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Private credit: Opportunities in today's market environment

April 2024

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Key points

- Private credit has historically delivered an "illiquidity premium" relative to public–market equivalents
- Private credit can serve as an alternative source of income
- Private credit has historically delivered attractive risk-adjusted results relative to traditional fixed income
- Private credit can provide diversification benefits relative to traditional fixed income

"We see parallels to the post-global financial crisis (GFC) market environment, where private credit managers stepped in to fill the void that traditional banks had left. In a post-SVB market environment, private credit managers will have the upper hand in negotiating favorable pricing, terms, and covenants."

Dover and Davidow, "2024 Alternative Investment Outlook," February 2024

Advisors and investors have been questioning the merits of the "60/40" portfolio in today's market environment. Specifically, they have been seeking alternative sources of **return and income, broader diversification, downside protection and inflation hedging**. Not surprisingly, private credit investments have been garnering a lot of attention from advisors and high-net-worth (HNW) investors due to their unique characteristics.

Private credit represents a diverse set of strategies, from direct lending to mezzanine and distressed debt. Private credit strategies invest in instruments that are mostly privately negotiated and not publicly traded; and private-credit instruments are originated by non-bank lenders.

The types of investments private-credit funds make can vary significantly, from a newly originated loan in a fast-growing company, to a distressed investment in a company running out of cash. The various types of private credit can be divided into discrete strategies.

Direct lending includes senior secured—first lien and unitranche—loans to middle-market companies. Mezzanine lending is the origination of unsecured, subordinated debt, often in conjunction with a private equity buyout transaction. Distressed credit includes investments in the debt of financially troubled companies facing liquidity issues. Specialty finance, such as aircraft finance, royalties and life settlements represent a growing segment of private credit.

Each of these types of private credit introduce their own unique risk-return and income characteristics. These investments can be used to provide diverse portfolio outcomes, such as increasing returns, alternative sources of income, diversification relative to traditional fixed income, and hedging inflation. In this paper, we explore:

- The growth of private credit
- The types of private credit
- The role of private credit
- Public versus private credit
- Accessing private credit

The growth of private credit

Historically, banks were responsible for originating most loans. Bank-originated debt would be held on the lender's balance sheet, or it would become a publicly traded debt security. This lending dynamic has shifted over the past 20 years. Today, while private credit remains a relatively small percentage of global credit outstanding, private credit firms are responsible for most of the middle market credit expansion.

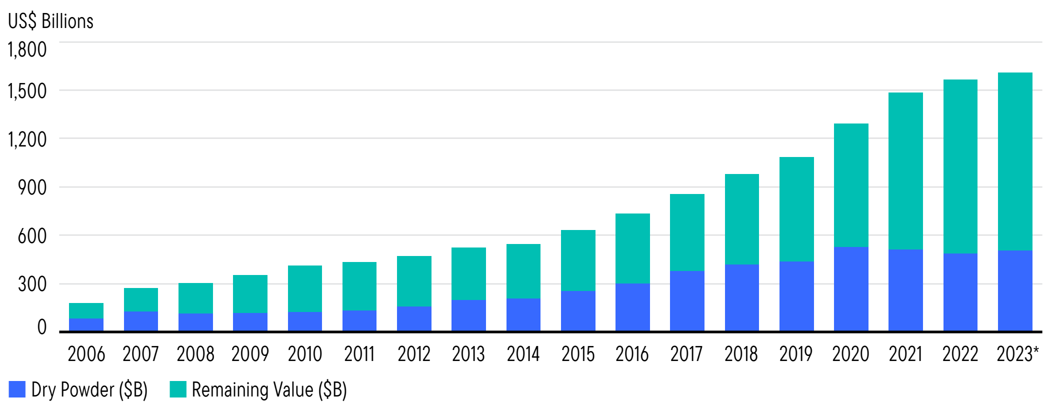
As the data below illustrates, private credit assets under management (AUM) have grown from around US$300 billion in 2008, to over US$1.6 trillion in 2023. The data includes total committed capital, a combination of money invested and "dry powder." Dry powder reflects money committed to invest, but not yet invested by the private credit manager.

Demand for private credit has risen steadily since the global financial crisis (GFC) as traditional banks have retrenched their lending to small-mid-size businesses. Private credit firms stepped in to fill the void by lending to these businesses and negotiating favorable terms.

