GOLUB CAPITAL

Separating Signal and Noise
Not All Unrealized Losses Are Created Equal

Unrealized losses in direct lending are not all the same. Some reflect changes in market risk premiums, while others reflect higher risk of credit losses from deterioration in borrower fundamentals. This distinction is critical. Unrealized losses from market-driven factors can be volatile and often temporary, while borrower-driven losses are more likely to result in permanent credit impairment by becoming realized losses. For investors, the key is not whether unrealized losses occur, but what is driving them—and what that implies for long-term outcomes.

Short-Term Volatility vs. Long-Term Outcomes

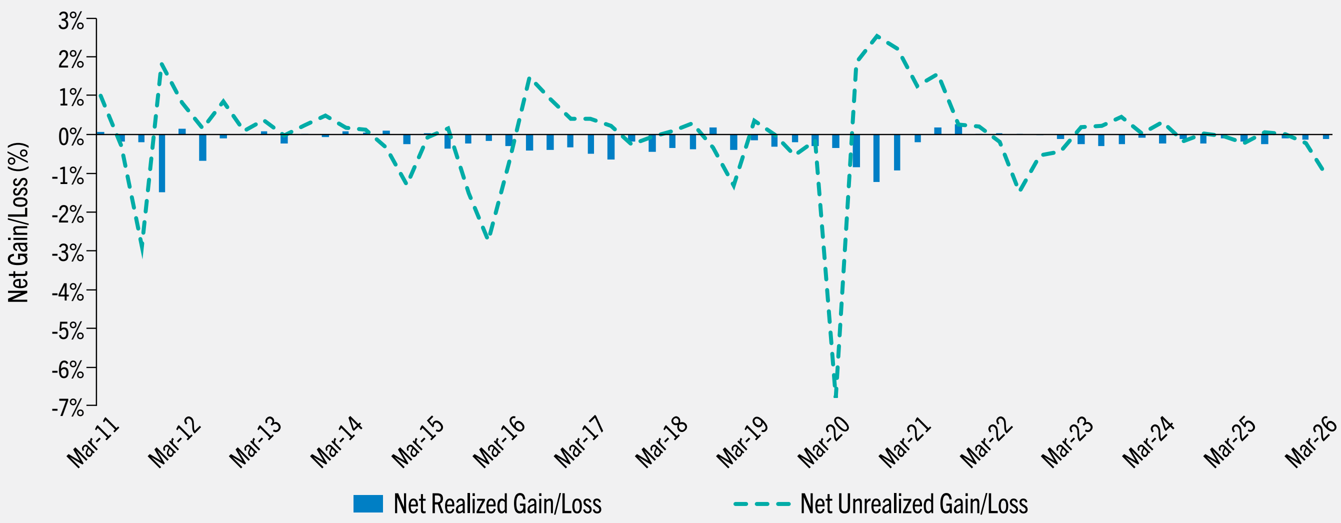
Over the long run, direct lending returns are driven by two components: investment income and realized gains and losses. Together, these determine the permanent economic outcome of an investment.

In the short term, however, reported results can be affected by *unrealized* gains and losses under a fair value accounting framework, which requires investments to be marked to market based on current conditions. These valuation changes can add volatility to reported performance, even when underlying borrowers continue to perform as expected (see Exhibit 1).

Exhibit 1

Separating Temporary From Permanent Outcomes

Unrealized vs. Realized Volatility



Source: Cliffwater Direct Lending Index. Data as of March 31, 2026.

A Framework for Unrealized Losses: Market vs. Borrower Factors

The primary driver of unrealized losses is changes in credit spreads. Credit spreads represent the additional return investors require for taking on credit risk. When the market requires a higher risk premium, the value of a loan generally declines, even though the contractual cash flows on the loan may be unchanged (see Exhibit 2).

