

The evolution of private credit

From direct lending to asset-based finance to commercial real estate debt

April 2026



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Private credit is still a relatively new asset class that represents a diverse group of underlying strategies including direct lending, special situations/distressed, asset-based financing (ABF), commercial real estate debt (CRE debt), and collateralized loan obligations (CLOs), among others. As the market has matured, and demand has risen, advisors are increasingly asking how to effectively allocate capital to private credit.

*In this paper, we will examine the growth and evolution of private credit, and how **history is repeating itself within the private credit universe**. We will discuss the unique risk, return and income characteristics of the various sub-strategies. We will explore the relative attractiveness of each of these strategies in today's market environment, discussing how its place in an investor's portfolio should evolve and be viewed as a fixed income replacement.*

The private credit landscape has evolved significantly over the past few years, driven by various macroeconomic factors, demand for flexible financing and advancements in technology. This paper delves into the recent developments in private credit, with a particular focus on asset-backed lending and commercial real estate debt.

Since the global financial crisis (GFC) in 2008, middle-market corporates and mortgage borrowing have increasingly moved away from banks. Overall, banks' share of private lending in the US economy has fallen from 60% in 1970 to 35% in 2023, according to a new National Bureau of Economic Research paper.¹

Leading up to the GFC, banks were the dominant lender of choice for both corporate and asset-backed borrowers, and non-bank lending was seen as an afterthought or last resort. The banking sector experienced a consolidation wave in the 1990s as larger institutions acquired and absorbed regional banks with fewer deposits. By 2008, the number of US

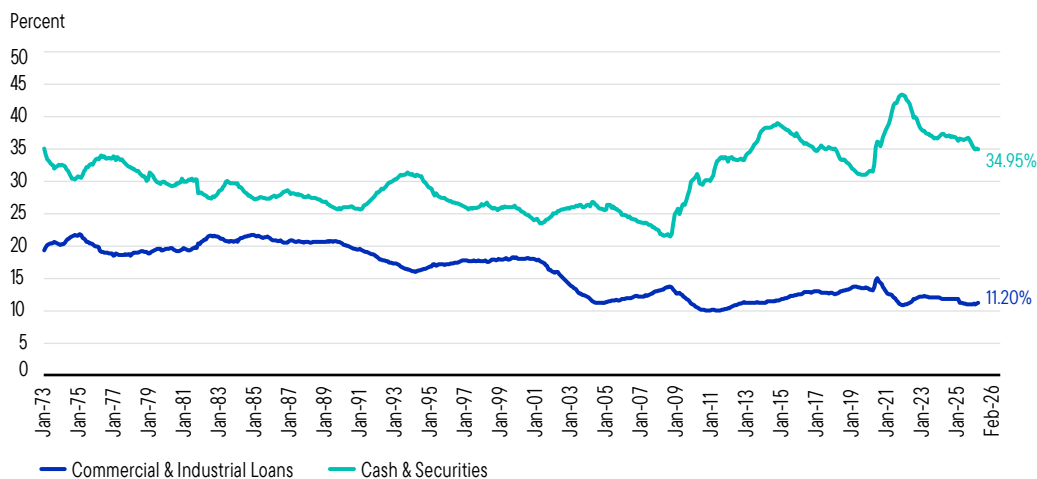
banks had dwindled by nearly half from 1990, and banks shifted their lending activities to focus on larger corporate borrowers.

After the GFC, banks retrenched from commercial and industrial (C&I) lending activity, partly in response to regulatory reforms and concerns about their balance sheets. Consequently, small- and medium-sized companies needed to find alternative sources of capital. Private credit managers stepped in to fill that void.

US Banks Have Cut Back on Commercial & Industrial Lending Due to Stricter Regulations

