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WEALTH SOLUTIONS

Office Quality, U.K. Water Woes, and Why High Yield May Withstand a Recession

CONTENTS

Overview

Welcome to the inaugural issue of ***Alts Quarterly*** from Brookfield Oaktree Wealth Solutions, a publication sharing our perspectives on alternative investing trends and the challenges facing investors.

In this issue, we offer insights on:

- **Real estate:** A well-established investing sector that is having to rapidly adapt to meet the challenges of a changed world and evolving corporate and consumer preferences.
- **Infrastructure:** In recent years, infrastructure has become more accessible for wealth investors. However, it can be more complex than many other asset classes and requires deep expertise to manage successfully.
- **Alternative credit:** When the U.S. economy is widely forecast to be headed for a recession, as is the case now, many investors typically sell their high yield bond allocations fearful that a spike in defaults could make the asset class too risky. Portfolios managers at Oaktree Capital Management, however, believe now is an attractive environment for high yield investments.

Our stories this quarter explain how a roof-top terrace can impact rent, explore what the U.K.'s water problems can teach investors about infrastructure and why Oaktree, a pioneer in credit investing, believes high yield investments remain attractive in today's environment.

Our ***Alts Market Dashboard*** shares some data, market and investing insights that we find interesting from across the alternative investing universe. Notable numbers include:

- The massive $466 billion of dry powder that stands ready to commit to deals in the alternative credit space, a gain of 12.7% year-to-date through August 14.[1]
- The 5% gain in Net Operating Growth (NOI) in the real estate sector.[2]

Finally, our publication closes with some definitions that investors who might be relatively new to alternative investing may find useful, including how to interpret NOI. Investors who want to explore any of the investment themes in this publication in more detail should consult with their financial advisor. We hope you enjoy these stories and welcome any feedback.

Real Estate: Adapting for a Changed World

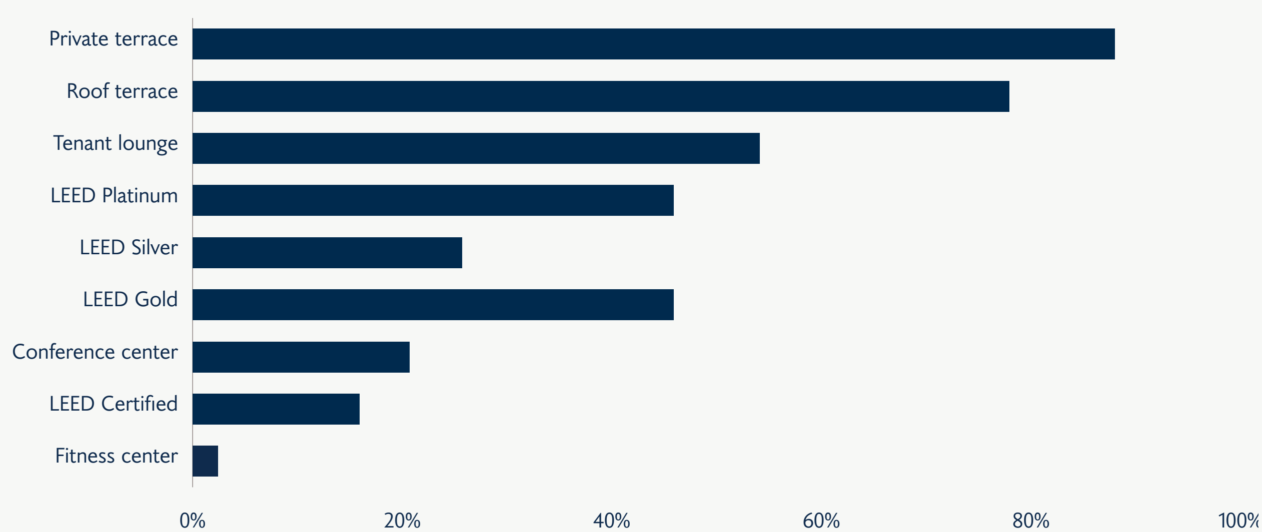
Just like today's younger generation looks at land-line phones with some confusion, future generations may view office and retail with a similarly perplexed gaze, wondering what purpose these structures served. We believe whether properties thrive or deteriorate will be heavily influenced by how buildings adapt for a changed world. To avoid obsolescence, owners must ensure assets such as offices, logistics hubs and apartments serve end users. Real estate has always evolved but change is accelerating at the fastest pace we have seen in decades as work and home habits change.

