



New York ● London ● Palm Beach

4Q25 Quarterly Letter

January 8, 2026

Dear Partners:

In Samuel Beckett's *Waiting for Godot*, two lovable losers pass time waiting for a savior they hope will show them a better life. They're so optimistic about what Godot will bring that there's no limit to how much time they'll invest. The 1989 slacker movie *Bill & Ted's Excellent Adventure* is as culturally removed from Beckett as possible, starring eponymous high schoolers traveling through time to complete a history paper. The personal stakes are high—failure to act means military school and the end of their rock band—but unbeknownst to them, the stakes for humanity are higher, as the band's music will be necessary to usher in a utopian age. You might be surprised to learn that there is currently on Broadway a rendition of *Waiting for Godot* starring the original leads from *Bill & Ted's*. It has played to good reviews. The irony of combining the two stories is that to Beckett, the act of waiting is the tragedy because it's stagnant. In *Bill & Ted*, the "waiting" is a joyful race to learn enough to keep the future intact. It makes us think about our own painful wait for the promise of Artificial General Intelligence (AGI).

"Mere" artificial intelligence (AI) is, of course, already transforming our lives. It's the driving force behind the US economy and is changing how we research, write, and (vibe)code. Yet all anyone cares about is what comes next. Klarna thought it was "there" when it replaced all its customer service representatives with bots. Only to bring many of the humans back when AI failed to deliver. The *Wall Street Journal* handed management of its office vending machine to Claude. It ordered wine and PlayStations and eventually dropped all prices to zero before it was unceremoniously unplugged. All disappointments of AI while we wait for AGI. Yet imagine back to the 1850s. The first group of Americans is riding the transcontinental railroad from New York to Chicago. They're marveling at the speed and convenience as they zip past horse drawn carriages. Do you think they were all just really thinking about how much better it would be if the train went to California? Or if it were faster? Similarly, the early days of the internet were heady times. There was real excitement about checking the weather on your desktop or emailing a friend even as dreams of the future were feverishly mined. With AI, however, no one is content to enjoy waiting. The investment is just too enormous for us not to end up with something much (much) better than what we have now. The narrative in markets this quarter was thus squarely on the questions of how long we'll need to wait in this awful purgatory of AI, what we do while we wait, what it might cost to make it to the productivity utopia of AGI, and which companies or tech ecosystems stand best positioned to succeed. For the quarter, the S&P 500 was +2.6% (+17.8% YTD), the High Yield (HY) index +0.7% (+7.8% YTD), and the IG index +0.8% (+7.8% YTD). IG and HY spreads widened 3bps (-3bps YTD) and 1bps (-11bps

YTD) respectively. The Diameter Master Fund (DMF) returned +0.3% net (+8.0% YTD) with average net exposure of 45%. Diameter Dislocation Fund (DDF) III Base, which is long only and 20% drawn, returned -5.0% in the quarter (+9.0% ITD). DMF and DDF III's unsatisfactory performance this quarter was mostly attributable to First Brands and Eye Care Partners, on which we'll have much to say below. DDF II and DDF I are both in harvest and have returned 60% and 110% of paid-in-capital, respectively.

We've talked a lot about AI in our recent letters. Today we'll focus more on some of the mistakes we made in distressed while looking ahead to the investment themes for 2026 that emerged from our December research offsite. We'd be remiss, however, not to at least fill you in on how we participated in the AI SuperDuperMicrocycle this past quarter. We made a large investment in the debt of Beignet Investor LLC, a JV between Meta and third-party investors. Meta wanted to finance an AI data center in Louisiana without levering its pristine balance sheet. Investors demanded a corporate backstop. The compromise is a structure that requires Meta to "make whole" the \$27 billion of bonds if it ever abandons the project. For the complexity and illiquidity, Meta offered a spread roughly 150 bps wide of its equivalent-duration bonds. DMF was the only hedge fund with a large allocation, thanks to our relationships with the bank, the largest mutual fund lender, and Meta's AI team. The bonds rallied eight bond points on issuance (45 bps of spread on ~20-year WAL). We still hold a sizable position in the debt that offers attractive absolute and relative value.

Our investment in Beignet was about earning excess spread for IG risk. Not every hyperscaler has that type of balance sheet to leverage (or protect). We've previously written on our investment in the xAI corporate debt, backed by the colossus data centers Colossus I & II, the Grok LLM, and some GPUs. We like the debt for its 12.5% coupon. To lower its cost of capital, xAI found a party willing to take GPU residual risk. That wasn't for us. But this is America, which means they then trashed the investment, with a senior layer that amortizes over the life of the GPU lease while retaining a first claim to the chips. We make 10% at the top which we think is good risk.

The drumbeat of AI deals was constant in the quarter. We like the ones that are hyperscaler backed and guaranteed with contracts that exceed the debt service period. We don't think it's wise to take the highly speculative gamble of GPU residual risk for a fixed debt return. We've had these principles in mind for most of the last two years. Yet it's also important to note that the AI credit cycle evolved last quarter. First the sheer diversity of deals. There are full GPU residual deals and those where you only take part of the long-term risk. Away from just chip financing, we've seen construction loans that are hyperscaler backed from the outset and those where the guarantee only comes once the building is ready for racks. There are others that involve a hyperscaler, but only partially guaranteed, and still others that are built on speculation with a whisper of an eventual hyperscaler tenant. Some are trashed and others have contractual amortization for all or part of the life of the loan. Getting the details right is crucial, especially given the pace of transactions.



**Recent Financings & Potential Trades:
Rel-Val of Recent DC-Related Financing Transactions**

Criteria → Deal ↓	Debt Type	Location	Source / Bank	Hyperscaler Backed?	100% Contracted?	Guarantee?	Liquid?	Rate
LLM Provider	GPUs	Midwest US	Sponsor	Yes	Yes	Yes / IG	No	10%
LLM Provider	Hyperscaler Direct	Southeast US	Bank	Yes	Yes	Yes / IG	Yes	T+225
LLM Provider & Partners	Construction	Southern & Midwest US	Sponsor & Bank	Yes	Yes	Yes / IG	No	S+250
LLM Provider & Partners	GPUs	Southern US	Bank	Yes	Yes	Yes / IG	No	S+450
Data Center Operator	Construction	Southern US	Bank	No	No	Yes	No	S+475
LLM Provider & Partners	Construction	Northeast US	Bank	70%	Yes	Yes	Yes	8%
LLM Provider & Partners	GPUs	Europe	Bank	Yes	50%	Yes	No	S+475
Infrastructure Provider	Construction	Southwest US	Bank	Yes	Yes	Yes / IG	No	S+250
Infrastructure Provider	Construction	Midwest US	Bank	TBD	TBD	Yes	Yes	9.25%
Infrastructure Provider	Converts (Corporate)	Northeast US	Bank	Yes	Yes	N/A	Yes	1-3%
Infrastructure Provider	Construction	Northeast US	Bank	Yes	Yes	Yes / IG	No	S+250

It's also no longer sufficient to just gain comfort with the presence of a hyperscaler. Google, Meta, Microsoft, and Amazon are still the gold standard for guarantees. Investors are rightfully less sure about the neoclouds, which serve as downstream debt arbs for hyperscalers and, increasingly, for less well capitalized players. Oracle spent time on both sides of the divide. In October, it was a darling, getting credit for its "remaining performance obligations" with OpenAI. By Christmas those same obligations were millstones, contributing to ballooning credit spreads. Much of this critical discernment was a symptom of the widening debate around the differences between the Google (TPUs) and Nvidia (GPUs) ecosystems. Only Google, with its TPU chip, realized significant scaling gains in 2025. The Nvidia team was caught for much of the year in a wait for the new Blackwell chip, which had impatient investors wondering if OpenAI, Anthropic, xAI, and Meta would be able to replicate Google's feats. By the end of 2026, we'll know whether scaling laws will hold across technologies. OpenAI and Oracle, in particular, will shift in the wind until ChatGPT can release a version that hunts with Gemini 3.