Exhibit 1: Private Credit Has Risen Steadily since the GFC, Crossing the $1.6 Trillion Mark

Global Private Debt AUM

*As of June 30, 2023



Source: PitchBook's 2023 Annual Global Private Market Fundraising Report

Bank consolidation

During the 1990s and early 2000s, regulatory pressures and consolidation caused bank lending activity to decline. New regulations encouraged bank consolidation and discouraged lending activity to lower and core middle-market borrowers. This included the Riegle-Neal Act of 1994, which permitted interstate banking activity and allowed banks to acquire other out-of-state banks. Small banks were targeted as acquisitive banks expanded their regional footholds.

The repeal of the Glass-Steagall Act in 1999 further encouraged consolidation. The repeal allowed banks to combine commercial and investment banking activities, creating an incentive for banks to grow larger. As banks achieved scale, efficiencies were gained, and many banks reduced their headcounts to cut costs. These cuts resulted in fewer loan originators and loan activity becoming more focused on banks' larger clients and borrowers.

High-net-worth demand

Coming out of the GFC, global central banks sought to keep rates low to stimulate growth. In fact, many countries began issuing negative-yielding debt. At the peak, there was roughly US$19 trillion of negative yielding debt globally. While the United States resisted the temptation to offer negative- yielding debt, the Federal Reserve (Fed) kept rates at near zero for much of the bull market, fueling the growth of the stock market to record highs.

Unfortunately, the consequence of this action was investors struggled to find adequate yield without introducing significant risk. Many investors began to move beyond traditional fixed income options, seeking alternative sources of yield, including investing in real estate investment trusts (REITs), master limited partnerships (MLPs), and dividend-paying stocks. However, these investments are equity surrogates, and are more correlated to the equity markets.

Beginning in 2022, the Fed began aggressively raising interest rates to tame inflation. Since most private credit is floating-rate, this favored the asset class, because rates adjusted accordingly. As noted, the collapse of Silicon Valley Bank, and concerns about contagion throughout the banking sector, meant that traditional lenders (banks) would retreat from lending to small-middle market companies. This creates an opportunity for private credit managers to negotiate favorable terms and conditions.