These shifting preferences will determine which buildings are renovated or repositioned. New research from broker Avison Young suggests that a focus on quality buildings that have quality amenities will be crucial to growing cash flows and successful real estate investing overall.

For example, the office sector has garnered countless doomsday headlines as some professionals resist the erstwhile Monday-to-Friday, in-person 9-to-5 routine. Now, the *U.S. office market report* from Avison Young for the second quarter of 2023 finds that companies will pay *significantly* higher rents for offices with amenities that can help attract and retain top talent. Second quarter U.S. office leasing data[3] confirms these premiums are significant: **Figure 1** shows offices with private or roof terraces can fetch rent premiums of 88% and 78%, respectively; and high rated Leadership in Energy and Environmental Design-certified (LEED) assets or 'green' buildings, command premiums of 25-45%.

Figure 1: Terraces and LEED-Certified Buildings Command Higher Rents in U.S. Office Market

Asking Rent Premium for Certain Amenities



Source: *U.S. office market report*, *Q2 2023*, Avison Young, data as of June 30, 2023

We believe that great assets will endure and adjust for the new reality. Over centuries, quality real estate has proven to be an exceptional long-term investment, regardless of its end use. We don't think this cycle will be any different, but we may end up with many more buildings with terraces.

Infrastructure: Lessons from the U.K.'s Water Woes

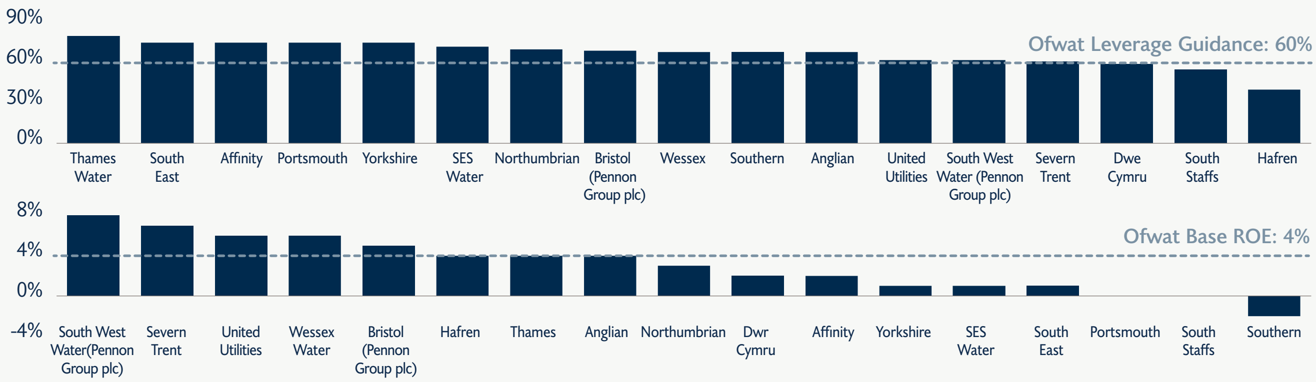
As interest rates have risen rapidly, firms with floating rate debt have seen financing costs surge. That dynamic has thrown the U.K. water sector into something of a crisis, raising the possibility that some of the nation's largest water utilities may need a bailout after their net financing costs jumped.

Britain's regional water utilities had £60.6 billion of debt at the end of March 2022 (the latest data available), with more than half of that indexed to inflation, according to U.K. water regulator Ofwat. The peculiarly British affinity with floating-rate debt coupled with high levels of leverage set up the sector for problems.

