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Investing in Structured Credit

A Primer

2024

- *Structured credit comprises a large component of the U.S. fixed income bond market; however, it is generally underrepresented in many traditional fixed-income portfolios, in our opinion.*
- *Progress in structured credit markets has reshaped U.S. fixed income markets by taking relatively illiquid assets and creating tradeable securities. This may have benefits for investors, lenders and underlying borrowers.*
- *We believe that structured credit investments offer many portfolio benefits:*
 - ⇒ *Diverse underlying credit exposures with fixed or floating coupons*
 - ⇒ *Securities with recourse to real assets can potentially mitigate inflation risk*
 - ⇒ *Structural features enable evolving credit profiles over time*
- *The following primer is meant as an introduction to the structured credit asset class.*
 - ⇒ *Market Overview*
 - ⇒ *Diversified assets types and credit profiles*
 - ⇒ *Basic understanding of the securitization process*
 - ⇒ *Risk Mitigation Strategies*
 - ⇒ *Structural Credit Enhancement*
 - ⇒ *Investment Characteristics*

Investing in Structured Credit

Introduction

Structured finance is a large component of the U.S. fixed income bond market and, yet, generally underweighted in many traditional fixed income bond portfolios, in our opinion. The breadth of investment alternatives is quite large owing to the diversity of underlying collateral types and investment structures within. This primer is meant as an introduction to the structured credit asset class and provides the following:

- Overview of the securitized credit market
- Description of the underlying asset types
- Basic understanding of the securitization process
- Overview of what we believe are attractive investment characteristics

At the core of structured finance is:

- Pooling of similar debt obligations/assets
- Structuring of the underlying cash flows
- Selling the resulting structured cash flows as investable securities

The process of structured credit has reshaped the U.S. fixed income markets by taking relatively illiquid assets and creating liquid tradeable securities. This may have benefits for investors, lenders/issuers, and the underlying borrowers.

- Investors may benefit from the diversification of investment alternatives relative to more traditional fixed-income exposures.
- Lenders and issuers benefit from the addition of a new source of financing. Securitization can potentially provide off-balance sheet treatment of assets, better asset/liability matching, and potentially lower financing costs.
- Borrowers may benefit as lower financing rates for lenders increases competition and ultimately translates into lower borrowing costs for consumers and businesses.

Structured Finance is a Large and Diverse Market

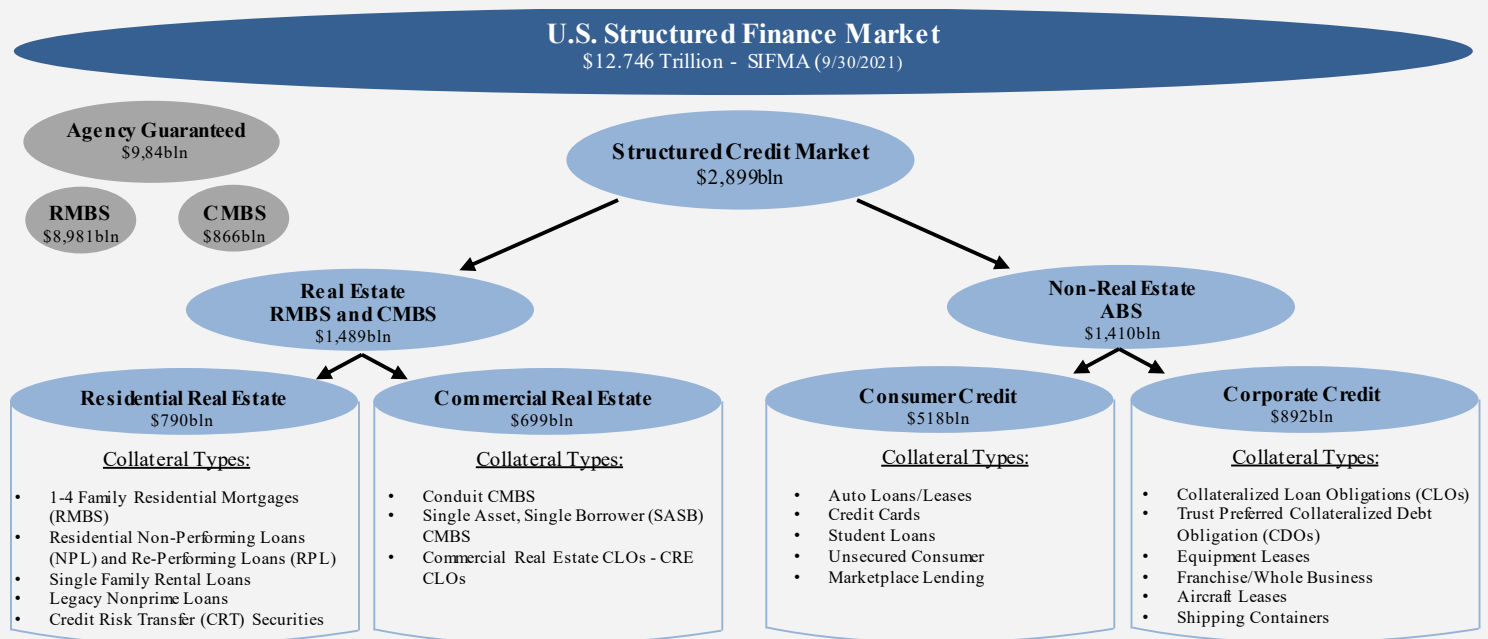
Exhibit 1:
Outstanding U.S. Bond Market Debt
\$ Billions

