# Opportunistic Credit Investing

**Understanding the opportunity**

**June 2024**

*From our U.S. partners.*

Opportunistic credit, like other alternative investments, offers the chance to pursue potentially higher long-term returns and greater diversification than may be available through traditional investment products.

## What is opportunistic credit?

Opportunistic credit investing seeks to take advantage of market inefficiencies by purchasing securities at discounted prices. These securities are typically an obligation, such as a bond or loan, but may also be equity in a recapitalized company.

Security prices of this subset are driven lower (sometimes significantly so) by investors reassessing the risks of specific issuers, sectors, or the overall market. The transition in ownership from investors who do not have the resources or inclination to assess increasingly complex situations may present opportunities for those who do.

One or more of the following definitions typically applies to a given security in this set:

- Stressed: debt securities associated with low public credit ratings and relatively high yield/credit spread (low security prices).
- Distressed: the subset of stressed debt securities formally defined as trading at a credit spread above 10% (1000 basis points).
- Defaulted: a security no longer current on payments due, typically triggering a formal workout procedure.
- Restructured: a security that is part of a restructured company's resulting capital structure.

Typically, stressed/distressed obligations will either recover toward stated value (i.e. par) or be subject to some form of settlement (either negotiated or court ordered). Restructured equity securities may be received in exchange for debt and/or issued as part of the process of recapitalizing a company. These equity securities may benefit from the tailwind of a less leveraged balance sheet following a company restructuring.

This process of investing involves assessing the future value of the company, the return potential of the various components of the company's capital structure, and the ability to influence the outcome through in or out of court settlement. Identifying investments both at the issuer level as well as within the issuer's capital structure requires deep knowledge of companies and intimate understanding of the workout process. These skills, in addition to the size of assets represented, are important factors in the ultimate influence an opportunistic credit manager has on the outcome of the process.

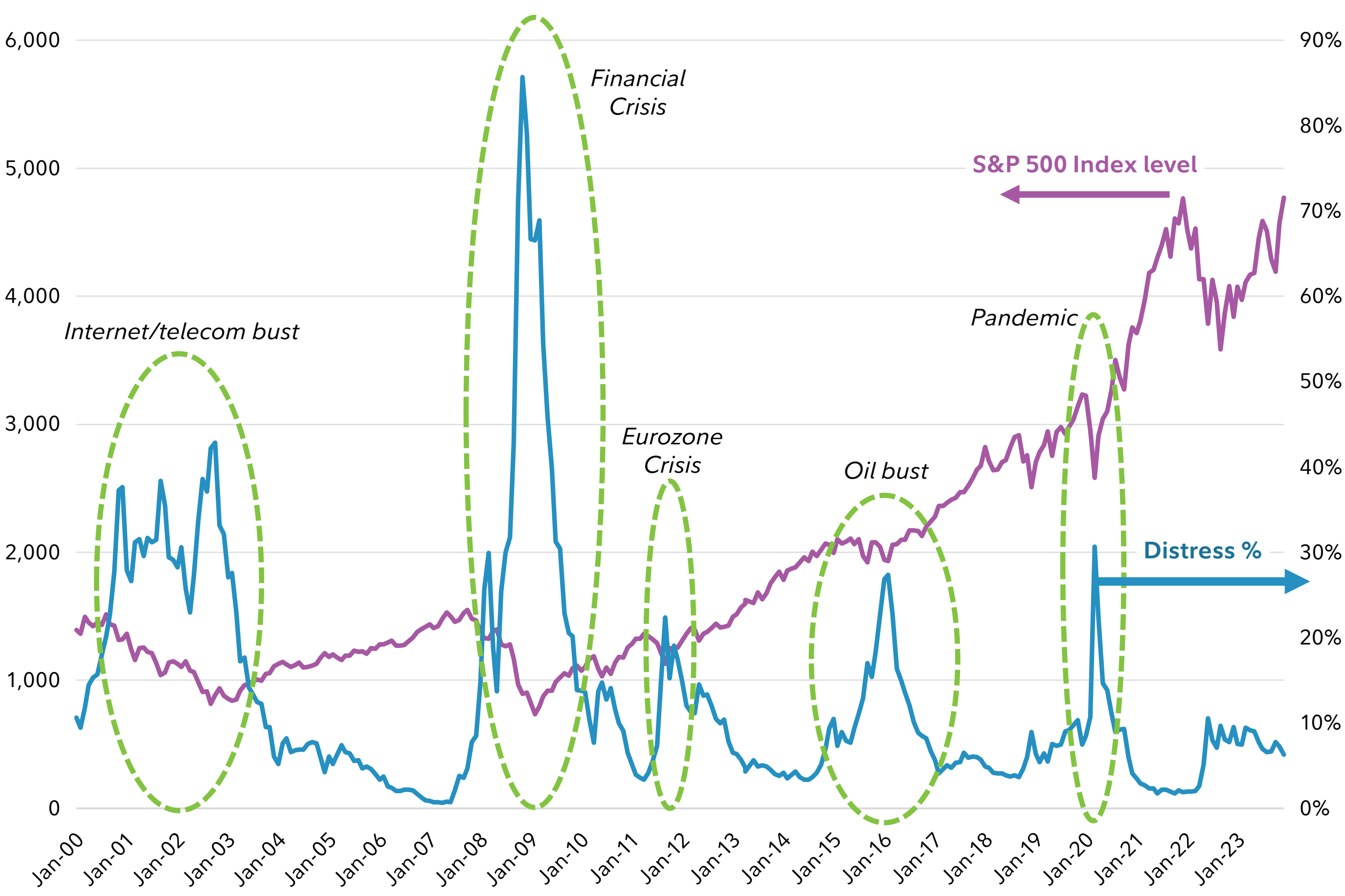
## Broad Credit Distress Has Displayed a Cyclical Pattern

