

SPEAKING OF ALTERNATIVES

S1 EP18: Let's Talk Asset-Based Financing

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>> Speaking of Alternatives with Keshav Rajagopalan, Managing Director, Head of Product and Strategy at PGIM.

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Securitized products, including asset-based financing, offer fresh opportunities for companies to access capital and for investors to diversify. Keshav delves into the dynamic and growing world of ABF with Edwin Wilches, Co-Head of Securitized Products at PGIM.

>> Welcome to Speaking of Alternatives, the podcast where we dig into the many layers of the alternatives landscape. I'm very excited to have Edwin Wilches on with me, a good friend and colleague, and we'll be diving into private asset-based finance. Edwin is the Co-Head of Securitized Products at PGIM and runs over 145 billion across the securitized products landscape. Today, we're specifically going to be focusing on the asset-based finance world, where PGIM is a market leader. A theme that is emerging in many conversations that I and others are having with clients and other investors is the blurring of public and private credit, and I think ABF sits right at the nexus of that. Edwin, thanks again for joining me.

>> My pleasure. Thank you.

>> To jump in, we'd love to just get to know you. What brought you into the world of investing? What brought you to PGIM and what's kept you here?

>> Sure. So what brought me to investing and asset management? I went to Rutgers, undergrad. At the time, I was really looking at computer science and thinking about economics. Junior year college, I was really lucky. One of my econ professors invited me to participate in the Federal Reserve Challenge, and they grabbed a bunch of econ students at Rutgers, and we got to compete, making believe we were studying Fed policy. To be completely honest with you, before I went to school, I didn't really know much about investing. I migrated here from South America, and it just was not something that I really knew about. And once I was able to experience this, I was hooked. I absolutely loved it. I pivoted my last year to focus predominantly on econ and was fortunate enough to land a job here at PGIM. And as you mentioned, that was over two decades ago. Once I started here on the ops team, it gave me an opportunity to really understand the inner workings of finance. Pre-GFC, I was able to join the CLO structuring team. That was the start of my securitized career. And post-GFC, the

opportunity set was quite clear for clients within securitized products. And a few years later, here I am, fortunate enough to co-lead the securitized team as I look out two decades beyond. What's kept me interested at my core? I do love puzzles. I love learning, and I love a challenge. Investing really combines all that. It's pattern recognition, looking at different data trends across markets, trying to solve evolving puzzles. There's constant change, keeps you learning. I'm really drawn to that challenge of trying to make decisions amid uncertainty while connecting insights from econ, psychology, and technology, really to help our clients. So to me, that's all super exciting. The world keeps changing. We keep changing. And, you know, it's nice to be at the forefront of all that.

>> Well, you can definitely hear the passion in your voice, and as you talk about the two decades at PGIM, what strikes me is how many different hats you've worn, whether it's starting in an ops role, a structuring role, investing role, now obviously a management team leadership role. And as you mentioned, what's happening in your space specifically is so much rapid change that learning must be fun, but also paramount to continuing to build and grow our platform for our clients. To set this up, asset-based finance, what is it? Maybe put it in the context of securitized products, and then we'll dive into some other themes that it'll help set the landscape overall.

>> So I would say securitized products at its core is fixed income securities that are securitized or collateralized, or stated differently, secured by generally hard assets or some sort of real assets. So at its core, we're financing the real economy.

>> An important development in today's investment world is the blurring of lines between public and private credit. This is creating new opportunities for financing.

>> Public or securitized products or ABF or the private side, it is very similar. And I think at the core, the true difference is how investors are finding these assets. On the public side, there's generally going to be a bank that is an intermediary, some originator or someone needs financing, and a bank has helped them come up with the best solution for that financing, and they'll come to capital markets. Again, it sounds awfully similar to what you might see in the corporates, right? There's some financing need, and Wall Street banks will help find an asset owner for it. On the ABF side, again, similar, except that now we have a team that's working directly with the folks that need that financing, not too different from their corporate colleagues. Well, we're working directly with the originators or working directly with the companies that are looking for alternate sources of financing. And we're able to structure our cash flows, structure our risk, structure our tenors to match the needs of our clients. The opportunity set is quite large. If we take a really big step back, securitized products on the public side is about \$4 trillion. And from the private side, we think the addressable market is somewhere around 10 trillion. But if you look at everything in the banking system that's kind of, in theory, up for grabs, those numbers can get up to 40 trillion. So we're talking about an asset class that's very