Exhibit 1: Banks' Holdings as a Percentage of Total US Commercial Bank Assets

As of February 2026



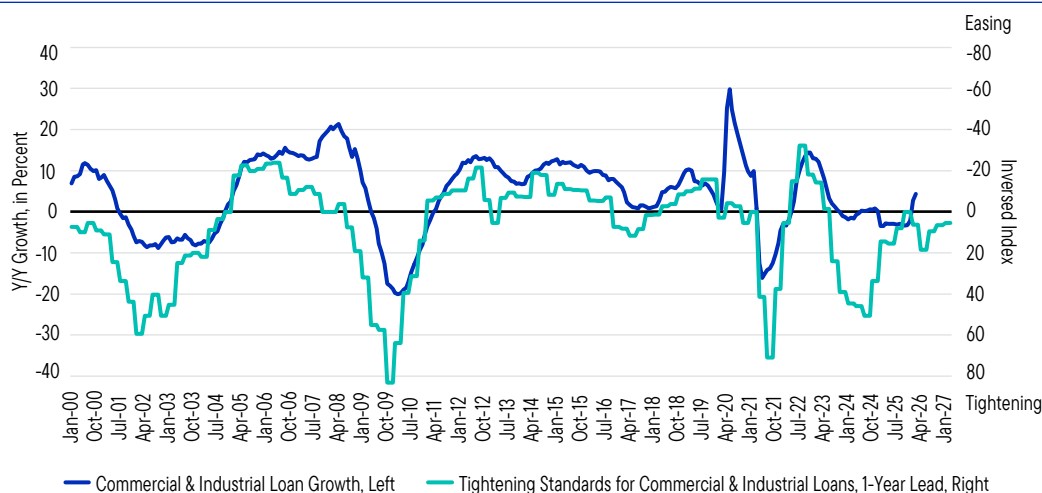
Source: Federal Reserve. Analysis by Franklin Templeton Institute.

In recent years, private credit managers have expanded their reach by lending to various forms of asset-based financing, which can be divided into financial assets (consumer finance and small business financing) and hard assets (airplane and equipment leasing and residential financing). One of the advantages of ABF is cash flows are contractually derived from pools of capital. Following the collapse of Silicon Valley Bank in 2023, banks have been reluctant to lend capital to small and middle market opportunities, instead favoring large corporate assets.

Bank Lending Standards Have Eased but Remain Tight, Likely Limiting Loan Growth

Exhibit 2: Commercial & Industrial Loans depend on Bank Lending Standards

As of February 2026



Source: Federal Reserve. Analysis by Franklin Templeton Institute.

Private credit market dynamics

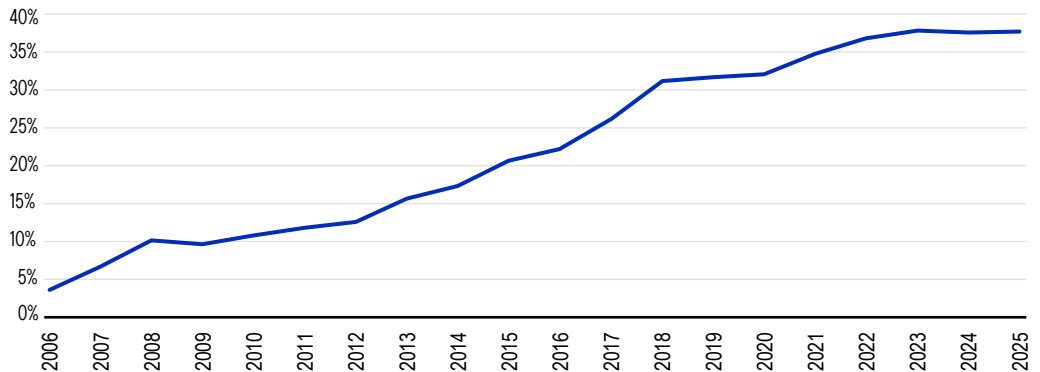
Growth of private credit—direct lending

Private credit markets continue to increase in size and importance. PitchBook estimates they currently stand at around US\$1.97 trillion as of June 30, 2025, (including around US\$618 billion of dry powder). The US market accounts for the lion's share (around US\$1.3 trillion), with Europe accounting for most of the remainder. A large portion of the private credit assets is invested in direct lending.

Direct Lending's Share of Private Debt Assets Under Management (AUM) Remains High, but its Recent Growth Has Stagnated

