



Direct Lending



# Pursuing Income Stability: Direct Lending in Uncertain Environments

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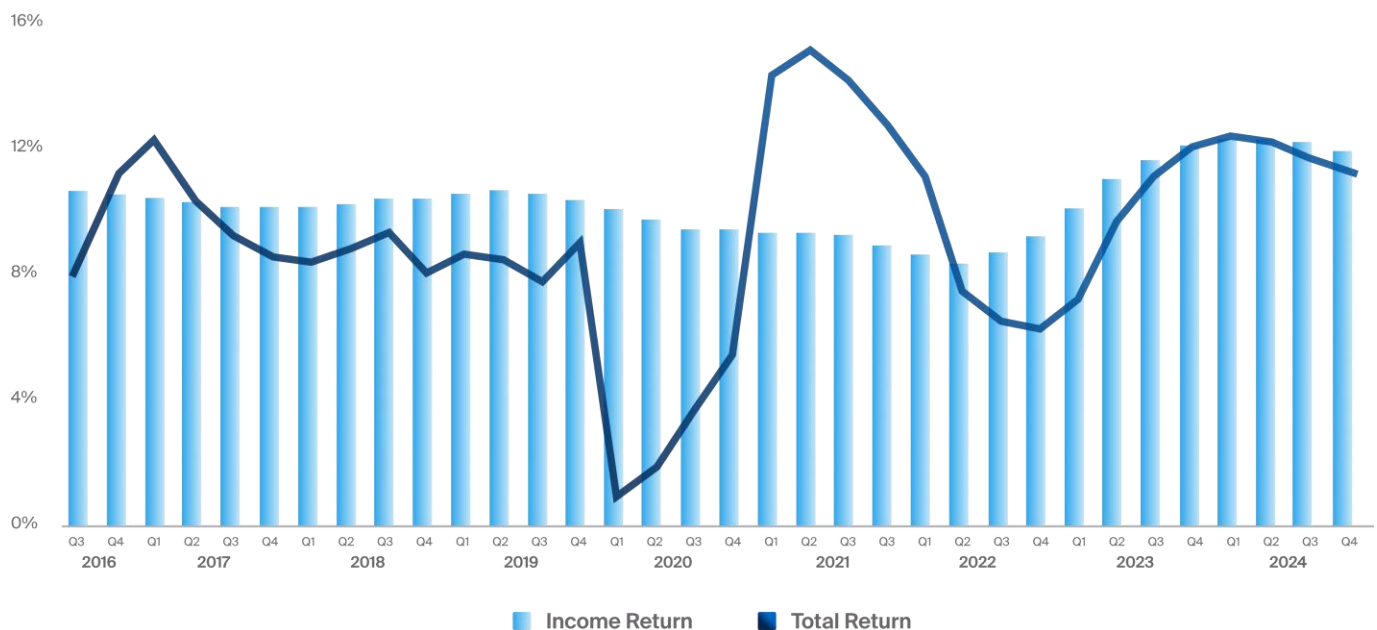
## Pursuing Income Stability

# Direct Lending in Uncertain Environments

Though it took off in the aftermath of the global financial crisis (GFC), direct lending has emerged as a durable segment of the alternative investment landscape. Advisors increasingly consider it when pursuing income within diversified, long-term portfolios.<sup>1</sup>

### Exhibit 1

**Income return<sup>2</sup> from direct lending strategies has remained relatively stable since 2015, with total return surpassing 8% in more than 70% of quarters analyzed.**



**Source:** Cliffwater Direct Lending Index; Income and total return is shown for the trailing 12-month period at each quarter end; Note that investors cannot invest directly in an index and past performance does not guarantee future results.

Direct lending strategies grew in popularity following the GFC when interest rates hit historical lows and elevated all-in yields were harder to come by in traditional fixed income. Indeed, direct lending collectively delivered total returns surpassing 8% during more than 70% of quarters in the last decade (Exhibit 1). After interest rates rose in early 2022 and as volatility remained elevated, direct lending strategies performed well given the floating-rate nature of the asset class, coupled with their comparatively stable income returns relative to public fixed income markets (Exhibit 1).

Volatility in public markets and downgraded confidence in US Treasuries may be helping to sustain interest in direct lending strategies for this relative income stability; however, advisors should note that past performance is not guaranteed.