large. Where is this coming from? You know, GDP in the US is about \$29 trillion a year. All of that GDP needs financing, and we're seeing the banking system blend differently. And we think the need for capital continues to grow. Securitization and ABF in particular are going to be critical sources of funding for the real economy. In case of where we see this really increasing a lot is actually globally. In the US, we have a very developed capital market system, very developed securitized product, and growing private ABF market. But we're really seeing some changes in Europe. And a lot of this is being driven by regulation. And the catalyst was Mario Draghi, a few quarters ago, saying we need to get GDP back on par with the rest of the world. That's going to require securitization, not the silver bullet, but it is a key part of the solution. So we're really excited. We're seeing growth in our market everywhere, but it comes back to there's a real economy need for this. There is a growing secular change of how the economy funds itself, not just in the banking system, but away from it. And we're seeing a lot of growth. At its core, ABF is really private securitized products. It's going to have different asset types. Sometimes there'll be different types of risk, but by and large, it's all secured lending against an asset that you were originating or sourcing it differently than we would on the public side.

>> I think a lot of themes there, and thanks for the good and quick and helpful primer. As we look at the landscape, as you pointed out, there's the twin effects of the way financing is different today, both here in the United States and on the other side of the pond. But it's also because of how companies are seeking financing. It's also how clients, investors view the world. It's a lot more boring. And you talked about our PGIM platform also evolving to bring public and private together. And that's really in response to how the economy is being financed and how clients are thinking about credit. And your team really sits at the nexus of that, which is really exciting. So what is the pitch for ABF today? I'm an institutional investor. I'm an insurance company. What makes ABF a compelling investment for me to think about?

>> I think key here is what are the client's needs? And what we see today is really a need for diversification away from their traditional fixed-income portfolios. When we think of fixed income, it's usually going to be either sovereign risk or corporate risk. And there's this 4 to \$40 trillion market that's also accessible by investors. So it provides quite a bit of diversification. But importantly, it also provides additional income or spread or yield, depending on how you want to say it. So it's a market that, you know, diversifies existing portfolios, provides additional income, but importantly, is also quite scalable.

>> While diversification on its own has merit in terms of defraying exposure to risk, it can also lead to improved overall investment returns, particularly when viewed on a risk-adjusted basis.

>> You can see a tangible and real impact on an investor portfolio by adding securitized and, in particular, ABF. So we're seeing clients, whether it's insurance, whether it's

pensions, and increasingly even retail, really focus on this market as a way of enhancing their risk-adjusted returns. Ultimately, when we say it diversifies your portfolio and it increases your spread or your yield, what we're really saying is if you have this efficient frontier, if you have this optimal portfolio, when you include something that has better spread and better risk-adjusted returns, you're shifting that portfolio up. And it's not just because it's private that we're getting that diversification benefit. When I say diversification, I mean true fundamental diversification. Our cash flows are not predicated on a company's enterprise value in five years or 10 years. We're going to be secured by real assets, by real contractual cash flows that most of the time are going to be self-amortizing. So we're not reliant on something in the future to refinance us, which I think is key in terms of the attractiveness of the asset.

>> [Inaudible] and we'll talk about more of the use case in portfolios in just a bit, but it helps give the rationale for this year. So we always like to unpack a headline, what's in the news and related to this, and it's a theme we already hit on. The FT had an article relatively recently. It's an op-ed that was titled "The Bright Line Between Public and Private Markets is Fading Fast." You and I have talked about this, and we've talked about it with clients as well. You have the corporates. You've got the corporate team, the securitized team. Now we're bringing more of the private credit team closer to the platform and just integrating it. What do you see in here as you walk the floor in that blurring in public and private credit?