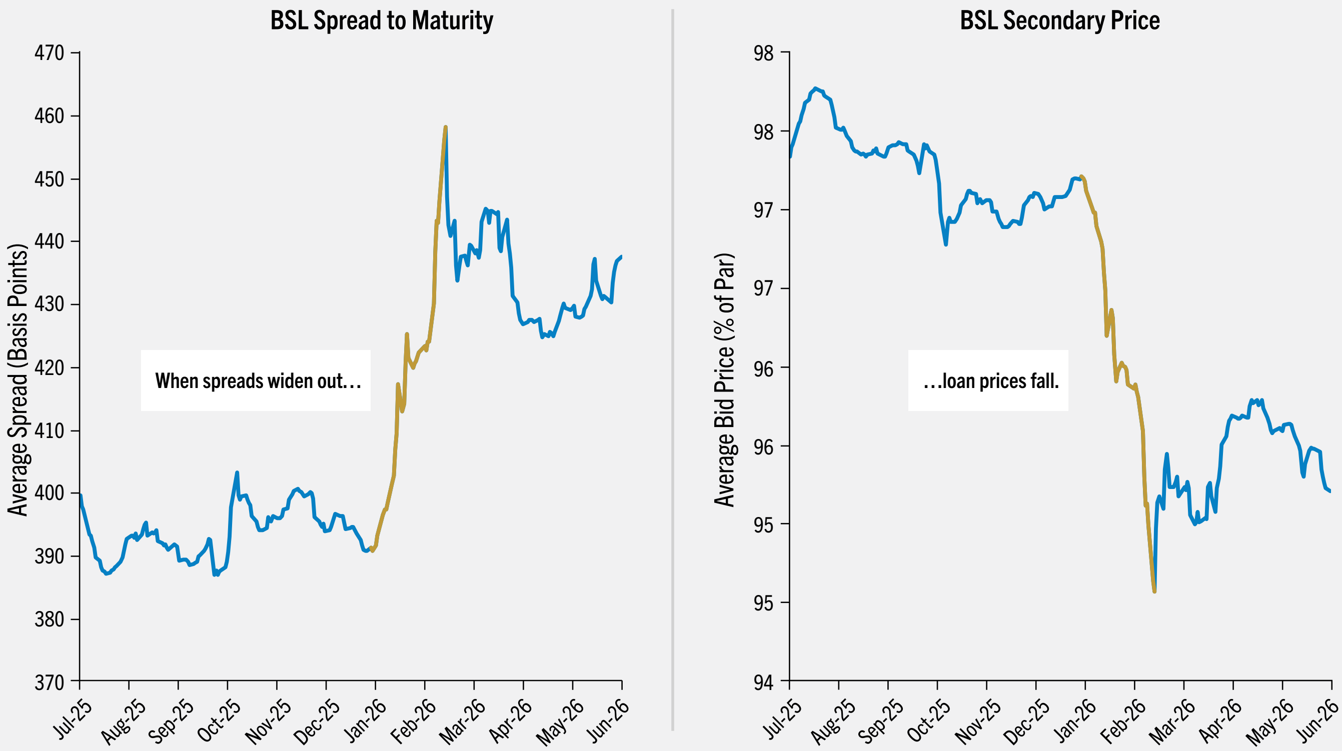
While this explains the mechanics of the valuation change, spread movements can have different underlying drivers—and those drivers carry different implications:

1. **Market-driven factors:** Changes in broader economic conditions and outlook can impact investor risk appetite, as can supply and demand for credit. These forces ebb and flow over time.
2. **Borrower-specific factors:** Deterioration in a company's financial performance (or outlook) can also lead to wider spreads. When we see deterioration in credit quality, we are more likely to see permanent losses.

Exhibit 2

For Each Action, an Equal and Opposite Reaction

Spreads and Loan Prices



Sources: "BSL" is defined as broadly syndicated loans. BSL spread-to-maturity is based on the spread-to-maturity for LSTA leveraged loan index (all loans) from PitchBook. BSL secondary price is based on average bid price for LSTA leveraged loan index (all loans) from PitchBook. Data as of June 30, 2026.

Implications for Investors

So how can investors distinguish temporary market repricing from a more lasting credit issue?

