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CAPITAL PARTNERS

Expanding Horizons in U.S. Nonbank Lending

Exploring the Value of Nonbank Lending to Investors

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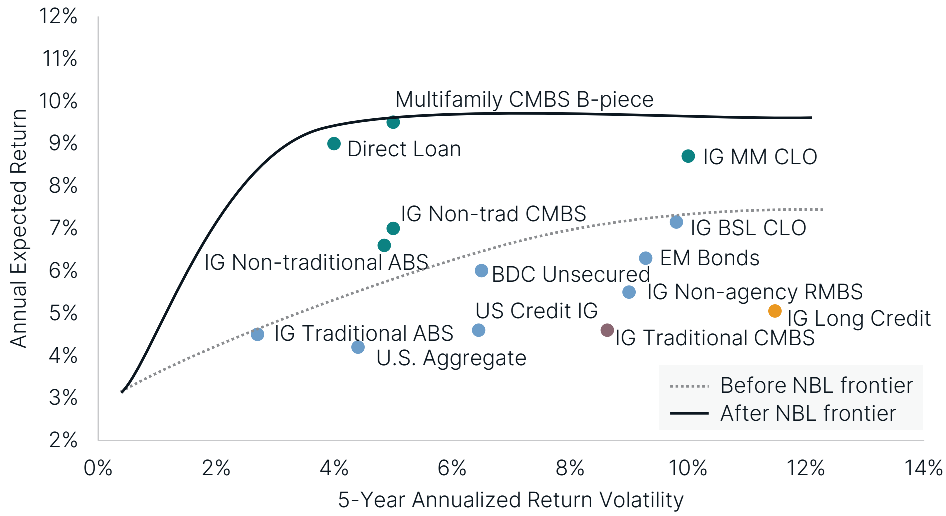
The U.S. has the most dynamic financial system and capital markets in the developed world. Borrowers and lenders can access and extend credit through plentiful bank and capital market channels. The Global Financial Crisis (GFC) and its legislative repercussions curtailed banks' risk-taking activities. Nonbank lenders (NBL) stepped into the vacuum, growing and evolving to maintain the credit creation vital to consumer and economic health. Yet as its economic importance grows, much of the NBL sector remains poorly understood and sparsely invested, offering investors attractive compensation amidst some unfamiliar risks.

In a series of whitepapers, Partner Neil Hohmann dives into the NBL sector and its opportunities. In a previous article, we examined why NBL continues to offer compelling opportunities for institutional investors. Now, we turn to how NBL investments can enhance portfolio construction. With attributes like contractual cash flows, diversification, and structural protections, NBL strategies can offer measurable improvements in return potential, volatility management, and customization across investor types.

Investor portfolio optimization through loan-backed investments

We believe that NBL investments considerably expand the universe of compelling attribute mixes beyond what's available in a more traditional investment portfolio. These attributes should appeal to many investor types: demonstrated capital preservation, elevated income opportunities, diversification, contractual-based cash flow streams, and structural protections.

Exhibit 1: Typical insurer's efficient frontier with and without NBL



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A growing body of empirical evidence demonstrates improved portfolio outcomes, including higher returns, low volatility, demonstrated correlation benefits, and limited downside risk through multiple market cycles.

Additionally, current NBL investments have performed through a variety of challenging market environments, including the GFC, unprecedented commodity weakness, the COVID-19 pandemic, a surge in interest rates, and a regional banking crisis.

We have partnered with hundreds of clients to integrate these investments into portfolios and help meet their objectives. For prudent fit, we evaluate, among others, supply and demand technicals, credit risk, liquidity, mark-to-market volatility, credit ratings, loan type exposures, interest rate risk profile, and return correlations to other assets. Having the broadest range of NBL investment attributes available allows our clients an unusual degree of portfolio customization and return optimization potential.

Insurance

Our insurance clients commonly pursue higher return potential subject to specific ratings/capital charge and gain/sale constraints. Insurers typically seek investments that:

- Have higher-quality credit ratings that do not entail high risk-based capital charges
- Complement their internal and existing investing capabilities
- Reduce balance sheet volatility

Exhibit 1 shows the efficient frontier of the typical insurer opportunity set. Numerous NBL-sourced opportunities substantially expand the frontier, boosting the yield of their fixed income programs while satisfying capital and liquidity objectives. Investment grade-rated nontraditional ABS, commercial mortgage-backed securities (CMBS), and collateralized loan obligation (CLO) positions offer expected returns well north of the conventional frontier, offering a highly effective means of raising income while maintaining or lowering credit and price risk.

Pension plans

The breadth of NBL investments solutions for pension plans is as wide as the breadth of types of plans themselves. They can address the plans' many goals: enhancing traditional fixed income portfolios, bridging the risk/return divide between fixed income and equities, and achieving returns comparable to but diversified from their public equity strategies.