# Direct Lending’s Momentum Persists

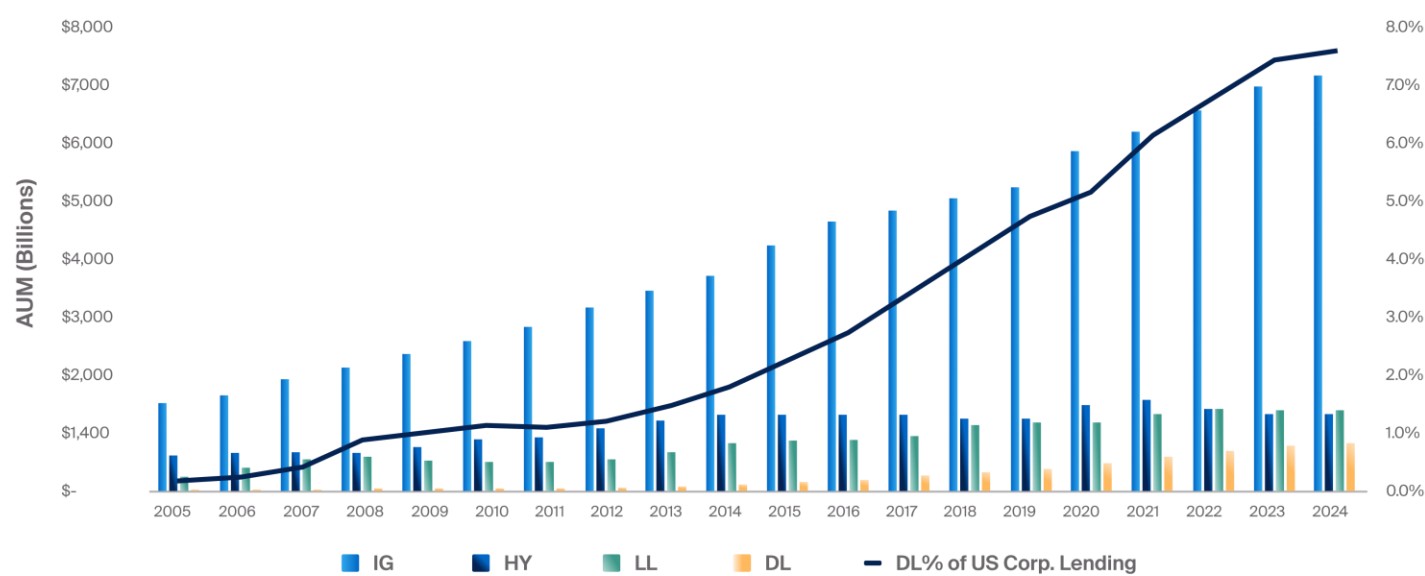
After expanding nearly eight-fold over the past decade globally, direct lending has continued to grow, both in absolute terms and relative to other private credit strategies. Heading into 2025, direct lending strategies accounted for more than \$848 billion in AUM,<sup>3</sup> more than half of all AUM and dry powder in private credit, which sits at roughly \$1.7 trillion in AUM today.<sup>4</sup> The opportunity set for these strategies appears primed for continued growth.

Direct lending funds provide loans directly to companies. These loans are negotiated bilaterally between the lender and the borrower at a floating-rate coupon rate and tend to have a senior claim in the company’s capital structure. Direct lending deals also often involve a private equity (PE) sponsor. However, some private credit managers have teams dedicated to originating loans outside the PE ecosystem.

Collectively, direct lending funds have increased their share of both available lending opportunities and fundraising, and there’s still room to grow in both areas. In 2024, US corporate lending, which includes direct lending, along with investment grade and high-yield bonds and leveraged loans, totaled more than \$10.6 trillion (Exhibit 2). Direct lending has gradually gained ground as a portion of overall corporate lending, more than tripling its share from 2.3% to 7.6% between 2015 and 2024.<sup>5</sup>

Exhibit 2

Though investment grade bonds still lead significantly, direct lending has more than tripled its share of overall corporate lending AUM in the US since 2015.