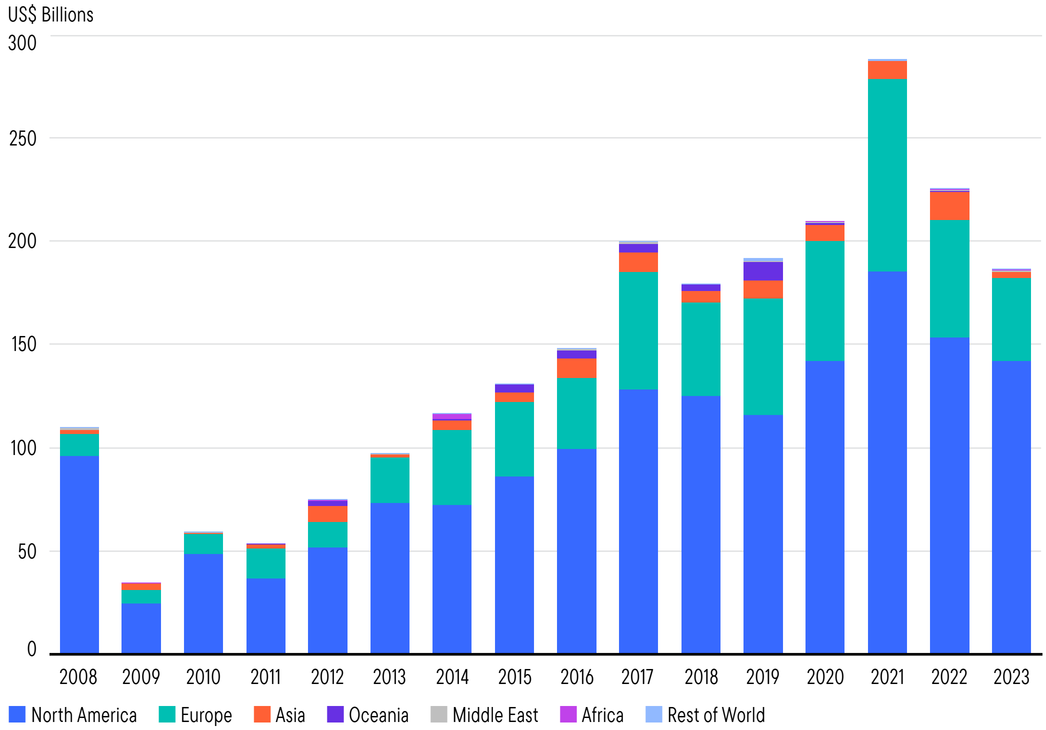
Global growth

While the factors cited have led to accelerating growth in the United States, we shouldn't lose sight of the growth and opportunities outside of our borders. Europe and Asia have experienced similar growth of private credit, as investors have demanded access to these markets. As the data below illustrates, the United States represents the largest segment of private credit, but Europe and Asia have increased their market share since 2010.

Exhibit 2: United States Represents the Largest Segment of Private Credit, but Europe and Asia Have Been Increasing

Global Private Debt Capital Raised, by Region

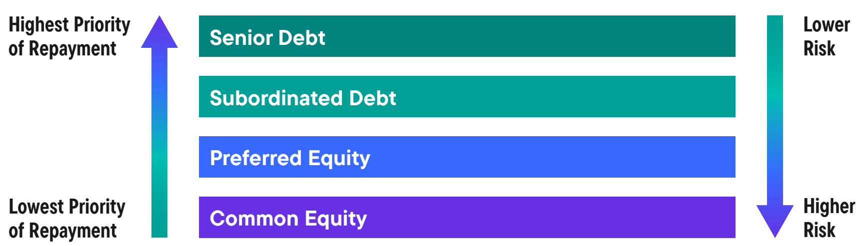
As of December 31, 2023



Source: PitchBook's 2023 Annual Global Private Market Fundraising Report

Capital structure hierarchy

When we consider private credit, we should evaluate where each segment falls in the capital structure hierarchy ("the cap stack"), and its priority in getting paid. Senior debt (direct lending) has priority relative to subordinated debt (mezzanine), which has priority relative to equity holders (preferred and common).



For illustrative purposes only.

As its name implies, subordinated debt is junior to senior debt, which means it is paid back after senior instruments. Investors are paid a yield premium to compensate them for the additional risk. If a company underperforms, the senior debt could get paid back at par, while the subordinated debt may receive pennies on the dollar, due to its lower priority in the capital structure. Mezzanine is a form of subordinated debt and faces low recovery rates and higher potential losses compared with other debt instruments.

Companies may issue preferred equity to investors. Like mezzanine debt, it pays a higher yield than senior debt. It is also senior to common equity. However, it is not a loan, and it's generally unsecured. Preferred equity may also include a call provision which allows the preferred shares to be converted to common shares at a predetermined price. This creates the potential to capture some of the upside of owning common shares.

Finally, equity represents ownership of a company. In one sense, equity represents the ownership of a company's net asset value—or cash that remains after all assets are liquidated minus liabilities (such as debt and preferred equity). However, the equity also has a claim on a company's earnings. Equity can participate in the upside of a successful company—if earnings and the net asset value increases. But compared with debt investments, it's subject to a greater risk of loss.