But as we covered at our offsite, the funding won't wait. After \$90 billion of AI related IG issuance in the fourth quarter, we expect at least \$50 billion more in the first three months of the year. This will take AI related exposure to 15% of the IG index, larger than banks. That's only IG. OpenAI, xAI, and Anthropic will need to fund themselves. That's partially why OpenAI built a spider's web of relationships to effectively borrow IG balance sheets from Oracle and Nvidia. They can't stop there. We model that OpenAI needs to raise ~\$600 billion between now and 2029. They'll look for capital in any crevice that works, from commercial real estate, to asset backed finance, to special sits. The flavors will metastasize

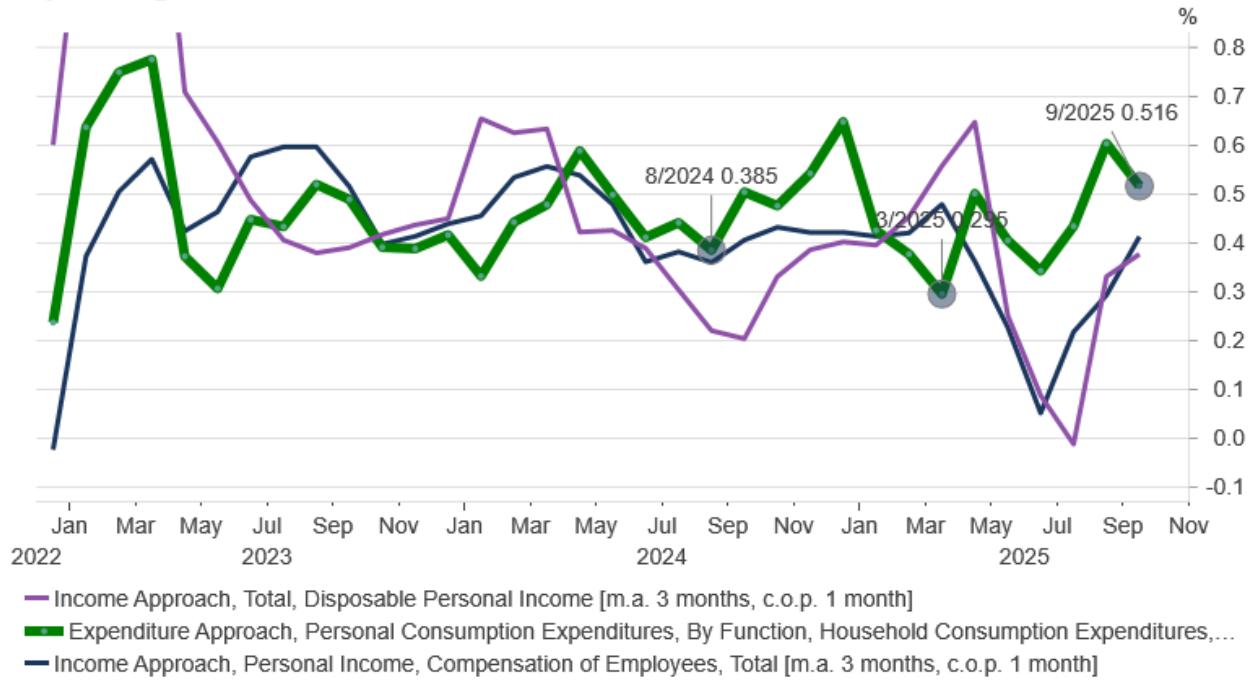
again from the multiple different structures we considered and invested in last year. We've been saying for nearly two years that as AI advances the path won't be linear and that winners and losers will emerge along the way. That started in 4Q25. The next year promises more dispersion amidst massive issuance.

Our AI-fueled investment in the equity and debt securities of EchoStar was our best performer for the second straight quarter. We gave the full saga in our last letter. In brief, EchoStar hoarded vast amounts of wireless spectrum. The market was valuing the company below its spectrum value because the network buildout expenses to put the spectrum to work were considered an unfunded liability. Our view was that EchoStar's spectrum would become critical to the inference phase of AI and be coveted by spectrum hungry wireless carriers. With a nudge from the Trump Administration, EchoStar moved from builder to seller, realizing great sums for its spectrum. In one of the deals, EchoStar took back \$11 billion in SpaceX stock priced at a \$400 billion valuation. The EchoStar stock was a beneficiary when rumors surfaced this past quarter about SpaceX valuations of between \$800 billion-\$1.5 trillion. EchoStar remains a large position for us, trading well below the sum of its (mostly cash) parts.

The quarter also saw one of the periodic "consumer recession" scares that have roiled markets repeatedly since COVID. We've done well seeing through them. The reason we reflexively doubt abrupt accounts of consumer demise is that spending this cycle has been financed mostly by income rather than debt. Every time the howling begins about sudden slowdowns in consumer spending we turn to the first derivative, income, which if intact, usually means the anecdote spreaders are either management teams looking for excuses or hedge funds desperate for volatility.

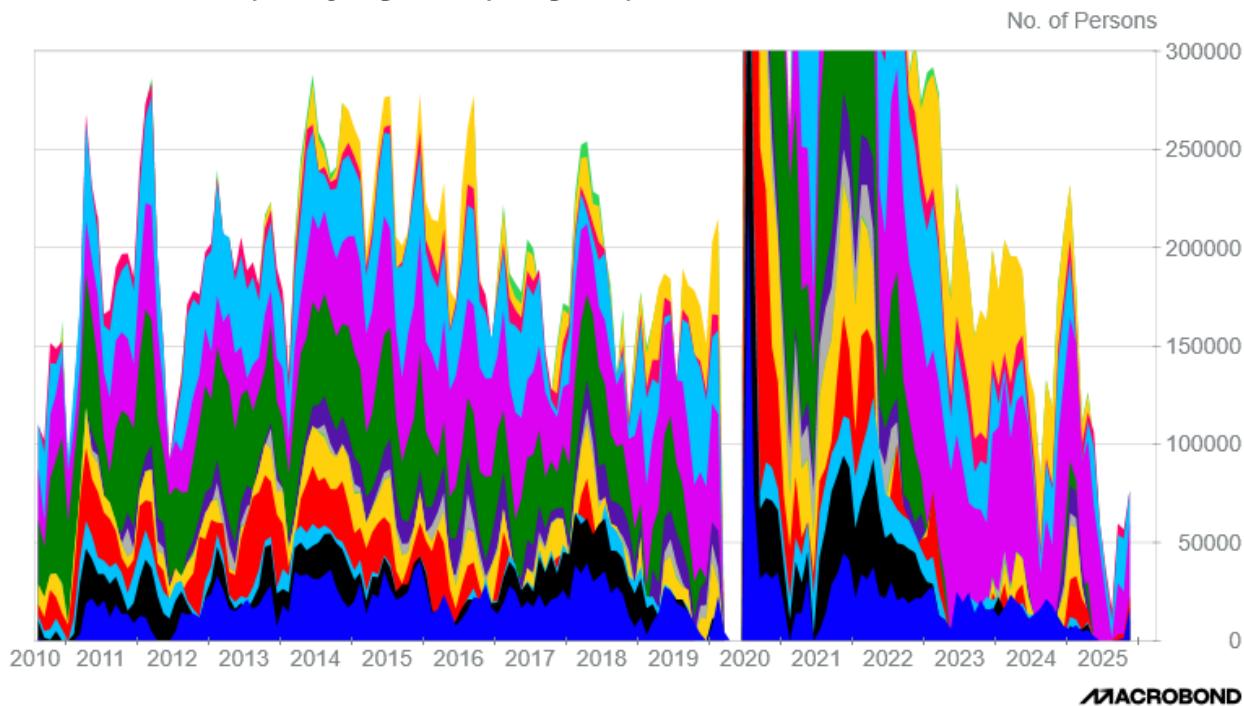
The chart below shows household spending (green) against two calculations of income: total disposable income, including government transfers (purple), and income from wage compensation (blue). We've annotated the green line with the last few instances of market recession (RECESSION!) fears, which came in summer 2024, Feb-March 2025 (right before Liberation Day), and again this past quarter. Before each of these episodes you can see that the green line, consumption, had begun to outpace the two income lines. Consumers this cycle, however, have largely shunned living above their means for too long, which has meant an eventual reversion of the spending path (green moves back down below purple and blue). These reversions have been our recession scares. They're rarely long lived as income growth spurs new spending.

