MANAGER PERSPECTIVES

OPPORTUNISTIC CREDIT: RESILIENCE ACROSS CYCLES

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As credit markets become more complex, attractive opportunities are emerging beyond traditional bonds and loans. Ryan Kelly, Rob Fawn and Rishav Puri explain how opportunistic credit seeks to generate differentiated returns, reduce dependence on market direction, and help manage downside risk.

A DISTINCT OPPORTUNITY SET

Q: What is opportunistic credit and what role can it play in a portfolio?

RK: Opportunistic credit is a flexible, unconstrained approach that seeks to capitalize on mispriced credit across global leveraged finance markets. Untethered to benchmarks, credit ratings, or market segments, these strategies allocate dynamically across performing, stressed, and distressed credit, as well as bespoke financing opportunities, as conditions evolve. By investing in senior, contractually protected debt securities at attractive entry valuations, opportunistic credit targets equity-like returns with credit-like downside risk. Returns are driven primarily by security selection and catalyst realization, not broad market beta.

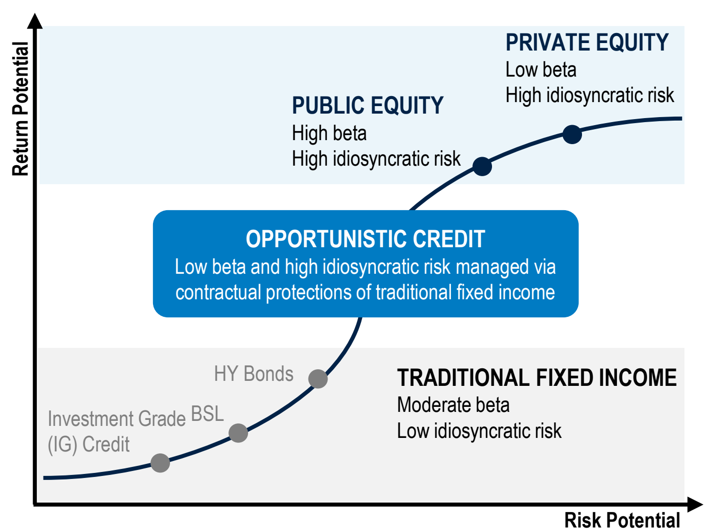
Dislocations create the opportunity. When forced selling, liquidity shortages, rating changes, or corporate events drive a wedge between trading prices and intrinsic values, investors with flexible capital and specialized underwriting expertise are positioned to act. These inefficiencies are where the strategy seeks to earn its return.

Positioned between traditional fixed income and private equity (PE), opportunistic credit combines the contractual protections of debt with the return potential of equity, offering a differentiated source of idiosyncratic returns across market cycles. The opportunity set spans broadly syndicated loans (BSL) and high yield (HY) bonds and includes capital solutions, structured corporate investments, preferred securities, and post-reorganization equity. What sets opportunistic credit apart from traditional leveraged finance is its exceedingly low beta risk and outsized return potential.

In practice, these strategies can serve a dual purpose within a single mandate: enhancing returns in benign markets and stabilizing portfolios when broader stress emerges.

- **Enhanced, Low-Beta Returns:** Targets mid-teens through contractual cash flows on discounted debt and process-driven catalysts, independent of multiple expansion or market direction.
- **Diversification:** Structurally low correlations to traditional credit and equity; performance is idiosyncratic and manager-skill dependent.
- **Downside Protection:** Strong asset coverage and contractually protected senior-secured loans and unsecured bonds bought at meaningful discounts to intrinsic or liquidation value.
- **Adaptability, Countercyclicality:** Built to adapt to changing credit cycle conditions; can dampen volatility during dislocations as the rest of the portfolio marks down.

Hybrid sourcing creates attractive opportunity set



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EVOLVING OPPORTUNITIES THROUGH CYCLES

Q. How do opportunities shift throughout the cycle and where are we in the current cycle?

RF: The opportunity set for opportunistic credit investors evolves with the credit cycle, as financial conditions at different phases of the cycle present different types of transactions.