The chart below shows the long-term total return of the S&P 500 and the time series of the share of distress in the US high yield bond market. The share of the US high yield bond market qualifying as distressed (>1000 bps yield spread) is in blue on the right axis, with the level of the S&P 500 in purple on the left axis.

Note the directionally inverse relationship between equity returns and high yield distress; as stock performance declines, the share of distress in the market tends to rise and vice versa. Each of five specific events highlighted below have unique underlying causes, yet the directional relationship is consistent.

The higher leverage of constituent companies and generally lower liquidity in the over-the-counter high yield market can lead to sharp increases in the amount of debt that rises to the level of distress during cyclical events. These regularly occurring events can present opportunities to invest in the debt of companies at depressed prices.

**Distress Typically Rises During Challenging Macro Environments**

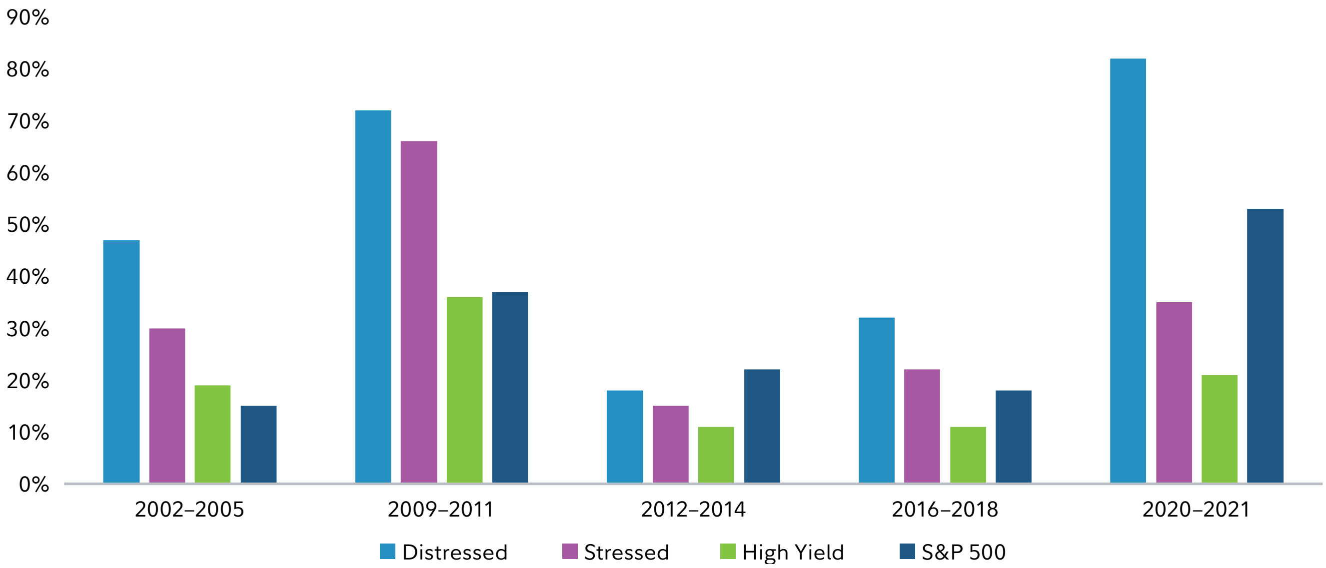



Source: BofA Securities and Bloomberg, December 2023. Distressed represented by ICE BofA Distressed HY Index.
Past performance is no guarantee of future results.

## Looking Back at Past Dislocations

*Significant returns from distressed credit regardless of the type of past dislocation*

**Historical Annualized Returns Following Spikes in High yield Market Distress**




| | 2002–2005 | 2009–2011 | 2012–2014 | 2016–2018 | 2020–2021 |
|---|---|---|---|---|---|
| **Distressed** | 47% | 72% | 18% | 32% | 82% |
| **Stressed** | 30% | 66% | 15% | 22% | 35% |
| **High Yield** | 19% | 36% | 11% | 11% | 21% |
| **S&P 500** | 15% | 37% | 22% | 18% | 53% |