Sources: Cliffwater, Bloomberg, Pitchbook | LCD, Preqin; Direct lending (DL) represented by Cliffwater Direct Lending Index; investment grade (IG) represented by Bloomberg US Corporate Index amount outstanding; high yield (HY) represented by Bloomberg US Corporate High Yield Index amount outstanding; leveraged loans (LL) amount outstanding provided by Pitchbook | LCD, as of June 30, 2024

Over the same 10-year period, even as it more than doubled its own AUM (Exhibit 3), direct lending strategies raised only 9.25% of the capital raised by private equity funds.<sup>6</sup> This steady imbalance of equity and debt capital could also mean ongoing tailwinds for direct lenders within the private-equity-backed segment of the middle market.

The overall segment is also projected to keep growing as more companies, across all sizes and growth strategies choose to stay or go private (Exhibit 4). In line with a decline of initial public offerings (IPOs), more than eight in 10 companies with revenues of more than \$100 million in the US are private.<sup>7</sup> Into the first quarter of 2025, private credit strategies have maintained their dominant share over broadly syndicated loans (BSL) in leveraged buyout (LBO) financing (Exhibit 5), due to the relative speed of execution, privacy, and customization direct lenders can offer both management teams and PE sponsors.

Throughout the rest of this paper, we explore some reasons borrowers and advisors alike may continue to turn toward direct lending amid fluctuating macroeconomic conditions.

Exhibit 3

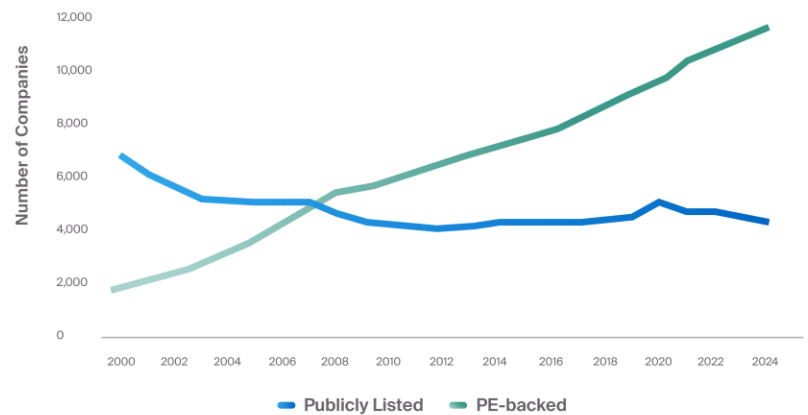
**Direct lending strategies raise less than a tenth of the capital raised by private equity strategies.**



Source: Preqin

Exhibit 4

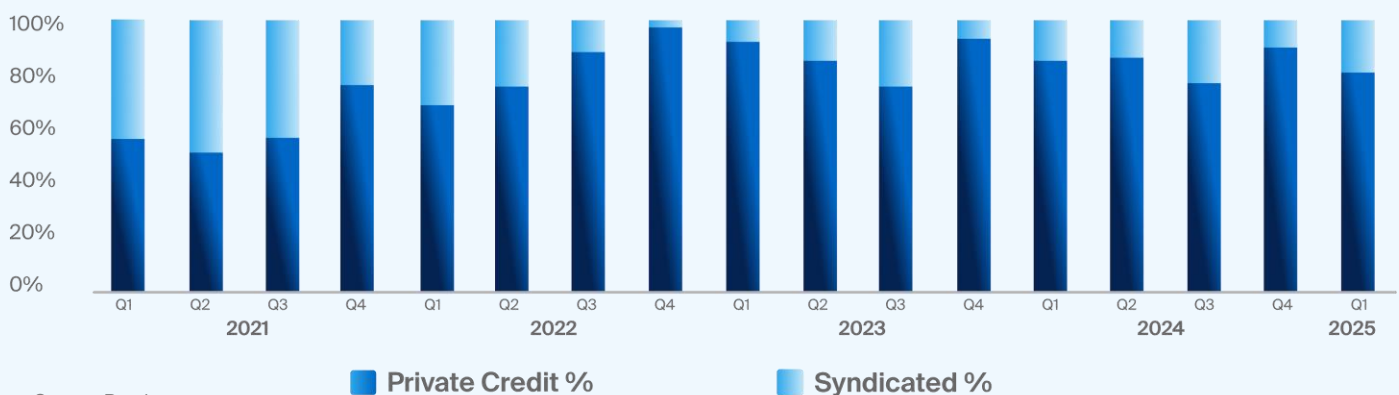
**The opportunity set for direct lending continues to grow as the number of PE-backed companies rises and the number of publicly listed clients stagnates.**



Source: Pitchbook

Exhibit 5

**Private credit continues to finance more than double the amount of buyout deals financed by bank loans.**



Source: Preqin



# Why Borrowers Might Choose Direct Lenders Over Banks

A primary reason corporate borrowers may choose to work with direct lenders, despite the premium they typically demand (Exhibit 6), may be access. Bank financing is not always available to certain companies during risk-off environments when banks tend to tighten their balance sheets.