Spending to Income



So the real question is whether income growth will continue. Which is another way to ask about jobs. And here there are some concerns, especially compared to previous periods in this (income) cycle. We laid out a framework for thinking about labor in a letter earlier this year. Since COVID, the disproportionate share in job gains have come from education, healthcare, and government. As those industries got far above pre-2020 trend, however, it was unrealistic to assume they could keep growing. Other industries, still well below trend, like business services, need to take the handoff for the labor market to keep growing. That hasn't happened. The chart below is one we love and that would also get us fired if we were publishing analysts at a bank. Each color represents the number of monthly jobs created by a given sector. The hot purple in the middle that contributes handsomely throughout is healthcare. The light blue above it is leisure & hospitality. The yellow line is government and the dark blue and black lines at the bottom are construction and manufacturing respectively. All the way to the right, you can see that the anemic total job creation at present is supported by precious few colors, chiefly healthcare and leisure. Construction (dark blue), which mysteriously disappeared over the summer, is now back and was probably mistakenly understated earlier in the year. Nearly everything else is negligible. If the trend sustains it portends poorly for income growth and perhaps spending.

United States, Employment, Payroll, SA



Or does it? Claims have remained muted, which means the labor weakness post-Liberation Day could be short-lived. Moreover, as the labor market decelerated last year it didn't dent the pace of aggregate income or GDP. Some of that had to do with investment in AI, but it's also about a surge in productivity that predates ChatGPT. Look at the above chart again at the green line in the bottom middle. It's business services, which used to be a major engine of job creation. It now has nearly entirely disappeared along with manufacturing (black). Productivity gains have squashed the need for hires. The period after the GFC offered historically low productivity gains as healing of balance sheets bested investment and innovation. We've now had a recovery while most sectors are still waiting for the Godot of an AI-induced productivity boom. Once AI starts working closer to 100%, which means agentic capabilities that can adapt to real world deviations, then presumably the productivity trends will reinforce. This past year gave us a glimpse into that future.

Another thing we saw in 2025 is that productivity can narrow the distribution of economic gains. The graph below shows income growth by quartile. Dark blue is the lowest earners. You can see that they did comparatively poorly after the financial crisis. Starting in the early Trump years they surged and truly took off during the pandemic. This year, however, low-income wage growth was the worst amongst the quartiles. It's still at a high absolute level. But with sticky inflation it means more parlous real earnings. In the early aughts, promises to retrain workers displaced by globalization went nowhere. The result was populism across the west. If 2025 is any guide, then we ain't seen nothing yet.

United States, Wages & Salaries, Median Wage, 12 Month Moving Average



MACROBOND

Before the impact of uneven productivity gains will be felt on the streets, it will show up in opportunities in distressed debt. We're already observing this trend in sectors like packaging and food, which face headwinds from GLP-1s, shifting consumer tastes, and low-income wage stagnation. We're excited about this future opportunity set. We also recognize the need to refine our underwriting and position-sizing processes in distressed. Despite the success of EchoStar, originally a distressed investment, and the continued profitable realization of FTX, we had a bad year and a disastrous fourth quarter in distressed debt investing.

You've heard us for years describe distressed as an episodic, non-asset class. It should only be approached during economy-wide disruptions like recessions, which have become fast and rare, or during industry microcycles, which have provided most of the opportunity over the last 15 years. The key in microcycles is identifying which stressed or distressed companies within a disrupted industry will emerge as winners once the cycle troughs. In retail and energy last decade, for example, we focused on companies with prospects outside the mall and with excellent rock, respectively. As industries move through microcycles, often driven by technological change or policy volatility, the gyrations can expose weak management teams. Such companies can materially underperform peers, particularly when overlevered, creating opportunity both from improving industry conditions and from new leadership. That same theme of poor management also gives rise to one-off distressed situations where a company in a good industry is so mismanaged, or even defrauded, that relatively small fixes can return it to a more profitable trajectory.

This approach of investing in mismanaged distressed companies failed us consistently this year, first in older positions like Cano and Rite Aid, which were written down, and then in the fourth quarter in EyeCare

Partners (EYEPAR) a PE-backed rollup of optometry and ophthalmology practices. EYEPAR did a poor job integrating acquisitions; the cardinal sin of a rollup. This failure left its 2021-vintage capital structure non-refinanceable. We helped lead an LME in 2024 that injected new capital, elevated our debt, and tightened documentation. As the cost structure improved, we believed the positive industry trends would lift margins from below five percent toward the 10% earned by peers. With profitability restored, the company could again benefit from the high multiples afforded steady healthcare growers. This thesis began to show traction in 4Q24, when earnings and the 2025 budget took the debt from the 60s, where we bought, into the low 80s. We hoped to sell in the high 80s and held. That was a mistake.

The first hit was 1Q25 results. The improved cost story persisted. Revenue, unfortunately, was a surprisingly significant miss. Regeneron and other drug manufacturers had halted a program to help Medicare patients with large co-pays on branded retina drugs. It was known heading into 2025 that these programs were ending. Yet management materially underestimated the impact as patients shifted to less profitable generics. Management also failed to accurately predict physician vacation schedules at the same time as churn was rising across its 900 plus doctors. What had been a cost recovery story now had revenue in question, and the debt traded back into the 60s. We added to our position, encouraged by the sponsor's replacement of the underperforming CFO. However, third quarter results, while stable on revenue, remained underwhelming, and the cost momentum stalled. The debt ended the year in the low 40s. We have stopped adding and believe the company will struggle to refinance in 2027. We expect delevering asset sales this year and remain invested because the debt feels too cheap to sell. It's a powerful reminder to avoid situations that have been so poorly managed.

Unfortunately, we had not yet fully absorbed these lessons when we encountered First Brands (FB), which began as a major win and ended as the worst loss of our careers. FB is an aftermarket auto supplier built from more than a dozen acquisitions over a decade. It manufactures products globally, ranging from brakes and wipers to lighting. Acquisitions were financed with debt, which the company was able to raise repeatedly due to a track record of margin improvement. In 2024, FB reported \$5 billion of revenue and \$1.2 billion of EBITDA against \$6 billion of syndicated loans and a complex web of receivables and inventory financing. The business was tightly controlled by its secretive founder, Patrick James, who had prior run-ins with creditors before eventually "succeeding" with FB.

When we started going through the FB syndicated loan in 2024 we didn't like what we saw. Reported margins were unrealistic compared with peers, and cash flow reconciliation to EBITDA fell well short of adjusted figures. We had particular trouble reconciling footnotes about the factoring of receivables and pledging of inventory with the audited financial statements, which smelled of fraud. We doubted the company could refinance.

