Evaluating the Opportunity and Cycle in Special Situations and Distressed Debt

June 2026

Special situations and distressed debt investing focus on corporate credit and equity opportunities at companies facing financial stress, bankruptcy, or major corporate change. Rather than traditional loans or bonds, these strategies target mispriced opportunities arising from companies under financial strain or undergoing significant corporate events. By investing at potentially significant discounts to intrinsic value, managers aim to generate attractive returns as conditions stabilize or events unfold. For financial advisors considering alternative investments, these strategies can help diversify client portfolios and enhance return potential, although they also involve greater risk and complexity.[1]

Distressed as an investment strategy

Distressed debt and special situations are two closely related strategies that both involve investing in companies facing challenges or undergoing significant change driven by operational and/or financial trouble. However, each focuses on different types of opportunities and tactics:

- **Distressed debt:** This involves buying the loans or bonds of companies in severe financial difficulty—for example, firms approaching bankruptcy, in restructuring, or suffering liquidity crises. Because of their financial troubles, these companies' debts can trade at deep discounts to their face value. Managers who purchase this "distressed" debt seek to profit if the company recovers, causing the value of the debt to recover.

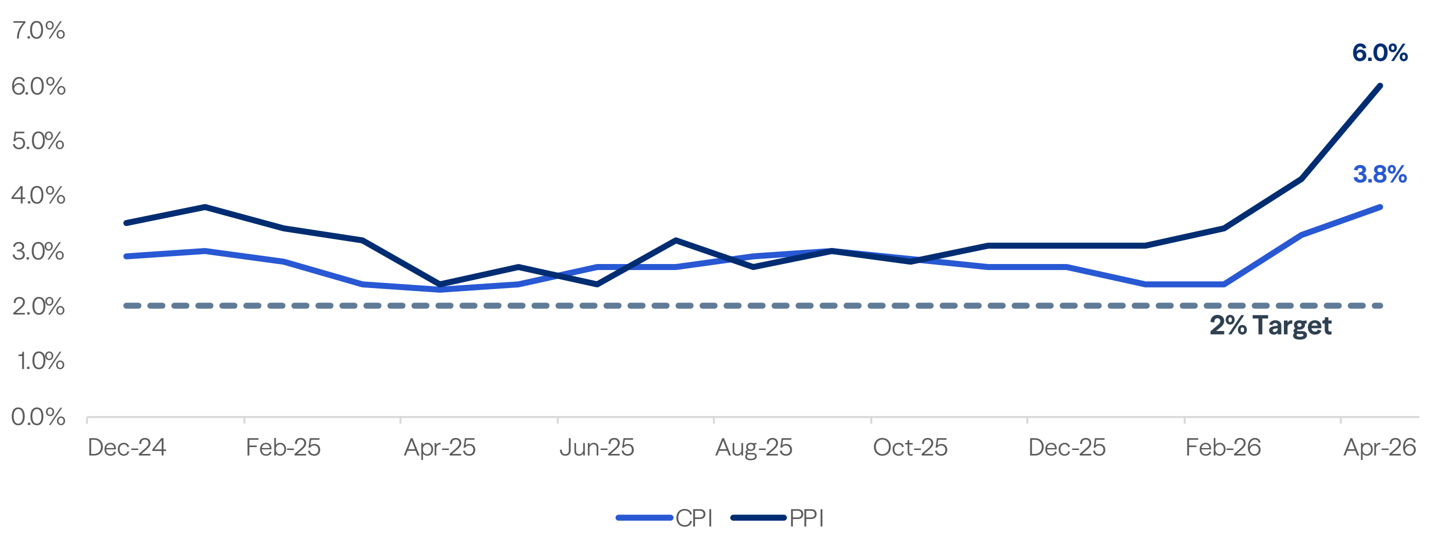
  Distressed debt investors often aim to become significant creditors, giving them a voice in restructuring negotiations (for example, by joining creditor committees) or even enabling them to take control of a company through a debt-for-equity swap. Their expertise in legal processes (such as bankruptcy law) and capital structure analysis helps them assess what a company's assets might be worth if it reorganizes or liquidates. In some cases, the strategy resembles deep-value investing, where a fund might take over a troubled business at a low price and work to turn it around, aiming for a profitable exit when conditions improve.

- **Special situations:** This is a broader, more event-driven category of investments that goes beyond just companies in distress. It focuses on idiosyncratic corporate events or complexities that create price dislocations or force selling by other investors. These events are often one-time or unusual in nature—breakups of conglomerates, regulatory changes or legal outcomes, or companies undergoing major strategic shifts or turnarounds.

