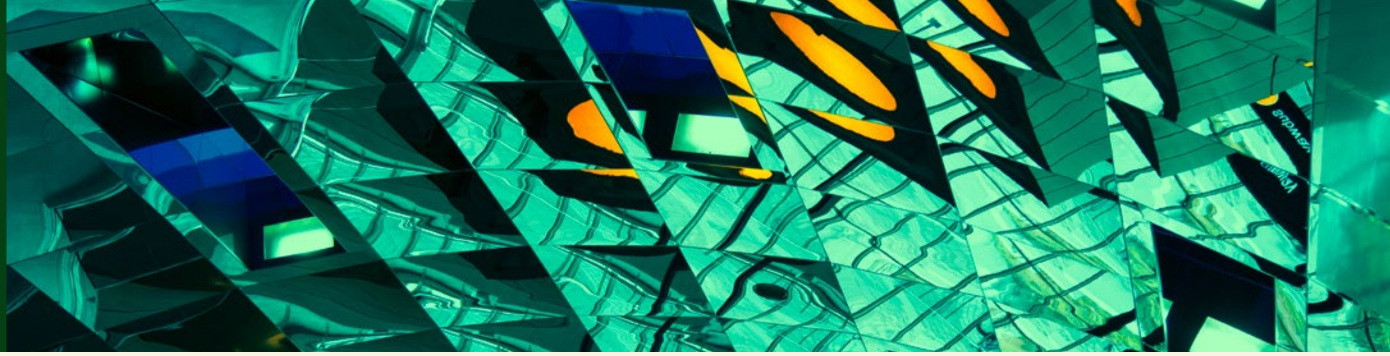

Commentary

From our U.S. partners.

Direct lending: The missing ingredient within a strategic credit allocation

Structural bifurcation offers attractive opportunities in the traditional middle market; secular conditions support credit allocations and exposure across the high-yield spectrum.

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Key takeaways

- Credit is often underutilized in portfolio construction,[1] yet may provide attractive income, downside protection, and total return across market cycles.
- By combining complementary sources of public and private credit, investors can potentially enhance return consistency, income durability, and compounding potential.
- The direct lending market comprises a bifurcated ecosystem, with attractive opportunities in the traditional middle market due to higher spreads, stronger loan covenant protections, and less leverage.

Direct lending is here to stay

The private credit market has grown substantially over the past two decades, with direct lending now rivaling the traditional high yield and leveraged loan markets (Exhibit 1). This growth reflects a structural shift as traditional banks retreat from leveraged lending. U.S. commercial banks have declined from 14,500 in the 1980s to under 4,000 today.[2] In turn, middle-market borrowers have increasingly turned to private, non-bank lenders. Unlike traditional banks, these lenders can provide efficient solutions tailored to the unique needs of the respective businesses to support growth, while providing speed of execution and a partnership mindset. The U.S. middle market—comprising about 200,000 private businesses with $10M–$1B in revenue—represents a vast, diversified opportunity set, accounting for one-third of U.S. GDP and private sector employment.[3]

Access to private credit is also expanding. Vehicles such as BDCs and interval funds allow traditional public credit investors to gain exposure to private markets, enhancing portfolio flexibility and income potential.

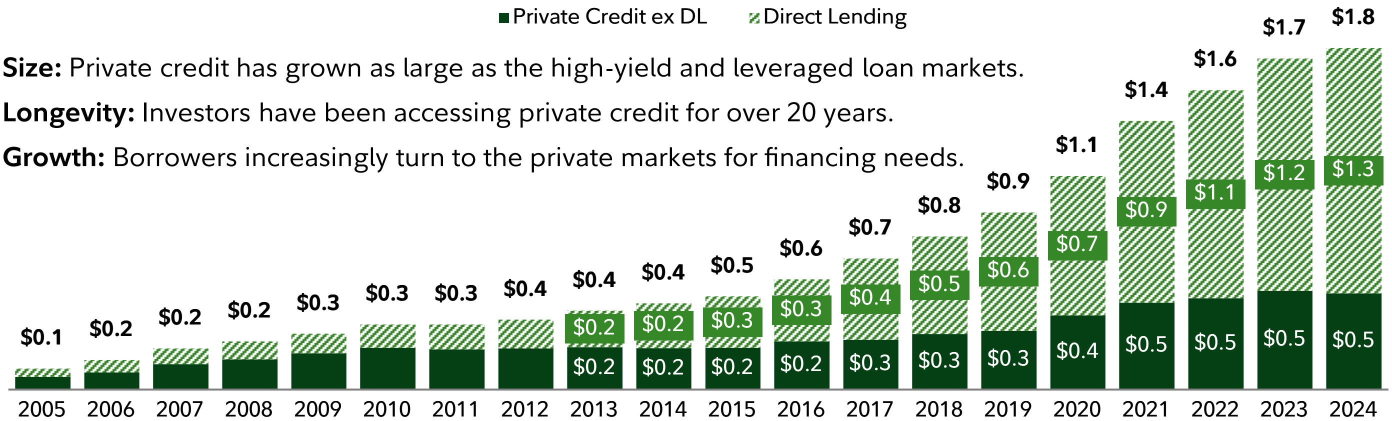
Exhibit 1: The rise and resilience of direct lending

Size of U.S. private credit market ($T)

Size: Private credit has grown as large as the high-yield and leveraged loan markets.