We should pause to note that we rarely short loans. There's no true borrow in the loan market, settlement takes one to three months, and there's a constant need to trade the position if held for the long-term. More importantly, across our funds we aim to be solution providers to issuers, even in tricky situations. Fraud, however, is an exception. With FB, we believed the refinancing attempt in 2025 would surface fraud rumors quickly, limiting how long we'd need to hold the short. We also don't feel compelled to support fraudsters. Accordingly, in mid- 2024 we initiated a short in the senior secured loan in the high 90s.

And then it worked. Really worked. As the company tried to refinance, indications of accounting fraud became more evident, making it hard for the company to renew any of its working capital lines. FB collapsed into bankruptcy in September. We covered the last of the short in the high 40s as things worsened and remained tightlipped when the press reported on our short (we reiterate that if you're not a fraud, then you shouldn't worry that we'll short your loans. If you're committing fraud, then *caveat emptor*). Once the company landed in bankruptcy, its advisors needed to raise over \$1 billion in debtor-in-possession (DIP) financing. We had by that time tracked down the comprehensive information memos (CIMs) for all of FB's acquisitions since 2018. This allowed us to aggregate a revenue number for these previously standalone companies of \$4.7 billion, or ~90% of the total revenue reported by the company. It was external confirmation that revenue had been "real." We then compared the profitability of FB's businesses, before and after acquisition, to other companies with similar products. We concluded that FB's average EBITDA margins were likely 13-15%. While a far cry from the reported low-20s, it still meant \$600-800 million in "real" EBITDA. We also spoke to former employees and competitors and were able to piece together that several of FB's businesses benefited from favorable end market trends and attractive market structures. The segments could fetch attractive multiples in an orderly sale. We also went deep into the reported financials to reconcile cash flows from operations to earnings. We thought it demonstrated EBITDA in the many hundreds of millions. In short, we saw a company that had fraudulently factored the same inflated receivables to different parties while striking multiple secured financings on the same set of inventories. As long as the revenues were mostly real, of which we liked our chances on close to \$5 billion, the business would have value on the other side of the fraud. Accordingly, as the incumbent lenders were panicking at the onset of the bankruptcy, we bought ~\$100 million of the senior secured bank loan in the low 30s that gave us the partial right to purchase over \$100 million of the new DIP A at 95, earning 20%+. The company needed to eventually be worth \$2-2.5 billion to cover the DIP A and just under \$4 billion to pay back our basis in the pre-petition loan, which had been rolled up into a DIP B. Given our triangulated estimate that FB was earning approximately \$700 million in "real" EBITDA, we thought valuation was compelling below \$4 billion (5.5x). We joined the steering committee for the ad hoc group and hunkered down for what we hoped would be a profitable case. A mere three months later, and the letters F-B haunt us every time we close our eyes.

Almost immediately in bankruptcy the company was having trouble fulfilling customer demand for product. This "fill rate" in North America, which should be at 90%, was coming in at ~60% of orders. When a company that had been strapped for cash files for bankruptcy, the DIP commitment usually allows it to reset supplier relations and grow its payables. As a fraud, however, FB saw much of its management team pick up and leave. The restructuring consultants who stepped in made the fateful decision not to pay many of the pre-petition suppliers. We didn't fully appreciate this dynamic at the time. The fill rate shortfalls so concerned us, however, that in mid-November we decided to swap half of our exposure from the DIP B to the "safer" DIP A. Moving up in the capital structure was designed to protect us should the fill rate issues lead to an earlier need for capital, which would further subordinate the DIP B. We got out of half our DIP B exposure at what were then good prices. Unfortunately, switching from DIP B to A in the name of safety turned out to be just as illusory as seeking relief in AAA CDO squareds that were entirely composed of (worthless) BBB RMBS. In a skydiving accident, it's the helmet wearing the person.

We're now on the private steering committee and subject to NDA, meaning we can't be as fully transparent as we'd like (we are very appreciative that our letters have stopped leaking the last few quarters. Let's keep the streak alive!). FB will need more capital in early 2026 to pay the payables it should've budgeted for in the beginning and fund operating shortfall. There are almost two parallel universes from here. In one, the case becomes more regular. The new numbers are "real" and the new money need knowable. Or, as can happen in frauds, more and bigger shoes keep dropping. You've now had a pre-petition term loan and then a DIP collapse from near par to zero and mid-20s respectively in a matter of months. Certainty will be hard to come by as will large checks. We sold all of our DIP B and 2/3s of our DIP A at prices materially above current, yet it cost DMF 123 bps and DDF III 96 bps (on NAV+Undrawn) in the fourth quarter.

We've thoroughly reviewed, and continue to assess, what went right and then horribly wrong in FB. There are few exercises more satisfying than turning a successful short into a profitable long. We had a head start on others because of our work on the short. As the debt collapsed, we were too confident in that advantage and too excited about reversing the trade and thus moved too quickly to buy the loan at its pre-petition lows. We thought that our work reconciling the revenues from acquired businesses from external sources demonstrated ~\$5 billion in "real" sales. We now think that once FB acquired a company it would offer significant discounts to customers in return for working capital allowances. This helped it feed the merry-go-round of receivables fraud that it needed to make payroll each week. The CEO would then feed fake inflated sales numbers into the company's ledgers, which fooled the auditors and also our advisors, who were confident in the revenue numbers when we funded the DIP A. The result was a company with far lower revenues than what it had acquired. We wonder now if EBITDA, after the discounts, was even positive. A bankruptcy shines unforgiving sunlight on a company. When the proximate cause of a filing is fraud, it probably makes sense to miss the initial trades and allow the rays to work as disinfectant.

We also made the wrong choice once we saw the fill rate problems. We did many calls with customers and suppliers and still couldn't fully explain why the company was struggling so mightily to source materials. Our discomfort led us to reduce DIP B in return for DIP A. In a fraud, if something seems off, you should just get out. Finally, we bought the DIP A because we liked the yield relative to the LTV. We do this a lot with senior risk in restructurings. The company only needed to be worth ~\$2-2.5 billion to cover the DIP A, and we thought it was worth \$3.5-5 billion. A fraud is not the right type of situation to size senior risk since you can never truly be sure of your margin of safety. We will continue to share our lessons learned from this debacle as the case plays out.

One of the things we want to focus on more closely going forward in distressed is whether management is up to the task of the turnaround. We've gotten that wrong a few times recently, as just discussed. Which makes it ironic that one of the more profitable distressed names in the quarter for DMF and DDF II was Signature Bank, the bankrupt institution being managed by the federal government. Don't worry free marketeers, the government outsourced management of the bank's assets to three private managers. They've done a good job, which has enabled faster payback of the government debt. More importantly, at the end of the quarter the FDIC clarified that our bonds are senior to interest earned on the

government's claim. Together, the two pieces of news sent the bonds from the 50s to the 70s with potential final claims at 125+.

We also had good news in the quarter relating to DMF and DDF II's distressed position in the AT1s of Credit Suisse. When the Swiss government arranged the shotgun marriage between Credit Suisse and UBS over a hectic weekend in March 2023 it made the highly unusual decision to zero out the Credit Suisse AT1s while providing compensation to the more junior equity. We bought the AT1s between three and 10 cents, after the seizure, and then joined with other aggrieved parties suing the Swiss government. This quarter, a Swiss lower court found for similarly situated plaintiffs, creating the possibility that our bonds could be reinstated or repaid. The bonds went to the 30s. The case is now pending before the Swiss Supreme Court, and we think the bonds have significant additional potential.