Source: ICE BA and Fidelity Investments, Distressed represented by ICE BofA Distressed HY Index, Stressed represented by ICE BofA CCC and Lower Const. Index, High Yield represented by ICE BofA US HY Constrained Index, as of 09/15/2023. It is not possible to invest directly in an index. All market indices are unmanaged. Does not represent the performance of any investment. There can be no assurance that there will be a dislocation in the future. Past performance is no guarantee of future results.

The chart above shows the annualized returns of several different components of the high yield bond market in the periods directly following the decline in equities/spike in distressed outlined on the previous page. Included are the returns of the distressed and stressed component of the high yield bond market (defined in footnote and on Page 1) as well as the broader high yield market and the S&P 500 equity index for comparison.

Note the outperformance of the distressed segment over both stressed and broad high yield across all time periods and over the S&P 500 in 4 of 5 periods. This outperformance is made possible by the severity of the dislocations that can occur in the high yield market.

Importantly, neither the stressed nor distressed return streams include any return recovery from defaulted securities, which are removed from the high-income market indices following default. Selectively investing in defaulted securities, backed by the proper analysis and influence in the restructuring process, could further boost the return profile of a portfolio focused on stressed, distressed, and restructured opportunities.

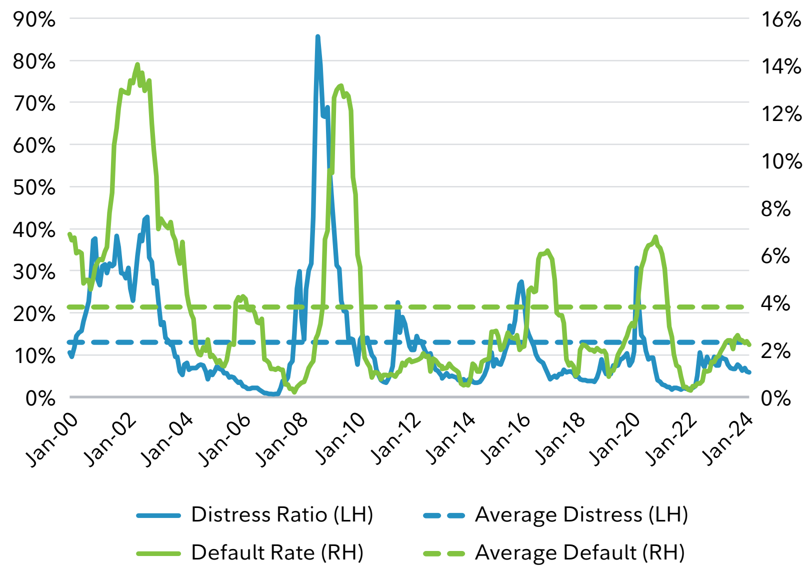
## Distress/default is ever present in high yield bonds