Types of private credit

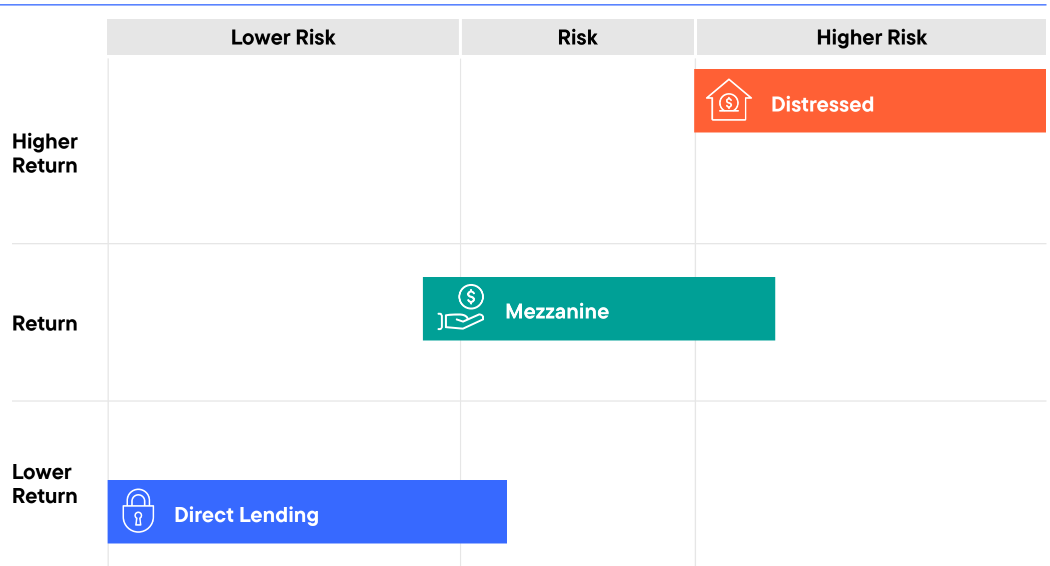
Like private equity, not all private credit strategies are created equal. The types of investments private credit funds make can vary significantly, from a newly originated loan in a fast-growing company, to a distressed investment in a company running out of cash. Private credit represents a diverse set of strategies, usually categorized as the following:

- Direct lending, which traditionally includes senior secured—first lien and unitranche—loans to large and small companies. Unitranche represents a hybrid structure that includes both senior and subordinated debt.
- Mezzanine lending, which is the origination of unsecured, subordinated debt, often in conjunction with a private equity buyout transaction. Lying between senior debt and equity, mezzanine debt is a hybrid security and often includes an equity kicker (e.g., convertible bonds, preferred equity) and therefore can have equity-like characteristics.
- Distressed credit includes investments in the debt of financially troubled companies facing liquidity issues.

The various types of private credit have their own unique return, risk and income profile. Direct lending carries the lowest risk and consequently offers the lowest return, while distressed credit offers the highest return and highest corresponding risk.

We have seen strong growth across the private credit spectrum as investors have been seeking alternative sources of income, and with the growing number of products, these strategies are now available to a broader group of investors.

Exhibit 3: Not All Private Credit Strategies are Created Equally



For illustrative purposes only.

The role of private credit

Private credit has gained traction in recent years due to several factors, including the growing number of private credit opportunities, investors seeking alternative sources of yield, and more products geared toward HNW investors. While their structures had existed for decades, interval funds, tender-offer funds and business development companies (BDCs) became a popular means of accessinwg illiquid private credit opportunities. These structures are generally available to accredited investors or below.

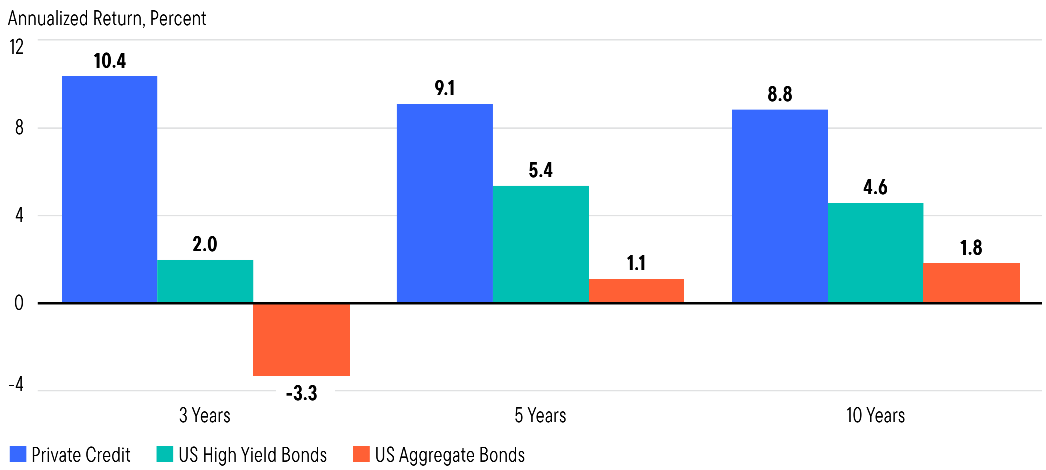
The growth of registered funds has helped to democratize this once-elusive asset class by making the opportunities more broadly available to investors. Historically, private credit was only available to large institutions and family offices, at high minimums, and limited liquidity. In recent years, we have seen top-tier managers begin to offer these investments in registered funds.