Exhibit 3: Direct Lending as a Percentage of Private Debt AUM

As of June 30, 2025



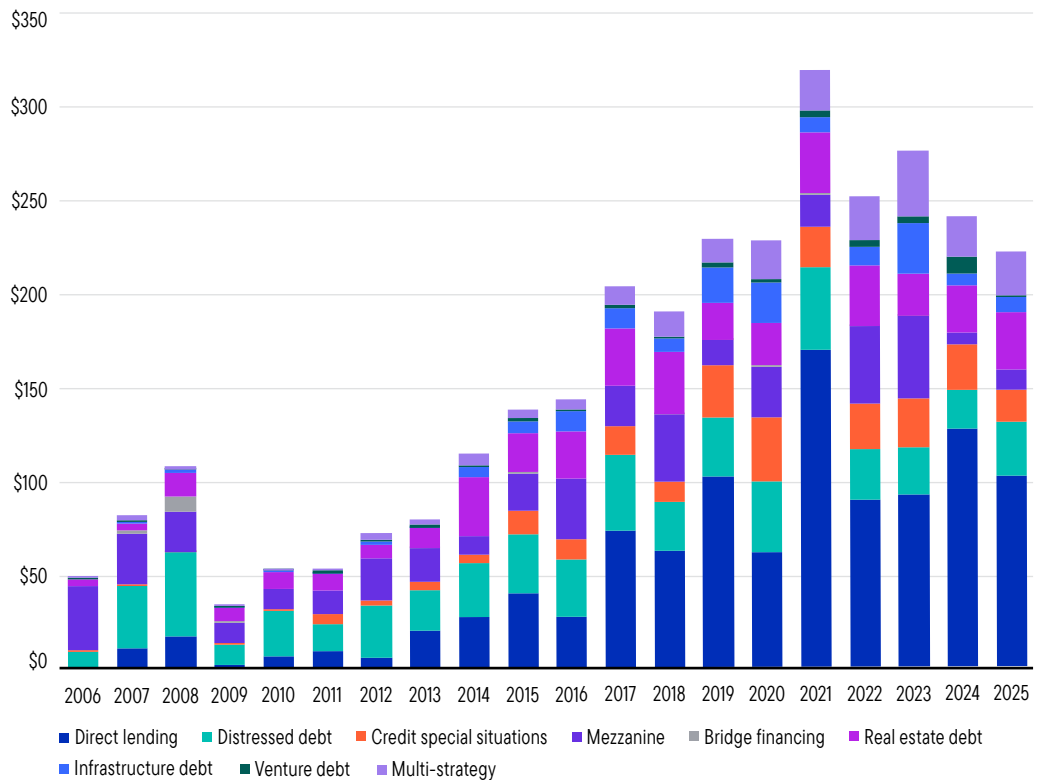
Source: PitchBook. Analysis by Franklin Templeton Institute.

Recent private credit allocations have shifted to less traditional areas of the private credit market due to several factors, including banks' reluctance to lend, the need for flexible financing and technological advancements, among others. Asset owners have begun to focus on alternative sources of income. Specifically, areas like ABF, real estate debt and other types of debt financing.

A Notable Rise in the Non-Traditional Sectors of the Private Credit Market

Exhibit 4: Global Private Debt Capital Raised (US\$B) by Type

As of December 31, 2025



Source: PitchBook.

Reasons for growth in private credit

The attractiveness of private credit is rooted in its flexible structure. The asset class offers borrowers the opportunity to tailor their financing structures over a longer time horizon, outside of the volatility experienced in public markets.

Borrowers see that the private markets can offer greater certainty on deal closure, more financing options, the ability to work with fewer lenders and more efficient loan restructuring when necessary. This blend of bespoke terms and ongoing opportunity is allowing private credit to compete head-on with numerous liquid markets. Supporting this competitiveness is the ability of private lenders to provide capital to high-quality companies without forcing a share price reset or generating meaningful dilution.

Private credit managers are often able to negotiate better terms and covenants, and they can make provisions meant to offer downside protection for lenders, such as a company's need to maintain specified thresholds for liquidity and leverage. Loans with strong covenants are different from those in the public markets which have typically been "covenant-lite" following the resurgence of the leveraged loan market in 2011, post-GFC.

Innovative strategies

According to PitchBook's 2025 Global Private Debt report, direct lending remains the preferred strategy within private debt, accounting for 46% of the overall mix of funds closed in 2025. Mezzanine and infrastructure debt funds were in high demand last year.

However, beneath the surface, private debt remains highly diverse, with fund sponsors continually innovating and developing new strategies to fill the gaps left by traditional bank lenders.

Asset-based financing (ABF), or asset-based lending (ABL), has grown dramatically in recent years. Unlike a corporate bond whose return depends on the performance of the issuer, ABF's return depends on the cash flows of the underlying assets.

ABF is bespoke, privately originated and negotiated by a private credit fund that can diversify exposures by duration, quality and type of collateral. Private credit managers can invest across various ABFs, providing managers the flexibility to tailor portfolios to meet precise risk and return criteria, and provide attractive relative value. The four major categories are consumer finance, hard assets, commercial finance and contractual cash flows.