Longevity: Investors have been accessing private credit for over 20 years.

Growth: Borrowers increasingly turn to the private markets for financing needs.



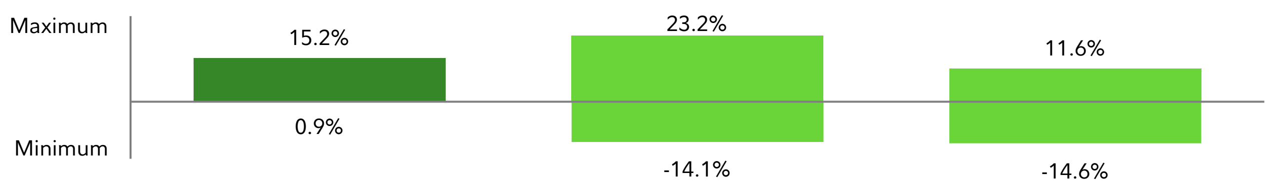
Source: PitchBook Data, Inc., Preqin, Cliffwater, Bloomberg Finance LP, Fidelity Direct Lending estimates. The cited data has not been reviewed by PitchBook analysts and may be inconsistent with PitchBook methodology. Asset growth from 2005 through 12/31/24, the latest available data.

Public and private credit: Complementary, not competing

Public and private credit are not mutually exclusive—they are complementary. Direct lending, high-yield bonds, and investment-grade bonds form a complementary portfolio trio, each offering distinct idiosyncratic opportunities, risk premiums, and return drivers. Direct lending delivers elevated spreads through an illiquidity premium, floating rate contractual income, and secular growth credit composition. High-yield bonds add liquidity, moderate duration, and credit risk premium, with a cyclically oriented credit composition. Investment-grade bonds contribute high credit quality, deep market liquidity, and duration exposure. As outlined in Exhibit 2, it is this ability to participate in risk-seeking markets while protecting in risk-off markets that makes direct lending unique.

Exhibit 2: Direct lending has exhibited lower dispersion of returns over the past decade.

Rolling one-year returns, September 2015–June 2025



	Direct lending	High yield	Investment grade
Annualized return	9.0%	5.3%	1.8%
Annualized volatility	2.9%	8.7%	5.3%
Return per unit of risk	3.1%	0.6%	0.3%
Max drawdown	-4.8%	-21.6%	-15.9%

Source: Fidelity Investments, Bloomberg Finance LP. Performance data shown represents past performance and is no guarantee of future results. Volatility measured by standard deviation. Bars represent the range of returns for the rolling four quarters for each respective index over the period, using rolling one-year returns as of 6/30/2025, the latest available data. Direct lending represented by the Cliffwater Direct Lending Index; high-yield represented by the ICE BofA U.S. High Yield Index; and investment-grade bonds represented by the Bloomberg U.S. Aggregate Bond Index. See endnotes for index definitions.

New proprietary research from Fidelity have found that elevated interest rates and inflation has pressured public debt levels, creating a challenging environment for fiscal and monetary policy. For more, see "Unsustainable debt: Strategic asset allocation for a new era." This uncertainty and heightened rate volatility highlight the importance of understanding, and combining, complementary sources of risk and return within fixed income portfolios. Specifically, we see credit as an underappreciated tool given high absolute yield, which reduces sensitivity to changes in credit spreads, alongside a supportive fundamental and technical backdrop.

Structural bifurcation in direct lending

A bifurcation exists in the market between the traditional middle market (borrowers with EBITDA* of roughly $150M or less) and upper middle market (those above $500M). Both segments exhibit distinct risk profiles given that competition has mitigated once-attractive loan terms and deal structures in the upper middle market. As a result, traditional middle market loans have offered more favorable deals with higher spreads, stronger loan covenant protections, and lower leverage.

Among these factors, leverage, more common with larger borrowers, is the most statistically significant predictor of defaults. As leverage increases, especially during downturns, the compounding effect of earnings compression can quickly erode equity cushions and intensify liquidity stress. These structural characteristics can not only enhance downside protection for the traditional middle market but may also support more stable and predictable return profiles.