The first objective we hear from pensions is enhancing their existing fixed income portfolio. Pension clients typically seek to enhance their existing fixed income portfolios without adding lower-quality credit risk or related return volatility. They seek higher-quality, liquid, and fixed-rate instruments. Exhibit 2 shows how the inclusion of many NBL investments (green) can enhance a fixed income portfolio comprising more publicly available active fixed income investments (blue).

Many NBL investment opportunities can offer returns that better public market equities. Their returns are driven by loan contractual cash flows, are disconnected from public market valuations, tend to be stable and diversifying, and can exceed equity return levels. Exhibit 3 shows investment types that can jointly push out a pension plan's efficient frontier. Unrated direct loans, junior multifamily mortgage, junior ABS, and CLO positions can offer a substantial boost in return above the conventional frontier with modest price and return volatility, albeit with some give in liquidity.

Exhibit 2: NBL can expand the efficient frontier in pensions' fixed income portfolios

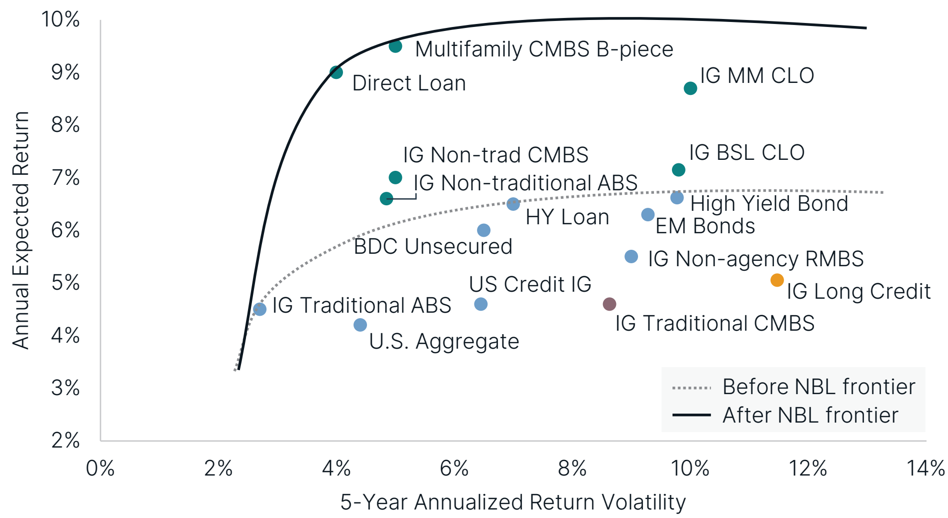

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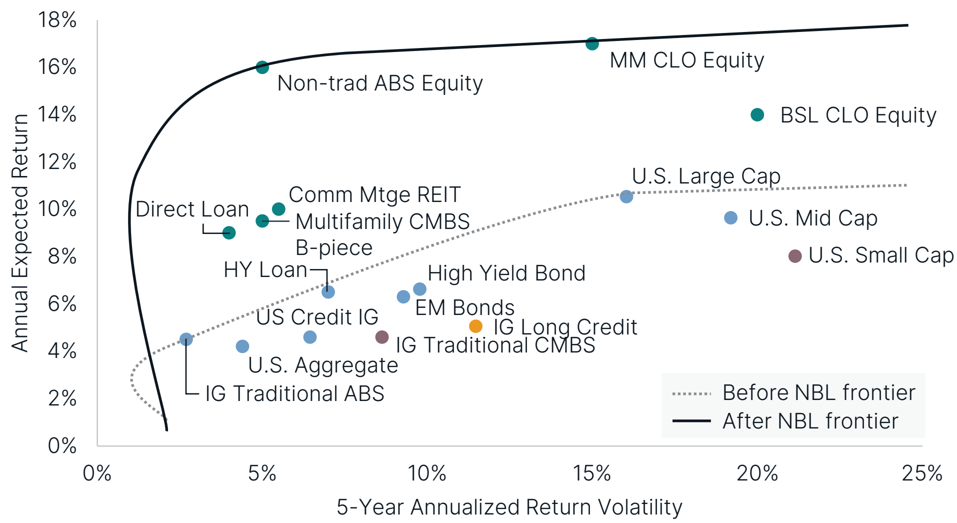
Exhibit 3: Pensions can enjoy plan-level benefits from including NBL