Private credit provides several unique advantages that make them very appealing in today's market environment. As the data below illustrates, private credit has historically delivered an illiquidity premium relative to traditional fixed income. The magnitude will vary over time depending upon the type of private credit and prevailing market conditions.

Exhibit 4: Private Credit has Historically Delivered an Illiquidity Premium

Annualized Return Private Credit vs. US Bonds, Gross of Fees

As of December 31, 2023



Sources: Cliffwater, Bloomberg, Macrobond. Analysis by Franklin Templeton Institute.

The indexes are total returns in US dollar terms. All returns are gross of fees. Indexes used: Cliffwater Direct Lending Index, Bloomberg US Corporate High Yield Total Return Index Value Unhedged USD, Bloomberg US Aggregate Total Return Value Unhedged USD 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.

An important benefit of private credit is the increased due diligence provided to private credit managers. An investor in a traditional bond or bond fund relies on the due diligence performed by the underwriter. For investors in new debt issues, due diligence is limited to what is available in the public domain and regulatory filings. However, if investors in a fixed income deal experience a loss, or if a company has financial difficulties, the underwriter faces few repercussions.

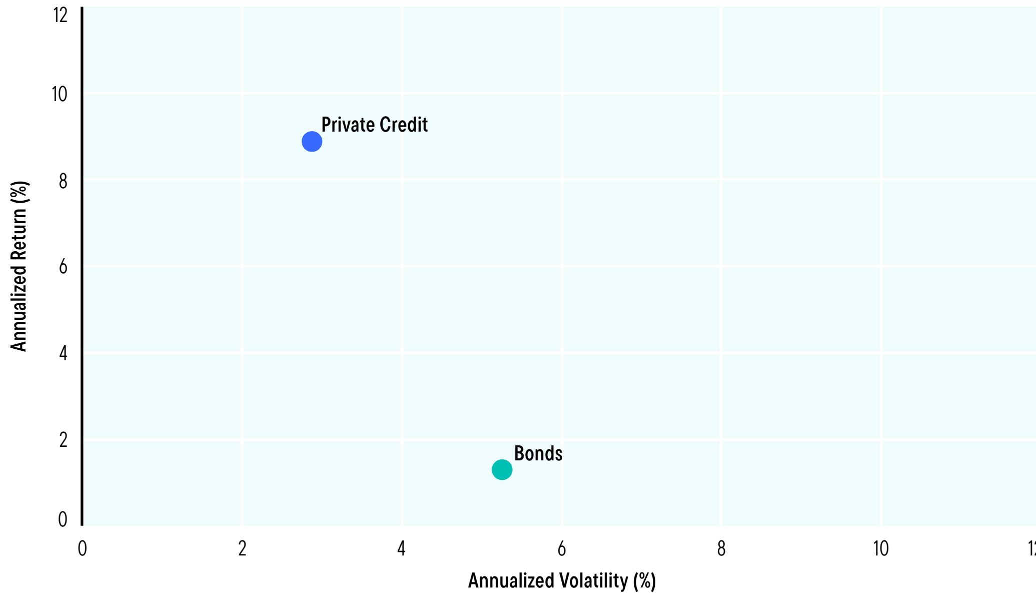
In contrast, private credit managers have access to extensive due diligence resources before financing an investment. The diligence process takes place over an extended period of time and typically involves a thorough review of financial statements, on-site visits, interviews with management and employees, accounting due diligence, and background checks. This alignment between the loan origination and underwriting process and the credit investor does not exist in public markets.

As the data below illustrates, private credit has historically delivered attractive risk-adjusted returns, and low correlation, relative to traditional investments. This makes private credit a valuable component of a diversified portfolio, providing attractive returns and helping to dampen volatility.

Exhibit 5: Private Credit Has Historically Delivered Attractive Risk-Adjusted Returns

Historical Performance vs. Risk 10 year period, Quarterly Data

As of December 31, 2023



Sources: Prepared by Franklin Templeton Capital Markets Insights Group. Bloomberg, Cliffwater, Morningstar, Macrobond.