A useful starting point for this analysis is borrower performance. Loans moving to non-accrual status or deterioration in core credit metrics—such as rising leverage, weakening interest coverage and tightening liquidity—are more indicative of underlying credit stress and carry a higher likelihood of becoming realized losses.

By contrast, unrealized losses on loans to borrowers that remain current on payments with stable credit metrics are more likely driven by broader market repricing. In these cases, periods of dislocation can create attractive opportunities as performing loans recover over time and new loans are made at higher interest rates.

Ultimately, the signal lies in borrower performance.

SIDEBAR

Loan Math: A Simplified Market-Driven Loan Markdown

To make this more concrete, consider a simplified example:

- A loan is originated at SOFR + 5.0%.
- The loan has approximately four years remaining.
- Market conditions shift, and comparable loans are now issued at SOFR + 5.5%.

An investor now requires an incremental 0.5% annual return to hold similar risk. Over a four-year period, that equates to roughly 2% of additional required return (0.5% × 4 years = 2%).

Because the loan's contractual cash flows have not changed, the only way to deliver this higher return is through a lower purchase price.

In this example, the loan's fair value declines from par (100%) to approximately 98%.

The key point is what did—and did not—change:

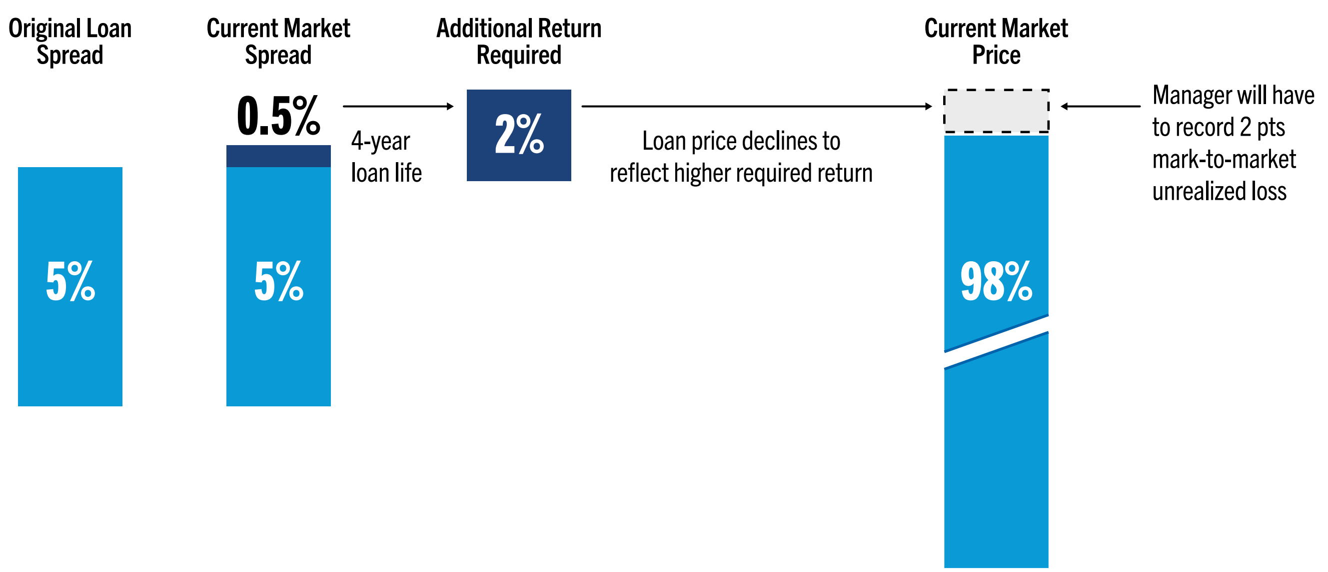
- Changed: The market spread and required return
- Unchanged: Borrower performance and expected cash flows

As a result, a manager holding this loan will record an unrealized loss due to spread widening, even though the borrower continues to perform as expected.

Exhibit 3

Loan Fair Value 101

Same Loan, Same Cash Flow -> Lower Price Driven by Higher Required Return



Note: Illustration not drawn to scale.

Source: Golub Capital internal analysis. For illustrative purposes only.

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