

# Asset-based finance: quantifying diversification benefits and return potential

Asset-based finance (ABF) may offer a compelling opportunity to diversify portfolios and pursue risk-adjusted returns, but a robust framework for measuring associated risks and returns is essential.

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Asset-based finance is gaining traction among institutional and wealth management investors. As traditional bank lenders retreat amid tighter regulations and financing conditions, non-bank lenders are seeking to capitalize on opportunities in sectors such as residential mortgages, consumer finance, aviation, and data infrastructure. With a market value estimated more than \$ 20 trillion, ABF may offer a compelling opportunity for private credit investors.

In our view, the advantages of ABF are that it has the potential to enhance diversification, provide resilience in fluctuating economic conditions, and deliver attractive returns.

This is particularly interesting for Dutch institutional investors, who have been investing in ABF for many years in the form of Dutch mortgages. The development of the broader market is an opportunity to extend this locally focused ABF allocation with global allocations and tap into this opportunity to seek to increase returns and improve diversification.

However, we believe many investors lack the robust framework necessary to effectively measure these advantages. Without such tools, assessing ABF risks, understanding its relationship with existing portfolio assets, and determining optimal allocation sizes become significant challenges.

Therefore, we have developed a public market equivalent (PME) benchmark and risk factor model for ABF funds, which provide the tools to help evaluate performance, measure risks, and determine optimal allocation strategies for effective portfolio construction.

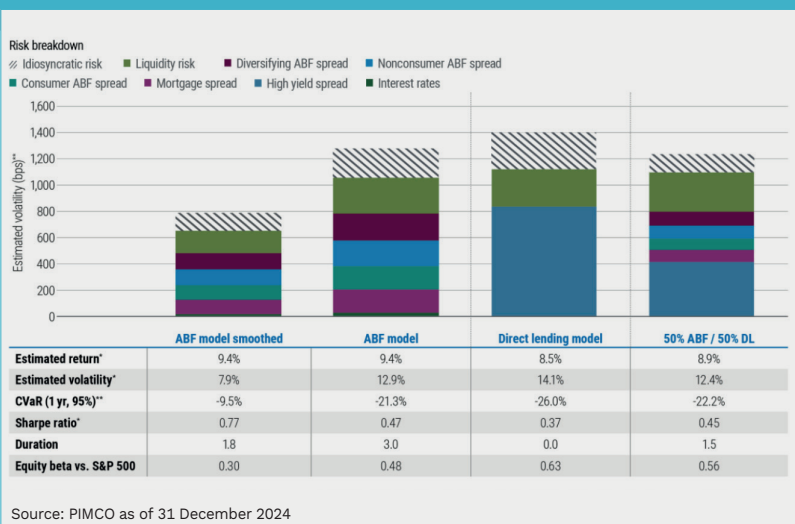
## Potential diversification benefits of ABF

Our detailed modelling has enabled us to measure correlation structures within the ABF asset class and how an aggregate ABF risk factor interacts with other risk factors, such as corporate high yield (HY). The average correlation among the consumer, non-consumer, diversifying asset-backed, and residential mortgage ABF credit factors is only 0.55, indicating diverse risk capture and limited overlap. This high degree of risk factor diversification and the resulting reduction in volatility are key reasons for the attractive Sharpe ratio of the ABF beta.

The correlation of 0.61 between the leveraged ABF and direct lending public market equivalent indicates the potential for meaningful diversification between the total returns of these two asset classes.

Using a risk factor perspective, we assessed the co-movement of ABF and HY credit risks in isolation of other factors like interest rates. Over the full sample, we find a correlation of 0.59 between the aggregate ABF and HY risk factors, indicating ample room for diversification benefits. While

**FIGURE 1: HIGH DEGREE OF RISK FACTOR DIVERSIFICATION IN THE ABF MODE**



the long-term diversification of ABF to HY corporate credit is impressive, it is important to note that, in line with most factors within the credit and equity universe, correlations tend to increase during periods of stress. For instance, the ABF-HY correlation jumps to 0.83 in months where HY spreads widen by more than 50 bps.

### ABF is complementary to direct lending

It is widely recognized that the absence of mark-to-market pricing in private markets leads to a smoothing bias and can create a misleading impression of low volatility. Since alternative investments are exposed to many of the same risk factors that influence public (and liquid) financial markets, we address the downward bias in reported volatility by developing risk factor models that aim to measure 'true' economic risk.

We believe that the ABF and direct lending models shown in Figure 1 allow for consistent comparisons to traditional asset classes and are valuable for optimizing multi-asset portfolios across public and private markets. The risk factor diversification within ABF is evident, while the volatility in direct lending is primarily driven by HY corporate and liquidity risk.

Although the leveraged credit spread duration is higher in ABF than in direct lending, its volatility and equity beta are expected to be lower. This lower volatility in ABL can be attributed to the lower volatility per unit of spread duration compared with HY corporate risk factors and the correlation benefits of combining various ABF credit risk factors. An important finding for investors with existing direct lending exposures is that these two private credit strategies may perform better together. A hypothetical equally weighted mix of ABF and direct lending yields approximately 22% higher estimated risk-adjusted returns and a 12% lower equity beta than direct lending alone.

### Stress tests point to ABF's resilience and upside potential

Several fundamental factors suggest that ABF may be more resilient than direct lending during market downturns. Due to high borrowing costs and weakening covenants, some market participants anticipate declining recovery rates on defaulted loans. In contrast, many private ABF deals are backed by hard assets, can

benefit from diversification across a large pool of loans, typically have higher credit quality compared to non-IG corporate debt, and feature resilient, self-amortizing cash flows that may be less correlated with the economic cycle.

Our stress tests indicate that ABF could potentially experience approximately 45% less drawdown in a recessionary shock, thanks to its diversified spread factor footprint, moderate duration, and focus on non-corporate risk. However, in scenarios where both bonds and equities sell off simultaneously (for instance stagflation), we do not expect ABF to meaningfully outperform direct lending.

Moreover, ABF has the potential to outperform direct lending during positive growth shocks, driven by its higher (leveraged) spread exposure and the currently tight starting level of corporate spreads in public and private markets. Our stress testing assumes that credit spreads will not tighten below all-time lows, which limits the potential for capital gains in corporate compared to structured credit spreads.

### ABF offers the potential to enhance risk-adjusted returns at the total portfolio level

Based on historical data and current valuations, we believe that private ABF portfolios can generate higher returns than direct lending funds. We also estimate that ABF has lower economic volatility and is less procyclical than leveraged direct lending or equity markets.

The potential diversification benefits within the asset class, as compared to other assets, make ABF a valuable addition, not only for private market portfolios, but also for multi-asset portfolios. Strategically incorporating ABF may allow investors to thoughtfully increase their private credit allocations, while potentially enhancing risk-adjusted returns at the total portfolio level. ■

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## SUMMARY

ABF offers diversification, resilience, and attractive risk-adjusted returns.

ABF complements direct lending and can improve overall portfolio efficiency.

Stress tests show resilience in downturns, but robust risk frameworks are essential.