

Private Credit: Fact versus Fiction



Private credit has evolved from a niche corner of the market (before the Global Financial Crisis) into a major force in today's financing landscape, eclipsing the high-yield market and becoming a dominant lending channel for private equity-backed companies. With that growth has come more attention, more scrutiny, and lately, more headlines.

Credit Quality

Current Conditions

The recent narrative around private credit has centered on defaults, credit deterioration, and the idea that trouble is brewing beneath the surface. That makes for compelling copy, but it is less compelling as a complete and honest description of the current market.

Current credit conditions remain constructive. A number of private credit lenders we have spoken with continue to report healthy operating performance across their portfolios, with revenue growth in the high single digits and profit growth in the mid-teens. Within the strategies we have recommended to clients, defaults remain limited, and forward looking loan risk ratings have not shown signs of negative migration.

Market Cycle Considerations

This does not mean defaults will stay this low forever. Credit is cyclical, and private credit is no exception. Investors should expect defaults over time just as they would in high-yield bonds, bank loans, or other credit markets. The relevant question is not whether defaults will happen. The relevant question is whether they are happening at a level that suggests broad impairment today.

At the moment, that does not appear to be the case. The Cliffwater Direct Lending Index, a commonly referenced benchmark in the private credit market, has averaged a 1.0% default rate over the past 20 years, compared with a trailing 12-month rate of 0.6% (as of September 30, 2025)¹, which remains near cycle lows.

These metrics are backward-looking, and we recognize that risk needs to be assessed based on what lies ahead. In other words, effective analysis requires looking through the windshield rather than relying solely on the rear-view mirror.

Looking ahead, we recognize that risks are emerging in the software sector, and we expect some defaults in software loans over time. More broadly, business conditions will not remain as constructive as they have been indefinitely, and defaults resulting from economic cyclicalities will inevitably occur. Private credit investors should expect this.

However, that does not mean private credit will be unable to generate reasonable returns during periods when default rates rise. The additional yield earned in private credit can help offset the effects of defaults, especially when results are viewed over a multi-year period, which we see as the only appropriate way to evaluate illiquid private investments. We also believe that in periods of greater stress, which we aren't seeing today, investing in the right assets and with the right private credit manager becomes paramount. Not all strategies will perform equally, which is why we place such great emphasis on understanding the broad spectrum of private credit managers and allocating capital only to those we believe are the most disciplined underwriters.

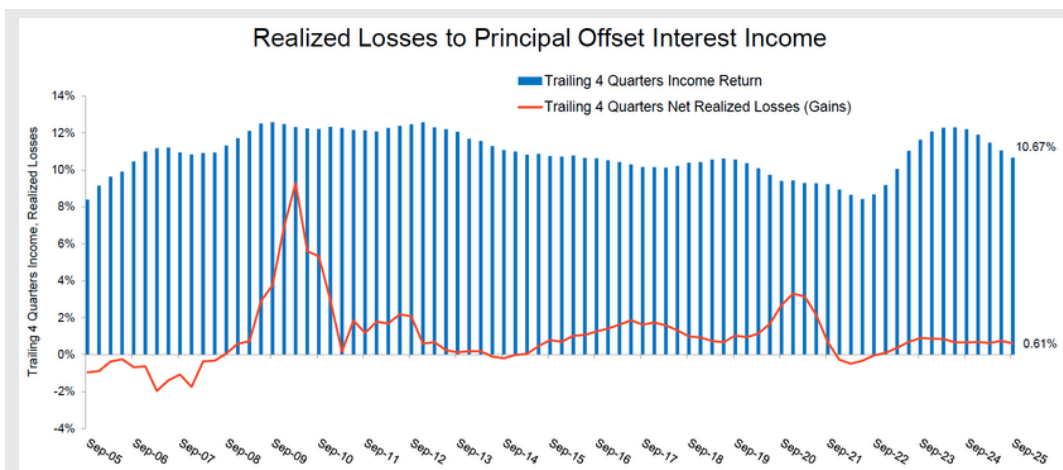
¹Cliffwater. As of 9/30/2025. Based on Cliffwater Direct Lending Index. Trailing twelve-month default rates are defined by realized losses over the past 12 months.