Total	51,183	%
Treasuries	21,873	43%
Structured Finance	12,746	25%
Corporate	10,010	20%
Municipals	4,036	8%
Money Market	1,071	2%
Federal Agency	1,447	3%

* Source: SIFMA (as of 09/30/2022)

Exhibit 2:

The U.S. Structured Finance Market is a Large and Diverse Subset of the Overall U.S. Bond Market



The origins of structured finance date back to the 1970s when government agencies began bundling pools of residential home mortgages and selling residential mortgage backed securities (or RMBS, as they are commonly known). Throughout the 1980s and 1990s, the structured finance market expanded to include many other income-producing debt obligations, such as commercial mortgages (CMBS), and a multitude of alternative types of consumer and business debt (ABS). Today, the size of the U.S. structured finance market is large, totaling \$12.7 trillion or roughly 25% of the total outstanding U.S. bond market (Exhibit 1).

Approximately 77% of the overall U.S. structured finance market is guaranteed by a U.S. government agency (both RMBS and CMBS) and therefore effectively bear limited credit risk. The remaining 23%, which is not guaranteed by a U.S. agency, is what is generally referred to as “structured credit” (Exhibit 2). While agency-backed MBS and CMBS can offer compelling investment opportunities, the focus of this article is on the subset of structured finance, which is non-agency guaranteed or structured credit. We believe excess returns may be available to investors who have a differentiated view of the underlying credit fundamentals. The interplay between these cash flows and the myriad of nuanced structural characteristics that exist within structured credit can provide further excess return opportunities, in our opinion.

The diversity of collateral types backing the U.S. structured

credit market is large and can be broken down into four primary exposures (Exhibit 2).