Exhibit 5: Description of the Different Types of ABF, the Underlying Assets and Source of Income

ABF Type	Description	Underlying	Income
Consumer finance	Consumer lending	Mortgages, credit cards, student loans	Interest payments
Hard asset	Tangible assets	Aircraft, rail cars, home rentals	Leases and rents
Commercial finance	Secured loans	Equipment leasing and receivables	Interest payments
Contractual cash flows	Cash flows	Music royalties, intellectual property	Royalties/revenue

Sizing the opportunity

According to McKinsey, the potential addressable market for private credit exceeds US\$30 trillion across a diverse range of asset classes. The opportunity set is much broader than traditional corporate lending, with ABF representing a growing and diverse set of opportunities.

While there have been concerns about the amount of capital flowing into direct lending, we believe that the future growth of the private credit market will come from new verticals including ABF and commercial real estate debt, which represent attractive areas of financing.

ABF has emerged as a new avenue for deploying capital and represents a broad and diverse set of opportunities, from auto loans to aircraft leases and music royalties, among others. For skilled managers, the ABF market offers an opportunity to tap into an area with potentially healthier spreads and less market efficiency. As direct lending has become increasingly competitive, yields in many pockets of ABF look more attractive.

In recent years, there has been a substantial dropoff in bank-originated ABF. We believe that private credit lenders will play an increasing role in ABF, filling the “financing gaps” from some banks’ more selective appetite to lend capital. We believe that the collateralized nature of ABF provides an advantage when lending capital.

There are several advantages of ABF relative to traditional corporate lending. The repayment of the obligation is provided by contractual cash flows from a discrete pool of collateral, rather than the general obligations of traditional corporate lending. ABF not only can provide diversification, but it also has the potential to deliver the alpha, versus the highly competitive direct lending market where spreads have come down substantially.

Benefits of the expansion of private credit into ABF include differentiated sources of capital available to borrowers and the potential for higher alpha for investors. While the potential for higher returns and broader diversification from ABF may be enticing for investors, this alpha stems from the less-understood and more complex nature of the assets.

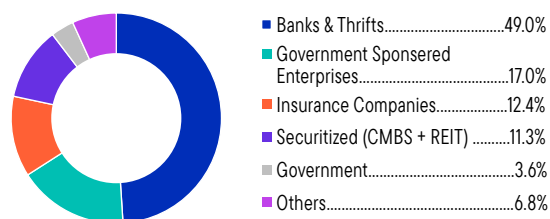
Commercial real estate debt

As private credit has expanded over the years, we believe that commercial real estate debt offers one of the most attractive opportunities, with about US\$6.1 trillion debt outstanding.³ The lender base is quite diverse and includes banks, agencies, life insurance companies, commercial mortgage-backed securities (CMBS) issuers, debt funds and mortgage real estate investment trusts (REITs).

Exhibit 6: Deconstructing US\$6.1 Trillion in CRE Mortgage Debt

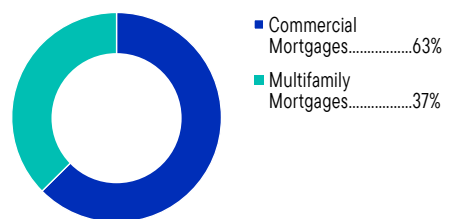
As of September 2024

CRE Loan Exposure by Lender Type



Source: Trepp, Inc.

CRE Loan Exposure by Property Type

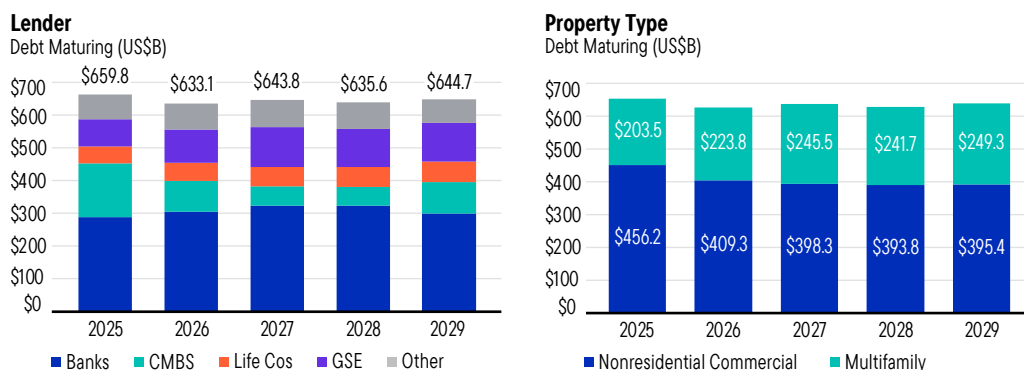


The commercial real estate market has faced numerous challenges, particularly since the Federal Reserve began raising interest rates in early 2022. However, we believe that this disruption has created opportunities for seasoned managers. The resultant rise in financing costs, deceleration in rent growth and decline in property valuations have significantly impacted the market. The office sector has been especially hard hit, driven by reduced demand due to work-from-home policies.