Liquidity

Another recent source of anxiety is that a number of funds with periodic liquidity have not fully satisfied recent redemption requests, instead returning only a prorated portion of the requested amount. While this has understandably drawn scrutiny, we do not interpret it as evidence of portfolio issues or broad weakness in private credit. These vehicles are designed to provide limited liquidity while investing in illiquid assets, and private credit investors should expect that liquidity may be constrained at times, particularly during periods of elevated redemption demand.

In our view, the current use of redemption limits in private credit should be understood in a similar light: not as evidence that something is broken, but as a reflection of how these structures are designed to function.

This is understandably frustrating for investors who want immediate access to capital, but it is important to be precise about what this does, and does not, mean. There was similar press in 2022 and 2023 when the largest private real estate investment trust limited redemptions. That issue was worked through over six quarters, with redeeming investors receiving their capital back and remaining investors continuing to hold a well-balanced portfolio. In our view, the current use of redemption limits in private credit should be understood in a similar light: not as evidence that something is broken, but as a reflection of how these structures are designed to function.



Source: Cliffwater. Data from Cliffwater Direct Lending Index. As of September 30, 2025.

These redemption limits exist for a reason. Private assets cannot always be sold quickly without harming remaining investors. Periodic-liquidity structures are intended to provide some access to capital while reducing the risk of forced selling, and, in our view, funds today continue to manage liquidity within their prescribed thresholds.

Limited liquidity is a feature of private credit, not a footnote, and anyone allocating to the asset class should do so with a multi-year mindset and the understanding that liquidity may be partial, delayed, or both during periods of elevated redemption demand.



FACT

Credit conditions are presently favorable, although below average default rates suggest that levels may not always remain this low.

Some semi-liquid private strategies have received redemption requests exceeding quarterly redemption limits.

Advances in AI may weaken the competitive positioning of certain software companies and contribute to credit deterioration in select software-backed private credit loans.

FICTION

Credit quality across private credit is rapidly deteriorating.

Private credit funds are not fully meeting redemption requests and facing risks related to credit quality and portfolio structure.

All software-backed loans are at risk of AI disruption.

Our Approach

In private credit, investors aren't rewarded with more upside. The maximum return you can generate is the contractual cash flows, or yield on the investment. However, what sets good managers apart is how they perform in the face of adversity. Specifically, whether they can limit defaults and the magnitude of any losses. As a result, investing with the right private credit managers and owning the right loans is paramount.