>> There's two sides to this. One is simply the larger companies are looking to diversify their funding sources. So if you're the CFO of a company or you're running a business, and I think COVID really highlighted this, right? There was a disruption in funding. At some points, it was in the public market because folks were concerned about liquidity, and in other points, private markets had also retrenched. I think what we saw was companies saying, "If I can find multiple types of capital to help finance my business, that is incredibly important." And to some degree, it's perhaps the fiduciary of that seat. So we're definitely seeing an increase from our relationships and our partners of our borrowers. We're definitely seeing a strategic shift to looking at both public and private sources of capital. This is happening from the smallest companies to even some of the largest companies. Another headlines that we see in the news are some of the largest companies, the S&P 500 also looking to do private deals, again, because multiple sources of financing that are needed. When we're looking at something like data centers, the conversation really straddles the entire floor. We see data center financing in our ABS team. We see it in the CMBS team. We see it on the ABF team with regards to some of the private fundings. We see it in the investment-grade corporate space. We see it in the bank loan space with some of the operators. So it's quite fascinating to see how the markets are financing themselves and how it's really not just blurring the lines between public and private, but also even between asset classes. And it really does require a lot of depth and breadth. It's happening quite fast. And I think it's actually

really exciting because if you have expertise in both markets and you bring it together, again, what we've done here at PGIM, the synergies are quite important and quite special.

>> An important aspect of financing corporations on an ongoing basis is being able to meet evolving needs as that company grows and matures. Securitized products can help to facilitate that.

>> And the breadth, to your point, is important. Our credit platform, because public and private credit now is 1.1 trillion. So PGIM is one of the largest credit managers in the world. Something needs financing, and it's the way these companies are engaging the marketplace. It used to be very bank-dominated. Now, banks, given regulatory changes, are not front and center anymore. So asset managers, asset owners, investors are coming into the picture. But it's not only at that time; it's the evolution of financing needs as well. We talked about a company growing up. We may see a company that's a small business doing a middle market loan with our private credit team. And then we can follow that company grow up as it then accesses public markets. So it's both the types of needs, but then the evolution that creates attractiveness to the breadth of a platform like PGIM.

>> Absolutely. I like actually using the example of a parking garage because it's something that we could all conceptualize. You could have a single parking garage, and maybe you could lend to that business at an early point in its life when it's a much smaller company. And then as it continues to grow, maybe now they have a lot of parking garages and they need bigger loans. But at some point, they might also start getting folks that are doing monthly leases. And now all of a sudden, that operator can say, "Wait a minute. I don't need to keep taking on unsecured debt. I still need some, and I still want to work with PGIM to do that." But maybe there's also a way to securitize these contractual cash flows as an alternate way for me to fund our business. So I think it is actually very interrelated. And we're definitely seeing that sometimes when I'm talking about just corporations. And at the same time, I'm saying we're not backed by the corporation. In that case, whether the corporate's operating or not, if people still want to park outside the building, whether it says parking garage A or B, you just need a parking spot. So it is really fascinating how it's all coming together. Our partnerships continue to evolve and grow. The need for different types of capital is critical.

>> Very true. Diving a little deeper now. Talk a little bit, the opportunities in the space that you and the team are seeing, and then maybe some of the considerations or challenges as investors begin to think about accessing and investing in this space. So in terms of opportunities first, what are you and the team seeing? What's in the pipeline? Because ABF, as you mentioned, is pretty broad. So what are we focused on? And especially in terms of origination and flow, where are we seeing opportunities and where we're trying to put capital to work?