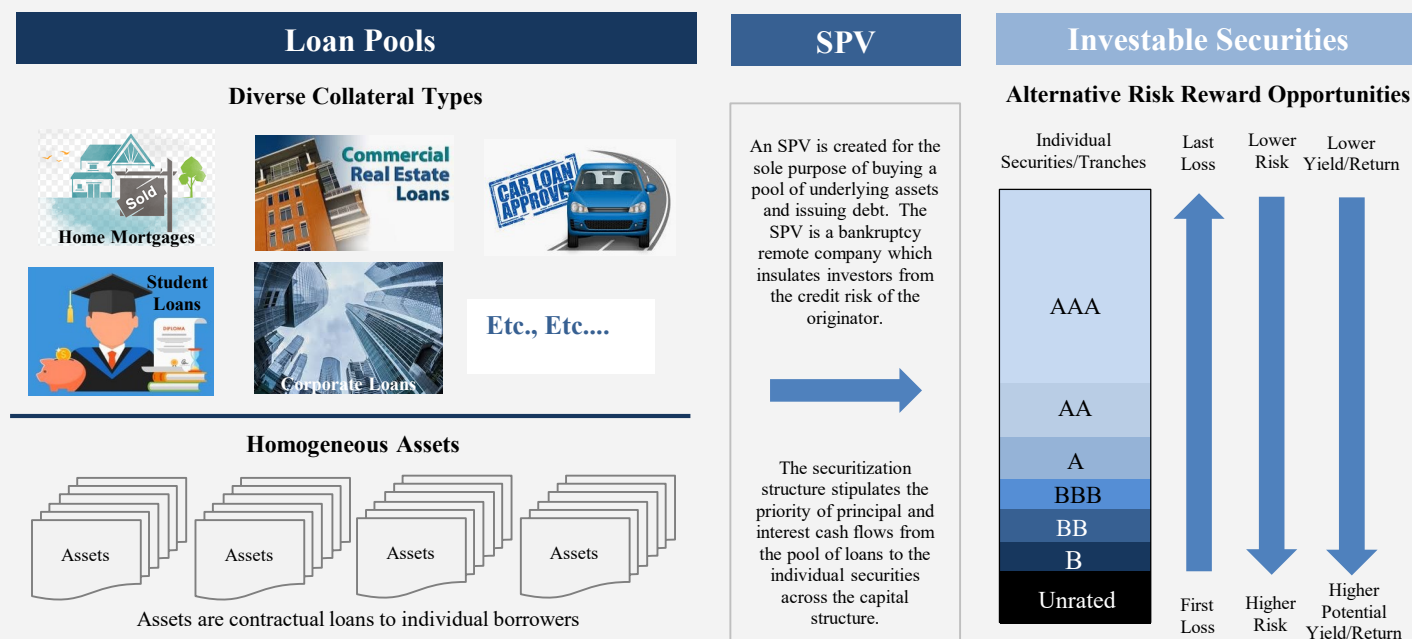
- Residential real estate (RMBS)
- Income producing commercial real estate (CMBS)
- Loans to consumers (consumer ABS)
- Loans to businesses (commercial ABS)

Within the consumer ABS market, primary collateral types include auto loans, student loans, credit cards and unsecured consumer loans - including those from rapidly growing fintech lenders in the point-of-sale (POS) and buy-now-pay-later (BNPL) sectors. In the business or corporate ABS sector, collateralized loan obligations (CLOs) account for the majority of issuance and outstanding; however, corporate ABS can be backed by a host of other business exposures, including equipment and aircraft leases, shipping containers, and many others.

The Securitization Process

- **Step 1** - securing a pool of homogeneous assets/loans, such as home mortgages, auto loans, or other financial contracts. The pool of loans may have been originated by a bank, a finance company, or other non-bank entity. Alternatively, the pool of loans may have been acquired from the original lender by a third-party entity for investment.
- **Step 2** - creation of a special purpose vehicle or SPV

Exhibit 3:
Creating Investable Securities From Homogeneous Loan Pools



(as it is commonly known). An SPV is a legal entity created for the sole purpose of acquiring a pool of underlying assets and issuing tradeable securities secured by those assets. The advantage of creating an SPV is that it is legally independent of and considered bankruptcy-remote, from, the originator/seller of the underlying assets. As a result, investors of the securitized assets issued by the SPV are not exposed to the potential bankruptcy risk of the originator/seller of the assets. This is an important feature because it removes the idiosyncratic credit exposure of the originator/seller of the assets.

- **Step 3** - “structure”, or create, individual securities/tranches to be sold to investors. The structure stipulates the priority of payment, principal, and interest cash flows received from the pool of loans, to the individual securities issued by the SPV. The diagram in Exhibit 3 highlights a sample securitization structure and hypothetical credit ratings of alternative tranches. The most senior tranche generally has first claim to the interest payments generated from the underlying loans. After interest is paid to the first tranche, remaining interest is then paid to the second, third, etc. The reverse is true for bearing any losses. The bottom-most tranche will be the first to realize any losses recognized on the underlying loans.