We also see upside in some of our other distressed losers. We've been early to the housing velocity recovery trade, which we've talked about as a new microcycle, and that cost us in the debt of Springs, the stressed supplier of window treatments. We really like the market structure in blinds and think the new management team is poised to abate share loss suffered on a bad rollout of new product. You better believe we're stress testing this last assumption. We also got dinged in the debt of US cable operator Altice USA and its foreign cousin, Altice International. Both are controlled by Patrick Drahi who is moving assets around to try and effectuate liability management transactions. We like our positioning in both situations and think they'll be active opportunities in 2026.

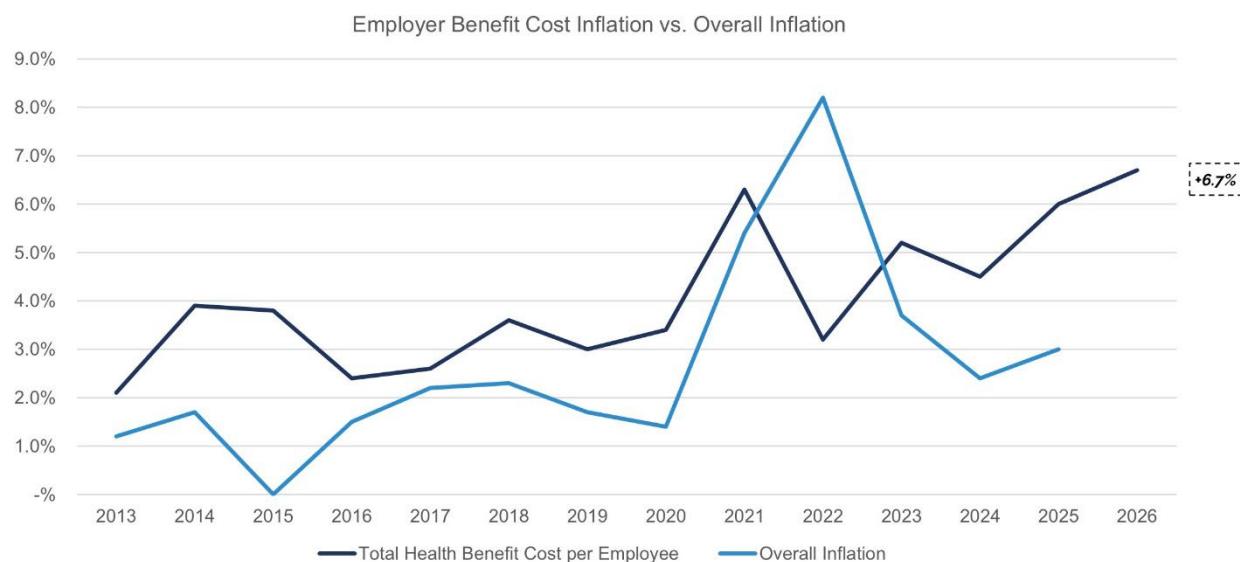
Which is a good segue to what we think is in store for the year just started. We expect another year of heavy M&A. The urgency might even increase as CEOs reckon with the possibility that we could be one year closer to Lina Khan back at the FTC (as if we're going to have real elections in 2028...). We had a nice M&A win in the fourth quarter when Enviro Solutions, an environmental solutions provider, sold its main business at a nice price. We were also long DigitalBridge in the fourth quarter, before its announced acquisition by Softbank, and had a winner in Warner Brothers. We hope to find more M&A trades in 2026. One of our offsite presentations highlighted the M&A surge to come in large cap pharmaceuticals from an unprecedented roll off of drug exclusivity. We expect this general rush of M&A to be funded by IG, which together with AI could up push others needing capital into private or alternative markets. We've all spent our careers watching every supposed leveraged finance maturity wall evaporate into dust. The coming wall, mostly from PE-sponsored companies with capital structures designed for lower rates, will be no different. Instead of defaults we'll get more "capital solutions." This quarter DMF and DDF III helped two levered trucking parts companies consummate a merger by providing senior debt and preferred that came at 98 with a 14.5% coupon and three percent of the common equity. Realizing the synergies is the only way for the PE sponsors to delever the businesses, and we like where we sit in the structure. We also closed a preferred deal with a PE-backed company in the live event media services that used our capital to reduce its secured leverage. DDF III partnered with a different PE shop and the pref has both a high teens coupon and a mechanism for the equity to seamlessly transfer from the sponsor to us. We also, in DMF, earned a low-teens return in a large deal for Liberty Media's Puerto Rican entity that was backed by assets stripped from creditors. The sponsor was able to get its creditors to the table. As we said, capital solutions.

We think we are only at the tip of the iceberg for capital solutions, particularly for zombified PE-backed companies. The structures come in many flavors, from true rescues with warrants, to stripped collateral, to prefs and hybrid equity. The common denominator is helping the current owner prolong runway. Given our broad industry focus, integrated direct lending and CLO businesses, and hedge fund that assesses nearly every deal in public markets, we believe we have edge in sourcing and underwriting these complicated opportunities. We expect capital solutions to be a major theme in the years ahead.

Our research offsite in December was aimed at identifying investable ideas for the coming year. As a reminder, our analysts are industry experts. It's the only way to be fast and smart. The unintended consequence of following a sector closely, however, is capture by industry consensus. The idea of the offsite is for each analyst to use primary data to test consensus and develop unique views.

We always spend a lot of time on healthcare at our offsites given the industry's consistent pairing of policy volatility and heavy debt loads. Last year, we focused on the unusual level of uncertainty as the new administration emphasized cost cuts (remember DOGE?). The one certainty we highlighted was that the Affordable Care Act (ACA) enhanced insurance subsidies were set to expire at the end of 2025. Heading into 2026, the key question is now whether those subsidies will be extended. The implications are significant. The US uninsured population sits near historic lows, but that will change if subsidies roll off and individuals are forced to choose between premium increases of 70 to 85% or dropping coverage altogether. And this may only be the first wave of healthcare affordability challenges.

Last year, commercial insurance costs borne by employers rose roughly 7%, driven by specialty oncology drugs, GLP-1s, and persistently elevated post-COVID utilization. We think it's likely employers will begin passing more of these increases on to employees. In that scenario, those losing ACA subsidies may simply be first in line to absorb rising healthcare inflation. All of this is negative for hospitals, which have performed well recently in both equity and credit markets. We're more cautious in a year where consumers may be forced into unusually difficult tradeoffs.



We had success in the fourth quarter in shorts of global chemicals companies bedeviled not so much by sudden drops in demand (RECESSION!) than by the evolution of supply. Our offsite made us even more negative. The problem is China, which seems determined to add capacity up and down the chemicals chain. By 2030, you could shut all the ethylene and propylene capacity in Europe and Japan and still have more excess than we have today.



The victims won't only be Western producers of base petrochemicals like olefins and aromatics. The Chinese are moving up the tech stack as they add capacity to commoditize what is today considered specialty. A whole host of western chemicals factories will soon lie as dormant. We think this is already starting to happen in TiO₂ (paint coatings), resins, and advanced polymers. It's coming for adhesives, sealants, and water treatment. On the opposite end, Chinese planners seem to be ignoring chemicals for food ingredients. We have shorts in the most impacted names and believe that 2026 will be a watershed inflection for chemicals.

When it comes to overcapacity there are few sectors with a more well-known problem than liquified natural gas (LNG), which will see a rush of new projects come online between 2027 and 2030. The question at our offsite was how the price of global gas would adjust to stimulate new demand. This will be tested in 2026, ahead of the capacity, as the warm start to winter in Europe reduces the urgency to rebuild inventory this summer. Gas pricing markets are thus already looking to the Winter 2027 glut. To truly spur switching from other fuel sources, global gas prices need to get below \$7 from \$9 currently. We have a secured convertible investment in Delfin, an LNG developer with a permit and firm offtake contracts for LNG vessels in Louisiana. We like the low-cost assets Delfin constructs and its contracted cash flows. Other LNG companies, however, have a portion of EBITDA exposed to commodity prices. As the "LNG Winter" dawns, now slightly earlier than anticipated, security prices in the industry will continue to come under pressure. This could create opportunities to step in and buy long-lived crucial infrastructure projects cheaply. We'll be ready.

