



Investment Perspectives

Opportunities in Credit: An Active Approach Broadens the Opportunity Set

The credit market landscape has evolved, and a focused credit approach may help investors navigate it.



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KEY POINTS

- Capital markets have adapted to changing liquidity mechanisms brought about by well-intended regulations.
- These adaptations result in more frequent and extreme changes in flows, creating opportunities for a flexible credit manager.
- A focused credit strategy that seeks to identify idiosyncratic ideas in the new liquidity landscape may provide a broader opportunity set to potentially source better alpha-generating investments.

Following the Global Financial Crisis (GFC), regulators have worked to build a framework of laws designed to limit the emergence of market conditions like those that contributed to the GFC. These laws, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act, reduced the appetite for risk-taking for many market players, and helped to create the credit market liquidity mechanisms of today.

Against this backdrop, which continually evolves with each episode of market stress, an active and deep credit approach may capitalize on select opportunities. A focused credit investment thesis that identifies idiosyncratic opportunities across a broad set of credit sectors expands the potential for alpha-generating ideas.

Evolution of the Fixed-Income Landscape

At its core, the GFC was driven by that original sin of finance: asset and liability mismatching. Banks by their nature generally fund longer-term lending with short-term deposits. When credit markets ceased to provide liquidity, market participants such as banks, which financed investments through borrowings, were forced to unwind positions in a disorderly fashion. This same dynamic, similar in nature if different in detail, plays out periodically; two recent examples include the regional banking crisis in the United States (U.S.) in the spring of 2023 and the market volatility following tariff announcements in April 2025.

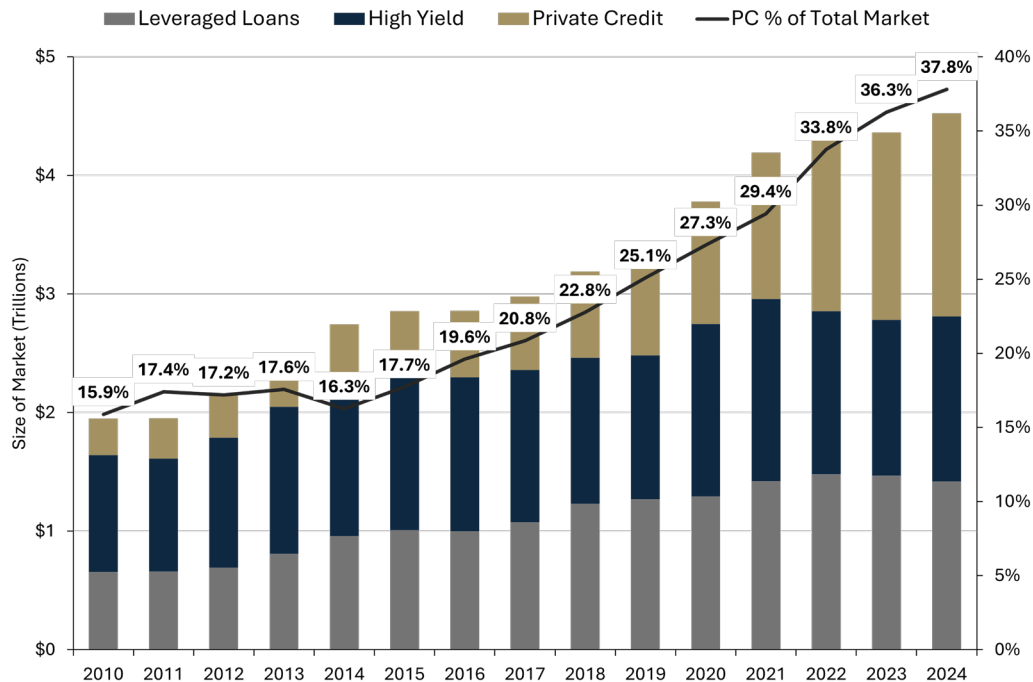
Regulators continue to adjust rules to limit, if not avoid, these episodes. On the horizon is Basel III Endgame, which is the most recent update to the regulations developed by the Basel Committee on Banking Supervision. Basel III Endgame includes far-reaching changes to banks' risk-based capital frameworks. Potential changes to Securities and Exchange Commission (SEC) Rule 22e-4, which pertains to liquidity risk management programs adopted by 40-Act mutual funds, are also forthcoming.