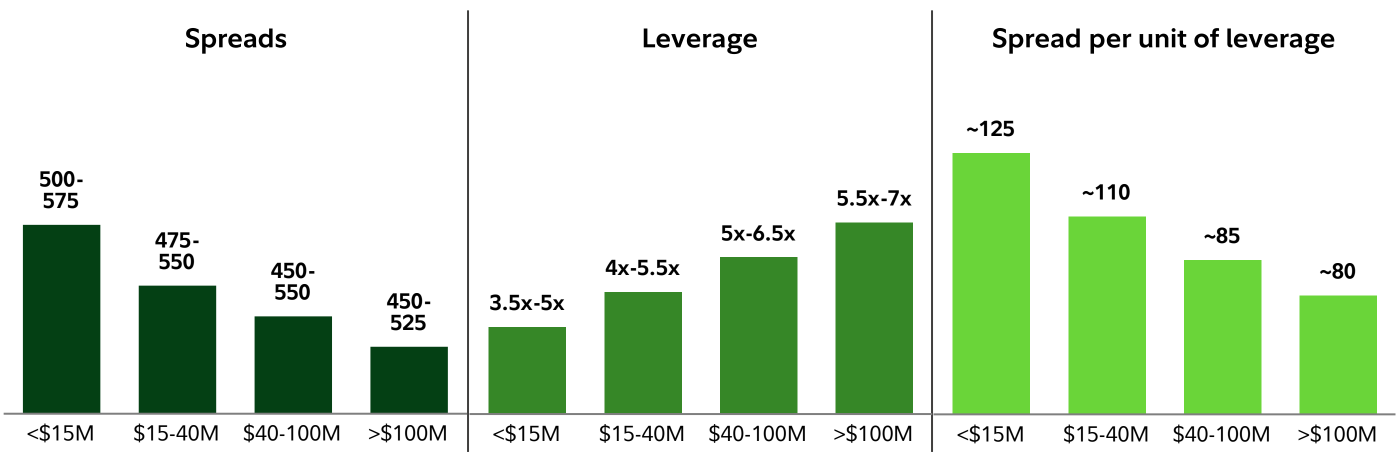
Financial covenants appear in 97% of loans under $350M, compared with just 38% of loans over $1B.

Source: S&P Global Ratings, Q4 2025.

Exhibit 3 outlines some of the differences between spread (return potential) and use of leverage, along with spread per unit of leverage (the risk-adjusted spread) by deal size. Smaller lenders provide roughly 50% higher compensation per unit of leverage compared with their larger counterparts.

Exhibit 3: Spreads, leverage, and spread per unit of leverage (risk-adjusted spreads) are more favorable for smaller loans.

New deal data grouped by closing EBITDA cohorts



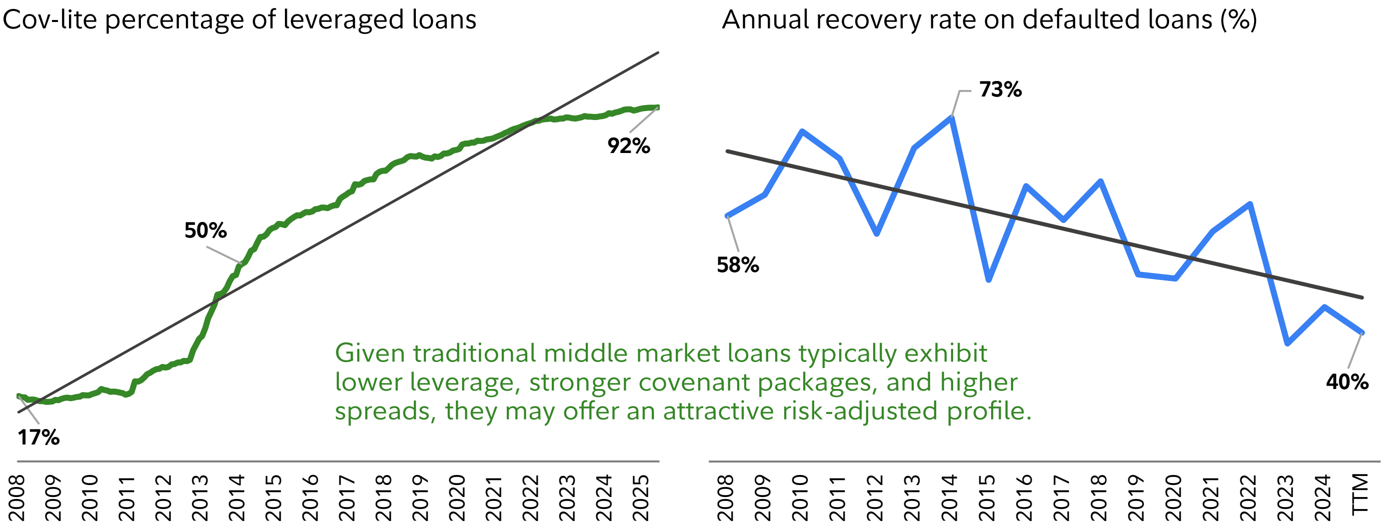
Source: Direct Lending - Lincoln International Valuation and Opinions Group. Unit of Leverage defined as Leverage as a multiple of EBITDA.* Oct. 31, 2025, the latest available data.

