Buckingham

Middle Market Lending FAQ

August 2023

Who Is Cliffwater?

Cliffwater is a leading investment consulting and asset management firm focused on alternative investment strategies with offices in Chicago, Los Angeles and New York. As of December 2022, Cliffwater had $106 billion of assets under advisement. Cliffwater is widely viewed as an industry leader in private debt research and its CEO, Stephen Nesbitt, has been named one of the 30 most influential people in private debt by the publication *Private Debt Investor*.

Buckingham's Investment Policy Committee (IPC) has approved two of Cliffwater's funds for use in client portfolios. We believe the strategy may provide expected returns higher than those of high-quality fixed income while providing modest diversification of equity market risk.

What Are Alternative Investment Strategies?

True alternative investment strategies 1) may provide higher expected returns than stock-oriented investments or 2) provide diversification of stocks similar to high-quality bonds but may offer higher expected returns. In practice, most alternative strategies that have been pitched as having higher expected returns than stocks have failed to outperform stocks.

Buckingham's IPC believes Cliffwater's strategies fall into the second category, meaning the IPC does not expect any of the alternative strategies we recommend to clients to generate higher long-run returns than stocks, but the IPC does expect that they may generate higher long-run returns than high-quality fixed income while providing similar diversification benefits.

What Is Middle Market Direct Lending?

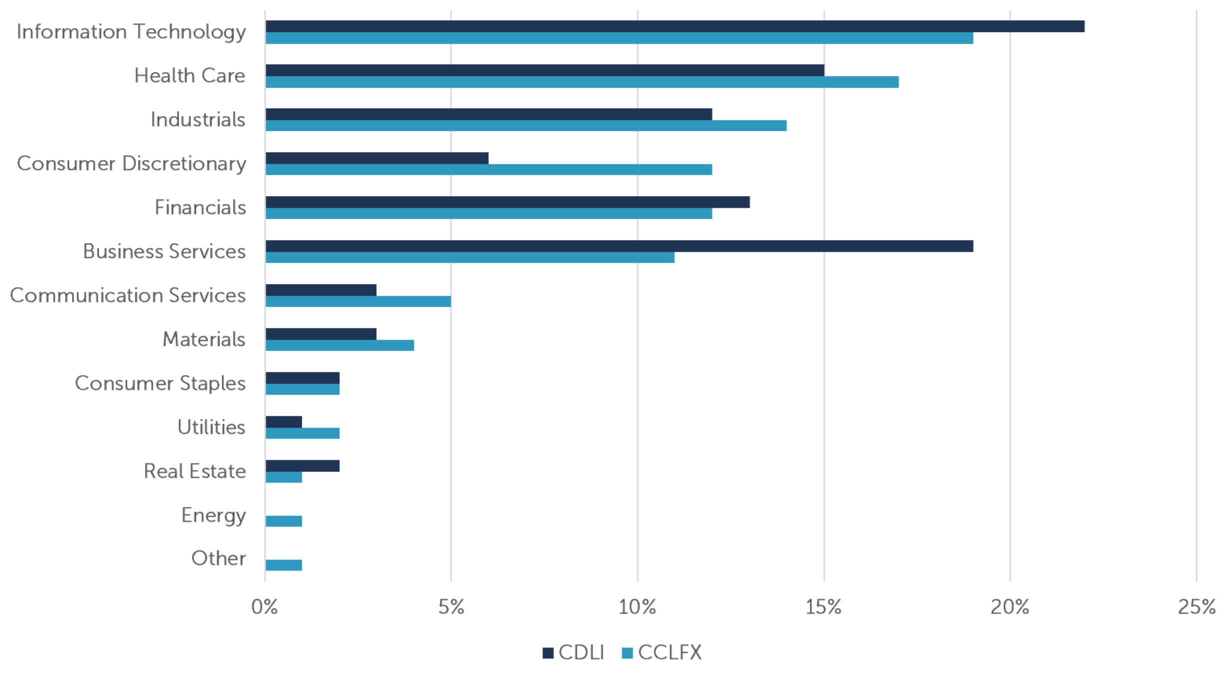
It is lending by asset management firms to corporations with profits from $10 million to $100 million. These loans typically have a five- to seven-year maturity and charge floating interest rates based on a reference rate like the Secured Overnight Financing Rate (SOFR) plus an interest rate spread to compensate for the risk of loss from borrower default and illiquidity. The interest spread varies depending upon many factors, including the perceived riskiness of the borrower, industry, loan-to-value ratio, seniority and covenants.

Historically, banks have been the primary lenders for this type of borrowing, but over the past decade, more and more of these loans are being funded by independent asset managers, or “shadow banks,” utilizing capital from institutional investors. The main reason for this shift is federal regulation implemented following the Great Recession that significantly limited the ability of banks to make traditional loans to U.S. middle market businesses.

What Is the Cliffwater Corporate Lending Interval Fund?