Capital markets have adapted to these changes, but not without major modifications. One of the largest has been well-exploited by investors—the rise of private credit. Borrowers have many reasons for seeking to place their debt privately, but one of the most significant may be the unwillingness of traditional banking channels to extend credit at a level and with terms borrowers find attractive.

Figure 1. Private Credit Has Become a Core Part of the Leveraged Finance Markets

Size of the high yield bond, leveraged loan, and private credit debt markets, December 31, 2009–December 31, 2024



Source: Prequin and Bloomberg. Historical data as of 12/31/2024 (Prequin, most recent data available). For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

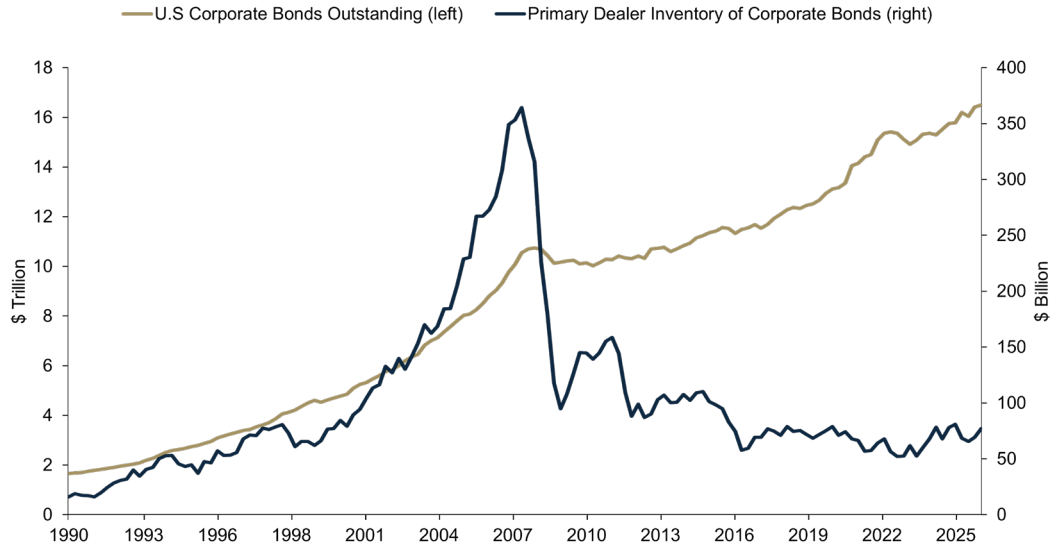
Public debt markets have also expanded to fill the void of bank financing. Looking at the size of the U.S. corporate bond market, the amount outstanding today is three times the size of the market before the GFC. But the holders of these securities have changed dramatically, with dealers holding 80%–90% fewer corporate bonds in inventory than prior to the GFC. Mutual funds and exchange-traded funds (ETFs) have grown by roughly four times over the same period. These structures offer a high degree of liquidity, while investing in long-dated instruments, so they're theoretically mismatched as well and, as such, each must manage flows amid a market of participants managing the same liquidity needs.