While macro-related dislocations can present a broad opportunity set, in reality, distress and default are persistent in the high yield market.

The chart to the right shows the time series of both the US high yield distress ratio (same as the chart above) and that of the US high yield default rate. Each is expressed as a percentage of the overall high yield market.

Over the last 20+ years, distress has averaged 13% and defaults nearly 4%. These monthly observations have also always been non-zero. While the magnitude of each series varies over time, distress and default are commonplace in the high yield market.

**US High Yield Bond Market: Distress and Default**




Source: ICE Data Services, 3/31/24. Distressed is a point in time measure while defaults are the aggregate of occurrences over the previous 12 months.

Additionally, the impact of dislocations on market sectors varies across cycles. The table below shows the high yield bond market sectors with the largest share of defaults in the five market events outlined earlier. Note the changes not only in rankings but also in the sectors themselves from one period to the next. For this reason, knowledge across all sectors can be a significant competitive advantage in opportunistic credit investing.

### Sectors with the Highest Share of Defaults Following Market Dislocations

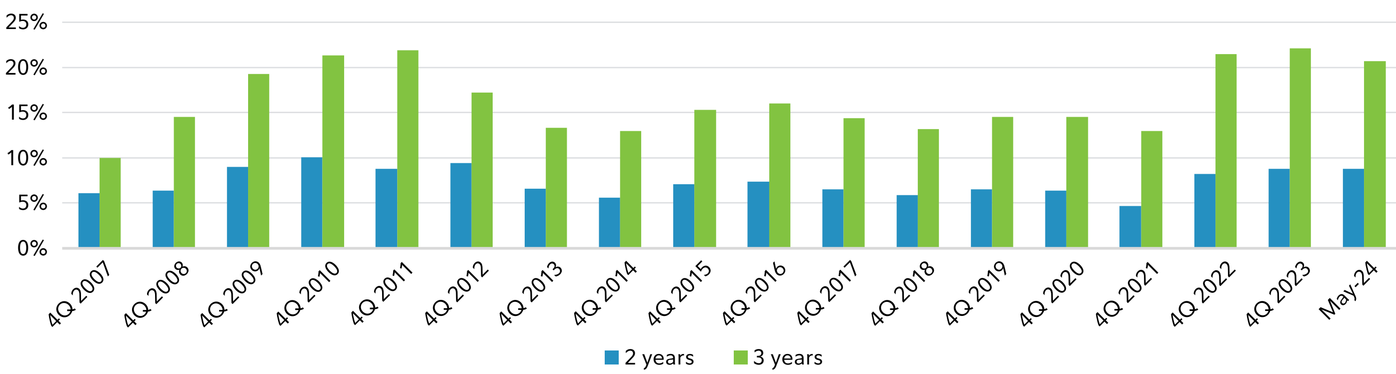
| 2001 | 2009 | 2011 | 2016 | 2020 |
|---|---|---|---|---|
| Financial | Media | Transport | Energy | Telecom |
| Telecom | Auto | Utility | Metals | Energy |
| Auto | Financial | Paper | Paper | Retail |
| Metals | Cable | Food | Utility | Cable |
| Consumer | Paper | Energy | Services | Media |

Source: ICE Data Services, 3/31/24. Rankings in descending order.