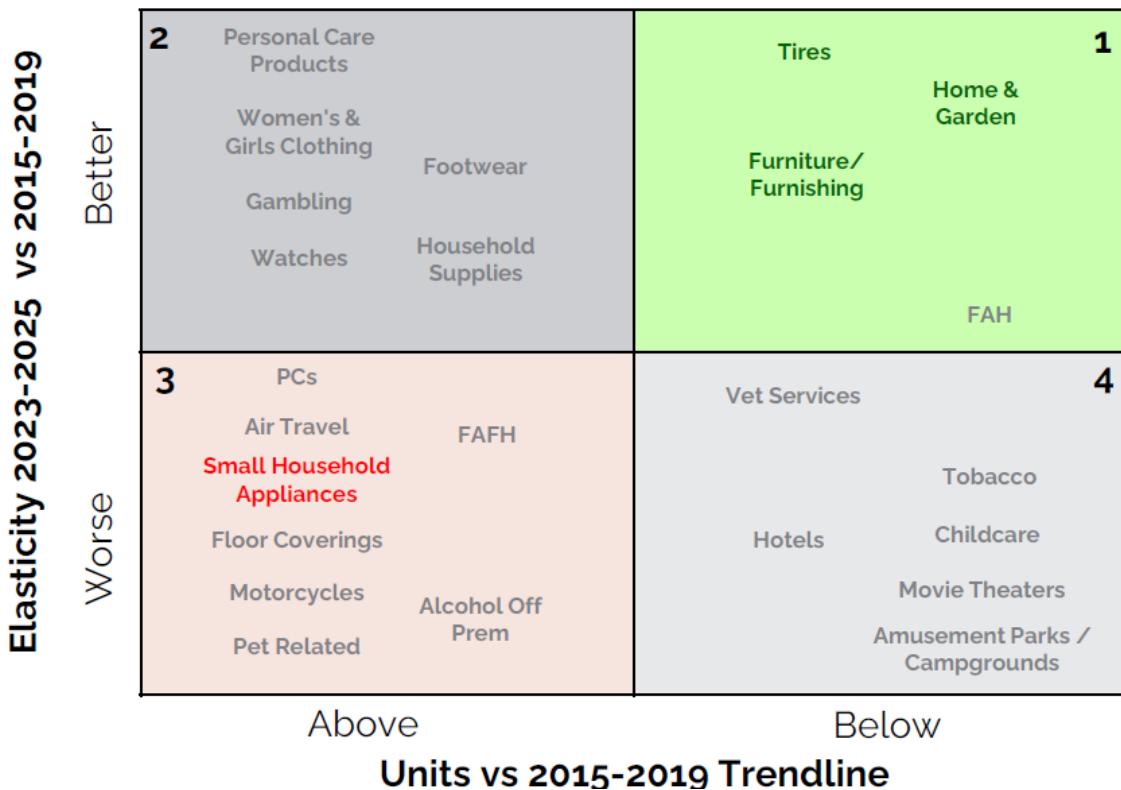
One complicating factor for LNG is that US natural gas prices, which are an input cost to US LNG, are poised to remain firm given the strong demand for power from AI datacenters. We covered the AI-power theme in our last letter and did a session at the offsite. Despite the unprecedented activity in datacenter construction, there are still many aspirational announcements for datacenters that will never get past the press release. Of the 140 GW projects we track, we think about 90 GW get built over the next five years,

40% of which are in the PJM region spanning Pennsylvania, New Jersey, Maryland, Ohio, and Virginia. There's already been a lot of datacenter activity there, mostly from independent power producers like Talen. Our matching of projects with regulated footprints makes us think that utilities like AEP might be future beneficiaries of an enhanced rate base, while NiSource and PPL could win with their ringfenced deregulated GenCos. More fundamentally, however, PJM's early projects have been largely connected to the grid. It's no surprise that power prices are surging. Yet they're not rising enough to incentivize new power commitments. This imperils the sustainability of PJM's capacity market as higher prices without new supply is a lose-lose for consumers. The future in all regions will be "behind-the-meter" where the datacenter brings its own power source that exists independently of the grid. This will allow for more innovation than the grid permits. The winners will be equipment providers and those with battery, turbine, fuel cell, and storage solutions to maximize power generation at the lowest cost. We have one high yielding investment in a behind-the-meter beneficiary and will look for more as the power cycle evolves.

Consumers, of course, are the ones most at risk from AI power price shocks. And we had five different sessions at our offsite touching on the health of the consumer. In Europe, the consumer remains resilient, which in continental terms, outside of Spain, means eking out something around 1% real growth. We think many of the consumer goods companies in Europe, especially those facing structural volume headwinds like alcohol and snacks, were overly reliant on price during the 2022-25 inflationary period. We worry that the jig is up and have found a few shorts. European luxury is emerging from a cyclical COVID-echo trough. The flagship brands have sustained for decades. Yet many of the traditional houses are going through creative resets at a time when old strategies are waning. The increasing importance of the aspirational customer and growth in the resale channel creates both perils and opportunities. Most of the investments in luxury are in equities, but there are a few LBOs, such as Breitling, that we're watching closely.

The US consumer got most of our attention, with the low-income varietal back to its struggling baseline. Low-income shoppers are overweight food, packaged goods, and clothing. We think those areas will be soft again in 2026. The top-30% of earners, by contrast, are 50% of spending and they're underrepresented in healthcare and non-discretionary which they compensate for in services and durable goods. At the offsite, the team tracked through multiple data sets to find spending categories that are below trendline and have become less elastic for the rich. The best examples are home & garden and furniture. The worst are pets, air travel, and small household appliances.

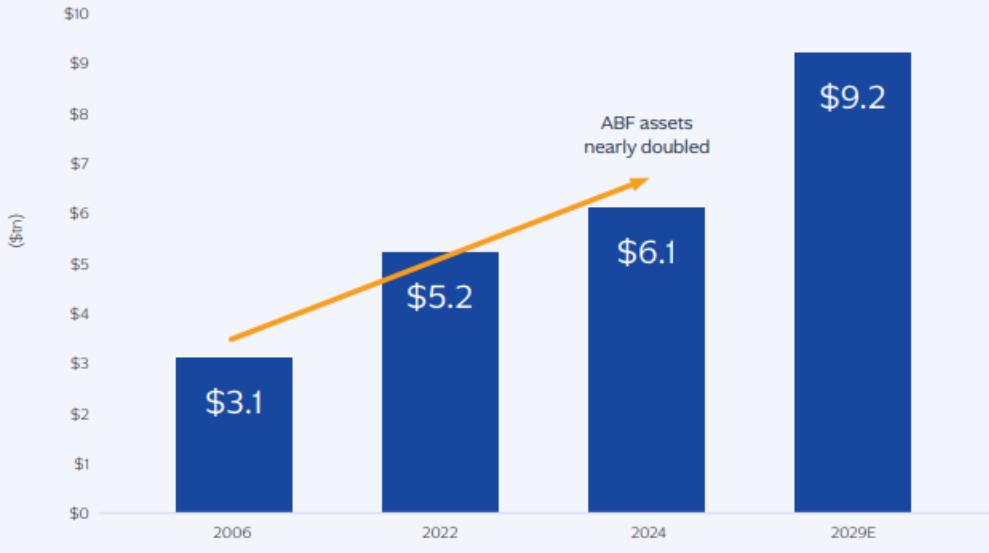
Elasticity vs Unit Trends 2015-2019 vs 2023-2025



We think this can be something of a roadmap for longs and shorts throughout the year, especially as income for wealthier Americans continues to outstrip spending.