>> There's a lot of folks that have been coming into ABF. And again, it's probably important to at least acknowledge that ABF wasn't a term maybe five years ago, or definitely not 10 years ago. However, when we're talking about privately originated, securitized, it's something we've been involved in for over three decades. So this is not a new market. It's just maybe more of a new label. But as we see more and more folks coming in, one of the things where we have a competitive advantage is having a fulfilled vision. We're really fortunate. You mentioned we're managing over \$145 billion of securitized across public and private. What that gets us is the breadth across a lot of different markets and asset classes. It allows us to have really big teams of significant investment in technology. So we have the luxury on behalf of our investors to look across the lending space. And our core principles is we want to lend where there is a supply, demand, and balance of capital. Where is that? A couple of years ago, we saw opportunities in things like fund finance. We saw opportunities in other kind of consumer-type assets. Today, what we're increasingly seeing is a couple different themes, something we can't get away from AI or data centers. There is a meaningful need to finance. Some southside research has put it up as high as two or \$3 trillion. We see a lot of headlines of \$30-plus billion data center projects. We're seeing it across the energy complex in terms of our teams talking about the need. What else does that bring? You need power. You need cooling. So there's a lot of demand for that capital. We're definitely seeing quite a bit of opportunities in different ways to finance the AI evolution or revolution, depending on how you think about it. We're also seeing a pretty big trend in companies overall, looking to become more asset-light. What I mean by that is companies that historically held a lot of assets on their balance sheet. We're seeing them find ways to get loans on the contractual parts of their businesses, core assets to run their business. But they're just looking to be more asset-light. And we're seeing a lot of those opportunities come into ABF as well. And last but not least, we do continue to see some opportunities in what we call fund finance. There is still a need for funds to get financing. Banks, again, I would say, continue to be very relevant. We're not looking to disintermediate the banking system. In fact, we're really looking to partner with them. There's a lot of needs for ongoing financing. And there's some really interesting opportunities. Again, I would say these themes are global. It's not just here in the US. The US is the largest market for sure. But we're having a lot more discussions in Europe and the UK.

>> What's interesting about what you said, the opportunity set with ABF is inherently almost kind of multi-strategy, multi-asset, right? You can have different exposures built through ABF as an asset class that, again, comes back down to the fundamentals of contractual cash flows. But the exposures that you could build around it could be very specific if you're trying to dive after one area, if you want to play that AI data centerpiece, or if you're looking to build a multi-asset, multi-exposure strategy, you can do that as well, too.

>> Absolutely. It allows you to diversify within the strategy. I think one of the challenges, post-GFC, we saw a couple dedicated specialty lenders, which they are kind of mostly rebranded to ABF. And they've had some great businesses. They were very niche. I think as the market has continued to grow, I expect to continue to see some consolidation across these niche players. I think part of the reason for that is that the opportunity set is broad. And when there is a specific opportunity, it seems like capital gets raised very quickly or folks can shift there very quickly. So the durability of the alpha in just one part of the economy is quickly getting arbitrated out because folks like us that do have scale and size can identify it, lean into it, provide that capital, and not be married to it and be able to move on. So I agree. It's vast. It's across different sectors. But I think it is important to back to this concept of field of vision. I do think that's what makes it exciting, right? Because what's interesting today is likely not to be as interesting a year or two from now. And as the economy evolves and the banking system evolves, let's not forget, in a few years, there might be different regulation and different concerns and different needs. And it's important to remain nimble with your eyes open in terms of what the opportunities are.

>> It seems like ABF gives you that vantage point in terms of being able to finance different areas of the economy at different points in time. Talk to me a little bit about some of the challenges. Let's say I'm a new investor in this space. What are some of the things I need to think about? Some of the challenges, as you point out, there's a lot of names popping up, a lot of interest in it. So how do you delineate the good from the bad, and where you can find differentiation in terms of managers to partner with?

>> I think what's key -- and this is probably true for a lot of asset management -- is the teams. What is the depth of your team? Where does it focus? I think technology remains a very critical aspect of securitized in general, but ABF in particular. While we have a good amount of transparency and a lot of transparency in the assets that we're financing, it's a lot of data. And the need to analyze that data is real. And it's not just analyzing it on the first day, but it's continuing to surveil it month after month, then make sure that you can actually appropriately size the risk through time. So I think large teams are important. Data and technology is really important. The other piece is the -- just something clients and asset allocators need to think about. True ABF players, I think a simple question is, show me how much is being bilaterally originated? I think that is a real value add. The other piece is, you know, how do you originate? We have an open architecture model, simply meaning we don't own any origination platforms. There are some very large players that focus predominantly on the origination businesses they own. I think through cycles, there's going to be benefits and drawbacks to each of those strategies, or maybe the benefits will outweigh one over the other.