## Looking Ahead

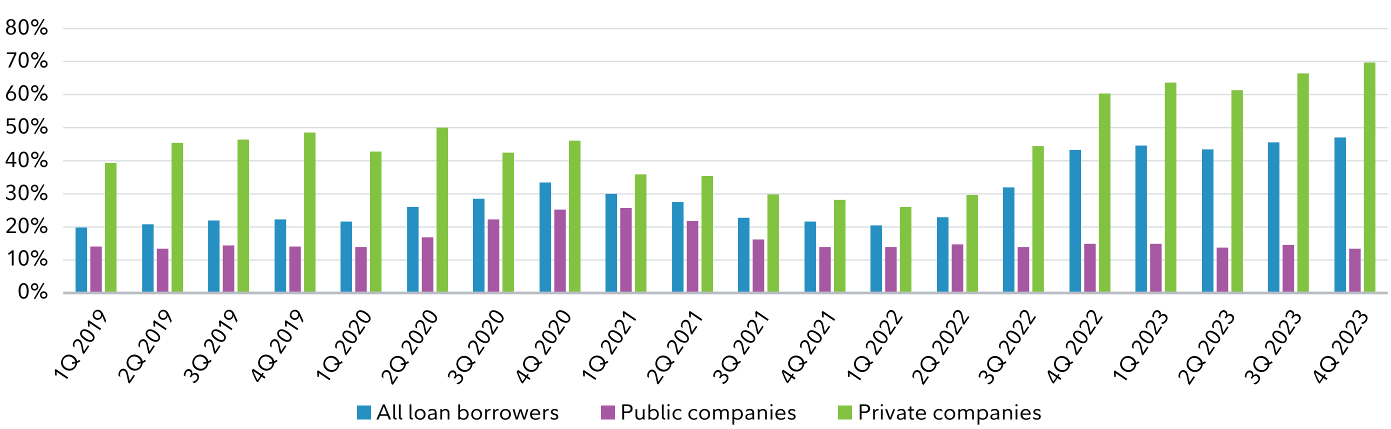
We see two main factors potentially driving broader market challenges over the course of this year and into next: 1) more than 20% of the aggregate of outstanding leveraged loans and high yield bonds are coming due over the next several years. This debt was issued at much lower rates during the pandemic, and companies will need to refinance at materially higher rates. And 2) the rise in interest rates is already starting to pressure company finances. Not surprisingly, higher interest rates are becoming a greater challenge for companies with variable rate debt. The floating rate structure of leveraged loans has left companies directly exposed to the rise in interest rates, and earnings have not been keeping pace. This is particularly true of private leveraged loan issuers, which comprise 75% of the leveraged loan market. Within this cohort, the number of loan issuers with interest rate coverage below two times EBITDA has doubled over the last year.

**2 and 3-year forward leveraged debt maturities as % of Outstanding[1]**




Source: JP Morgan, *Maturity Schedule High Yield Bonds and Leveraged Loans, May 2024*
[1] Includes HY bonds and leveraged loans.