There is a “Wall of Debt” that will need to be refinanced in the next couple of years, and banks will likely be reticent to lend capital, creating an opportunity for private credit managers who can negotiate favorable terms. Private credit managers can now be “term makers” versus “term takers,” which was the environment in 2021.

Exhibit 7: Wall of Debt Maturities for Commercial Real Estate Loans

As of Q3 2024



Source: Trepp, Inc.

Notes: Other category is primarily composed of multifamily lending by Fannie Mae and Freddie Mac. This could also include finance companies (private debt funds, REITs, CLOs, etc.), pension funds, government or other sources.

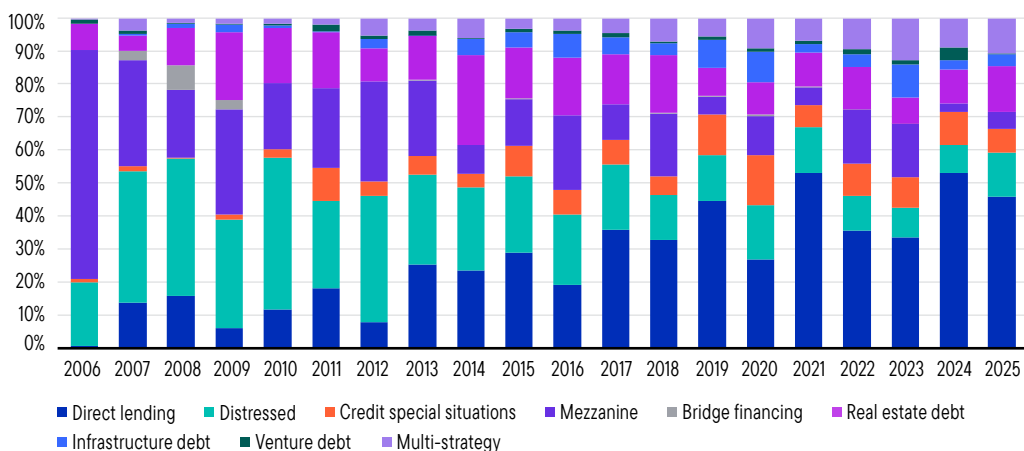
Capital raised for real estate debt has increased

As noted, direct lending has been the dominant private credit strategy, representing 46% of the global private debt of capital raised in 2025. We believe that ABF and CRE debt will fuel the next wave of growth, with commercial real estate debt representing an attractive opportunity given the current market environment, its strong risk-adjusted results and its low correlation to other investment options.

Direct Lending Led Capital Raising in 2025, Though Other Strategies Are Gaining Ground

Exhibit 8: Share of Global Private Debt Capital Raised (US\$B) by Type

As of December 31, 2025



Source: PitchBook.

CRE debt's ability to potentially offer substantial returns at lower risk makes it a compelling option for investors seeking a balanced risk/reward scenario. Historically, CRE debt has served as an effective hedge against inflation. As inflation has risen, so have interest rates, consequently increasing returns from CRE debt investments.

If we compare direct lending to ABF to CRE debt, we can see that there are substantive differences in the underlying assets, debt payment and cash flow.

Exhibit 9: Key Comparisons of Direct Lending, Asset-Based Financing and Commercial Real Estate Debt

