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Ares' Brufsky: In Low-Yield World, Diversified High-Yield Holdings Are Worth A Look

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Chuck Jaffe, in The NAVigator podcast, interviewed Seth Brufsky, chief executive officer at Ares Dynamic Credit Allocation Fund, ticker ARDC. Read the Q & A below as Chuck and Seth discuss how investors can benefit from expanding their fixed-income holdings into leveraged loans, and how collateralized loan obligations and other high-yield investments can add more juice to a fixed-income portfolio in a low-rate environment.


Seth Brufsky

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The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Seth Brufsky, chief executive officer at Ares Dynamic Credit Allocation Fund is here and we're talking high-yield investments and more today in The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry, from users and investors to fund sponsors and creators. Today we're talking with somebody behind one of those funds. Seth Brufsky is chief executive officer at Ares Dynamic Credit Allocation Fund, that's ticker symbol ARDC. It's a closed-end fund that looks to provide a high-level of recurring current income and attractive total returns by investing in various types of high-yield investments. To learn more about the fund, go to AresPublicFunds.com. If you want to learn more about closed-end fund investing, the Active Investment Company Alliance is online at AICAlliance.org. Seth Brufsky, good to have you on The NAVigator.

SETH BRUFSKY: Thanks Chuck. Thanks for having me.

CHUCK JAFFE: Let's start by talking about the reasons why a high-yield investor would be interested in Ares Dynamic Credit Allocation Fund. It's not just, "Oh, here's high-yield bonds." You guys are looking at leverage loans, and high-yield bonds, and collateralized loan obligations, and those are very specific types of high-yield. Who should they appeal to? Who should be interested?

SETH BRUFSKY: When you look at investors interested in this kind of fund, in ARDC, it's investors who are really looking for a high-level of current income, somebody who's also looking for a stable dividend. Most importantly, as you know in the closed-end world, that dividend is actually covered by the earnings of the company, and income generated by the underlying asset classes of that fund. When you look at ARDC, it does open up a universe of leverage finance investments, as you mentioned, that are just not high-yield bonds, which are generally fixed-rate investments. But it also gives you the floating rate options of leverage loans and some structure credit investing through CLOs; collateralized loan obligation investments. Having all of those different asset classes under one umbrella, provides a lot of flexibility to invest across any environment that you see. Whether you want to be longer duration, shorter duration. At the end of the day, they're really focused on generating strong income from each one of those asset classes. When you look at it specifically for Ares, in each one of those underlying asset classes, loans, bonds, and structured credit, Ares is a top five CLO manager currently, and a leading investor in that market. We've also been doing this for over twenty years, so we're pretty experienced. When it comes to these kinds of funds, there can be relatively rapid movements in the changes in environment, and you really do need an experienced manager to understand how to manage those different asset classes to get the income result you're looking for.

CHUCK JAFFE: One asset that you talked about in there, leveraged loans. My audience has heard a lot about how closed-end funds often operate with leverage, but a leveraged loan is a very different thing. Explain what a leveraged loan is, and why that doesn't affect the leverage situation in a closed-end fund as we traditionally think of leverage for closed-end funds.

SETH BRUFSKY: On the basis leverage, a leveraged loan is a debt instrument, a credit instrument that is issued by a large corporate entity. So often in the past, as an example, DIRECTV, HCA, Charter Communications, these are all issuers or have been issuers of leverage loans in the past. As opposed to, you're going to a bank to borrow against your property to get a mortgage. These are actual securities that are floating rate in nature. They're senior secured, so they have a priority position in capital structures, meaning that they sit at the top of the capital structure. Then subordinated to that tend to be bonds. Below that are preferred equity. Below that is common equity. So this is generally considered the most defensive part of a company's capital structure that you can invest in. They are all secured, meaning that they're collateralized by the assets of the business, sometimes the equity of the business, the trademarks of the business, and the physical property of the business. So it's a bit different than looking at the old mortgage backed securities of the past, which would be a collection of mortgages.

CHUCK JAFFE: In there you talked a little bit about groupings of bonds in other ways. Well, collateralized loan obligations, help my audience understand a little bit more why CLOs are attractive and how they further diversify.