**Interest Rate Coverage[2] less than 2x: % of Leverage Loan Issuers**

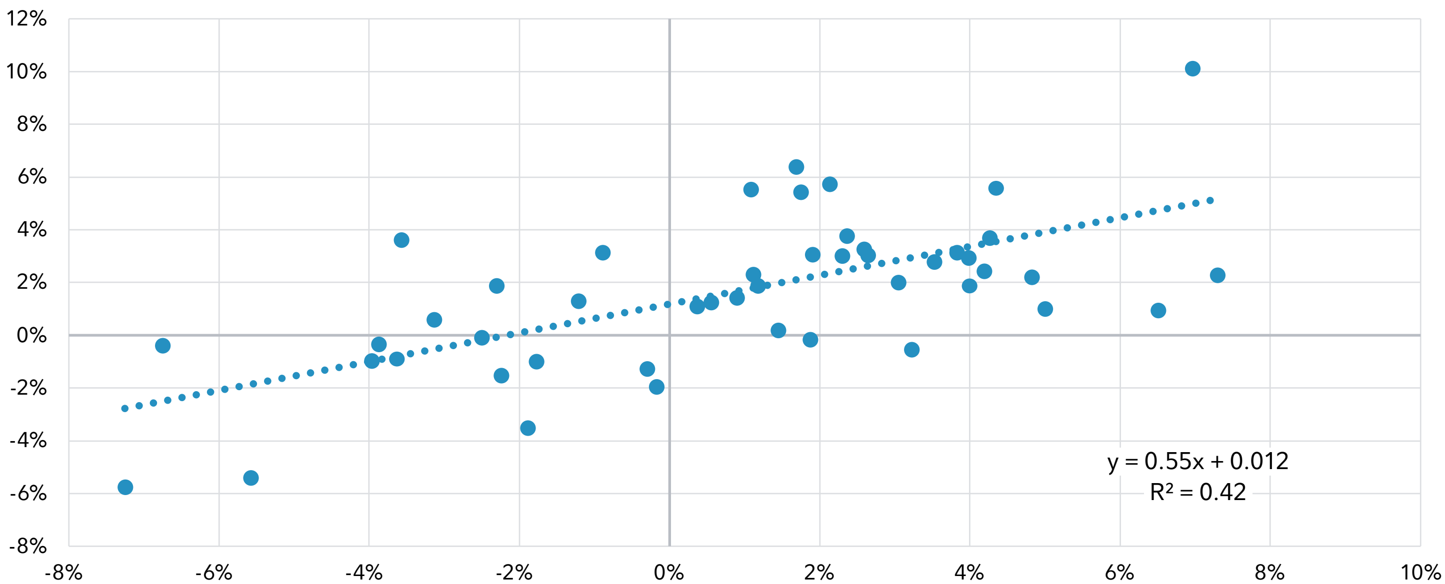



Source: JP Morgan, US High Yield and Leveraged Loan Strategy, May 14, 2024; data as of Q4 2023
[2] Coverage = EBITDA/Interest Expense

## Opportunistic Credit Investing & Diversification

The goal of opportunistic credit investing is to take advantage of the idiosyncrasies of the leveraged credit market noted above. When carried out effectively, such a strategy may help to diversify a traditional portfolio.

**Monthly Total Return: y axis = FCOF I, x axis = 60/40 balanced portfolio**




The scatterplot above displays the monthly return history of Fidelity Credit Opportunities I ("the Fund") relative to a typical 60/40 portfolio.[3] The equation of the best fit line indicates a weak relationship between the two return streams (R^2 = 0.42). This is a function of both the higher average monthly return and lower return volatility of the fund relative to the typical portfolio. This differentiated relationship is also apparent in up/down market capture. The fund captured 98% of the traditional portfolio's total return during positive return months ("up" markets) and only 30% during negative return months ("down" markets). The Fund outperformed the traditional portfolio in more than 80% of monthly down-market observations.[4]

[3] 47 months time series from May 2020 inception of Fidelity Credit Opportunities Fund I through March 2024. The 60/40 portfolio is a blend of 60% S&P 500 and 40% Bloomberg Aggregate.

[4] Of the 47 monthly observations, 17 exhibited negative total return for the traditional portfolio; FCOF I outperformed the traditional portfolio in 14 of the 17 months.

Source: Bloomberg and Fidelity Investments, March 2024

**Past performance is no guarantee of future returns of Fund I or of future vintages.** Fund I performance shown is for the period 5/5/20 –3/31/24 and is unaudited. Fund I is closed to new investors. Returns of less than one year are not annualized. Shareholder performance will vary based on (among other factors) the fee applicable to their investmentNet performance is aggregated for all fee-paying investors and deducts management fees and operating expenses, or any other Fund-level expenses. Net performance is based on contributions, distributions and ending unrealized value. There is no primary benchmark for Fund I. Indices may not be representative of the types of investments made by Fund I and there can be no assurance any such historical trends will continue in the future.