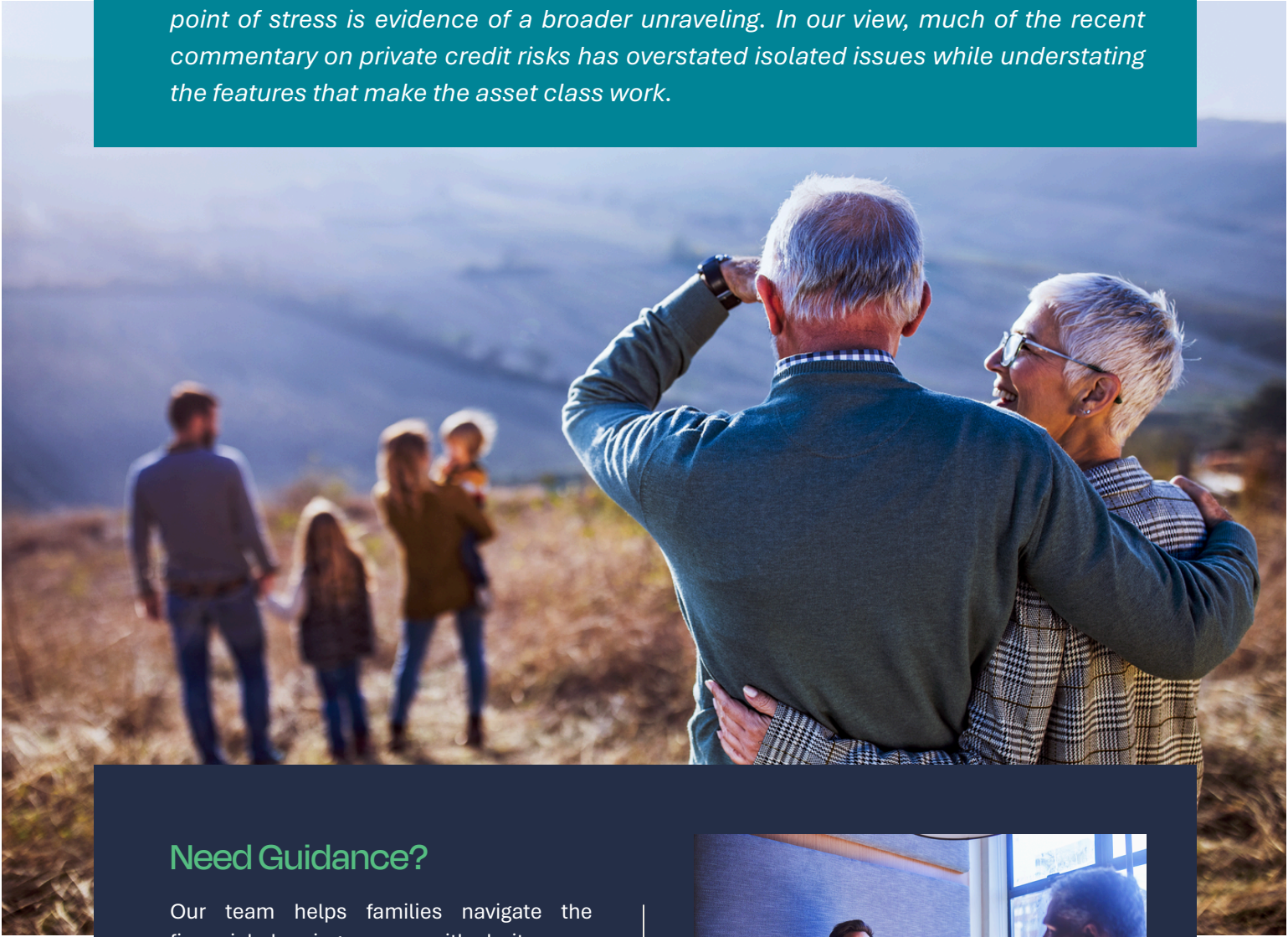
We continuously review quarterly filings, pore over portfolio holdings, and stress-test portfolios to ensure that what our clients own continues to align with our convictions. We also place great emphasis on portfolio construction. We know no one can anticipate every uncertainty; however, prudent and thoughtful portfolio construction that can withstand both known and unknown risks is critical to achieving desired investment outcomes.

In this environment, we want our clients to be attuned to what is fact and what is fiction in private credit. Should the facts change, so will our perspective and guidance. But when the facts remain largely the same, and the rhetoric evolves, we believe it is important to remain grounded and stay focused on the purpose private credit is intended to serve in a portfolio.

While we support private credit investments for clients where appropriate, private credit may not be suitable for every investor. We strongly believe investors should be committed to the asset class over a full market cycle, as there will inevitably be periods of greater credit risk and/or liquidity constraints when immediate redemptions may not be feasible.

A Quick Note...

We welcome honest scrutiny. This is a large and increasingly influential market, and investors should ask hard questions. But not every headline is a signal, and not every point of stress is evidence of a broader unraveling. In our view, much of the recent commentary on private credit risks has overstated isolated issues while understating the features that make the asset class work.



Need Guidance?

Our team helps families navigate the financial planning process with clarity, care, and perspective. Composition Wealth is an independent RIA firm providing fiduciary advice, modern technology, and personalized guidance designed to evolve with you—so you can focus on writing the next chapter of your financial story with confidence. From securing accounts to creating a thoughtful plan for inherited assets, we're here to support you.



info@composition.com

www.composition.com

Composition Wealth, LLC ("CW") is a registered investment advisor. This 1099 is provided for informational purposes only. CW does not provide tax advice and is not responsible for the accuracy of third-party tax documents. Clients should consult their tax advisor to determine how this information applies to their specific situation. All investments involve risk, including the potential loss of principal. Additional information about CW's services, including applicable risks, is available in our Form ADV Part 2A, which is publicly available.