Another attraction for borrowers—and increasingly those who also have access to banks or public debt markets—is the speed and certainty of execution that direct lenders can provide. In periods of market volatility or when timelines are tight, borrowers often value a lender that can move quickly and decisively. Unlike banks, which may face regulatory hurdles or internal red tape, direct lenders can often approve and disburse loans on a much shorter timeline.

Flexibility and customization are also strong drivers. Many borrowers prefer working with lenders who can structure deals around their unique needs, rather than forcing them into a more standardized syndicated solution. Direct lenders tend to approach deals as partners, crafting bespoke capital solutions that better align with a company's operational and strategic objectives.

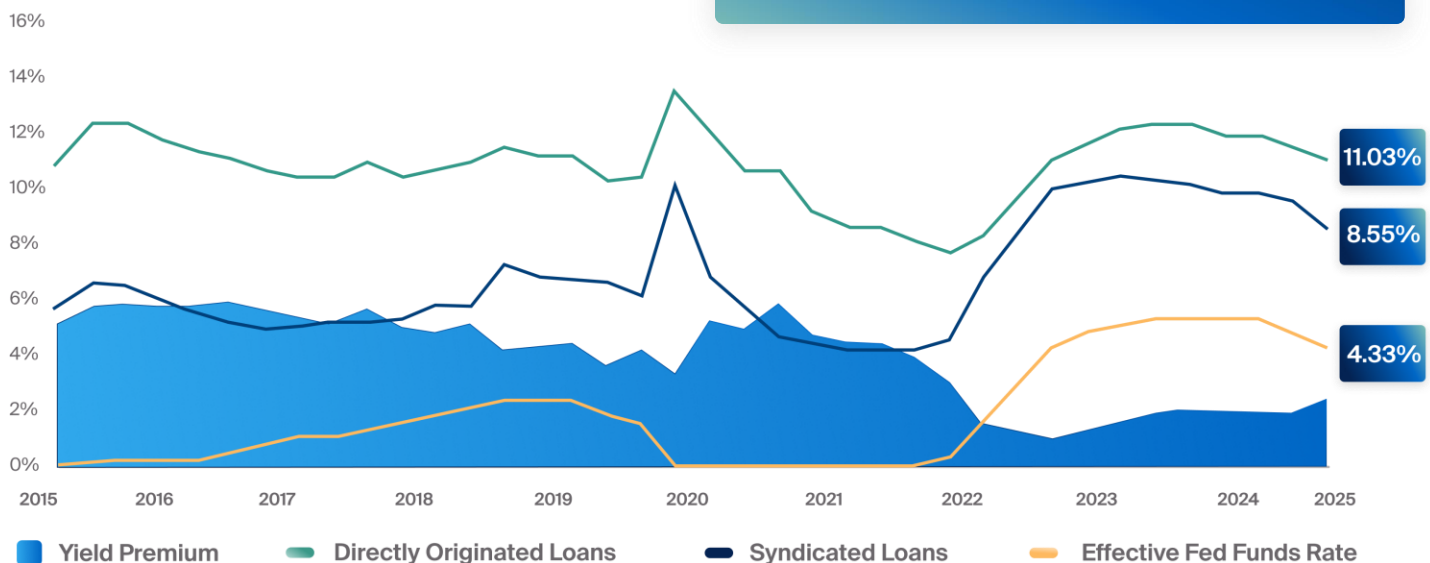
Additionally, confidentiality can be a significant draw for corporate borrowers, who tend to appreciate the privacy that comes with direct transactions. Public or syndicated deals can invite broader market scrutiny and information leakage, and especially in competitive industries or sensitive situations like acquisitions or restructurings, this discretion can be essential for maintaining an advantage.