Figure 2 shows a baker's dozen of U.K water utilities have leverage of >60%, the regulator's guidance and that only a handful had a return on equity (ROE) above the recommended 4%.[4] The situation is so dire that Ofwat said it has "elevated" concerns about the finances of eight of 17 water utilities it regulates. Together, they provide drinking water and wastewater services to 62% of the population.

Figure 2: Leverage in U.K. Utilities Highlights Danger of Leverage on Return on Equity

Leverage Ratios and Return of Equity ("ROE") Across U.K. Water Utilities – Privately-Held Water Utilities



Source: Ofwat (Water Services Regulation Authority), Morgan Stanley, data as of December 31, 2022, reflecting latest available data.

The U.K. water meltdown underscores the importance of maintaining prudent leverage levels for regulated assets. While regulated assets often have high visibility into their cash flows, asset owners need to run their business with more than debt repayments in mind. They must satisfy all obligations, including serving the public good and making sure that high financing costs do not result in underinvestment in the assets themselves and deteriorating service.

Brookfield's infrastructure team conservatively manages assets, seeking predictable financing costs and minimal surprises by locking in long-term, fixed rate debt in the hope of attaining investment-grade ratings.

We believe the U.K.'s water challenges reinforce the importance of being prudent with leverage, a cornerstone of Brookfield's investment philosophy for decades.

Credit: Why High Yield Bonds Could Weather a Recession

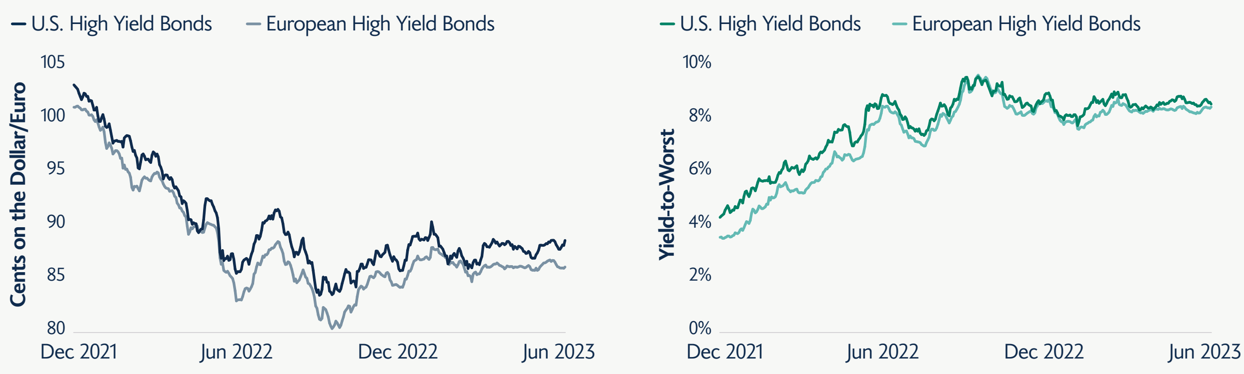
After more than a decade of equity returns buoyed by low interest rates, a spike in inflation caused a policy reversal and higher interest rates, prompting many investors to rethink their credit exposure. Now, entering what we believe is a new market phase where credit should outperform, is high yield an attractive investment today?

Today, consensus expectations are that the U.S. economy is headed for a mild recession. Alternative credit portfolio managers at Oaktree Capital mostly share that view but believe the economy may muddle along for another few quarters before the slowdown. Typically, as the economy cools, many credit investors make a tactical trade and cash out of high yield holdings, fearful that a recession will spark a spike in defaults, which have historically hit double-digits during past recessions. This could be a mistake. We believe investors should not shy away from high yield today.