We recommend this fund for gaining exposure to middle market direct lending. The fund (ticker: CCLFX) uses multiple sub-advisors to access a diverse portfolio of U.S. middle market direct loans. As of March 31, 2023, 93% of loans were secured by a first lien on borrower assets and cash flows, with an average loan-to-value ratio (LTV) of 42%. The manager intends to maintain a substantial overweight to first-lien loans, with the intention of generating lower risk and less cyclical returns. The fund strives to maintain a portfolio of more than 2,000 different credits across various industries to maintain proper diversification. The chart below details the loan exposures by sector for CDLI and CCLFX through Dec. 31, 2022, and March 31, 2023, respectively.

CCLFX and CDLI Loan Exposures as of 3/31/2023 and 12/31/2022



Note that CCLFX is a closed-end interval fund instead of an open-end mutual fund. The primary distinction is that the fund can only be sold quarterly and there is no guarantee that an investor would be able to liquidate his or her entire position in one quarter or even over multiple quarters. CCLFX is required to provide quarterly liquidity of 5% of the total value of the fund. This is large enough that, in most quarters, investors should be able to redeem their entire position should they choose to do so, but if a large number of investors chose to redeem in the same quarter, the fund would provide pro-rata redemptions to each investor. The fund is organized in this form because the underlying illiquidity of its holdings makes it incompatible with a daily liquid fund structure.

What Evidence Is There in Support of Middle Market Corporate Lending as a Viable Investment Strategy?

While the particular form of middle market direct lending that Cliffwater implements is relatively new, middle market direct lending has been around for decades. In 2004, Cliffwater created the Cliffwater Direct Lending Index (CDLI) to better track the performance of U.S. middle market direct loans. The index shows that U.S. middle market direct lending has generated very healthy annualized returns net of default rates.

How Have Middle Market Direct Loans Performed?

The CDLI is the best gauge of performance of middle market direct loans. The index dates back to 2004 and covers more than 8,000 loans with aggregate principal value exceeding $172 billion. The table below reports return and risk for the CDLI together with the same statistics for other major asset classes.

Over this period, the CDLI earned a 9.3% annualized return with 3.6% volatility (standard deviation). While private equity performed better, at 12.4%, the CDLI's lower risk gives it the highest return-to-risk ratio of all asset classes. It is important to note, however, that some portion of this low realized volatility is almost certainly because middle market direct loans are not publicly traded securities. If they were, volatility would likely be more comparable to high-yield corporate debt.

How Exactly Would the Pro-Rata Redemption Process Work?

Let's assume that 5% of the value of the fund was $250 million. In this particular quarter, investors requested $500 million of total redemptions. In this case, all investors who requested redemptions would get redeemed 50% of what they requested (i.e., 250 ÷ 500). Keep in mind that redemptions could be pro-rated over multiple quarters if redemption requests exceed the liquidity that the fund is able to provide over multiple quarters.

Essentially, this means that you may not be able to liquidate your full investment for long periods of time, especially in times of distress, dependent on requested redemptions. Individuals with short-term liquidity needs should not utilize this fund.

Is the Fund Priced on a Daily Basis?

Yes, CCLFX is available for purchase daily. Even though the fund can only be sold quarterly, the fund's holdings are priced daily via a partnership between Cliffwater and a third-party pricing firm. Further, redemptions occur at net asset value (NAV), unlike most closed-end funds where investors may sell the fund at a premium or discount to NAV.

What Is CCLFX's Expense Ratio and How Did Buckingham's IPC Get Comfortable With This?

The fund's Morningstar adjusted expense ratio is roughly 1.63% as of May 1, 2023. We use the Morningstar adjusted expense ratio because it strips out interest and dividend expenses, which provides an apples-to-apples comparison of expense ratios across funds.

While this is a significantly higher expense ratio than any equity or bond strategy we are using, we believe the fund can provide benefits after accounting for this higher expense ratio. We believe the fund has expected returns above that of high-quality fixed income and provides some diversification benefit to equity and high-quality fixed income.

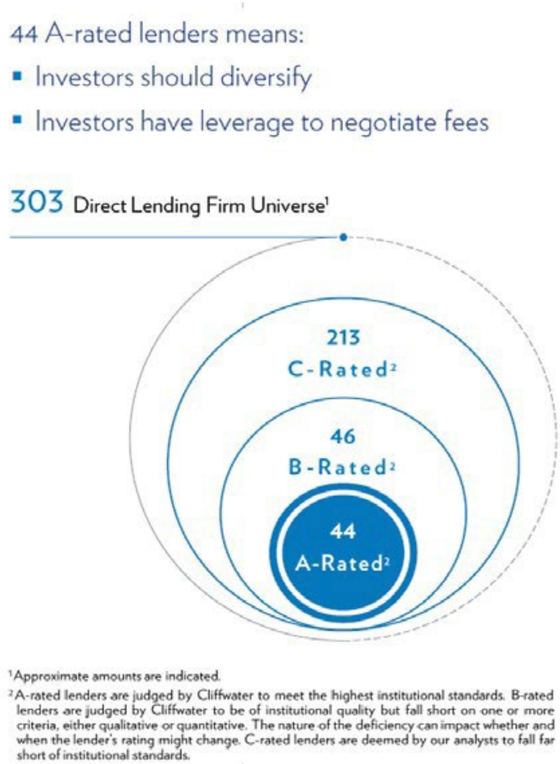
Are These Loans Typically Collateralized?