Criteria		Direct Lending	Asset-Backed Finance	CRE Debt
Credit Characteristics				
	Borrower type	Typically lending to small and medium-sized enterprises	Multiple borrowers—consumers or corporate entities	Property developers, real estate investors and operators of commercial properties
	Underlying assets	Loan is provided to a single corporate entity; usually backed by collateral	Pool of loans or cash flow streams that are either financial assets or hard assets	Commercial real estate properties such as office buildings, retail centers, industrial facilities or multi-family residential complexes
	Return of principal	Refinancing or sale of business	Self-liquidating pool of assets	Refinancing or sale of property
	Covenants/credit protection	Minimal covenants	Protective covenants backed by diversified collateral	Protective covenants backed by tangible collateral
Return Characteristics				
	Repayment structure	Typically bullet repayment	Typically amortizing repayment	Typically bullet repayment
	Inflation hedge	Risk of poor business performance and debt servicing issues from inflationary pressure	Asset values tend to rise with inflation	Asset values and rents tend to rise with inflation
Complexity		Simpler structure	Complex structure	Simpler structure
Valuation Considerations		• Can be dependent on significant intangible assets • Business performance of potentially less mature businesses	• ABF backed by tangible assets leads to clearer price identification • ABF backed by intangible assets more complex and dependent on specialized knowledge	Property valuation with clearer price identification

Source: Franklin Templeton Institute.

Private credit represents a diverse set of opportunities from direct lending, asset-based financing and commercial real estate debt. As noted in Exhibit 9, there are differences in the underlying investments, portfolio characteristics and sensitivity to economic conditions. We believe it is possible to use them to complement one another and/or as replacements for traditional fixed income allocations.

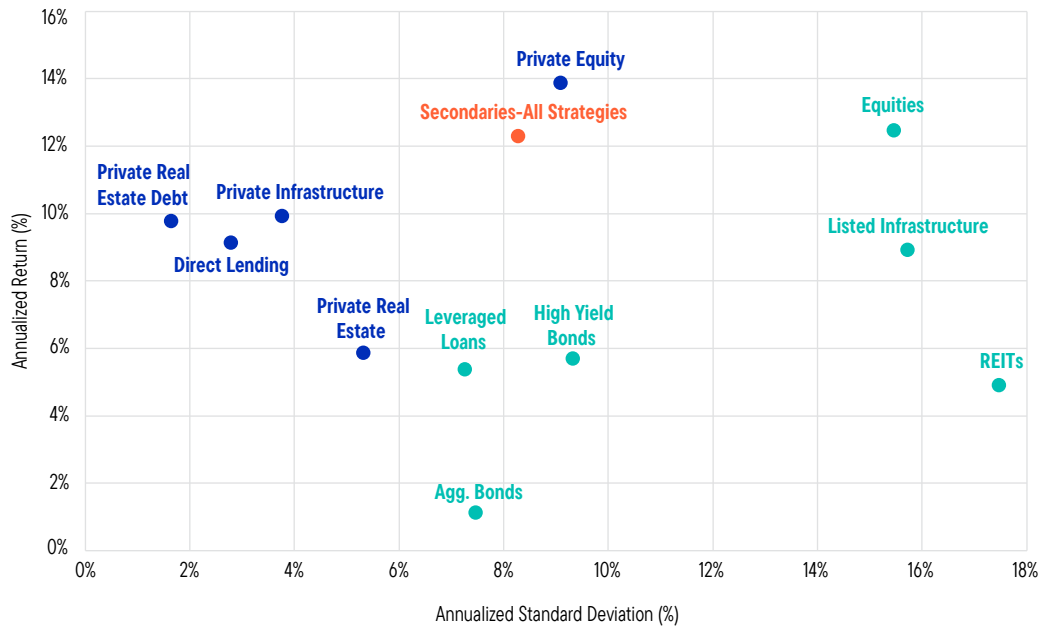
Allocating to CRE debt

We believe that the macro-environment sets up well for commercial real estate debt. As the data below illustrates, commercial real estate debt has historically provided attractive risk-adjusted returns and has exhibited low-to-negative correlations to other investment options, making it an ideal complement for building portfolios.

CRE Debt Has Historically Delivered Attractive Risk-adjusted Returns

Exhibit 10: Historical Performance vs. Risk

10 years ending
September 30, 2025



Sources: SPDJI, Giliberto-Levy, MSCI Private Capital Solutions, Bloomberg, Cliffwater, FTSE, MSCI Indexes, Morningstar, PitchBook LCD, ICE BofA Indices, Macrobond, Analysis by Franklin Templeton Institute.