Each security or tranche issued has a different risk-and-return profile, each appealing to alternative types of investors. Senior tranches have the lowest potential risk and thus offer lower potential yields/returns, while the more junior tranches have higher risk and thus offer a higher potential return. Each securitization offers different types of investor

protections against potential losses from the underlying loans.

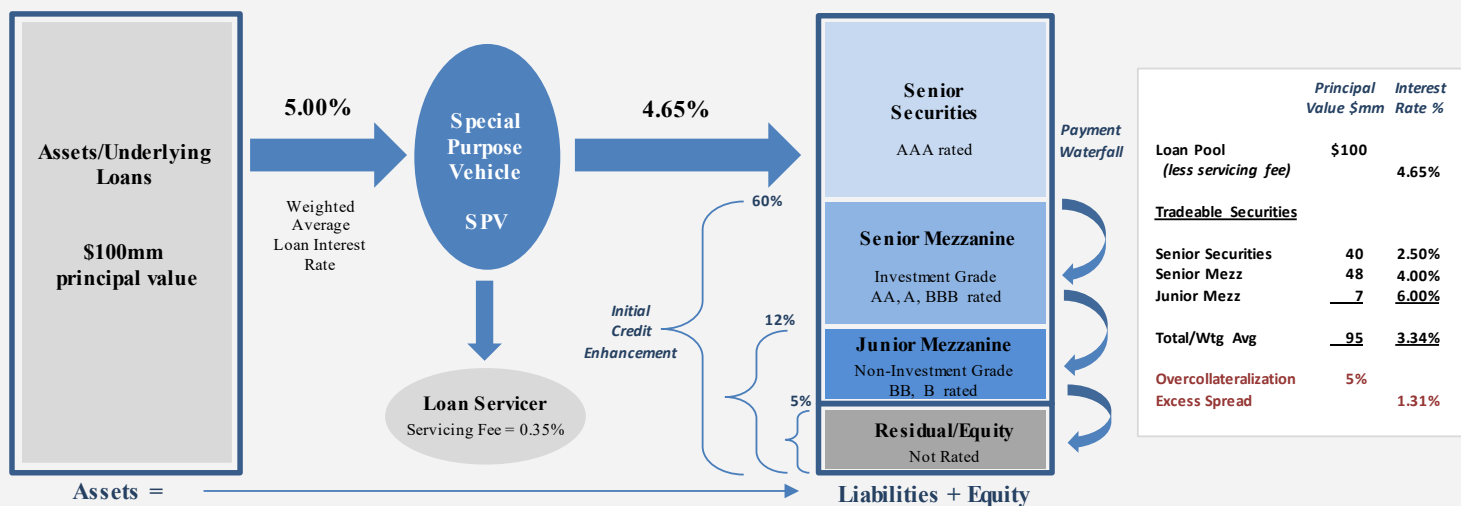
Risk Mitigation Strategies

One type of risk mitigation/loss reduction is the “secured” or “collateralized” nature of many types of structured credit assets. The assets backing structured credit are contractual loans to underlying borrowers. However, in many cases these contractual loans contain terms which provide recourse to collateral backing the loans. For instance, residential mortgage loans are secured by the underlying home. In the event that a homeowner defaults on their mortgage, the underlying home can be repossessed and sold in an attempt to recover the principal amount of the loan. This is an important feature of many types of structured credit securities and helps to differentiate them from corporate bonds, for instance.

The degree of credit protection derived from the underlying assets can vary significantly across different collateral types and originators. One measure would be the loan-to-value ratio (LTV), which specifies the size of the loan relative to the market value of the underlying asset. All else equal, a lower LTV would generally imply a higher likelihood of being able to recover the principal owed on the loan from the sale of the asset.

However, not all structured credit securities are backed by loans secured by an underlying asset. There are many types of consumer and business loans which are not secured and rely on structural features within the securitization to provide credit enhancement and risk mitigating features.

Exhibit 4:
Sample Securitization



Structural Credit Enhancement

Aside from the collateralized nature of many structured credit assets, securitization structures offer a number of other forms of credit enhancement that can provide important investor protections. Credit enhancement is a method of risk-reduction to help mitigate credit risk from potential losses under stressed asset scenarios. There are many types of structural characteristics that can be utilized within a securitization to help mitigate investor risk, and it is not uncommon that many securitizations utilize several within a given securitization. The three most common types of structural credit enhancement are subordination, overcollateralization, and excess interest.