>> Having an open architecture platform can provide value in many ways, including diversification. It can also facilitate a more nimble approach, avoid conflicts of interest, and provide the potential to achieve better overall results.

>> We do think that having a bit more of an open architecture lends better to our first principle thinking around relative value. We don't want to be tied down to being captive to origination that we have to fund because we own the platform. We constantly try to avoid conflicts in our business. Again, this per durable alpha concept through time. But I think those are two key things. It's how much is truly bilateral. What is your area of focus? Again, we favor having this full field division, having a lot of different places to look at. And then ultimately, do you own the origination, or are you able to pick and choose back to that first principle point? We're trying to find places where we're going to get paid to provide financing because there's a true demand/supply imbalance in the need for capital. And I think that's where you get really the best risk-adjusted return. And this will continue to change as time rolls on.

>> As you think about investors coming into this space, how should they be thinking about liquidity? These are shorter-duration, usually floating-rate assets. So there's natural liquidity in the sense that you're not buying a 30-year bond here. But how should you think about the constraints given these are complicated, structured transactions? So what's a consideration there that is always top of mind for you as you look at things?

>> Yeah, investor communication is key. So we want to always make sure investors understand what we're looking to invest on their behalf. And a lot of it is actually quite circular. It's really asking them, what can we help you with? There's a good amount of our space that is floating rate. There's a good amount of opportunities also in fixed. And then tenors generally -- and I think this is definitely where you were going -- are going to be somewhere between three and five years. If a lot of these assets are assets that banks once financed, banks don't generally finance very long assets, right? So they're trying to put it all together. It makes sense that these assets aren't going to be incredibly long. Now, there's always exceptions. There's definitely some pretty long opportunities in ABF as well. But I'd say those are much more limited relative to the size and the numbers that we discussed earlier. So in terms of liquidity and how clients think about it, a lot of it is just trying to structure portfolios the way they want us to. Our ability to sell these assets is going to be quite limited. These are sometimes -- or many times bilaterally originated or, as you mentioned, are hard to transfer or just require a lot of depth in both the analysis and the team to get your arms around it. Generally, we're looking at ABF as an asset that you're going to hold. There are opportunities for us to get liquidity, but that's not how we frame it to our clients. We say, just assume we're going to own it. Now, if clients are thinking, "Okay. Well, I have a one or two or three year time horizon or I'd like to incorporate ABF into maybe a liquid portfolio." And think of this as almost like a semi-liquid complement to a broader strategy. Then we could help say,

"Okay. Well, this is within the universe of opportunities we're seeing that we find attractive today." These are the types of cash flows that we can deliver you. And the good news is you can get liquidity monthly from ABF through natural amortization. I think a lot of it comes down to communicating appropriately with clients, and it's really portfolio construction. I go back. This market is in the trillions, so it truly does lend itself to being able to customize both tenor and risk profiles. So I think that is a critical piece.

>> Very helpful. And I think to your point, the nice thing is the characteristics themselves are based on cash flows. So you kind of have the natural ability to think about not having to just wait for a payout at the end of a maturity, right? So we typically like to wrap up with burning questions, what we're hearing from clients or other partners. Let me actually start with one. I spent a lot of time in the insurance space myself. So in insurance, we talked about this at the beginning. ABF is becoming interesting. Why is that? As you talk to some of our insurance partners, insurance clients, our own parent company, obviously, why is ABF becoming more and more interesting to them in terms of a portfolio construction idea?