For the vast majority of the portfolio, the answer is no. Instead, they are unsecured loans that rely on the likelihood of a corporation repaying all principal and interest. If the corporation is unable to repay, the loans are in default and the investor will experience a loss. Note, however, that a large fraction of the loans held in CCLFX are at the top of the borrower's capital structure, meaning these loans would be first in line to be paid if the borrower were to run into financial difficulties. Typically, this would mean that some portion of the investment is recovered rather than entirely lost. Note, also, that this is the same security structure as most publicly traded corporate bonds (i.e., the "security" is entirely based upon the borrower's financial ability to pay back the loan).

How Does Cliffwater Evaluate the Managers They Choose to Invest With?

Cliffwater has selected several top-tier direct lenders to be sub-advisors to the fund at attractive asset-based fees and no incentive fees. Cliffwater is not restricted to investing exclusively with these sub-advisors, but it expects the majority of fund assets to be allocated using a sub-advisory structure. Note that this structure means that Cliffwater is not underwriting the loans in CCLFX but rather hiring third-party private credit managers as sub-advisors to conduct the underwriting of each portfolio company and the associated loans.

From a database of roughly 303 U.S.-focused direct lenders, Cliffwater conducts a due diligence process to screen the universe of potential lenders to roughly 44 A-rated candidates and selects a subset for client allocations. Cliffwater's due diligence covers multiple facets of a firm's capabilities as depicted in the following figure.



What Is the Downside Risk of the Fund?

Based upon our research of the fund's strategy, we believe the fund has more downside risk than high-quality fixed income but much less than a diversified portfolio of stock funds. We also expect losses will be largest during periods of severe economic distress. Therefore, we expect this fund will have positive correlation with stock market performance over the long term.

In a bad year, we would expect fund total returns to be down around 8%. In an extremely bad year, fund total returns could be down 30%, or lower. These years would tend to correspond with large economic downturns.

The primary risks the fund is exposed to are default and liquidity risks. Because of the floating-rate structure of most loans held in CCLFX, there is minimal exposure to broad market interest rate risk.

What Is a Business Development Company (BDC) and How Does That Compare With Cliffwater's Corporate Lending Interval Fund?

A BDC can be either a publicly traded security or a private security where the holdings within the BDC are typically middle market loans underwritten by the issuer of the BDC, who is frequently a private credit manager. There are many differences between BDCs and CCLFX, but two of the most notable are 1) that Cliffwater's fund tends to be much more highly diversified than the typical BDC, and 2) the all-in expenses associated with Cliffwater's fund tend to be much lower than the average BDC.

Why Does It Make Sense to Invest in a Fund That Is Exposed to Credit Risk When Historically We Have Avoided Credit Risk in Fixed Income Investments?

Historically, we have avoided taking credit risk in fixed income-oriented investments because corporate credit risk is highly correlated with stock market performance and investors who needed higher returns could instead invest a portion of their portfolios in stock funds. The differences here are that 1) we believe expected returns for CCLFX are higher than publicly traded, high-yield corporate fixed income, and 2) we think of CCLFX as an alternative investment strategy and not a fixed income strategy since CCLFX will tend to have low correlation with the type of high-quality fixed income investments we utilize.

Does the Fund Use Leverage?

Yes, because the performance of short-maturity loans tends to have extremely low volatility, the fund does use a modest amount of leverage. At most points in time, it will have leverage of about one-half the size of investor-contributed assets.

Is the Fund Expected to Be Tax Efficient and Should It Ever Be Held in Taxable Accounts?

Every year the fund has positive returns, the IPC expects that the entire return will be taxed at ordinary income rates. Therefore, the fund will be tax inefficient. It is best to hold the fund in tax-advantaged accounts. However, the forward-looking, after-tax return expectations for the fund are still higher than the returns the IPC expects to be provided by high-quality taxable and tax-exempt fixed income. So, in some circumstances, it can make sense to hold the fund in taxable accounts if you are unable to place it in a tax-advantaged account. However, investors who go this route should expect substantial taxable distributions in most years.

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When evaluating an investment, Buckingham Wealth Partners' Investment Policy Committee (IPC) develops estimates of expected return and portfolio volatility. These estimates are statistical estimations for the average growth rate of the asset class over the long-term. The estimates are based on an average from the distribution of possible returns and are not a guarantee of future results. These estimates are subject to numerous assumptions, risks and uncertainties, which change over time and actual results may differ materially from those anticipated by the expected return forecast. These estimates are hypothetical in nature and should not be interpreted as a demonstration of actual performance results or be interpreted as a target return. Investors should carefully consider the Fund's risk and investment objectives, as it may not be appropriate for all investors and is not designed as a completement investment program. This fund involves a high degree of risk, and it is possible the Fund may result in a loss of some or all of the amount invested. Individuals should review additional detailed information, including related risks about CCFLX.