We also delved into asset-backed-finance (ABF) which now includes everything from unsecured consumer loans to aircraft and equipment finance, small business loans, and even Buy-Now-Pay-Later (BNPL) for Botox. Insurers have been selling record numbers of annuities to aging Americans. The insurers in turn need to invest the proceeds in safe, highly rated assets. Such assets don't usually yield much above the cost of the annuity. So insurers are interested in anything that is safe and even slightly more yieldy than regular IG. Every basis point counts. To satisfy this hunger, asset managers tranche up a myriad of loans to offer insurers both safety, through structural seniority, and an additional 100 to 200 basis points of yield. ABF is gold to insurers and has grown meteorically.

EXHIBIT 2 | ABF Is a Fast-Growing Market with Room to Run

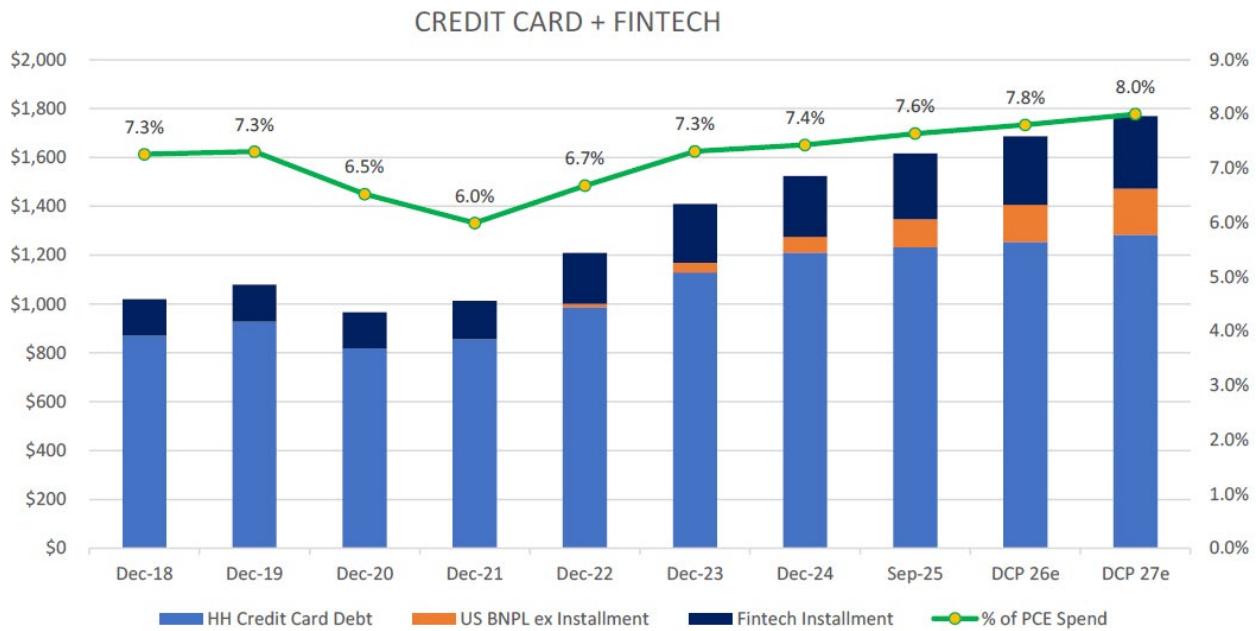


But what happens to the bottom of the structure? The less safe parts that many insurers don't want?

Here is where it's helpful to think back to a memorable episode from the 1990s hit show *Seinfeld* where two characters partner to open a highly specialized bakery selling nothing but muffin tops. It's the only part of a muffin that people really like. Yet, their venture "Top of the Muffin to You!" fails quickly. It turns out that muffin tops baked alone, without stumps, don't taste the same as tops popped off of completed muffins. So they changed course and baked the full muffins before removing the tops. This resolved the taste and texture issue, but opened a new dilemma: what to do with the stumps? No one wanted them. The garbage dump wouldn't take them (they're not trash) and a homeless shelter returned them as inhumane food. The venture shut because they had nowhere to put the stumps.

This search for low risk "excess" yield is the tail wagging the dog of a growing market as asset managers scramble to offer ABF to insurers. But just like the *Seinfeld* bakery, the market has a dilemma with the stumps. Insurers don't want the residuals; they're too poorly rated. Originators prefer not to hold them, as they need to recycle capital. The result is a cottage industry of "special situation" and interval funds designed to hold the stumps. Many of these funds are managed by asset managers that own insurers. Sometimes they even take the stumps and try to create new muffin tops out of them. The taste is different even if the rating is the same. We've looked at many of these residuals, and after taking our own lumps in solar and student loan ABS, we generally pass. These stumps can offer carry without convexity, often with long-dated cash flows that preclude the early de-risking featured in CLO equity. While most should work out, history suggests that exponential growth in an asset class usually invites sloppiness. We suspect that when the first signs of trouble mount, the market may eventually refuse to take the stumps which could lead to both losses and the grinding halt of the ABF machine.

As we plan to do more ABF both in the secondary market and as an originator, we focused on our offsite on potential areas where problems could emerge. Non-bank lenders like Affirm, SoFi, Upstart, and Pagaya stick out. We've wondered aloud in these letters (and on [podcasts](#)) if the explosive growth in these products is being captured in Federal Reserve statistics that show an historically underlevered consumer. After doing our own calculation, we think that BNPL and FinTech are mostly just replacing credit cards, particularly amongst younger consumers.



What's more interesting is how demand for loans to feed insurers¹ is leading to wider credit boxes and the entry of new originators with limited track records. It's a race to the bottom. Consider that Pagaya has made a business of lending to borrowers that other platforms have rejected. They tout improved AI models and internal credit risk scores, but its average debt-to-income for borrowers has moved from 22% to 29% in three years. Annual volume has grown 6X from \$1.6 billion in 2020 to over \$10 billion in 2025. And, least surprisingly, it recently announced its first dedicated off-take agreement with asset managers so that it doesn't need to eat its own stumps. Good luck to whoever needs to swallow them once the consumer shows trouble.

The other issue to consider with ABF is fraud. There's been a surge in what is euphemistically known as "credit washing," egged on by a closet industry of TikTok influencers peddling artificial ways to boost credit scores. Not surprisingly, credit-washed loans have performed poorly, with recent TransUnion auto charge-off data showing meaningfully worse outcomes.