Subordination is the process of creating tranches or different classes of securities and prioritizing the order of principal and interest payments made to those individual securities, such that the lower-rated junior bonds provide credit support for the higher-rated senior bonds. As we described earlier, interest payments are first paid to the most senior bonds and then sequentially down the capital structure, or payment waterfall, as it is sometimes referred. Thus, any potential interest shortfall will be absorbed by the more junior bonds first. Alternatively, principal losses are allocated from the bottom up. Therefore, any principal losses realized from the underlying loans will result in a write-down of the principal on the most junior bond first. In our sample securitization diagram (Exhibit 4), the senior securities have 60% subordination or, in other words, the underlying loan pool would need to realize more than 60% principal losses before the senior securities would realize a loss.

Overcollateralization is another form of credit enhancement in some securitization structures. Overcollateralization refers to the par value of the underlying loans/assets being greater than the par value of the securities issued by the SPV. For instance, in our sample securitization, the \$100 million loan pool is supporting only \$95 million of issued securities. This overcollateralization provides a form of credit enhancement by having a larger amount of assets supporting the cash flows of fewer liabilities.

Excess spread can be another form of credit enhancement in some securitizations. The majority of securitizations have excess spread, which arises when the income being generated from a pool of assets is greater than the total interest paid to the structured liabilities including fees. In our sample securitization, the underlying assets have a weighted “For Retail Distribution”

average interest rate of 5.00% or 4.65% after paying a servicing fee, while the weighted average interest cost of the securitized liabilities is only 3.34%. This creates an excess spread of 1.31% from the underlying assets within our example securitization. The actual amount of excess spread will depend on a number of factors including other fees associated with the securitization. How this excess spread is utilized and/or distributed within a securitization depends on many factors, including the type of collateral, other forms of credit enhancement, and details specific to a given securitization. In many cases, the excess spread flows to the equity or residual owner of the securitization. However, if the performance of the pool of assets deteriorates, or specific performance triggers are breached, the excess spread can be diverted from the residual owner to paying down the principal balance on the most senior tranches, thus de-leveraging the structure.

While not exhaustive, these are some of the primary types of credit enhancements utilized within the securitization market to provide risk mitigation against potential principal loss. In addition, the nature of asset securitization - aggregating large pools of many individual assets - provides diversification and may limit idiosyncratic exposure to individual loans.

However, while the secured nature of many collateral types and structural protections built into securitization structures are meant to create investor protections against potential credit loss, the risk of default/loss cannot be eliminated. In certain market environments, collateral performance can deteriorate, increasing the risk of potential loss.

Potentially Attractive Investment Characteristics

We believe that structured credit assets can offer many attractive investment opportunities, owing to the diversity of underlying credit exposures and the many nuanced structural features that can influence asset performance. Diversification does not protect against investment losses. Understanding the unique structural characteristics of a given securitization is critical to both understanding and managing the embedded risks but also in identifying potential opportunities for outperformance.

- **Potentially Attractive Yield and Return Opportunities:** In part due to their complexity, we believe structured credit investors are often compensated via a higher relative risk premia/yield compared with traditional fixed income credit securities. We believe that, in addition to outright value, many idiosyncratic return catalysts can drive excess return opportunities, due to the

many structural nuances that vary across deals and time.

However, structural complexity can create barriers of entry and result in reduced market liquidity for some securities, particularly during times of market stress.