Indexes used: Private Infrastructure: MSCI Private Capital Solutions - Private Infrastructure across all regions; Listed Infrastructure: S&P Global Infrastructure Total Return Index; Private Real Estate Debt: Giliberto-Levy High-Yield Real Estate Debt Index; Private Real Estate: MSCI Private Capital Solutions' fund search results for Private Real Estate across all regions; Private Equity: MSCI Private Capital Solutions' fund search results for Private Equity funds (all categories) across all regions; Direct Lending: Cliffwater Direct Lending Index; Secondaries All Strategies: MSCI Private Capital Solutions search results for global secondaries across all strategies; Public Equities: MSCI All Country World Index, Agg. Bonds: Bloomberg Global Aggregate Index (Total Return), REITs: FTSE EPRA/NAREIT Global REITs Index, Leveraged Loans: Morningstar Global Leveraged Loan Total Return Index, High Yield Bonds: ICE BofA Global High Yield Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

Exhibit 11: Historical 10-Year Correlation of Select Asset Classes

As of September 2025

	Equities	Aggregate Bonds	High Yield Bonds	Leveraged Loans	Private Equity	Direct Lending	Private Real Estate	Private Real Estate Debt	Private Distressed Debt	Asset-Based Finance
Equities		0.52	0.89	0.89	0.64	0.71	-0.02	0.16	-0.25	0.86
Aggregate Bonds	0.52		0.69	0.43	0.21	0.01	-0.28	0.20	-0.71	0.37
High Yield Bonds	0.89	0.69		0.89	0.41	0.61	-0.24	0.22	-0.42	0.77
Leveraged Loans	0.89	0.43	0.89		0.39	0.76	-0.24	0.12	-0.15	0.79
Private Equity	0.64	0.21	0.41	0.39		0.47	0.53	0.10	-0.27	0.80
Direct Lending	0.71	0.01	0.61	0.76	0.47		0.16	0.06	0.30	0.70
Private Real Estate	-0.02	-0.28	-0.24	-0.24	0.53	0.16		0.29	0.32	0.23
Private Real Estate Debt	0.16	0.20	0.22	0.12	0.10	0.06	0.29		-0.05	0.13
Private Distressed Debt	-0.25	-0.71	-0.42	-0.15	-0.27	0.30	0.32	-0.05		-0.23
Asset-Based Finance	0.86	0.37	0.77	0.79	0.80	0.70	0.23	0.13	-0.23	

Sources: MSCI Indexes, Bloomberg, ICE BofA Indices, Morningstar, PitchBook LCD, MSCI Private Capital Solutions, Cliffwater, Preqin, Giliberto-Levy, PitchBook, Macrobond, Analysis by Franklin Templeton Institute.

Quarterly data analysis from Q4 2015 to Q3 2025 based on USD total returns.

Indexes used: Equities: MSCI AC World Index, Aggregate Bonds: Bloomberg Global Aggregate Index (Total Return), High Yield Bonds: ICE BofA Global High Yield Index, Leveraged Loans: Morningstar Global Leveraged Loan Total Return USD Index, Private Equity: MSCI Private Capital Solutions' fund search results for Global Private Equity funds (all categories), Direct Lending: Cliffwater Direct Lending Index, Private Real Estate: MSCI Private Capital Solutions' fund search results for Global Real Estate funds (all categories), Private Real Estate Debt: Giliberto-Levy High-Yield Real Estate Debt Index, Private Distressed Debt: PitchBook's search results for Global Distressed Debt, Asset-Based Finance: Preqin's search results for Asset-Backed Lending Strategies under the Hedge Funds category. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future results. Important data provider notices and terms available at www.franklintempletondatasources.com.

We believe that commercial real estate debt represents a viable replacement for traditional fixed income. To illustrate the impact of adding an allocation to commercial real estate, we have compared the traditional 50/50 portfolio to a portfolio with 5%, 10%, and 15% commercial real estate. Not surprisingly, the portfolio with higher allocation to commercial real estate delivered higher returns, lower risk and a higher Sharpe ratio than the 50/50 portfolio.

Impact of CRE Debt on Portfolio Returns and Risk

Exhibit 12: Risk-Adjusted Returns (Based on data for US assets)

As of September 30, 2025

Portfolio Allocation	50% Equity 50% Bonds 0% Private Real Estate Debt	48% Equity 47% Bonds 5% Private Real Estate Debt	45% Equity 45% Bonds 10% Private Real Estate Debt	43% Equity 42% Bonds 15% Private Real Estate Debt
Annualized Returns	8.64%	8.74%	8.72%	8.83%
Annualized Standard Deviation	8.06%	7.73%	7.28%	6.95%
Sharpe Ratio	0.88	0.93	0.98	1.04

Sources: SPDJI, Bloomberg, Giliberto-Levy, Macrobond. Analysis by Franklin Templeton Institute.