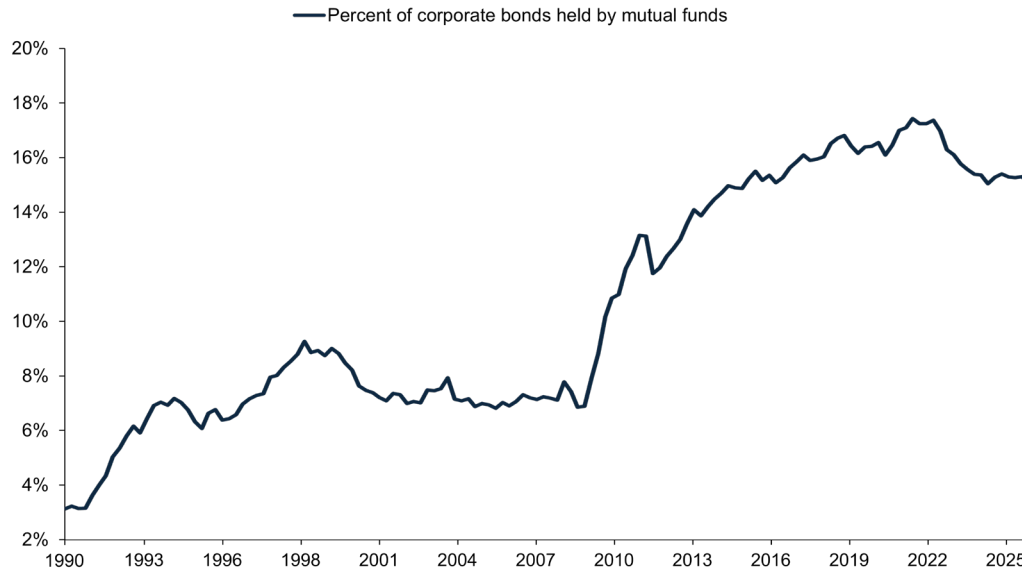
Figure 2. Ownership of Publicly Issued Debt Securities Has Shifted

U.S. corporate bonds outstanding and the amount held by brokers/dealers (top), and the percent of U.S. corporate bonds held by mutual funds, (bottom), March 31, 1990–June 30, 2025

Primary dealers hold a fraction of the bonds held prior to the GFC.

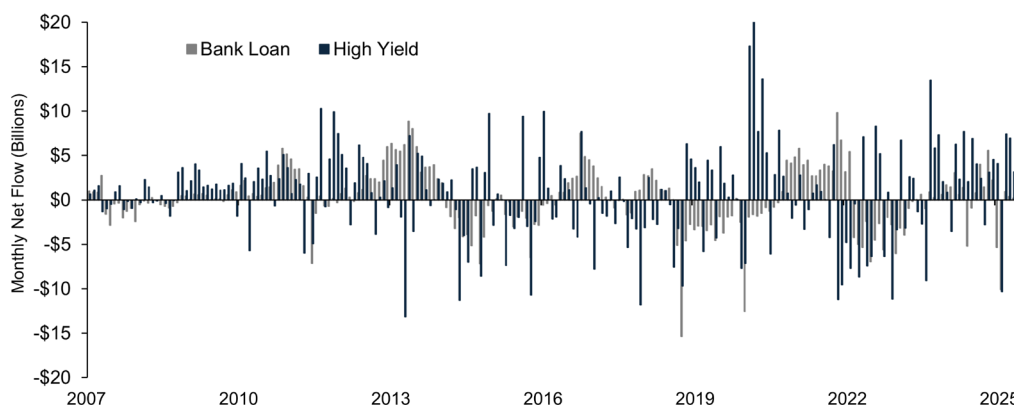


Mutual funds hold more of the outstanding share of corporate bonds since the GFC.



Source: Financial Accounts of the United States, Board of Governors of the Federal Reserve System. Data as of June 30, 2025. Most recent data available. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

The net result has been a more challenged liquidity environment, not only for lower-quality and off-the-run instruments but also increasingly for larger and more liquid structures. This was shown in March of 2020, when the onset of COVID-19 caused a dramatic sell-off in instruments that, on a normal day, trade at extremely tight bid-ask spreads. High-quality investments went from being very liquid to no-bid activity practically overnight, as demand for cash skyrocketed across all investor segments. This ownership profile has also led to more frequent and extreme changes in flows, shown in Figure 3, presenting opportunities for new liquidity providers, like asset managers, with flexible capital to invest.