## Exhibit 6

### Direct lending delivered annual yields in excess of broadly syndicated loans.

#### Averages (since 2015)

- Direct Lending (DL) = 10.8%
- Syndicated Loans = 6.8%
- Effective Fed Funds Rate = 1.9%
- DL Yield Premium vs. Syndicated = 4.0%



Sources: Cliffwater, Pitchbook | LCD, Preqin, St. Louis FRED

# Why Advisors Might Consider Direct Lending

As long as quality borrowers continue to seek financing via private credit, direct lending will likely remain an increasingly accessible investment option for advisors looking to add diversification and income in their portfolios.

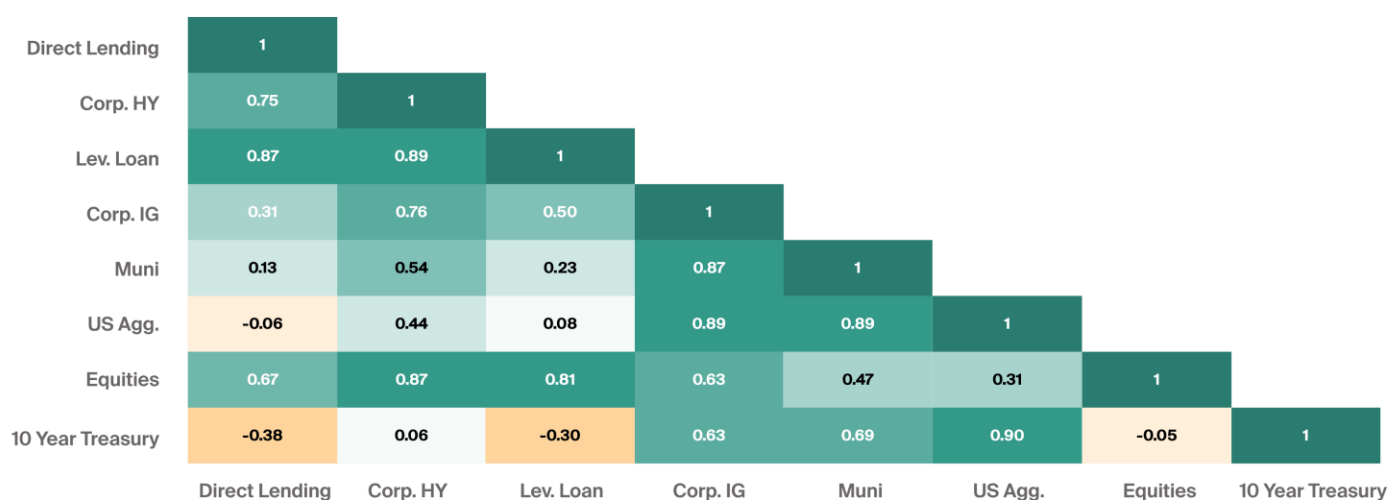


## Low Correlation to Traditional Fixed Income

Direct lending performance in aggregate has exhibited relatively low correlation to traditional fixed income, including US Treasuries and corporate and municipal bonds. These relationships have held up relatively well throughout the two of the most significant public market downturns of the last decade, including just after the COVID-19 pandemic hit and again in 2022 once inflation started to rise (Exhibit 7).

### Exhibit 7

Direct lending has historically exhibited lower correlation to US Treasuries, municipal bonds, and corporate investment-grade bonds, with higher correlation to corporate high-yield bonds and leveraged loans.



	2015-2024	Post-COVID (2020-2024)	Post Inflation (2022-2024)
Corp. HY	0.75	0.75	0.52
Lev. Loan	0.87	0.87	0.75
Corp. IG	0.31	0.34	0.30
Muni	0.13	0.20	0.20
US Agg.	-0.06	-0.06	0.20
Equities	0.67	0.75	0.60
10-Year Treasury	-0.38	-0.45	0.10

Source: Bloomberg; Cliffwater Direct Lending Index ("CDLI") for the period 9/30/2015 – 12/31/2024. Benchmarks: Cliffwater Direct Lending Index, Bloomberg Barclays US Aggregate Bond Index, Bloomberg Barclays U.S. Municipal Index, Bloomberg Barclays U.S. Corporate Bond Index, Bloomberg Barclays US High Yield Index, SP LSTA Leveraged Loan Index.