¹ <https://gftarticle.ft.com/gftarticle/actions/redeem/baccff25-bbb4-47fc-81c7-1b02f9b76127>

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Published Jun 12, 2025, 07:28pm EDT, Updated Jun 16, 2025, 10:14am EDT

THE WALL STREET JOURNAL

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Oct. 21, 2025 5:30 am ET

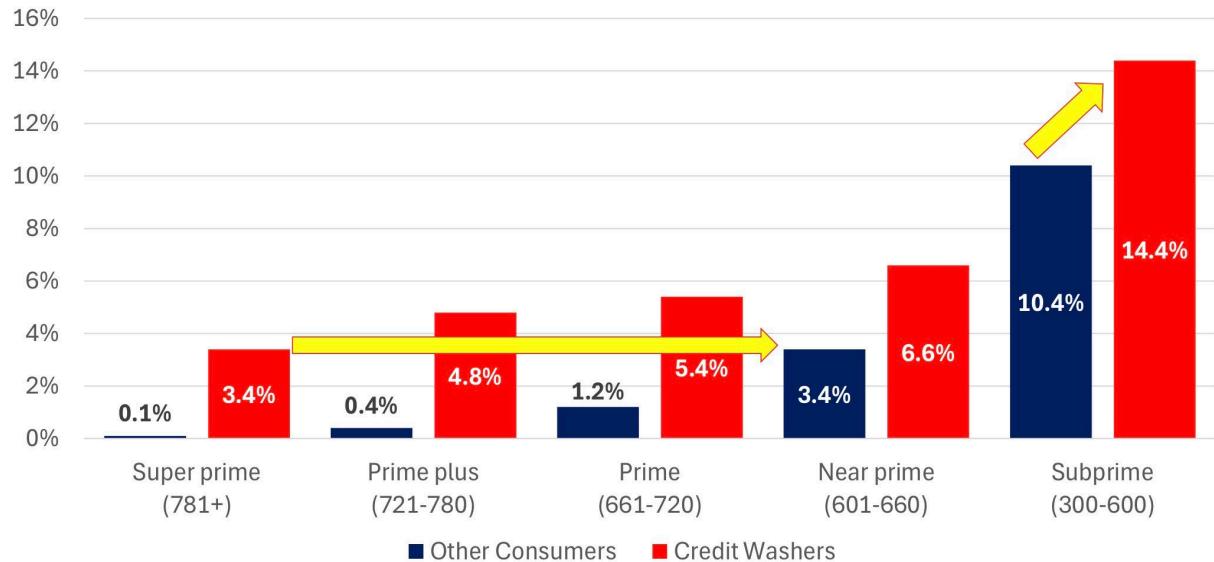
Detroit Free Press

SUSAN TOMPOR

Phony reports of ID theft to drive up credit scores contribute to car loan losses

By [Susan Tompor](#)
Detroit Free Press

Updated Oct. 16, 2025, 5:32 p.m. ET



Lenders may also be in on the fraud, most notably with subprime auto lender Tricolor. It's no shock that such a pristine and white shoe corner of the financial world has offered up multiple frauds. But our offsite touched on how ABF in general lends itself to fraud because of how many hands touch each loan. First there is someone on the ground with direct relationships with the customers. This is usually referred to as the "lender." They rarely have capital, however, and the entity funding the loan might be a few steps removed from the broker with the relationship. Then there's the borrower, who can lie on applications, and, of course, the lender and borrower can work together to "boost" the application. According to Transunion, 95% of instances where bad credit events are suppressed come from lender initiated "account maintenance" which is really about preserving the ability of the lender to make new loans to the same weak credit. Next you have the bundler of loans to create a securitization. They have limited skin in the game and huge influence on which loans get included (and if some loans get fraudulently counted twice!).

Fraud can be mitigated through sound operational controls. Avoid any lenders with history of chicanery. It can lead to too much compounding pain if there's one bad cog in the wheel. We wish we'd taken this advice in Cano and FB. Also insist that verification doesn't just come from one source, especially the lender. Eschew "unique" arrangements, such as Tricolor's vertical integration in car repair which allowed it to show exceptional recoveries. Shun models that use origination speed to compensate for lower rate. In sum, the popularity of annuities has fueled a surge in insurance assets that seek even the smallest incremental return over IG. ABF provides a solution. Avoiding the pitfalls will be key to differentiation.

We started our media offsite by marveling at the advertising recession that wasn't. It's now a \$400 billion market, up from \$240 billion in 2019. We had the opportunity this year to invest profitably in the IG bonds of Warner Brothers and Paramount, as they went through a host of special situation exchanges and mergers. Yet for the most part, we're usually confined to the \$70 billion part of the advertising market that is in decline, from radio to TV and broadcasters. It can be fertile ground for shorts. This past quarter we closed out a short in a provider of worthless ad-content at the bottom of webpages. The bond came at par in 2025, and we shorted it at issuance. It ended the year in the 30s as buggy whips have more relevance post-AI. We think that 2026 will see connected TV—basically everything that streams—take share from all mediums, which will pressure broadcasters. Against that negativity is the promise of M&A from the Trump FCC which seems poised to allow more broadcast concentration. The Netflix-Warner-Paramount love triangle should also continue to provide new issue and secondary opportunities in media this year.

We always spend a lot of time at the offsite on telecom, which is a microcycle with seemingly no end. The latest evolution is the capitulation of the entire US wireless industry to the allure of fixed wireless (FWA). It was 150% of broadband adoptions last year and that was before AT&T went all in. The appeal is the opportunity to put fallow wireless capacity to use. The share donors are legacy copper and coaxial cable. We think pure play cable companies remain ripe shorts. We also think, however, that the endgame for spectrum has to be in mostly wireless applications. FWA subscribers consume ~30x more bandwidth than the average wireless subscriber. At nearly half the price. And that's before demand for AI consumes more wireless bandwidth. Our thesis is that FWA is the waystation for carriers to win subscribers today, but that the long-term strategy will be to house them on fiber. Independent fiber operators, like TDS, Consolidated, and Brightspeed need to spend the capital and demonstrate initial positive penetration in their footprints. The major carriers can then buy them and rely on their converged wireless+wired offerings to boost penetration further. The debate over FWA and its impact on cable and fiber will come to a head this year, and we'll be looking for opportunities if fiber becomes too cheap or cable too expensive.

We covered a lot more at the offsite than we can write about here. In brief, our gaming session speculated that Las Vegas visitation suffered from consumer sticker shock on pricing. As time passes and prices grow more slowly, consumers will adapt and the numbers on the Strip can improve. The beaten-up Caesar's could be a prime beneficiary. In aero, we're with the consensus that the low-cost model in the US is broken and that United and Delta should earn more than 100% of industry net income. We think the debt of Latin American carriers, where growth is outstripping capacity, might make for more edged investments. European banks equity and credit were big winners last year, a theme we missed. They're

better capitalized and earn more than their US counterparts and yet still trade at lower multiples. Finding a unique angle is the hard part. It's been easier in the diverse housing space, which we've spent a lot of time writing about in these letters. At the offsite, we studied the relationship between new and existing home prices. The former are now below the latter as builders got ahead of themselves in COVID migration winners. We think starts will be down for the year which places us below consensus. Existing home sales are like a coiled spring, just waiting for any relief from rates to unleash pent up demand for discretionary moves. The Trump Administration seems laser focused on getting mortgage rates down to spur this activity. Earnings expectations have capitulated which could create asymmetry on the long side. The office market in the US has become bifurcated between trophy properties and everything else. Yet cash rents are lower than they appear because of soaring tenant improvement allowances. We think this will show up in dividend cuts from the larger office REITs.

Our biggest mystery at the offsite was packaging. It's supposed to be defensive. Yet packagers exposed to food, beverage, and home hygiene have experienced three years of volume declines. Changing alcohol habits and the rise of energy drinks play some role. So does the emergence of GLP-1s, which reduces overall grocery spend, as does the renewed struggling of the low-income consumer. Yet it also seems like something bigger is going on. Why are we selling fewer home hygiene products? If dining at restaurants and take out is surging at the expense of food-at-home is there really an economic component to the slowdown? We think the mix of secular and cyclical changes in how people spend is making it hard to predict earnings. The market expects food and beverage to bounce back this year. We aren't as sure. Packaging is the only sector that has widened enough to trigger DDF III's Contingent Fund. We haven't acted because we haven't solved the riddle quite yet. It's going to be an interesting year.

As always, please feel free to reach out with questions, concerns, or thoughts on how we can do better.

Sincerely,



Scott Goodwin, Managing Partner

CC: Diameter Team



Jonathan Lewinsohn, Managing Partner

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