**Figure 3. Ownership Shift Helps to Create Mispricing Opportunities***High yield and leveraged loan mutual fund net flows, March 31, 2007–September 30, 2025*

Source: Morningstar. Data as of September 30, 2025. High yield and Bank Loan fund flow data based on monthly net flow, all open-end funds in the High Yield Bond and Bank Loan category. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

How Higher Rates May Reshape the Liquidity Environment

What's different between 2020 and today is that, while regulatory and legislative efforts globally have limited the amount of risk financial institutions hold on their balance sheets, chiefly through higher capital charges, the impact has been somewhat blunted by a historically prolonged period of low rates. With the ending of ZIRP (zero interest-rate policy) the impact of restrictions, current and proposed, may be more fully felt.

For banks, the implications go beyond limiting further purchases and may extend into outright sales of existing holdings, including those originally earmarked to be held to maturity. Some of those asset sales will take creativity on behalf of buyer and seller and will in many cases be difficult for traditional fixed-income investors to participate in. Taken together, this represents both a curtailment of demand and a meaningful source of potential supply of fixed-income instruments.

Credit Strategies in Today's Environment

It appears that the current administration may have an appetite for loosening some of the restrictions facing financial institutions, but it's not clear how likely the changes are or how far they'll go. What is proposed so far seems unlikely to have a material change in market functioning.

One way to potentially take advantage of this landscape is to do what private credit investors have done—step into the shoes of market actors who have, for reasons already discussed, stepped away. Traded credit offers opportunity as well. With the right structure and the right investors, strategies can provide liquidity to market participants when periods of dislocation or capital shortages occur, acting in a sense as the new risk intermediary.

There are several ways to do this, and there's no shortage of strategies standing up to try to capture one part or another of this dynamic. Some are focused on pricing dislocations—generally at a market or asset-class level—and offering capital during periods of stress to reap the benefits as markets “normalize.” Others are focused purely on liquidity premiums—building a portfolio of off-the-run instruments and hoping to capture liquidity premiums over time. Each of these approaches has its merits, but they tend to be dependent upon macroeconomic catalysts or sector/asset class-specific dislocations that may be sporadic and limit the opportunity set.

We believe an optimal approach is to narrowly focus on specific instruments, specific investments, and specific stories, while viewing the dislocation as setting the table for opportunity, but not representing the central thesis for investment. The appeal of this investment-by-investment strategy is the broadening of the opportunity set that is evergreen rather than episodic. By focusing down to the line-item level, opportunities within a sector, an industry, an asset class, or a company, become much more frequent. There is also the added benefit of not basing a thesis around a macroeconomic outcome or seeking to benefit from a broad mean reversion within a sector or asset class. Instead, the investment thesis focuses on the specific structure of the security or company. The macro role, again, is limited to being an additional factor toward setting the valuation table.



Credit's Potential Role in an Existing Asset Allocation

We believe opportunistic credit can enhance an investment program in several ways. First, as a complement to private credit, we believe opportunistic credit is a great fit philosophically, as well as practically. Philosophically, the investor has already allocated to a space, which was also once dominated by banks, to directly capture value. Opportunistic credit strategies allow the investor to step in where traditional holders of risk, such as the capital markets desks at investment banks, or more recently the balance sheets of regional banks, have stepped away or have been forced away by regulatory capital pressures.

In addition to feeding from the same vacuum of competition, opportunistic credit complements private credit in a practical sense because private credit, by design, does not trade or price actively. In contrast, opportunistic credit strategies have an eye toward early monetization of good investments as the investment thesis plays out. While strategies should hold securities that are deemed attractive to maturity, it is also appealing to have the option to realize a gain and recycle the capital into a new idea when the market has caught up to your views.

As part of an overall asset allocation program, credit may also provide diversification benefits to equity risk. Credit has historically diversified rate risk by remaining negatively correlated to rates. In this sense, the role of credit becomes even more significant in terms of earning a strong return but with a lower level of risk than equities, as measured by standard deviation. Credit may also provide access and exposure to different risk premiums and sources of return, especially in a strategy that seeks idiosyncratic opportunities without the constraint of a benchmark. If you think about it simply as “Who gets most of the cash flows?”—for years that was tilted toward the bottom of the structure due to the rate environment. That has changed—as noted earlier, possibly for good—if the last 23 years turn out to have been an aberration. With the internal rate of return (IRR) opportunities we’re seeing in fixed-income markets, credit is making a very strong case for recapturing some of the allocation weights it lost during ZIRP.