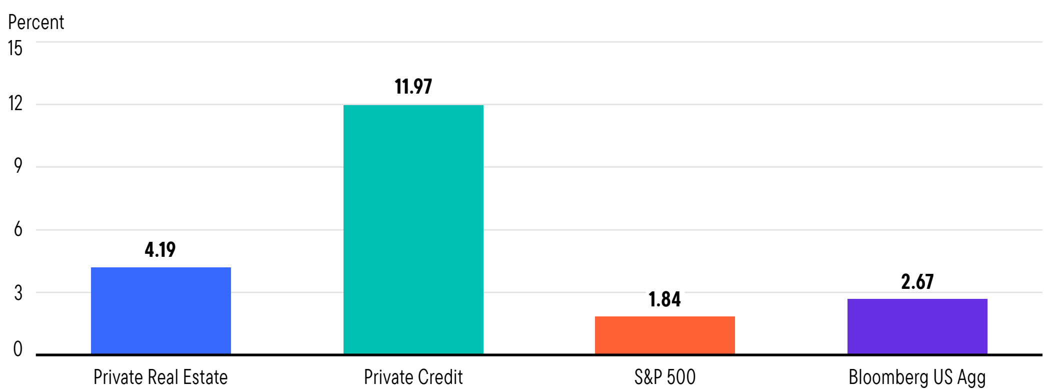
Private Credit: Cliffwater Direct Lending Index; US Bonds: Bloomberg US Agg Bond TR USD. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results**. Important data provider notices and terms available at www.franklintempletondatasources.com.

As the data below illustrates, private credit has also delivered an attractive yield (11.8%) versus investment-grade bonds (2.7%). This is important in an environment where so many investors are seeking incremental yields. Private credit is very versatile tool that can help advisors in achieving their client's goals and objectives with attractive risk-adjusted returns, high income and relatively low volatility.

Exhibit 6: Alternative Sources of Income

Annual Yields, 10-Year Average

As of December 31, 2023



Sources: NCREIF, Cliffwater, S&P 500, Bloomberg. Analysis by Franklin Templeton Institute.

Private Real Estate: 10-year average income return for NCREIF ODCE as of 12/31/2023, Private Credit: Cliffwater Direct Lending index current yield as of 12/31/2023; S&P 500: S&P Dow Jones Indices 10-year average dividend yield as of 12/31/2023; Bloomberg US Agg 10-year average yield to maturity as of 12/31/2023.

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Since private credit is predominately floating-rate, it can potentially serve as an effective hedge for rising rates, as interest rates rise the coupon fluctuates. Floating-rate funds may also be a hedge for rising inflation. Inflation hedging is particularly important in today's market environment, with inflation at the highest levels since the 1980s.

As we have covered, private credit can serve multiple roles in a client portfolio, delivering strong risk-adjusted returns, attractive income, diversification relative to traditional investments, and inflation hedging. This once-elusive asset class is now available to HNW investors, with lower minimums, and more flexible liquidity features. We will cover the structural tradeoffs later in this module, but as we discuss the benefits of private credit, we should also consider the risks.

Risk considerations

There are a number of risks that advisors should carefully consider before investing in private credit. Some of these risks are unique to private credit, and some are shared with traditional fixed income.

Interest rate risk

Most public credit borrowings, except for syndicated bank loans, are issued with fixed coupon rates; private credit loans typically are issued with floating-rate coupons that increase as interest rates rise. This means private credit is less exposed to rising interest rates. It is estimated that more than 80% of private credit is floating-rate. In comparison, investment-grade and high-yield bonds typically have fixed rates, which are valuable when rates drop, but can cause mark-to-market losses during times of rising rates. Floating rate debt mitigates both price risk and reinvestment rate risk.

Default risk

Ratings agencies do not cover private credit, making credit risk a challenge to measure. Studies suggest the average direct-lending borrower has an implied credit rating of B. Generally, they are riskier credits than investment-grade instruments because private credit borrowers are smaller, less diversified businesses. Distressed debt is unique because investors commonly expect a default.

Call risk

Private-credit investments typically have a call protection provision that requires the borrower to pay fees in the event of early debt repayment. Although investment-grade bonds frequently offer call provisions, it is uncommon to get prepayment penalties from syndicated bank loans and high yield. Call risk is typically not a factor in distressed investing as distressed companies typically lack the ability to refinance their debt, but the likelihood would increase if the firm's cost of debt drops substantially from either the general level of interest rates or improving credit quality.