Quarterly data analysis from Q1 2012 to Q3 2025; The risk-free rate considered for the calculation of the Sharpe ratio is the average yield on the three-month US Treasury bill during the period. Sharpe ratio is a measurement of an investment’s risk-adjusted return that considers of performance relative to volatility.

The asset classes described above have material differences between them, including varying investment objectives, costs and expenses, liquidity, safety, fluctuation of principal or return, and tax features.

Indexes used: Equity: S&P 500 Total Return Index; Bonds: Bloomberg US Aggregate Index (Total Return); Private Real Estate Debt: Giliberto-Levy High-Yield Real Estate Debt Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

Risk considerations

Real estate investments may include risks related fluctuations in lease occupancy rates and operating expenses, variations in rental schedules, which in turn may be adversely affected by local, state, national or international economic conditions. Furthermore, investments in real estate are also impacted by market disruptions caused by regional concerns, political upheaval, sovereign debt crises, and uninsured losses (generally from catastrophic events such as earthquakes, floods and wars). Investments in real estate related securities, such as asset-backed or mortgage-backed securities are subject to prepayment and extension risks.

Note, there are additional risks associated with private credit, including interest rate, default risks, and liquidity, among others.

Interest rate risk Most private credit is floating rate meaning that the coupon payment adjusts as interest rates change. In a rising rate environment, the interest payment rises, and in a falling rate environment, the interest payment falls.

Default risk Ratings agencies do not cover private credit, making credit risk a challenge to measure. Generally, they are riskier credits than investment-grade instruments because private credit borrowers are smaller, less diversified businesses.

Liquidity risk Private credit is generally less liquid than public credit and carries a yield premium to compensate investors. Investors should understand the illiquid nature of all private markets and view them as long-term in nature.

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Key takeaways

In this paper, we have examined the growth and evolution of private credit, from direct lending to asset-based financing to commercial real estate debt. We have analyzed the risk, return and correlation characteristics of the various credit options (traditional and private markets).

As the data has shown, commercial real estate has historically delivered attractive risk-adjusted returns and has exhibited low-to-negative correlations to other investment options. We have illustrated the impact of adding an allocation to real estate debt, increasing the return, lowering the risk and improving the Sharpe ratio.

The insights provided in this paper highlight the importance of developing an appropriate strategic asset allocation based on the current macro conditions and compelling historical data. We believe that commercial real estate debt represents a viable alternative to traditional fixed income options.

Endnotes

1. Source: "The Secular Decline of Bank Balance Sheet Lending." NBR working paper issued in February 2024 and revised in October 2024.
2. There is no assurance any estimate, forecast or projection will be realized.
3. As of Q3 2024. Source: Trepp, Inc..

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WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal.

Equity securities are subject to price fluctuation and possible loss of principal. Small- and mid-cap stocks involve greater risks and volatility than large-cap stocks.

Fixed income securities involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls.

Investments in many **alternative investment strategies** are complex and speculative, entail significant risk and should not be considered a complete investment program. Depending on the product invested in, an investment in alternative strategies may provide for only limited liquidity and is suitable only for persons who can afford to lose the entire amount of their investment. Diversification does not guarantee a profit or protect against a loss.

Risks of investing in **real estate investments** include but are not limited to fluctuations in lease occupancy rates and operating expenses, variations in rental schedules, which in turn may be adversely affected by local, state, national or international economic conditions. Such conditions may be impacted by the supply and demand for real estate properties, zoning laws, rent control laws, real property taxes, the availability and costs of financing, and environmental laws. Furthermore, investments in real estate are also impacted by market disruptions caused by regional concerns, political upheaval, sovereign debt crises, and uninsured losses (generally from catastrophic events such as earthquakes, floods and wars). Investments in real estate related securities, such as asset-backed or mortgage-backed securities are subject to prepayment and extension risks

An investment in **private securities** (such as private equity or private credit) or vehicles which invest in them, should be viewed as illiquid and may require a long-term commitment with no certainty of return. The value of and return on such investments will vary due to, among other things, changes in market rates of interest, general economic conditions, economic conditions in particular industries, the condition of financial markets and the financial condition of the issuers of the investments. There also can be no assurance that companies will list their securities on a securities exchange, as such, the lack of an established, liquid secondary market for some investments may have an adverse effect on the market value of those investments and on an investor's ability to dispose of them at a favorable time or price. **Past performance does not guarantee future results.**

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