SETH BRUFSKY: Just for your audience, a CLO, a collateralized loan obligation is really a securitization of a pool of assets of leveraged loans at the end of the day. Each CLO typically holds about two hundred to three hundred different assets, so you're getting a significant diversification within the pool of assets that you own. They are very high-income products. More so than loans and more so than bonds, because the market is a little bit smaller. But it still is a liquid market, they've performed very well over the course of time. But just to give you a sense of a CLO versus a straight single name loan, if it's a BB of CLO paper, you're generating somewhere in that seven and a half to eight and a half percent income range, and that's a pool of two hundred to three hundred loans. If you're a single name issuer in the BB loan market today, you're getting somewhere between three and a half and four and a half percent. So you can see there's a significant premium to own CLO paper. The reason behind that is obviously their leveraged structures. You're trouncing out a securitization of first loss, second loss, third loss of a pool of assets. Where we traditionally play is either in that first loss in a small way, or the second and third loss pieces of these structures. Now the credit performance of these CLOs are much more conservative than the traditional securitizations that you might have seen in the past. They have covenants in them that require certain amounts of lower rating assets that limit the amount of lower rated assets that are in them. They require certain levels of over-collateralization, so these tend to be very strong credit enhanced products. When you look at the twenty-year track records of CLOs, they've generally had an accumulative default rate of forty basis points. That's not four percent, that's 0.4%. Versus leverage loans at three percent and high-yield bonds at five percent. So to us it's a strong value proposition, versus a lot of other asset classes. It's also been a significantly growing market over the last ten to fifteen years, and there's tremendous trading liquidity in it versus ten to fifteen years ago. That makes it even more attractive to be able to actively manage the structures within our pool of assets of ARDC, but as a CLO manager, you're actively trading those two hundred to three hundred names, so it's not a set allocation. You can change that allocation based upon your relative value in the current prevailing environment in the economy.

CHUCK JAFFE: What does that mean in terms of performance? I'm not asking you to set expectations, but in terms of correlation to the rest of the market, if I look at you top ten holdings, it's names that I would recognize and see in other things. So what does this do to diversify a portfolio, compared to stocks, bonds, cash, the basics that everybody normally makes sure are in their portfolio?

SETH BRUFSKY: When you actually look at the three asset categories that are managed under the ARDC umbrella, that we have flexibility to trade in and out of and create different asset allocations depending on the environment, they are leveraged finance asset classes. But when you look at the correlation between traditional credit, meaning investment grade in treasuries or sovereign risk in Europe, because we do have an aspect of Europe that we're allowed to play here, the correlations are very low. So the way to look at this is, they tend to be a nice compliment to a broader pool of credit or fixed-income investments that most people traditionally hold a high percentage of in their portfolios. In addition versus equities, they also have a very low correlation. So again, it's a nice compliment to existing broader pools of traditional credit or traditional equity type investments. But at the same time in a world where there's tremendous volatility in equities and there's also extremely low rates in traditional fixed-income, people are getting pushed out on the investment curb in the world of credit, and these are a lot of the alternative credit categories that you can get excess yield in versus those. So if you look in today's market, the current yield on an investment grade rated bond might be three percent. CLOs in our portfolio generate somewhere between seven and ten percent depending on the name and where you play in the capital structure. The bonds and the loans typical generate somewhere between a five and an eight percent, these are unlevered, current income. So you can see there's tremendous excess return that you can generate from these asset classes with limited correlation to the more traditional asset classes that people are investing in.

CHUCK JAFFE: What about additional risk?

SETH BRUFSKY: You are taking on more risk and that's where the credit expertise of an Ares management comes into play, as well as understanding these asset classes. These are asset classes -- Ares has been around for nearly twenty-two years -- we've been in these asset classes since the beginning of that time when they were much smaller asset classes. So we've been through the evolution of these markets as they've grown, versus the traditional fixed-income markets, which have always been very big. But again, these are companies that have lower credit ratings than an investment grade. Typically B, BB types of ratings on average will be in these, versus traditional fixed-income investment-grade, which is going to be BBB, A on average rated.

CHUCK JAFFE: Seth, great stuff. Thanks for explaining it to us and thanks for joining us on The NAVigator.

SETH BRUFSKY: Thank you, Chuck. It's been great to talk to you.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I am Chuck Jaffe, your host, you can learn more about my show and my work at MoneyLifeShow.com. Thanks to my guest, Seth Brufsky, chief executive officer at Ares Dynamic Credit Allocation Fund, ticker ARDC. Learn more at AresPublicFunds.com. To learn more about closed-end funds and business-development companies, go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. The NAVigator podcast is available every Friday, please subscribe where you find all of your favorite podcasts. We hope you will join us again next week.

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