Adaptable strategy across environments

Cycle phase	Conditions	How the opportunity set shifts
Expansion	**Healthy** Growth, low defaults, and tight spreads pair with active M&A, spinoffs, and refinancing	Value lies in earning carry on sound credits and providing financing for corporate activity
Slow Down	**Risks building** Fundamentals soften and dispersion increases	Emerging stress creates demand for flexible capital, while richly priced credits become candidates to fade
Recession	**Peak dislocation** Defaults climb and liquidity retreats	Forced selling and complexity open the deepest value for capital willing to underwrite difficulty
Recovery	**Value realization** Defaults subside and spreads normalize	Appreciation is realized as mispriced credit recovers and repaired businesses re-rate

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Expansion, or growth impulses, can lead to a mispricing between debt and equity that drives capital structure arbitrage or more corporate actions (i.e., M&A, divestitures, and spinoffs) which create pull-to-par investment opportunities and a need for hybrid capital. Slowdowns tend to drive capital retrenchment, leading to emergent stress that sparks amend & extend transactions and complex forms of liability management exercises (LMEs). Drawdowns, or recessions, feed classic distress opportunities: creditors create value by converting debt to equity, providing debtor-in-possession (DIP) financing, and/or injecting new equity into companies as part of the capital structure fix. Carry opportunities generally tend to ebb and flow with the cycle.

We believe the traditional "credit cycle" oversimplifies today's complex market backdrop. With forces like higher-for-longer rates, AI disruption, and deglobalization, sector-level volatility can matter as much as broad moves in market beta. Today's environment is unique: heightened distress and elevated dispersion coupled with an influx of aggressive liability management transactions despite near-record tight credit spreads over the past 24 months. The driving undercurrents are elevated base rates and post-pandemic misallocations of capital, mostly by PE sponsors.

PGIM's economic base case calls for a higher probability of an overheating scenario with wider tails and rate hikes into 2027. Steady-to-higher base rates should continue to pressure enterprise valuations, driving greater need for capital solutions. So where are we? The honest answer is that it is hard to place, likely somewhere between slowdown and expansion.

On the surface, the backdrop resembles mid-expansion: strong nominal and above-trend growth and robust corporate earnings. Beneath, the market is increasingly multipolar, two-speed (e.g. K-shaped), divergent between AI winners and non-AI laggards and now coming to grips with rising real rates.

Q. Why is now a compelling time for this strategy?

RK: All-in yields are quite attractive by historical standards. While spreads are near record tights, yields across corporate credit sit in the third quartile, making carry a valuable feature for opportunistic credit investors. As investors move up in quality, they are significantly compensated in yield per unit of risk. With disciplined security selection, investors can realize low double-digit yields at a lower risk level than the return would suggest.

The AI infrastructure buildout is also delivering a larger boost to economic activity than many anticipated, lifting earnings and outlooks across a broad range of sectors. That tailwind, combined with attractive entry yields and the ability to allocate dynamically across performing, stressed, and distressed credit makes the current environment compelling for investors willing to look beyond index-level spreads.

MARKET COMPLEXITY & PRIVATE EQUITY CHALLENGES

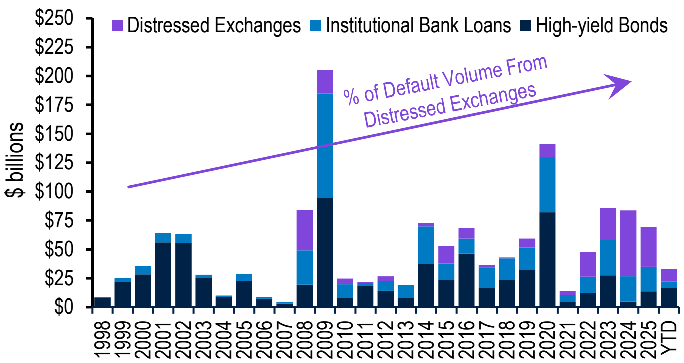
Q. Which key market dynamics are you watching closely?

RK: Credit markets are more complex beneath the surface than index spreads suggest. Structural shifts are challenging capital structures across several industries, driving volatility and the potential mispricing of credit risk. Elevated dispersion is showing up in distress and default metrics, specifically in the BSL market, where distress is near the 2023 highs of around 11%. It is extremely rare to see spreads tightening to record levels while stress, defaults, and dispersion are simultaneously rising.

Much of the dislocation is being driven by PE 2021 and 2022 vintage leveraged buyout cohorts. Private equity sponsors rapidly deployed over $1.5 trillion of capital over those two years at high valuations, and the multiples paid are unlikely to be realized anytime soon, leaving a sizable pool of investments stranded for the foreseeable future.