- **Portfolio Diversification:** In a portfolio context, we believe structured credit provides value owing to the broad diversification of underlying credit exposures. Residential and commercial real estate are both large market categories that offer subsectors with varying concentrations to specific property and borrower profiles. The multitude of sectors backed by consumer credit can provide broad diversification to traditional corporate credit.
- **Potentially Low Correlation with other Asset Types:** In part due to the diversity of underlying credit exposures, structured credit has historically displayed low correlation with other investment sectors (Exhibit 5). For instance, the Bloomberg ABS and CMBS indices have featured low correlation with treasuries, equities and even traditional corporate credit. Even CLOs backed by 1st lien senior corporate loans have shown relatively low correlation with traditional corporate bonds and equities. In a portfolio context, the addition of investment alternatives with low correlation can improve the overall risk/return profile of the portfolio while it does not eliminate risk.
- **Potential Inflation Hedge:** By very nature of many asset-backed securitizations, cash flows are derived from borrower payments on loans “secured” by real assets. If the underlying assets increase in value (like residential home values backing RMBS), asset coverage for the securitization increases and investors’ risk of loss declines. Increasing asset values both reduce the likelihood of borrower default and increase recovery values in the

event of default. As a result, many structured credit securities can provide an effective inflation hedge, which can be a driver of higher asset prices. Risk can increase if asset prices decline.

- **Amortizing Cash Flows:** Another unique characteristic of many structured credit securities, particularly consumer-backed sectors like RMBS and ABS is that many of underlying loans are fully amortizing, meaning that the underlying borrower payments are comprised of both an interest payment as well as partial repayment of principal. This is quite different from most fixed income debt, like corporate or sovereign debt, which typically have a fixed bullet maturity. As the underlying loans repay principal, the principal component is used to pay down principal on the outstanding securitized debt. This creates a deleveraging of the credit risk within the securitization over time and can be a source of investor liquidity even in times of market stress when risk premia have expanded.

Changes in interest rates may effect the value of structured credit securities prior to maturity date. Many of the underlying loans backing structured credit securities are fully prepayable, by the underlying borrowers. As interest rates decline, prepayments may increase causing a securities average life to shorten. Conversely, in a rising rate environment, prepayments may decline resulting in the securities average life to lengthen or extend. Changes in prepayments are a risk factor that must be evaluated when investing in structured credit securities.

While the many nuanced structural characteristics within structured credit is beyond the scope of this article, we believe the unique structural characteristics discussed above, along with diversified collateral types, differentiate structured credit from traditional credit sectors. We believe the

Exhibit 5:

Structured Credit Offers Low Correlation with Other Investment Sectors (20-year historical returns 9/30/2004 - 9/30/2024)

	Bloomberg ABS Index	Bloomberg CMBS Index	JPM CLO Index ¹	Bloomberg AGG Index	Bloomberg Inv Grade Index	Bloomberg High Yield Index	S&P/LSTA LevLoan Index	Bloomberg Treasury Index	S&P 500 Equity Index
Bloomberg ABS	1.00	0.45	0.43	0.51	0.61	0.58	0.59	0.28	0.24
Bloomberg CMBS Non-Agency		1.00	0.50	0.44	0.54	0.68	0.50	0.21	0.42
JPM CLO Index ¹			1.00	0.18	0.46	0.71	0.93	-0.09	0.51

Source: OWS, Bloomberg Indices, JPMorgan Indices, S&P Dow Jones Indices

¹ The JPMorgan CLO index history begins in January 2012 through Sept 2024

There may be material differences between the indexes referenced in Exhibit 5 and Structured Credit including, credit quality duration, investment type, etc.

See important disclaimers and definitions beginning on page 8. Investors cannot invest directly in an index.

“For Retail Distribution”

structured credit market encompasses a diverse set of cross-cycle investment opportunities that are accretive to all fixed income portfolios. The complexity of deal capital structures and the granularity of collateral risk attributes create barriers to entry for many investors that we believe result in market inefficiencies and alpha-generating opportunities. Idiosyncratic return drivers run the gamut, from time-varying structural nuances, to off-the-run collateral types, and a host of other unique sector/security-specific characteristics. Ultimately, we believe these idiosyncratic return catalysts are meaningful contributors not only to outright return performance, but also to diversifying and reducing the volatility of structured credit portfolios.

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Prior to investing, Investors should carefully consider the investment objectives, risks, charges and expenses of IWS Credit Income Fund. This and other important information about the Fund is contained in the prospectus, which can be obtained by calling (833) 834-4923 or visiting www.IWSCapital.com. The prospectus should be read carefully before investing. Investing in the Fund may be considered speculative and involves a high degree of risk, including the risk of possible substantial loss of your investment.