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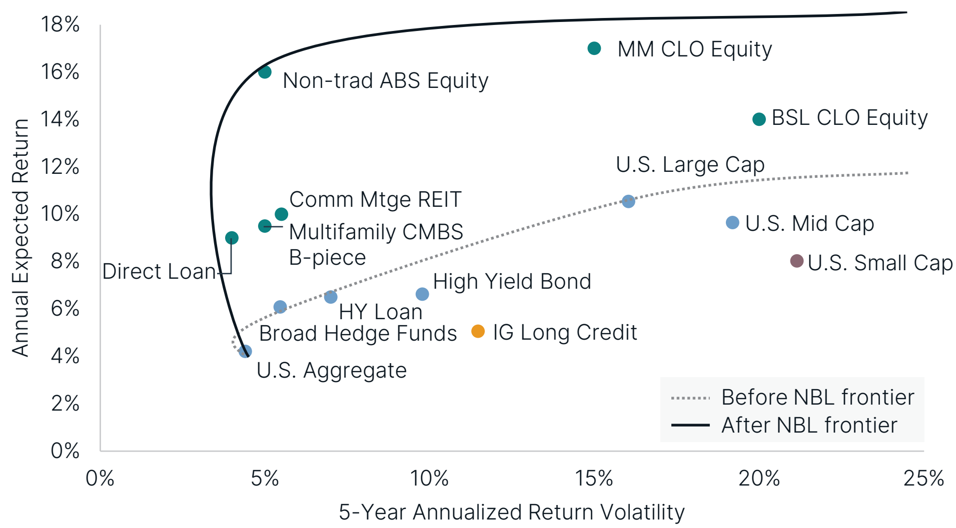
Endowments and foundations

Endowment and foundation (E&F) clients prefer higher return opportunities away from traditional fixed income sectors. They are less concerned with liquidity and credit ratings. NBL opportunities open up diversifying, high-income sectors where contractual cash flows, rather than public equity multipliers, drive performance.

Exhibit 4 shows that including some whole loan, equity, and securitization residuals can be highly additive to investment plans. Junior positions in ABS and CLOs offer transformational opportunities to shift up the return frontier by 10 points or more.

Exhibit 4: Expanded frontier with NBL for E&F clients



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Other investors

BBH partners with several other varieties of investors to embrace emerging NBL sectors that enhance the income and volatility profile of their portfolios.

- **Corporate and not-for-profit plans' operating cash pools** benefit from liquidity, shorter-duration, and high investment grade credit ratings of ABS, CMBS, and business development company (BDC) debt.
- **Registered investment advisors (RIAs)** seek novel credit ideas to deliver differentiated and complementary solutions for their clients, spanning sectors and credit ratings.
- **Non-U.S. institutions** seek highly rated investments to enhance income with minimal capital loss.

Conclusion

NBL-related investments can offer an investor the opportunity to expand their portfolio's return potential while taking risk efficiently. By tapping into diverse, contract-driven cash flows across asset classes, NBL strategies expand the efficient frontier for insurers, pensions, endowments, and other institutions. As the sector matures, it continues to demonstrate potential for strong performance across varied market conditions while helping investors address specific portfolio objectives.

SOURCES FOR EXHIBITS 1 - 4

Label	Source
US Credit IG	Bloomberg U.S. Credit Index
U.S. Aggregate	Bloomberg U.S. Aggregate Index
IG Long Credit	Bloomberg Long U.S. Credit Index
High Yield Bond	Bloomberg U.S. Corporate High Yield Index
Broad Hedge Funds	Eurekahedge Hedge Fund Index
Emerging Market Bonds USD	J.P. Morgan EMBI Global Total Return Index
U.S. Large Cap	S&P 500 Index
U.S. Small Cap	Russell 2000 Index
U.S. Mid Cap	S&P Midcap 400 Index
IG Traditional CMBS	Non-Agency Investment Grade CMBS: Eligible for U.S. Aggregate
IG Non-traditional ABS	J.P. Morgan Other ABS Index
Non-trad ABS Equity	BBH
Multifamily CMBS B-piece	BBH
IG Non-agency RMBS	BBH
IG Non-trad CMBS	BBH
Comm Mtge REIT	BBH
HY Loan	J.P. Morgan Leveraged Loan Index
IG BSL CLO	J.P. Morgan CLOIE
BSL CLO Equity	BBH
Direct Loan	BBH
IG MM CLO	J.P. Morgan CLOIE
MM CLO Equity	BBH
BDC Unsecured	BBH
IG Traditional ABS	Bloomberg U.S. ABS Index

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Risks

Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, maturity, call and inflation risk; investments may be worth more or less than the original cost when redeemed. Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices. Mortgage-backed securities have prepayment, extension, and interest rate risks.

Asset-Backed Securities ("ABS") are subject to risks due to defaults by the borrowers; failure of the issuer or servicer to perform; the variability in cash flows due to amortization or acceleration features; changes in interest rates which may influence the prepayments of the underlying securities; misrepresentation of asset quality, value or inadequate controls over disbursements and receipts; and the ABS being structured in ways that give certain investors less credit risk protection than others.