Beyond that, the clock is ticking on individual capital structures built for a much lower rate regime. Interest coverage ratios within the BSL market have eroded to concerning levels: approximately 30% of the U.S. leveraged loan index sits below a 1.0x coverage ratio, meaning interest costs are equal to, or exceed, EBITDA. A further 40% of the index is now below 1.5x. Rising leverage and underperforming businesses are forcing more capital structures into an unfinanceable state, resulting in higher distress, liability management exercises (LMEs), and defaults.

Years of loose underwriting fueling LME growth



Source: JPMorgan, Pitchbook, Bloomberg, S&P/IHS Market as of 6/30/2026.

Sector-level headwinds are also broadening beyond technology and software. Packaging and food and beverage industries face pressure from GLP-1 drug adoption. Energy market dynamics are impacting chemical, agricultural, transport, airline, and packaging sectors. Rate-sensitive sectors, including housing and consumer cyclicals, remain under pressure. Meanwhile, SpaceX's potential to transform the telecom industry has ignited a broadband price war with implications for cable companies and wireless valuations across Verizon, AT&T, and T-Mobile. The downstream effects on high yield and investment grade markets could be significant.

On the AI financing side, while hyperscalers garner most of the media attention, non-hyperscaler debt issuance has exceeded $300 billion since 2025 across high yield, BSL, and investment grade markets, and is on track to reach approximately $700 billion by year-end 2026 and extend into the trillions by end of the decade. The near-term effect is higher term premia and crowding out of issuance in other industries. If aggressive datacenter buildout or AI technology advances create excess compute capacity, we could face an industry-led distress cycle that rivals the telecom meltdown of the early 2000s. These are the fault lines that rigorous credit investigation is built to surface.

Yet for investors with the frameworks to navigate this complexity, the environment is equally rich with opportunity. Elevated dispersion, distressed valuations, and structural dislocation have historically been the conditions that reward disciplined, investigation-driven credit selection most generously, and we believe the current cycle is no different.

Q: Can you explain the private equity challenges and how this strategy can complement PE exposure?

RP: Private equity is navigating a difficult environment. A significant valuation reset from the post-pandemic period, when large amounts of capital were deployed at near-zero rates, is making exits harder to execute. As buyers demand lower multiples, hold periods are stretching, distributions to paid-in capital (DPI) are painfully low, and a large backlog of portfolio companies continues to build. At today's pace, it could take roughly 10 years to exit over 30,000 companies, against an average fund life of approximately 4.5 years. Under that pressure, PE firms are turning to secondaries, NAV loans, and continuation vehicles to generate liquidity for their LPs and extend investment runways, hoping valuations return to initial LBO purchase prices.

At the portfolio-company level, capital structures are straining under excessive leverage and refinancing pressure, as higher interest rates squeeze cash flows.

To avoid ceding control to lenders, sponsors are increasingly turning to LMEs, which can take many forms and vary widely in severity. Concentrated in the collateralized loan obligation (CLO)-dominated BSL market, LMEs can create significant volatility within a company's debt stack, alarming certain CLO investors given their relatively inflexible capital and information disadvantage relative to distressed investors.

This is where an opportunistic credit strategy can complement PE exposure effectively. By providing liquidity at attractive terms, acquiring sponsor-led debt at distressed levels, and taking equity ownership at trough valuations, opportunistic credit positions investors for meaningful upside when conditions normalize. If a PE investment deteriorates to the point where lenders take control, the strategy can generate significant returns. If sponsors successfully reflate the business, opportunistic credit investors benefit similarly, having either purchased debt at deeply discounted prices or deployed capital into investments generating immediate, outsized cash flows.

DIVERSE SOURCES OF ALPHA

Q: Where are you seeing the most opportunities and what is your investment approach in this environment?

RK: As capital market complexity and return dispersion persist, the ability to navigate bespoke capital solutions remains essential. We believe the most compelling path to uncorrelated, equity-like returns over the next decade is owning the debt of select, fundamentally sound companies that require those solutions.

The most significant opportunities, in our view, sit within the global BSL market, a $2 trillion sector within the $4.5 trillion leveraged finance universe. Base-rate effects, stranded PE capital from 2021 and 2022 vintages, and rapidly shifting competitive landscapes are creating demand for LMEs, hybrid capital, and mezzanine solutions. These pressures are straining CLOs, reflexively tightening financial conditions across loan-only capital structures and generating excess yield for a given level of risk.