Summing Up

Our view is that, as part of a credit allocation, an optimal strategy to consider is an active manager with deep credit expertise that can start with a blank piece of paper. Although there is an investment universe dictated by the manager’s resources and experience, in our view a superior approach to credit means not thinking in terms of indexes or buckets. Rather, the investment thesis is about maximizing the return potential for the risk the instrument represents. Today, selection is as important as it has ever been. Properly tailored and situated, we believe it is possible for opportunistic credit to deliver a risk experience in line with traditional index-tracking strategies, while delivering a return experience that is vastly different.



GLOSSARY AND INDEX DEFINITIONS

Alpha is a measure of the excess return of an investment relative to a benchmark index, adjusted for risk.

Capital markets are venues where financial instruments such as stocks, bonds, and other securities are bought and sold. They enable companies and governments to raise funds for operations or expansion and allow investors to allocate capital for returns.

Basel III is a set of measures developed by the Basel Committee for Banking Supervision in the years following the global financial crisis of 2007-09. The measures, rolled out over several years, aim to strengthen the regulation, supervision, and risk management of banks.

A **basis point** is one one-hundredth of a percentage point.

A **bid-ask spread** is the difference between the highest price a buyer is willing to pay (bid) and the lowest price a seller is willing to accept (ask) for a security.

A **dislocation** in finance refers to significant market disruptions causing asset mispricing, often during periods of stress or liquidity crises.

Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly known as Dodd-Frank, is a United States Federal Law that was enacted on July 10, 2010. The law includes consumer protection reforms, the Volcker rule that prohibits banks from engaging in proprietary trading or investing in hedge funds or private equity funds, enforcement authority for banks and credit unions with assets over \$10 billion and all mortgage-related businesses, systemic risk regulations, and derivative regulations.

Exchange-traded fund (ETF) is a type of investment fund that is also an exchange-traded product, i.e., it is traded on stock exchanges. ETFs own financial assets such as stocks, bonds, currencies, debts, futures contracts, and/or commodities such as gold.

An **index** represents the performance of a group of assets, such as stocks or bonds, often used as a benchmark for investment performance. Examples include the S&P 500 Index or the Dow Jones Industrial Average.

Internal rate of return (IRR) is the yield-to-maturity of a bond associated with buying that bond and holding it until its maturity date. In other words, it is the return on investment associated with buying the bond and reinvesting its coupon payments at a constant interest rate.

Macroeconomic catalysts refer to events or factors at the economy-wide level that trigger major changes in financial markets or economic conditions. Examples may include interest rate changes, inflation data, or fiscal or monetary policy shifts.

Mean reversion refers to the tendency of a value to move back toward its long-term average (mean) over time.

A **mutual fund** is typically a diversified portfolio of stocks, bonds, or other types of investment securities that pools money from multiple investors to invest in the portfolio, which is managed by investment professionals.

Off-the-run instruments are older Treasury securities (bonds or notes) that were issued before the most recent offering of the same maturity. They are generally less liquid than on-the-run securities.

Rate risk, or interest rate risk refers to the risk that changes in interest rates will affect the value of fixed-income securities.

The Securities and Exchange Commission (SEC) oversees securities exchanges, securities brokers and dealers, investment advisors, and mutual funds in an effort to promote fair dealing, the disclosure of important market information, and to prevent fraud.

SEC Rule 22e-4 requires an open-end fund and an exchange-traded fund that redeems in kind ("In-Kind ETF") to establish a written liquidity risk management program that is reasonably designed to assess and manage the fund's or In-Kind ETF's liquidity risk.

The U.S. Federal Reserve (Fed) is the central bank of the United States. The federal funds (fed funds) rate is the target interest rate set by the Fed at which commercial banks borrow and lend their excess reserves to each other overnight.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

Yield is the income returned on an investment, such as the interest received from holding a security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value, or face value. Yield-to-worst refers to the lesser of a bond's (a) yield-to-maturity or (b) the lowest yield-to-call calculated on each scheduled call date.

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