## Historical Premium Over Bank Loans

Due to the reasons listed in the previous section, directly originated loans have historically demanded a premium over bank loans (Exhibit 6). Between Q3 2015 and the end of 2024, this premium averaged 4%, fluctuating between 1% and 6% depending on the market environment.



## Floating Rate Loans

Floating rate loans provide an advantage in environments marked by rising interest rates. By adjusting interest payments periodically in line with market interest rates, these loans aim to mitigate the risk associated with interest rate fluctuations, offering investors potential protection against inflation and enhancing portfolio resilience.



## Positioning in the Capital Structure

Direct lending strategies typically prioritize positions higher in a company's capital structure, most notably senior secured debt. Emphasizing first-lien debt, these investments offer a relatively stronger risk profile characterized by priority claims on the borrower's assets. Historical recovery rates for first-lien debt are typically higher compared to subordinated debt, providing investors with additional safeguards in periods of market stress.



## Covenant Packages

Covenant packages form a critical component of direct lending strategies and contribute to their relative stability. Comprehensive financial maintenance and negative covenants embedded within loan agreements act as proactive mechanisms, helping lenders identify early signs of borrower distress.

These covenants may include terms on information sharing, board oversight, interest coverage, use of leverage, and more. By providing substantial protective measures and enhanced negotiating leverage, these covenants can allow a lender to intervene before problems escalate and to encourage adjustments aimed at preserving their capital and sustaining the credit quality of the borrower.



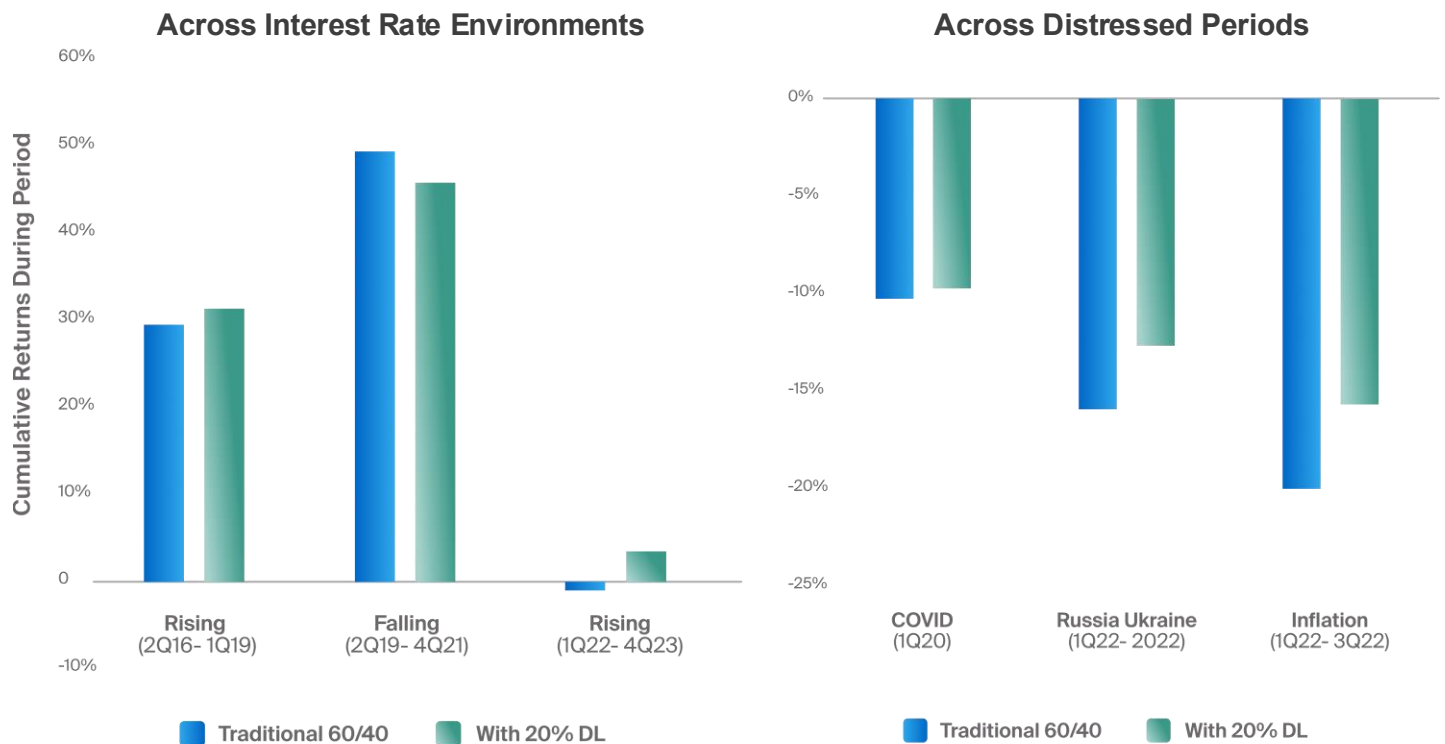
## Direct Lending Performance Amid Volatility