Today, bond market prices indicate that investors can potentially lock in roughly 10% annualized returns in *contractual payments* from high yield bonds—the type of attractive rates typically associated with riskier assets such as distressed debt. And despite some recent spread tightening, yields remain well above their 10-year average.[5]

Figure 3 shows that the price of high yield bonds has fallen significantly over the past year and a half while yields have risen substantially. However, fears of a recession have moderated and default expectations are low, positive indicators for high yield. Most strategists now forecast high yield defaults for 2024 of 3% to 4%, in line the long-term average of 3.55%.[6] Fitch Ratings forecasts cumulative high yield defaults for 2022-2024 to total 8% vs. 22% during the Global Financial Crisis of 2007-2009.[7]

Figure 3: High Yield Prices Have Fallen… …While Yields Are Substantially Higher



Yield-to-Worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting. U.S. High Yield Bonds are represented by ICE BofA US High Yield Constrained Index and European High Yield Bonds are represented by ICE BofA Merrill Lynch Global High Yield European Issuers Non-Financial 3% Constrained, Ex Russia Index data.

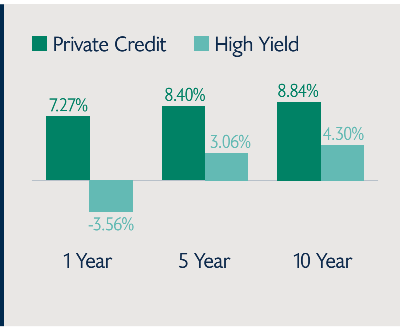
Source: ICE BofA, data as of June 30, 2023. The indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

What makes this cycle different is that this may be *the most predicted* recession in history. As a result, investors and companies have been preparing for more than a year. Portfolio managers have stress-tested portfolios and companies have cut back costs and redeployed cash to strengthen balance sheets. In addition, the pandemic was a cleansing event, pulling forward defaults that might otherwise have occurred during the coming recession. For these reasons, we believe high yield should weather the coming economic downturn, making us constructive about the outlook for the asset class.

Alts Market Dashboard

Metrics to help investors interpret market conditions within various sectors of alternatives, both in public and private markets. Brookfield and Oaktree believe the addition of both public and private alternatives can play an important role in an investor's portfolio.

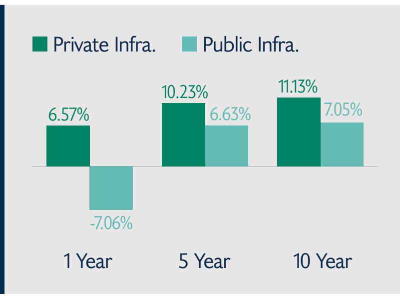
Alternative Credit



$53B Deal volume H1 2023	11.54% Direct lending yield[8] 3/31/2023	8.56% High Yield yield[9] 6/30/2023	$466B Dry powder 8/14/2023
-55% 1-yr change	+53 bps YTD change	-43 bps YTD change	+12.7% YTD change

- Performance suggests resilience in private credit markets
- Yields are high following the U.S. Federal Reserve's hiking cycle
- Significant dry powder poised to fill the void of banks de-risking

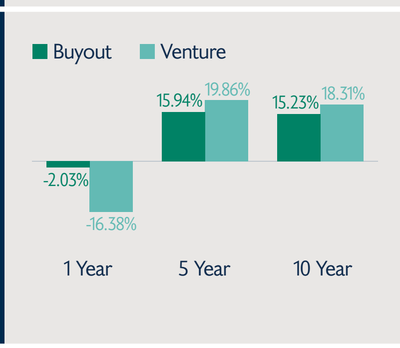
Infrastructure



$88B Deal volume H1 2023	3.54% Public infra. yield[10] 6/30/2023	10.8x Public average EV/EBITDA multiple[11] 6/30/2023	$340B Dry powder 8/14/2023
-59% 1-yr change	+3 bps YTD change	-0.4x YTD change	-1.3% YTD change

- Recent performance suggests resilience relative to many other asset classes
- Valuations and dry powder stable

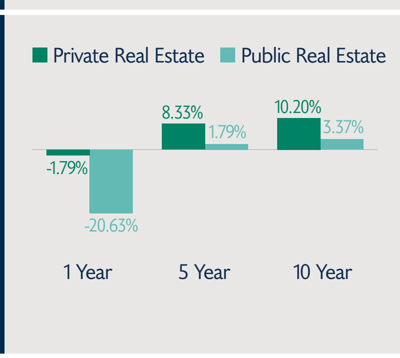
Private Equity



$60B Deal volume H1 2023	14.6x Buyout median EV/EBITDA multiple[12] Q1 2023	90% Buyout secondaries pricing[13] H1 2023	$2,676B Dry powder 8/14/2023
-68% 1-yr change	+3.4x 1-yr change	+6 pts Change since H2 2022	+8.8% 1-yr change