Liquidity risk

Liquidity is episodic for high yield and bank loans, and during periods of market volatility, it can be hard to sell this debt without experiencing steep losses. It is also tempting for investors in public credit to sell investments that are trading down in value instead of holding them for the longer term. That said, private credit is generally less liquid than public credit and carries a yield premium to compensate investors.

Private credit managers will mark down impaired credits, but they typically do not have the option to sell and will hold credits to maturity or a refinancing event. Distressed investments, meanwhile, have little to no liquidity. Investments are commonly exited following a multiyear holding period and through a liquidity event, such as an initial public offering or company sale.

Accessing private credit

Investors can access private credit through a variety of structures including direct private credit funds, feeder funds, BDCs, and registered funds (tender-offer and interval funds). Each has different features and structural tradeoffs to consider.

It is important to note, we are not suggesting that one structure is better than the next, we're merely highlighting some of the tradeoffs. The first generation of funds were geared toward institutions and family offices that could deal with the high minimums and limited liquidity. As HNW demand has grown, registered funds have evolved as viable solutions, for a broader group of investors.

Let us compare some of the features of each structure. Traditional private credit funds are only available to qualified purchasers, while tender-offer and interval funds are available to accredited investors or below. Traditional private credit funds typically have very high minimums, and registered funds may be available for as little as US$25,000, or below.

Traditional private credit funds follow a capital call structure, in which capital committed to the fund is periodically drawn down by the private credit manager as investments are made. By contrast, most registered funds invest the capital upfront and have no capital calls.

While registered funds don't have capital calls, they may exhibit a cash drag to compensate for the greater liquidity. Cash drag occurs in a registered fund structure because these funds need to keep a portion of their portfolio in cash or cash-equivalent assets to meet their redemption or tender- offer provisions.

In terms of tax reporting, traditional private credit funds are subject to K-1 tax reporting, which reports each individual investor's share of a partnership's earnings and losses. Advisors should be aware that K-1s are often delayed and may be restated, and advisors should address these issues with their high-net-worth clients in advance. Publicly traded BDCs and registered funds, however, offer 1099 tax reporting.

While registered funds differ in terms of their redemption and tender-offer features, they offer limited liquidity relative to a traditional mutual fund with daily liquidity. Traditional private credit funds are generally illiquid, with liquidity only available in the form of distributions from a liquidation of fund assets. Meanwhile, registered funds often have a limited redemption feature. For example, investors in an interval or tender-offer fund may have the option to redeem up to 5% of their net asset value on a quarterly basis.

Registered funds have experienced significant growth over the last couple of years as high-net-worth investors demanded access to the private markets.

Exhibit 7: Structured Considerations

As of December 31, 2023

	Mutual Funds	Registered Funds Interval Funds, Non-Traded BDCs	Traditional Private Market Funds
Eligibility	All	All/may be restricted	Qualified purchasers
Investments	Public and private investments	Public and private investments	Private investments
Continuous Offering	Yes	Yes	No
Daily Valuations	Yes	Yes	No
Minimum Investment	$1,000–$5,000	$2,500–$25,000	$1M–$10M
1099 Tax Treatment	Yes	Yes	K-1
Liquidity Provisions	Daily	Quarterly*	10+ year lockup Early liquidity not available or at high redemption fees
Capital Calls	No	No	Yes

Source: Franklin Templeton.

*Tender-offer and interval funds offer quarterly liquidity at board discretion while interval funds' quarterly liquidity provisions mandatory.

Conclusion

In this white paper, we have covered the unique features and benefits of private credit. Much like private equity and private real estate, these investments have historically been difficult for HNW investors to access, but now through product innovation and a willingness of top-tier managers to launch funds, this important asset class is more accessible to a larger group of investors.

Given the challenges today's market environment present, private credit is a valuable and versatile tool in sourcing incremental growth and income, dampening portfolio volatility, and hedging the corrosive impact of inflation. With banks retrenching from lending to small-middle market firms, private credit firms can fill the void, negotiating favorable terms and conditions.

To learn more about private credit, or other types of alternative investments, please visit our **Knowledge Hub** on Alternatives by FT.