Compared with traditional fixed income broadly, direct lending in aggregate has historically generated higher returns with less volatility. Part of that may be thanks to underwriting discipline and the aforementioned characteristics of direct lending. However, valuation processes also play a role. Publicly traded fixed income is marked-to-market, making it more susceptible to sentiment-driven swings related to inflation, interest rates, or the events and trends associated with borrowing companies. By contrast, direct lending strategies usually price net asset value (NAV) less frequently.

We've seen this relative stability in action during rising and falling rate environments since 2015, and the last two post-GFC dislocations: during the COVID-19 pandemic and starting in 2022 following the rapid rise in interest rates and the subsequent collapse of several regional banks across the country. Note that, at the time of publication, similar data is not yet available for the dislocation following tariff policy changes in April 2025.

### Exhibit 8

**Direct lending strategies may have enhanced performance when added to a traditional 60/40 portfolio of stocks and bonds during past rising interest rate environments and distressed periods.**



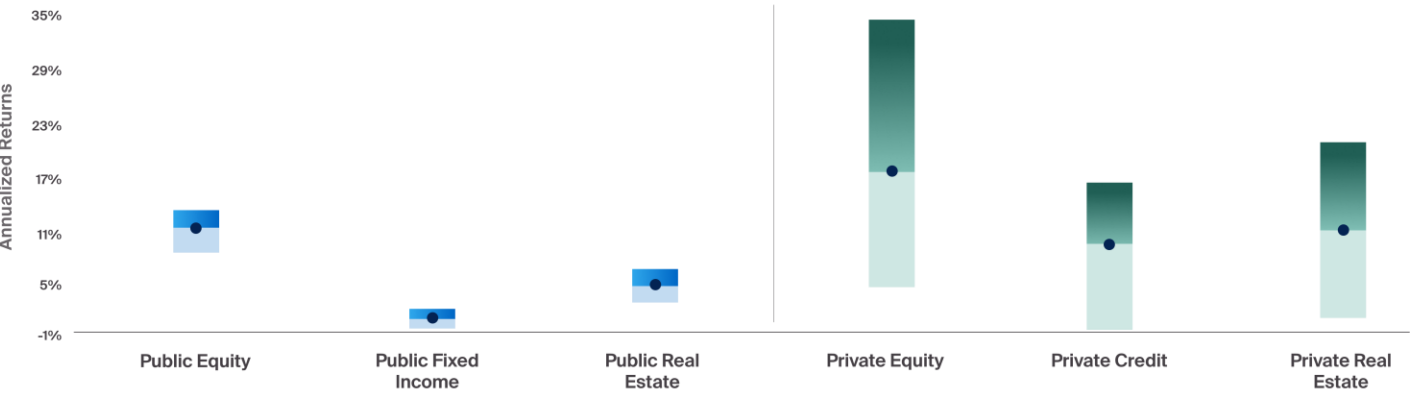
Source: Bloomberg; Cliffwater Direct Lending Index ("CDLI")



However, direct lending strategies can vary significantly among managers, underscoring the importance of rigorous due diligence and manager selection. There is meaningful dispersion in outcomes due to differences in underwriting discipline, deal sourcing quality, and risk management practices (Exhibit 9).

Exhibit 9

Manager dispersion has historically been greater in private markets compared to public markets; though, private credit strategies tend to have lower dispersion than other private markets asset classes.