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Limited liquidity is provided to shareholders only through the IWS Credit Income Fund's quarterly repurchase offers for no less than 5% of the Fund's shares outstanding at net asset value. There is no guarantee that a shareholders will be able to sell all of the shares they desire to sell in a quarterly repurchase offer. The Fund is suitable only for investors who can bear the risks associated with the limited liquidity of the Fund and should be viewed as a long-term investment.

Diversification does not eliminate the risk of experiencing investment losses. Below investment grade instruments or "junk securities" are particularly susceptible to economic downturns compared to higher rated investments. In addition to the normal risks associated with investing, investing in international and emerging markets involves risk of capital loss from unfavorable fluctuations in currency values, differences in generally accepted accounting principles or from social, economic or political instability in other nations.

Market risk may affect a single issuer, sector of the economy, industry or the market as a whole. Mortgage-backed and asset-backed securities are affected by interest rates, financial health of issuers/originators, creditworthiness of entities providing credit enhancements and the value of underlying assets. Fixed-income securities present issuer default risk. Prepayment and extension risk exists because a loan, bond or other investment may be called, prepaid or redeemed before maturity and similar yielding investments may not be available for purchase. Investing in structured finance securities may be affected by a variety of factors, including priority in the capital structure of the issuer thereof, the availability of any credit enhancement, and the level and timing of payments and recoveries on and the characteristics of the underlying receivables, loans or other assets that are being securitized, among others. Market or other (e.g., interest rate) environments may adversely affect negatively, impacting their price.

Investors should carefully consider the risks generally associated with Structured Credit, including the following:

Increased complexity; reduced liquidity and marketability. Structured credit investments may have limited or no liquidity. Liquidity risk exists when particular investments may be difficult to purchase or sell, potentially preventing sale of such illiquid investments at an advantageous time or price. Structured credit investments are complex securities that may trade infrequently and, therefore, may be difficult to price and to liquidate.

Credit risks and default risks. This relates to the risk of loss due to adverse developments in the underlying collateral. Credit risk is the risk that an issuer of, or obligor under, a credit investment, may be unable or unwilling to make dividend, interest and principal payments when due and the related risk that the value of a credit investment may decline because of concerns about the issuer's or obligor's ability or willingness to make such payments. This risk may be especially heightened for certain credit investments, such as below-investment-grade securities, and may include the possibility of dividend or interest deferral, default or bankruptcy. The market values for below investment grade securities or credit investments of comparable credit quality tend to be very volatile, and these instruments are generally less liquid than investment grade securities.

Inadequate collateral. There can be no assurance as to the amount of any funds that may be realized from recovering and liquidating any collateral or the timing of such recovery and liquidation and hence there is no assurance that funds will be available to offset any payment defaults. For example, with respect to real estate-related loans, the real property security for the loan may decline in value, which could result in the loan amount being greater than the property value and therefore increase the likelihood of borrower default. If a borrower or obligor enters bankruptcy, an automatic stay of all proceedings against such borrower's property will be granted. This stay will prevent any recovery and liquidation of the collateral securing such loan, unless relief from the stay can be obtained from the bankruptcy court. There is no guarantee that any such relief will be obtained.

Interest rate risk. Structured credit investments may decline in value because of changes in market interest rates. Interest rate risk is the risk that fixed rate instruments will decline in value because of changes in market interest rates. When market interest rates rise, the market value of such instruments generally will fall. Longer-term fixed rate instruments are generally more sensitive to interest rate changes. Moreover, an increase in interest rates could negatively affect financial markets generally, increase market volatility and reduce the value and liquidity of credit investments in which we may invest. Because the values of lower-rated and comparable unrated fixed rate instruments are more affected both by credit risk and interest rate risk, the price movements of such lower grade instruments in response to changes in interest rates typically have not been highly correlated to the fluctuations of the prices of investment grade quality instruments in response to changes in market interest rates. Default rates of credit investments may increase due to factors such as prevailing interest rates, the rate of unemployment, the level of consumer confidence, real estate values, the value of the U.S. dollar, energy prices, changes in consumer spending, the number of bankruptcies, disruptions in the credit markets and other factors.