  Unlike distressed debt which usually centers on financial distress, special situations can involve healthy companies experiencing special events that temporarily depress or confuse their valuations. The common thread is that something non-standard is happening with the company or asset, creating a chance for investors with insight and patience to benefit should normalcy return. Funds in special situations might invest across the capital structure, including equity or debt, depending on where they see the most attractive potential gains once the special situation resolves.

Exhibit 1: Inflation spiked higher in 2026 due to restricted supply

U.S. CPI and PPI year-over-year change (%)



Source: Bureau of Labor Statistics, data as of May 2026. Consumer Price Index (CPI) is the year-over-year percent changes in the prices paid by consumers for urban households and the Producer Price Index (PPI) measures the average change over time in the selling prices received by domestic producers for their output, as defined by the U.S. Bureau of Labor Statistics. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

In both distressed debt and special situations, investors have the benefit of participating in potential upside through equity or equity conversion instruments. In distressed debt investing, converting debt to equity is an important milestone for influence/control-seeking investors. In special situations, investors may enter the cap table[2] through preferred and/or common equity linked securities. In each case, the goal for long-term investors is to influence future outcomes and benefit from improved business performance. There is also a similar strategy of deep value equity investment that can come by gaining controlling equity position through a traditional buyout transaction in a troubled company where investors feel that they have a vantage point that will help resolve prevailing issues and unlock long-term value.

In all deal types, the common theme is an underperforming company that can address long-term issues through unique foresight and value-creation planning offered by asset managers looking to invest in such companies. Consequently, this investment type is best tackled by proven and experienced managers.

These investments are often made in companies with tangible asset bases such as real assets, plant, property and equipment, receivable and other assets. Managers in this segment look for downside protection and attempt to recover their investment value by disposing of assets if their thesis does not play out as expected.

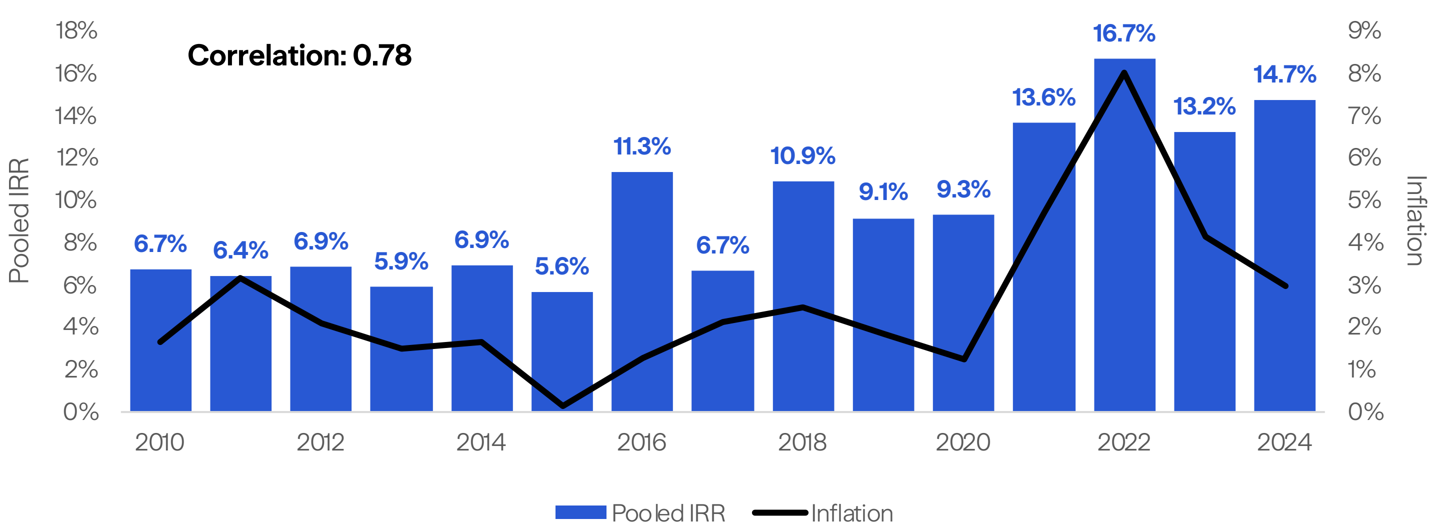
Catalysts and opportunity

Special situations and distressed debt strategies address market or asset inefficiencies. In times of severe corporate stress or complex events, many traditional investors may be forced to sell their positions or avoid these situations due to risk limits, regulations, or lack of expertise, which can cause securities to become undervalued. For example, when a bond falls to a low credit rating or a company approaches default, many conventional bondholders (like banks or mutual funds) might sell—leading to price drops that may overshoot the company's potential post-recovery value.