	Public Equity	Public Fixed Income	Public Real Estate	Private Equity	Private Credit	Private Real Estate
Top 25% Avg.	12.7%	1.8%	6.2%	33.7%	15.6%	20.1%
Median	11.4%	1.3%	5.0%	17.9%	9.7%	11.1%
Bottom 25% Avg.	9.1%	0.6%	3.4%	5.2%	-0.7%	2.1%

Source: Preqin, returns are for 2014 vintages that have last reported between 12/31/2022-12/31/2023. (North America, Closed funds): Private Equity (Buyout), Private Credit (all Private Debt strategies); Private Real Estate (Co-invest, Core, Core+, Debt, Value Added, FoF); Morningstar, returns are over a ten-year period from 1/1/2014-12/31/2023 (Open-end funds): Public Equities (US Large Blend); Public Fixed Income (US Intermediate Core Bonds); Public Real Estate (US Real Estate). Past performance is not indicative of future results. There can be no assurance that historical trends will continue.

While this dispersion can demonstrate the value of active management across these strategies, advisors may benefit from thoroughly vetting a manager’s track record, experience, and operational strengths when evaluating direct lending opportunities. Selecting managers with demonstrated capabilities and experience within private credit can influence the effectiveness of direct lending as part of an overall asset allocation strategy.



How Managers Further Mitigate Risk

Asset managers, like Blue Owl, may evaluate several factors when sourcing and underwriting loans within their portfolios. They may follow guidelines, such as the ones listed below.

- Aim for diversification across defensive, non-cyclical industries.
- Focus on upper middle-market borrowers, rather than smaller companies with less established business models or cash flows.
- Prioritize sponsor-backed deals to streamline sourcing efforts and gain the operational support and financial alignment of an established private equity partner firm in case of distress.
- Be disciplined around maintaining low loan-to-value ratios.

# Understanding Risks in Direct Lending

Direct lending offers potential stability and attractive yields but entails distinct risks. Chief among these may be illiquidity, even in many of the evergreen, semi-liquid structures that have proliferated in recent years. Direct loans are privately negotiated, which may introduce risk relative to more standardized syndicated loans. They also lack public trading markets, often requiring investors to commit capital for the loan's entire term, limiting liquidity except in occasional secondary market transactions. Additionally, these loans involve significant credit risk, as borrowers typically include sub-investment-grade companies unable to access traditional financing due to factors like size, leverage, or weaker credit profiles, increasing the likelihood of defaults.

Advisors should also be mindful of valuation opacity, as private negotiations and internal valuation methods may delay or obscure recognition of credit deterioration. Furthermore, although floating-rate loans can be advantageous, borrower stress can emerge during periods of rising rates, exacerbating risks of covenant breaches and defaults. Funds employing fund-level leverage may face additional refinancing challenges during market volatility, potentially triggering margin calls or forced asset sales. Finally, manager selection risk is critical, given that the outcomes of direct lending investments heavily depend on the chosen manager's underwriting quality, deal sourcing strength, and risk management rigor.

## Could Boring Benefit Advisors?

Direct lending may lack the flash or excitement associated with more headline-grabbing assets, yet this mundanity may be its core advantage in an era of unpredictability. For advisors, direct lending can potentially provide the structured alignment, protective mechanisms, and reliable income to support portfolios through periods of volatility. Although direct lending strategies have historically demonstrated resilience in turbulent markets, their role should not be viewed solely through the lens of crisis management. Rather, advisors may consider direct lending as a strategic portfolio component across varied market conditions.



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Blue Owl (NYSE: OWL) is an asset manager that is seeking to redefine alternatives. With over \$273 billion in assets under management, as of March 31, 2025, Blue Owl invests across three multi-strategy platforms: Credit, GP Strategic Capital, and Real Estate. Anchored by a permanent capital base, Blue Owl seeks to provide businesses with private capital solutions to drive long-term growth and offer institutional and individual investors differentiated alternative investment opportunities that aim to deliver strong performance, risk-adjusted returns, and capital preservation.

## References

1. CAIS and Mercer, [“The State of Alternative Investments in Wealth Management,”](#) December 2024
2. Note that income return, according to the Cliffwater Direct Lending Index, includes contractual interest payments, along with any price discounts or dividend payments reported. Total return includes income return plus any unrealized (reflected in the change in loan values) or realized (reflected in defaults or recoveries) gains and losses.
3. Preqin, as of September 30, 2024
4. Preqin, as of September 30, 2024
5. Note that our analysis starts in Q3 2015, following the update to the Cliffwater Direct Lending Index methodology.
6. Preqin, as of September 30, 2024
7. Capital IQ, as of March 31, 2025

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