- Deal volumes are down significantly
- Pricing and dry powder show signs of resilience

Real Estate



$60B Deal volume H1 2023	6.1% Average cap rates[14] 6/30/2023	11.54% 1-yr net operating income growth[15] 6/30/2023	$410B Dry powder 8/14/2023
-68% 1-yr change	+106 bps 1-yr change	+2.3 pts vs. historical average	+6.0% YTD change

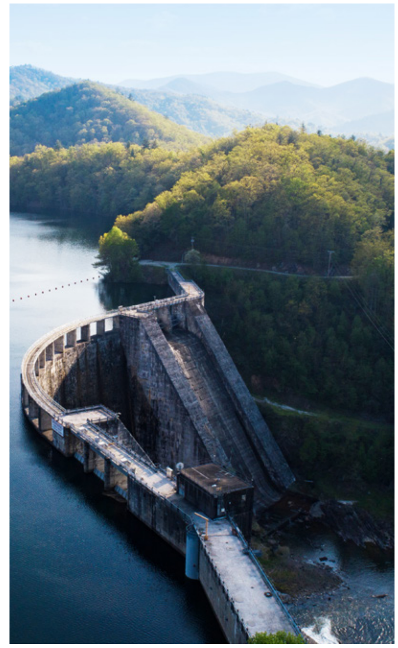
- Performance impaired by cap rate expansion
- Valuations attractive and transaction volume light
- Significant dry powder available to take advantage of potential opportunities

Private Credit reflects Cliffwater Direct Lending Index; High Yield the ICE BofA US High Yield Index; Private Infrastructure the Cambridge Associates Infrastructure Index; Public Infrastructure the FTSE Global Core Infrastructure 50/50 Index; Venture reflects Cambridge Associates Venture Capital Index; Buyout the Cambridge Associates Private Equity Index; Private Real Estate the Cambridge Associates Real Estate Index; Public Real Estate the FTSE EPRA Nareit Developed Index. The indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

Deal Volume and Dry Powder data as of August 14, 2023, unless otherwise noted and reflects Preqin Private Credit, Infrastructure, Private Equity, and Real Estate indexes, respectively.

Source: Bloomberg; Cliffwater, Cambridge Associates, data as of March 31, 2023, unless otherwise noted, the latest data available for private market indexes shown.

Alts Terminology Explained



Credit

Capital Stack

Senior debt is a company's highest priority debt; if the company goes bankrupt, senior debt is paid first, then subordinated debt, followed by mezzanine debt while equity holders have the last claim. Senior debt is typically secured by a claim against the company and so is considered less risky than subordinated or mezzanine debt and equity. The lower the repayment priority, the higher the expected return.

Real Estate

Net Operating Income (NOI)

Net operating income determines the profitability of a property, calculated as total revenue minus operating costs. NOI does not account for taxes, capital expenses, depreciation or amortization.

Infrastructure

Core Infrastructure

Like real estate, infrastructure investments are classified based on their risk/return profile. Core is the least risky type of infrastructure strategy.

Core strategies invest in lower-risk essential assets with long-term cash flow visibility, typically with long-term contracts. Core strategies aim to produce steady, predictable cash flows from such assets as gas, electricity, water suppliers, toll roads, bridges, airports and seaports.

ENDNOTES

[1] Source: Preqin, data as of August 14, 2023.

[2] Source: NCREIF, data as of June 30, 2023. Reflects net operating income (NOI) growth for properties included in the NCREIF Fund Index – Open End Diversified Core Equity (NFI-ODCE). NOI is a calculation used to analyze the profitability of income-generating real estate investments. NOI equals all revenue from the property, minus all reasonably necessary operating expenses.