These specialized funds step in as buyers, providing capital to distressed companies when traditional sources of financing dry up. In return, these investors can potentially generate higher returns if the company stabilizes, or the special event pays off. Success in such investments generally favors managers who can influence business recoveries through active support and management.

Exhibit 2: Periods of rising or elevated inflation are linked to higher distressed returns

Distressed debt returns (internal rate of return) and inflation (U.S. CPI)



Source: PitchBook and Bureau of Labor Statistics, data as of May 2026. Data available through 2024. Distressed returns are pooled internal rate of return (IRR) for private debt credit special situations benchmark, North America as defined by PitchBook. Inflation is U.S. Consumer Price Index (CPI) measured by the year-over-year percent changes in the prices paid by consumers for urban households. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

Distressed investing is cyclical, often driven by specific catalysts or policy shifts, so timing plays an important role. While some strategies may be designed to perform across different market environments, distressed approaches can be the most effective when capital is scarce and traditional lenders pull back. In these periods, distressed investors can step in as primary capital providers. One such current catalyst is persistently high inflation (Exhibit 1), and the projections are for inflation to remain higher than the 2% long-term objective stated by the U.S. Federal Reserve.

Some strategies capitalize on market risk, crisis and complexity. Historically, financial crises and economic downturns create fertile ground for distressed strategies. In fact, higher inflation tends to be linked with a distressed cycle and elevated returns. Since 2010, stronger performance for distressed funds has been linked (0.78 correlation) with higher inflation (Exhibit 2).

During recessions or market panics, business costs rise, credit tightens, and many companies struggle to refinance debt or fund operations. Inflation can also drive up the cost of borrowing as central banks use interest rate policy to manage price stability and inflation. This, in turn, can reduce financing sources and create a larger opportunity for those willing to make direct loans to stressed borrowers.

For distressed and special situations managers deploying capital today, the higher interest rates driven by inflationary trends can potentially provide fertile ground for identifying new opportunities. This is even more favorable for controlling distressed or special situations managers who have the operational know-how to help companies navigate these turbulent periods.

In more normal times, special situations investors look for less obvious opportunities—like obscure corporate actions or off-the-run assets—where they can leverage specialized knowledge and in-house operational teams to find and unlock hidden value.

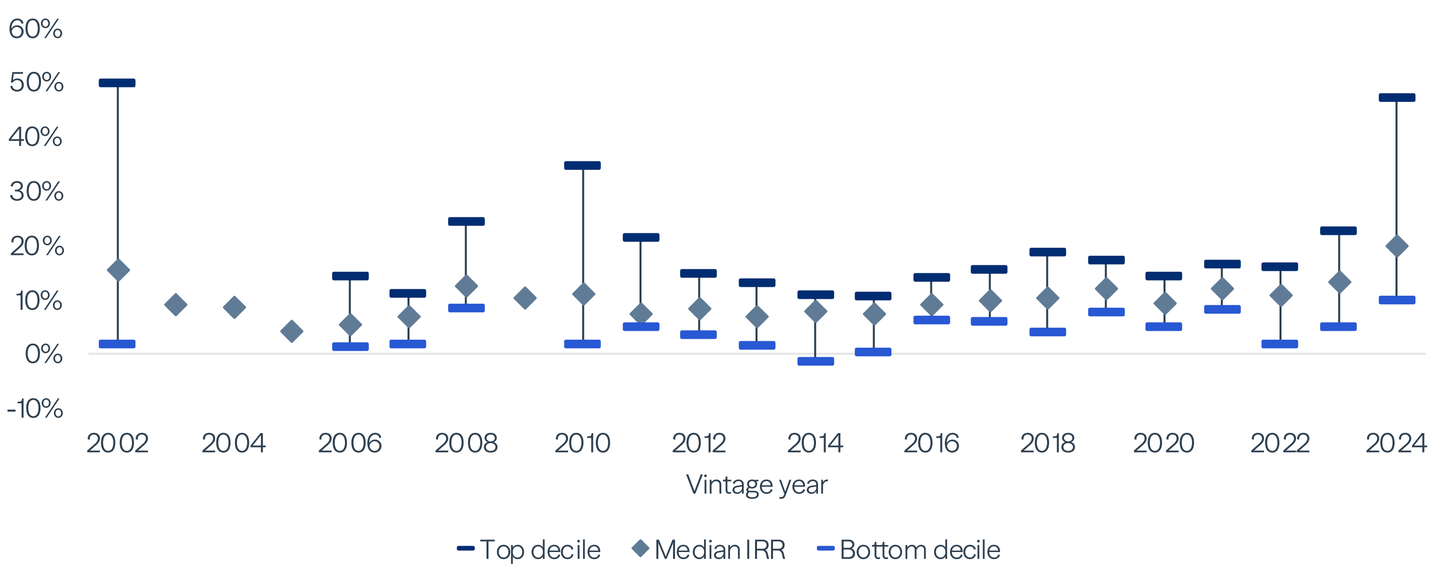
Path for returns

Investors in special situations and distressed debt strategies seek multiple potential sources of return that go beyond typical interest or dividends. Key return drivers include:

- **Price recovery and capital appreciation:** Perhaps the most straightforward outcome is buying low and selling high. If a distressed company successfully restructures or improves its fortunes, its heavily discounted debt and equity should be repriced to a materially higher recovery value.

Exhibit 3: Distressed returns tend to see wider dispersions due to highly varied outcomes

Distressed and special situations IRR dispersions by vintage year



Source: PitchBook, PitchBook Private Debt Benchmarks: Q3 2025, January 8, 2026. Data available through 2024. Distressed returns are IRRs by vintage year for distressed and special situations benchmark, as defined by PitchBook For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

- **Negotiation leverage and control premium:** By accumulating a large stake in a troubled company's debt, investors can gain influence through a controlling stake or even end up owning the business post-bankruptcy. This allows them to restructure the company more effectively or to negotiate favorable terms (for example, swapping their debt for equity ownership) that give them a share in any recovery upside (or equity alpha). The potential for turning debt into equity, and then benefiting from a company's turnaround, is a key attraction of distressed investing.

- **Value realization in special situations:** In special situations, returns often come from unlocking value tied to a specific catalyst or event. For instance, when a conglomerate spins off a subsidiary, investors might buy the parent or the subsidiary's stock if they believe the market doesn't fully appreciate the new value. Similarly, when a company's stock is depressed due to a lawsuit or regulatory overhang, a positive legal resolution can lead to a sharp rebound. Special situations funds profit from price corrections once the catalyst event unfolds, closing the gap between market price and intrinsic value.

- **Income or distressed yield:** In some cases, distressed debt investors can also earn high current income while waiting for capital appreciation. Because troubled companies must offer very high yields to attract capital, investors providing rescue financing or debtor-in-possession (DIP) loans can receive substantially higher interest rates than normal loans (albeit with significant risk). This yield component is an extra return driver on top of any potential price recovery.

Distressed strategies aim to combine one or more of the above factors to achieve private equity-like returns from credit and event-driven situations—but those returns are far from guaranteed. They depend on the investor's ability to correctly analyze each situation and successfully navigate complex processes (like legal proceedings or corporate transactions) to unlock value.

For these reasons, return dispersion in these strategies tends to be wide. Outcomes can vary significantly, particularly where manager experience and sourcing capabilities play an important role. Seasoned managers with specialized expertise and differentiated sourcing networks may be better positioned to generate enhanced returns.

Portfolio role and considerations

In a diversified portfolio, special situations and distressed debt can provide enhanced equity-like returns to credit allocations. Because the performance of these strategies is largely not correlated with traditional stock and bond markets, a small allocation can potentially enhance diversification and offer returns that don't move in tandem with the rest of the portfolio. For example, performance might be driven more by specific company workouts or credit events than by overall market trends, providing a hedge if public markets are struggling.

However, advisors should note that these strategies also come with risks and trade-offs:

- **Longer duration:** Investments in distressed or special situations are often long-term and not easily sold, since it can take years for a restructuring or special event to play out.

- **Complexity and manager skill:** Success in this space depends heavily on the manager's expertise in credit analysis, law, and operational turnaround. Due diligence on fund managers is crucial, given the specialized nature of the strategy.

- **Unique risk/return profile:** By definition, distressed companies could fail. If a turnaround fails or an event doesn't pan out, investors can experience losses. Distressed/special situations strategies carry the highest risk among private credit approaches and, hence, manager selection is more critical.

- **Market conditions driven:** Unlike traditional buyout investing, distressed/special situations investing need tailwinds from increase in default rate or related market turbulence. As such, these strategies are not all-weather and hence, manager selection is even more important.

For the typical financial advisor, special situations and distressed funds might serve as an **"opportunistic" sleeve**—a way to seek additional return and diversification, but in moderation and with a clear understanding of the unique risks involved.

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ENDNOTES

1. Investments in special situations/distressed funds carry higher risks as they are complex, require long-term commitment to see the gains, and have a high probability of loss. Therefore, such investments are not recommended for 'average' investors'.
2. A capitalization table (cap table) is a single source of truth for a company's ownership, showing all shareholders, their securities, and their ownership stakes.

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