*EBITDA, or earnings before interest, taxes, depreciation, and amortization, is a measure of a company's profitability.

In addition, one of the most notable shifts within direct lending has been the erosion of traditional credit protections, also known as loan covenants. The prevalence of covenant-lite loans has surged, now exceeding 90% of the leveraged loan market. The rise of these "cov-lite" structures has materially weakened the ability of lenders to intervene early in deteriorating credits, particularly in the upper middle market. Larger borrowers are also less likely to have maintenance covenants (allowing for restructuring, if needed), and for those that do, those covenants are more likely to be covenant-lite. Financial covenants appear in 97% of loans under $350M, compared to 40% of loans of $750M to $1B.[4]

Exhibit 4 illustrates this trend. The left line shows the percentage of loans with light covenant protections (cov-lite loans) within the U.S. Leveraged Loan Index of the broadly syndicated loan (BSL) market, while the right line shows the annual recovery rate on those loans that go into default. The BSL market of the largest institutional loans has ceded covenants and documentation principles, which we believe are a primary factor contributing to declining recovery rates over time.

Exhibit 4: Declining covenant protection in the broadly syndicated loan market is contributing to declining recovery rates over time, in our view.



Sources: PitchBook Data, Inc., Morningstar LSTA US Leveraged Loan Index. Data as of 6/30/25, the latest available data. The cited data has not been reviewed by PitchBook analysts and may be inconsistent with PitchBook methodology. See endnotes for index definitions.

Know what you own

As the direct lending market matures, understanding portfolio composition has become increasingly important. Overlap among managers, especially in upper middle market deals, can reduce diversification benefits. Investors should evaluate key portfolio characteristics such as exposure concentration, covenant strength, and the degree of private equity sponsor support. Managers who generate returns through disciplined underwriting and conservative valuation policies, rather than through levers of underappreciated risk and static pricing, are better positioned to deliver consistent performance across cycles. Given the limited liquidity profile of direct lending, a long-term, risk-aware approach is critical to achieving investment objectives across market environments.

For more on risk and returns in direct lending, including more on financial covenants and the use of leverage, please see "Direct lending: Does borrower size matter?"

Why now?

As interest rates normalize and credit spreads remain tight, maximizing return relative to risk has become increasingly critical. Direct lending is not immune from these dynamics. In 2025, 43% of LBO financings by direct lenders priced below SOFR+500, more than double the share in 2024.[5] Yet, despite these headwinds, the current environment presents an attractive entry point:

- **Improved credit quality:** Lower base rates enhance interest coverage.
- **Attractive yields:** Absolute and relative yields remain compelling.
- **Persistent financing gap:** Driven by record private equity dry powder.

These dynamics create a compelling case for credit to play a more prominent role within a portfolio, and within that, thoughtful, selective exposure to direct lending as a strategic allocation—particularly in segments and strategies that emphasize structural integrity, conservative leverage, and disciplined underwriting.

For more information on direct lending, please contact your Fidelity representative.

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Endnotes
1. Source: Fidelity Investments, "A study of allocations to alternative investments by institutions and financial advisors." Proprietary research from Fidelity explores emerging trends by segment, and strategies where investors may be under- or over-allocated to alternatives. Relative to stated return expectations, institutions across the board, including advisors, demonstrated under-allocation to private credit. **2.** Source: FDIC as of 12/31/24. **3.** Source: National Center for the Middle Market and International Monetary Fund (IMF) as of 12/31/24. **4.** Source: S&P Global Ratings, "Private Credit and Middle-Market CLO Quarterly: A Tale of Two Markets," Q4 2025. 5. Source: PitchBook Data Inc., Global Private Debt Report, as of 9/22/25.

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Index definitions
The Cliffwater Direct Lending Index is an asset-weighted index of more than 11,000 directly originated middle market loans. **• The ICE BofA U.S. High Yield Index** tracks the performance of U.S. dollar-denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market. **• The Bloomberg U.S. Aggregate Bond Index** is an unmanaged market value-weighted index for U.S. dollar denominated investment-grade fixed-rate debt issues, including government, corporate, asset-backed, and mortgage-backed securities with maturities of at least one year. **• The Morningstar LSTA US Leveraged Loan Index** is a market-value weighted index designed to measure the performance of the US leveraged loan market.

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