[3] *U.S. office market report*, Q2 2023, Avison Young, data as of June 30, 2023

[4] CNN Business, *Britain's water industry crisis: Sewage spills, huge leaks and crushing debts*, July 8, 2023.

[5] New York Times, *U.S. Mortgage Rates Jump to Highest Level Since 2002*, August 17, 2023

[6] JP Morgan July 31, 2023.

[7] Fitch Ratings, *U.S. and Euro Corporate Default Rates to Continue Ascent in 2023, 2024*, December 15, 2022.

[8] Source: *Cliffwater Report on U.S. Direct Lending*. Reflects CDLI 3yr takeout yield.

[9] Source: Bloomberg. Reflects ICE BofA US High Yield Index yield to worst. Yield to worst measures the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without default.

[10] Source: Bloomberg, reflects FTSE Global Core Infrastructure 50/50 Index dividend yield.

[11] Source: FactSet, reflects FTSE Global Core Infrastructure 50/50 Index average EV/EBITDA multiple, a ratio used to determine the value of a company, calculated as enterprise value (EV) divided by earnings before interest, taxes, depreciation, and amortization (EBITDA).

[12] Source: Preqin.

[13] Source: *Jefferies H1 2023 Global Secondary Market Review*, reflects transaction pricing for private LP portfolios in secondary market as a percentage of NAV.

[14] Source: Greenstreet. Reflects simple average of cap rates for U.S. property types.

[15] Source: NCREIF. Reflects net operating income growth for properties included in NCREIF Fund Index – Open End Diversified Core Equity (NFI-ODCE). Net operating income (NOI) is a calculation to analyze the profitability of income-generating real estate investments. NOI equals all revenue from a property, minus all reasonably necessary operating expenses.

A WORD ABOUT RISK

Investments in real estate related instruments may be affected by economic, legal, or environmental factors that affect property values, rents or occupancies of real estate. Infrastructure companies may be subject to a variety of factors that may adversely affect their business, including high interest costs, high leverage, regulation costs, economic slowdown, surplus capacity, increased competition, lack of fuel availability and energy conservation policies.

Alternative investments often are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment.

High Yield Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

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INDEX DEFINITIONS

The Cambridge Associates Infrastructure Index represents a horizon calculation based on data compiled from infrastructure funds, including fully liquidated partnerships, formed beginning in 1993.

The Cambridge Associates Private Equity Index represents a horizon calculation based on data compiled from private credit funds, including fully liquidated partnerships, formed beginning in 1986.

The Cambridge Associates Real Estate Index is an end-to-end calculation based on data compiled from real estate funds, (including opportunistic and value-added real estate funds) including fully liquidated partnerships, formed beginning in 1986.

The Cambridge Associates Venture Capital Index represents a horizon calculation based on data compiled from venture capital funds, including fully liquidated partnerships, formed beginning in 1981.

The Cliffwater Direct Lending Index (CDLI) seeks to measure the unlevered, gross of fee performance of U.S. middle market corporate loans, as represented by the asset-weighted performance of the underlying assets of Business Development Companies (BDCs), including both exchange-traded and unlisted BDCs, subject to certain eligibility requirements.

The FTSE EPRA Nareit Developed Real Estate Index is an unmanaged market-capitalization-weighted total-return index, which consists of publicly traded equity REITs and listed property companies from developed markets.

The FTSE Global Core Infrastructure 50/50 Index gives participants an industry-defined interpretation of infrastructure and adjusts the exposure to certain infrastructure sub-sectors. The constituent weights are adjusted as part of the semi-annual review according to three broad industry sectors - 50% Utilities, 30% Transportation including capping of 7.5% for railroads/railways and a 20% mix of other sectors including pipelines, satellites and telecommunication towers. Company weights within each group are adjusted in proportion to their investable market capitalization.

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 ICE BofA Merrill Lynch Global High Yield European Issuers Non-Financial 3% Constrained, Ex Russia Index is a sub-index that contains all securities in the broader index except those from Financial issuers or with Russia as their country of risk but caps issuer exposure at 3%. The index is rebalanced monthly. The index is USD Hedged.

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