Beyond those complex processes, the result is attractive carry across performing credit, stressed situations, and post-LME senior secured loans, with strong covenant protections and outsized yield relative to risk.

Focus on a diversified credit mix to optimize returns

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MANAGER PERSPECTIVES

Our approach targets securities where most systematic risk has already been removed. We focus on complex opportunities with asymmetric payoff profiles, combining structuring expertise, deep fundamental conviction, and a rigorous relative value framework. We rely heavily on industry credit research to identify issuers where we can drive solutions and unlock value. We favor fundamentally sound companies with challenged balance sheets: businesses with strong management teams, durable competitive advantages, capital efficiency, meaningful intellectual property, and low obsolescence risk. Artificial intelligence deserves particular attention here. While it has made obsolescence risk a primary focus, it is simultaneously reducing the requirement for companies to hold dominant market share to merit investment. AI is accelerating fast-follower dynamics across industries, shifting market share in ways that are creating compelling opportunities in emergent competitors, and that is a dynamic we are examining closely.

Creative capital solutions drive alpha

Solution	Target IRR
Performing / Pull-to-Par High-carry BSLs, HY bonds, and post-LME senior secured paper bought below intrinsic value	~15-20%
New-Money Financing DIP, rescue, bridge, and amend-and-extend loans that stabilize value and unlock transactions	~15-20%
Mezzanine & Hybrid Financing Junior capital for balance-sheet repair and growth, with equity-like upside	~15-20%
Liability Management Debt exchanges, up-tiering, and non-pro-rata deals that reset capital structures out of court	High Teens to Low 20s
Reorganization Equity Post-restructuring equity taken through the credit, capturing recovery upside as value re-rates	~20-25%

Source: PGIM. IRR: internal rate of return.

INVESTOR CONSIDERATIONS

Q: Why is opportunistic credit underallocated, and is sentiment changing?

RK: Many Limited Partners (LPs) have long viewed opportunistic credit through the narrow lens of market dislocation or distressed situations. That framing has kept many allocators anchored to a cyclical mindset and slow to recognize an opportunity set that has meaningfully expanded. Direct lending has compounded the problem. As LPs aggressively built out private debt exposure over the last decade, capital flowed overwhelmingly into senior-secured direct lending, chasing floating-rate yield in a low-default environment.

The result: most LP portfolios sit heavily weighted toward performing, sponsor-backed senior debt, leaving them underweight the flexible, capital solutions strategies best positioned to navigate stress, complex restructurings, and liquidity squeezes.

Opportunistic credit also suffers from an institutional categorization problem. It is too return-oriented for conservative senior debt mandates, too income-focused for traditional PE buyout buckets, and not purely distressed enough for dedicated turnaround allocations, a category many LPs had already deprioritized given the absence of widespread corporate bankruptcies. Because institutional governance moves slowly, LPs have been reluctant to carve out distinct, permanent line-item allocations for "capital solutions" or "flexible credit." The asset class has, in effect, fallen into a structural no man's land.

That is beginning to change. LPs have started shifting capital toward opportunistic credit through both private drawdown and evergreen hedge fund vehicles. The surge in hedge fund demand is a meaningful signal. Driven by the need to reduce correlations, beta, and concentration risk amid rising dispersion across markets, the roughly $5 trillion hedge fund industry recorded its highest capital raise in over a decade in 2025, with further growth anticipated in 2026. Pressure from private markets is also a contributing factor: stalled exit activity, extended distribution timelines, and valuation adjustments have accelerated the push toward more liquid and semi-liquid alternatives. Current estimates place $300 to $350 billion of the private credit market in opportunistic credit-like vehicles. For context, credit hedge funds account for $850 billion of the broader hedge fund universe, of which approximately $300 billion is comprised of opportunistic credit strategies.

Q: What are key investor considerations for opportunistic credit?

RF: Opportunistic credit introduces more complexity than traditional fixed income, which makes three things essential: quality deal flow; disciplined relative value analysis; a proven track record of identifying and structuring idiosyncratic opportunities before they become consensus trades.