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**RISK FACTORS**

Investors should review the offering documents, including the description of risk factors contained in the Fund's Confidential Private Placement Memorandum, including the Canadian wrapper (the "Memorandum"), prior to making a decision to invest in the securities described herein. The Memorandum sets forth more detailed information regarding the strategy, expenses, investment risks and conflicts of interest. An investment in the Fund involves a high degree of risk and is suitable only for those investors willing to risk losing some or all of their principal investment and who have the experience and ability to evaluate the risks and merits of an investment in the Fund. The Memorandum will include more complete descriptions of the risks described below as well as additional risks relating to, among other things, debt investments, market, credit and interest rate risk, conflicts of interest and regulatory and tax matters. Any decision to invest in the securities described herein should only be made after reviewing such Memorandum, conducting such investigations as the investor deems necessary and consulting the investor's own legal, accounting and tax advisors in order to make an independent determination of the suitability and consequences of an investment in the Fund. The Fund's performance can be volatile. The Investment Manager has total trading authority over the Fund and the use of a single adviser applying generally similar trading programs could mean lack of diversification and, consequentially, higher risk. The Fund's fees and expenses may offset the Fund's trading profits.

**Accredited Investor and Qualified Purchaser Status.** Each limited partner in the Fund must represent in writing, among other things, that such limited partner is an "accredited investor" as that term is defined in Regulation D promulgated under the Securities Act of 1933, as amended (the "Securities Act"), and a "qualified purchaser" as that term is defined in Section 2(A)(51) of the 1940 Act or a "knowledgeable employee" as that term is defined in Rule 3c-5(A)(4)(I) of Investment Company Act of 1940, as amended (the "1940 Act"). In Canada, a limited partner must qualify as an "accredited investor" and "permitted client", as those terms are defined in National Instruments 45-106 and 31-103, respectively.

**No Operating History; Loss of Capital**. The Fund has no operating history upon which prospective limited partners can evaluate performance. No guarantee or representation is made that the Fund will achieve its investment objective or that limited partners will not lose all or substantially all of their investment in the Fund. The past performance of the Investment Manager or its affiliates is no guarantee of the future performance of the Fund. There is no assurance that the Fund will be profitable. The success of the Fund will in a large part depend on its ability to identify and make profitable investments. Identifying and making profitable investments is difficult and involves a high degree of risk, competition and uncertainty, and the availability of such investments is subject to general market conditions. There is no assurance that the Fund will be able to successfully implement its investment strategy or attain profitability. The Fund's profitability is dependent upon many factors beyond its control.

**Fund Investments Generally; Risk of Partial or Total Loss of Capital.** A fundamental premise of investing in deep value, stressed, distressed, restructured, or otherwise undervalued investments is the acceptance of illiquidity and a higher degree of risk than is inherent in traditional public stock or bond investments, in expectation of higher returns. An investment in the Fund therefore involves a substantial degree of risk, and the purchase of Interests should be considered only by investors able to bear the risk of loss of all or a substantial portion of their investment. The success of the Fund depends on the identification by, and the availability of suitable investment opportunities to, the Investment Manager. Sourcing suitable investment opportunities will be subject to market conditions and other factors outside the control of the General Partner and the Investment Manager.

**Investments in Distressed Securities.** The Fund's investments will involve a high degree of risk, including risks associated with investing in "below investment grade" securities and obligations of domestic and non-U.S. issuers in weak financial condition, experiencing poor operating results, having substantial capital needs or negative net worth, facing special competitive or product obsolescence or other problems, including companies involved in bankruptcy or other reorganization and liquidation proceedings. Some of these securities may not be publicly traded, and it therefore may be difficult to obtain information as to the true condition of such issuers or to buy or sell these securities. Additionally, in certain periods, there may be little or no liquidity in markets for these securities. The public market prices of distressed securities may be subject to abrupt and erratic market movements and above-average price volatility, and the spread between the bid and ask prices of such securities may be greater than normally expected.

**Availability of Suitable Investments.** There can be no assurance that the Investment Manager will be able to locate and complete suitable investments that satisfy the Fund's objectives and that the Investment Manager believes will provide performance commensurate with the Fund's targets. If the Investment Manager does not locate suitable and compelling investment opportunities in which to deploy all of the Fund's capital, the Fund may not invest fully its available capital which may result in an adverse effect on performance results. "Fidelity Investments" and/or "Fidelity" refers collectively to FMR LLC, a U.S. company, and its subsidiaries, including but not limited to Fidelity Management & Research Company (FMR Co.).

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