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DEFINITIONS

AAA: AAA is the highest possible rating that may be assigned to a bond by any of the major credit rating agencies.

ABS: Asset-Backed Securities are instruments secured by financial, physical, and/or intangible assets (e.g., receivables or pools of receivables), and investments in any assets/instruments underlying the foregoing structured/secured obligations.

Agency Guaranteed: The majority of MBS and many CMBS are issued or guaranteed by an agency of the U.S. government such as Ginne Mae, or by GSEs, including Fannie Mae and Freddie Mac.

Basis Points (bps): A basis point is a common unit of measurement for interest rates and credit spreads and is equal to one hundredth of one percent.

Bloomberg ABS Index: Bloomberg AGG eligible ABS total return Index.

Bloomberg U.S. Aggregate Bond Index (BB US AGG Index): The index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency). Investors cannot invest directly in an index.

Bloomberg CMBS Index: Bloomberg AGG eligible Non-Agency CMBS total return Index.

Bloomberg U.S. Investment-Grade Credit Index (BB US IG Index): The index measures the investment-grade, fixed-rate, taxable corporate bond market.

Bloomberg U.S. High-Yield Credit Index (BB US HY Index): The index measures the USD-denominated, high-yield, fixed-rate corporate bond market.

Bloomberg Treasury Index: The Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.

CDO: A structured finance security that is backed by a pool of loans and/or other assets.

CLO: Collateralized Loan Obligations are instruments that represent debt and equity tranches of collateralized loan obligations and collateralized debt obligations.

CMBS: Commercial Mortgage-Backed Securities are fixed income instruments that are secured by mortgage loans on commercial real property.

CMBX: CMBX indices are synthetic tradable indices referencing a basket of 25 commercial mortgage-backed securities (CMBS).

Conduit CMBS: A securitization backed by a pool of commercial real estate loans.

Credit Quality Ratings: A bond rating is a measure of the credit quality of a bond. Bond ratings are determined by private independent bond rating agencies, such as Standard & Poor's, Moody's, Fitch, among others.

Correlation: Correlation is a statistical measure that expresses the extent to which two variables are linearly related (meaning they change together at a constant rate). A correlation coefficient's values range between -1.0 and 1.0. A perfect positive correlation means that the correlation coefficient is exactly 1. This implies that as one variable moves, either up or down, the other variable moves in lockstep, in the same direction. A negative correlation means that two assets move in opposite directions, while a zero correlation implies no linear relationship at all.

CRE CLO: CRE CLOs are a type of CLO collateralized by a pool of commercial real estate loans.

CRT: Credit Risk Transfer securities structure mortgage credit risk into securities, transferring credit risk exposure to private investors.

First Loss/Last Loss: First lost position refers to a security/tranche within a securitization which will be first to bear any principal losses if the credit quality of the securitized exposures deteriorates. Alternatively, last loss position refers to a security/tranche within a securitization which will be last to bear any principal loss from a deterioration in the credit quality of the underlying securitized exposures.

JPM CLO Index: The JPMorgan CLO index measures the total return of the U.S. dollar denominated CLO market.

Loan to Value (LTV): refers to the ratio of the loan amount relative to the value of the underlying property.

Mezzanine Tranche: A mezzanine tranche within a securitization lies in the middle of the capital structure, below the senior tranche and above the junior tranche (typically an unrated equity tranche).

NPL: Non Performing Loans are loans in which the borrowers are in default and hasn't made scheduled payments of principal or interest for some period of time.

RMBS: Residential Mortgage-Backed Securities are securities that may be secured by interests in a single residential mortgage loan or a pool of mortgage loans secured by residential property.

Risk Premia: Risk premia is the investment return an asset is expected to yield in excess of the risk-free rate of return.

S&P/LSTA LevLoan Indices: A market value-weighted index designed to measure the performance of the U.S. leveraged loan market.

S&P 500 w/dividends: The S&P 500 index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

Tranche: Tranches refer to the segmentation of a pool of securities/loans into individual securities with varying degrees of risks & returns.