compensate investors.

Investment Grade (IG) – Rating that signifies a municipal or corporate bond presents a relatively low risk of default. Bonds below this designation are considered to have a high risk of default and are commonly referred to as high yield (HY) or "junk bonds." The higher the bond rating the more likely the bond will return 100 cents on the U.S. dollar.

Mark to Market (MTM) – Method of measuring the fair value of accounts that can fluctuate over time, such as assets and liabilities. Mark to market aims to provide a realistic appraisal of an institution's or company's current financial situation based on current market conditions.

Morningstar LSTA US Leveraged Loan Index – This market capitalization-weighted index tracks the U.S. leveraged loan market.

Morningstar LSTA US Leveraged Loan TR USD – This index (formerly the S&P/LSTA Leveraged Loan Index) tracks the market-weighted performance of institutional weighted loans based on market weightings, spreads and interest payments.

MVIS US Business Development Companies Index (MVBDC) – This index tracks the performance of the largest, most liquid U.S.-based business development companies (BDCs), offering a modified market-cap-weighted exposure. The MVBDC provides comprehensive, quarterly reviewed, pure-play access to BDCs that invest in small- and midsize businesses.

Par – Short for "par value," par can refer to bonds, preferred stock, common stock or currencies, with different meanings depending on the context. Par most commonly refers to bonds, in which case, it means the face value, or value at which the bond will be redeemed at maturity.

Payment-in-Kind (PIK) – Use of a good or service as payment or compensation instead of cash.

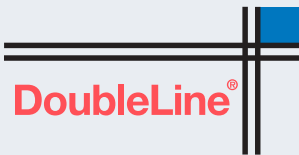
Russell 2000 Index – This market capitalization-weighted index comprises 2,000 small-cap U.S. companies and is considered a bellwether index for small-cap investing.

Sharpe Ratio – Used to help investors understand the return of an investment compared to its risk. The ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. Volatility is a measure of the price fluctuations of an asset or portfolio. Subtracting the risk-free rate from the mean return allows an investor to better isolate the profits associated with risk-taking activities. The risk-free rate of return is the return on an investment with zero risk, meaning it's the return investors could expect for taking no risk. The yield for a U.S. Treasury bond, for example, could be used as the risk-free rate.

Spread – Difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings or risk.

Yield to Maturity (YTM) – The total return anticipated on a bond if the bond is held until it matures. Yield to maturity is considered a long-term bond yield but is expressed as an annual rate.

You cannot invest directly in an index.



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Important Information Regarding This Material

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