>> I think it goes back to a couple of things we said, diversifying most or many insurance companies. A lot of what they see on balance sheets are corporate credit. It is a very strong diversifier. I think the other thing, in the last two to three years, in particular, as the secular shift in who's funding what in the economy has moved, assets that were investment grade in nature that banks were financing are now being financed in the ABF market. And that's critical. What that means is that now insurers who predominantly focus on investment grade, and naturally they also buy high yield, and they also buy direct lending, and they even buy alts. So it's not an absolute statement, but a lot of these portfolios are investment grade with the availability of investment-grade assets that are securitized in nature. One, it's going to diversify their private placement portfolio or their public corporate bond portfolio. But importantly, the spreads and the yields that one can achieve in ABF, because it's highly customized, and there's a lot of need for that financing. So it fits in extraordinarily well into the liabilities and into the asset portfolio, because again, just back to the first principles, right? It diversifies the portfolio and it increases the yield. And the change in the market, which really become exciting for our insurance clients, including our own parent, is that it's scalable. So these assets are real. These assets are out there.

>> There's a perfect segue. What does deployment look like? You mentioned the size of the market. Obviously, the origination is key, whether you're open architecture like we are, or maybe obviously have originators you own. But as people are trying to leg into this asset class, often with private assets, you always think that kind of a deployment timeline. What is it in ABF, and how should investors consider that?

>> To me, like the simplest answer is just thinking through the broader piece. So when I look at just generally speaking, just corporate credit, and I think this is where it's quite

different. So if we look at whether it's public or private, or just say large corporations or small ones, outstandings -- in whether we're talking about investment grade, high yield, lev loans, direct lending -- have been relatively stable. If you just look at leveraged finance, we've seen and we often hear BSLs losing assets to direct lenders, and direct lenders are coming to BSL and then high yield. There's a shift. But to me, if I just bucket that all as leveraged finance, that market has been relatively stable, maybe even shrinking because there's been defaults, and maybe there's some M&A where they get taken into IG. So that market's actually been quite stable. And so what happens is you continue. As the demand for that asset increases, the supply of the asset hasn't really moved. Companies, maybe you need more M&A to create more of this asset. Same thing on the IG side. We saw companies raise a lot of cash during COVID. This one, we added it to it because everybody needed liquidity. But post that asset raise, we've seen a lot of stability. Conversely, in ABF, it's quite the opposite. We've seen banks blend differently. If you think about just regional banks, and we're not talking about the largest banks, but the super regionals, regardless of where we are today, they have to hold more capital. All that excess capital that now has to be put on their balance sheet means they're not blending into the real economy. We've seen the size of the securitized market grow. So this is public issuance. Just this year alone, we've seen over a trillion dollars of issuance in the US alone. And again, we're seeing a lot more growth of the securitized in Europe and Australia as well. But what we've seen on the ABF side is a large amount of opportunities because the economy is growing and you need credit formation. And the one place where there is an availability of capital is in the private market. So in terms of deployment, we're seeing a lot of opportunities, some very attractive ones. And then we expect that to continue in the foreseeable future.

>> It sounds like part of it is that building a robust pipeline. You have to have the breadth of the platform and that different origination partnerships. Well, Edwin, thanks for such a terrific conversation. Obviously, you unpacked quite a bit on asset-based finance. And this is a space that continues to be garnering a lot of attention. So I'm sure there'll be more conversations to come. But for me, really three main takeaways. Number one, we talk a lot about the blurring of public and private credit from the investor angle, where investors are no doubt looking at that blurring between the asset classes. But it's also on the financing side. Companies seeking capital are using tools like ABF to access capital. And that really is sitting squarely at the blurring of public and private markets. So it's really a financing side as well, too. Second is ABF can help with the diversification of a portfolio. And then within ABF itself, there's quite a bit of diversification because you can finance all sorts of companies and different parts of the economy. So even within ABF, you can build a fairly diversified portfolio that, again, with the goal being how investors can achieve better risk-adjusted returns by moving up the efficient frontier. And third, it really is about distilling down what ABF is. It's contractual cash flows, as you put it. So in terms of investors thinking about the use case for this asset class, be

the insurance companies, pension plans, or other institutions, it's really understanding that what you're focused on is contractual cash flows. Edwin, thanks for a great conversation. And thanks to all of you for tuning in.

>> It's been a real privilege, Keshav. Thank you.

>> Join us next time on Speaking of Alternatives.

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5004263 Expiration: 01 January 2027