A rigorous relative value framework is the foundation. Without one, navigating the $4.5 trillion global leveraged finance market, filtering hundreds of issuers, and avoiding the value traps that have challenged distressed managers for years becomes largely a matter of luck rather than skill. Speed of execution has also become non-negotiable. Legal and financial technologies are now widely commoditized, meaning classic distressed funds and hedge funds no longer hold an inherent advantage from vintage effects. The edge has shifted elsewhere. We believe that edge separating disciplined managers from the rest of the market lies in three areas:

- Established lending relationships that provide direct insight into company-specific challenges and create opportunities to deliver holistic capital solutions
- Specialized industry credit research, as the complexity of opportunistic credit often extends beyond the reach of a generalist framework
- The situational awareness to synthesize macroeconomic conditions and company-level fundamentals into a single investment decision.

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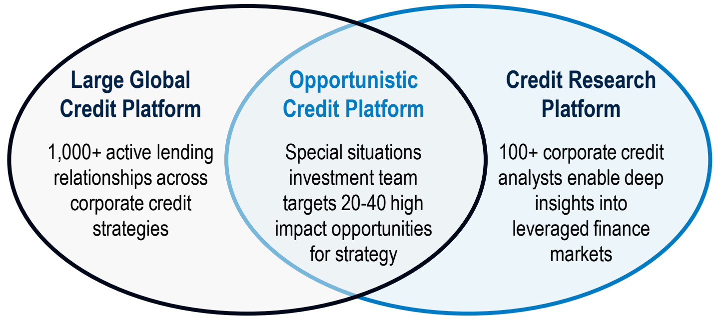
The structural opportunity remains significant. Credit markets have grown substantially, yet investors remain underallocated, and dry powder is minimal. The opportunity set far exceeds the capital available to pursue it. That said, the growth of inflexible capital is amplifying drawdown risks. The $130 billion of dry powder in opportunistic credit and special situations funds could be quickly overwhelmed in a stagflation, slowdown, or modest recession scenario. A median recession default rate could generate $300 to $400 billion of defaults in a single year, and over $1.2 trillion of distress that would seed future defaults or eventually pull to par. The supply-and-demand imbalance is creating clearing risks that deserve serious scrutiny, making selecting an experienced manager critical.

Highly integrated investment platform unlocks value



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OUR DIFFERENTIATED APPROACH

Q: What differentiates your approach and how can that help investors in this environment?

RK: Our approach is built on three pillars: differentiated deal flow, deep credit expertise, and expansive scale. We believe investors should seek a leading counterparty in the credit markets, and our platform is designed to provide that advantage.

PGIM's highly integrated investment platform extends across public fixed income—specifically between global leverage finance, opportunistic credit, and leverage finance research—combining the scale of a large global credit platform with special situations capabilities and credit research. Investment teams share issuer research, industry expertise, trading intelligence, and risk perspectives across strategies, while portfolio managers retain full discretion over capital allocation. PGIM's structure broadens idea generation, enhances underwriting, and creates information advantages that are difficult for pure-play, sub-scale, or more siloed large-scale managers to replicate.

Trusted leader: Our industry-leading leveraged finance platform allows us to take leadership roles in complex, large-scale transactions and provide the comprehensive capital solutions companies require while reducing execution risk. This partnership mindset, combined with a proprietary relative framework that ranks over 2,000 credits globally, helps us deliver heavily negotiated, win-win solutions that unlock value.

Industry specialization: Our special situations team consists of 55 higher yielding credit analysts across sectors and geographies who have deep relationships with management teams and have been building differentiated views—i.e., intellectual property—on most issuers in indexes for decades. The team sits within our leveraged finance platform, benefiting from an open architecture model rooted in deep industry knowledge across public and private leveraged finance markets. This structure allows us to identify and structure impactful opportunities, turning market dislocations into favorable investments.

Sourcing and due diligence strength: We use over 1,000 active lending relationships across the firm to create attractive investment opportunities, with over 80% of deals sourced internally. This reduces our dependency on market drawdowns and allows for high selectivity.

DISTINCT SCALE, ACCESS, AND EXPERTISE

20+	**$131B**	**55**	**2,000+**
Years of special situations experience for senior investment team members	Higher yielding AUM*, including $35B+ in special situations	Higher yielding credit analysts*	Global issuer coverage universe

Source: PGIM as of 6/30/2026. * Higher yielding refers to high yield, bank loans and emerging markets.