Contributors

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Definitions

Accredited investors are individuals with gross income of $200,000, or with joint income with a spouse or partner of $300,000 or more, in each of the two most recent years.

Bloomberg US Aggregate Bond Index is an unmanaged index that reflects the performance of the investment-grade universe of bonds issued in the United States, including U.S. Treasury, government sponsored, mortgage and corporate securities.

Capital calls are mandatory demands made on an ad hoc basis by private investment vehicles for additional capital from investors to support the original investment.

Closed end funds are a type of investment company created by the Investment Act of 1940 in which money is pooled for deployment in a specific set of assets. Many closed end funds raise capital at their inception and issue shares to investors which can be traded on public exchanges. An *interval fund* is a type of closed-end fund which is not publicly traded and allows shareholders to withdraw some portion of their investment at regularly scheduled intervals. A *tender-offer fund* is similar, but with redemptions available only at the discretion of the board rather than being available on a pre-determined schedule.

CPI (Consumer Price Inflation) is a measure of inflation calculated by the US Bureau of Labor Statistics based on price changes for a hypothetical basket of goods and services.

Distribution rate expresses the income and capital distributed to investors as a percentage of the total investment capitalization.

Family offices are private financial advisors employed by very wealthy families or individuals to provide customized planning and investment management services tailored to their specific needs.

40-Act funds are investment vehicles authorized by the Investment Company Act of 1940, including open-end mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts.

FTSE NAREIT All Equity REITs Index is an unmanaged index of public U.S. equity REITs that reflects the performance of the public REIT market overall.

K-1 is a US tax return schedule used to report an investor's share of the profits and losses from a business partnership.

NCREIF property index (NPI) is an unmanaged index of institutional property investments that reflects the performance of the real estate market in general.

NFI-ODCE (NCREIF Fund Index—Open End Diversified Core Equity is an unmanaged index of open-end commercial real estate funds that reflects the performance of investment real estate in general.

Private real estate is an asset class composed of pooled private and public investments in the property markets which are not traded publicly.

Qualified purchasers are individuals or family-owned businesses with $5 million or more in investments, or which invest $25 million or more for others, such as a professional investment manager.

A REIT (Real Estate Investment Trust) is a specialized type of company designed to own and/or invest in real estate properties which required by law to distribute at least 90% of its taxable income to shareholders. Shares in public REITs are tradable on public exchanges; non-traded REITs are privately held and may be very illiquid.

S&P 500 is an unmanaged index of 500 U.S. stocks that reflects the performance of large-cap U.S. stocks in general.

Standard deviation is a statistical measure of the variation from the average (mean) in a set of data commonly used to assess the volatility of investment returns over a given time period.

Yield to worst (YTW) is the lowest potential yield that can be received on a bond without the issuer actually defaulting.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal.

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. An investment strategy focused primarily on privately held companies presents certain challenges and involves incremental risks as opposed to investments in public companies, such as dealing with the lack of available information about these companies as well as their general lack of liquidity. 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.

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. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. **Low-rated, high-yield bonds** are subject to greater price volatility, illiquidity and possibility of default.

Equity securities are subject to price fluctuation and possible loss of principal.

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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Private equity investments involve a high degree of risk and is suitable only for investors who can afford to risk the loss of all or substantially all of such investment. Private equity investments may hold illiquid investments and its performance may be volatile. The risks associated with a real estate strategy include, but are not limited to various risks inherent in the ownership of real estate property, such as fluctuations in lease occupancy rates and operating expenses, variations in rental schedules, which in turn may be adversely affected by general and local economic conditions, the supply and demand for real estate properties, zoning laws, rent control laws, real property taxes, the availability and costs of financing, environmental laws, and uninsured losses (generally from catastrophic events such as earthquakes, floods and wars). The value of most bond funds and credit instruments are impacted by changes in interest rates; bond prices generally move in the opposite direction of interest rates. Investing in lower-rated or high yield debt securities ("junk bonds") involve greater credit risk, including the possibility of default, which could result in loss of principal—a risk that may be heightened in a slowing economy. Investments in derivatives involve costs and create economic leverage, which may result in significant volatility and cause the fund to participate in losses (as well as gains) that significantly exceed the fund's initial investment in such derivative. An investment in alternative securities 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.

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