How Alternative Credit Types Can Build Returns And Balance Risks

Friday, April 9, 2021

Chuck Jaffe, in this episode of The NAVigator podcast interviewed Keith Ashton, portfolio manager for the Ares Dynamic Credit Allocation Fund (ticker ARDC). Read the Q & A below as Keith talks about why he likes collateralized loan obligations and other credits as a way of adding low-duration, high-yielding income instruments to a portfolio, and discusses what investors should expect from adding these alternative credits for the income-generating side of their portfolio.

Keith Ashton

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

CHUCK JAFFE: Keith Ashton, portfolio manager for the Ares Dynamic Credit Allocation Fund is here, and we're talking about investing in alternative credit instruments like collateralized loan obligations. This is 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. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And if you're looking for more direction on closed-end funds and business-development companies, check out the Alliance website, it's AICAlliance.org. Today on The NAVigator I'm joined by Keith Ashton, portfolio manager for the Ares Dynamic Credit Allocation Fund, which you can learn about online at AresPublicFunds.com. Keith, thanks so much for joining me.

KEITH ASHTON: Thank you, Chuck. It's a privilege to join you today, thanks.

CHUCK JAFFE: Your fund specializes in alternative credit opportunities, trying to get recurring income and attractive total returns through some high yield, through some leverage, and through CLOs, which are collateralized loan obligations. Now I broke one of my cardinal rules here with that introduction when I started the very top of this segment where I said collateralized loan obligations, because I don't use jargon usually. But in this case the jargon, the CLO is central to your strategy. Explain what you're doing at the Ares Dynamic Credit Allocation Fund, and why it leads you to some credits that maybe the average investor, even though they're looking for yield, hasn't thought of.

KEITH ASHTON: Great question, and the way we think about ARDC or the Ares Dynamic Credit Allocation Fund is that it is a credit fund first and foremost, which means our process and our strategy is all about identifying companies that we can lend to. Now we can lend to them directly by buying their corporate loans, we can lend to them directly by buying their corporate bonds, or we can lend to them indirectly through CLOs. And I think the easiest way to understand CLOs or collateralized loan obligations is to think of them as a special type of institutional loan fund. They're just a loan fund like every other loan fund that you know, except that they provide investors like Ares and other institutional investors, different ways of investing, different options or choices.

CHUCK JAFFE: Why are CLOs particularly attractive right now? Obviously CLOs, they're not all the same flavor. It's not like, "Hey, you've got a CLO, they all invest in the exact same things." It's who they make loans to. But in this environment where people are worrying about inflation, where they're worried about what's going to be happening with rates, why are CLOs something that you seek out that investors should be seeking out?

KEITH ASHTON: That's a really important question, and it really goes to the very point of why we include CLOs as part of ARDC's strategy. As I've said, CLOs are a type of institutional

loan fund, and that's how we think about them. As institutional loan funds go, and each is managed by different managers, what we find, to your point, is that each manager may take a different approach to investing in the loan market. So you're right, all of the underlying loan portfolios are different, and that will vary primarily manager to manager. Some managers are more conservative and more defensive, or may be pursuing a certain strategy, a credit strategy within their fund that is we think aligned with our view or how we want to express a view on the loan market. While other managers might be more aggressive and taking on more risks. So where we have in the CLO market a big menu of options, there's over 1,500 CLOs out there right now, we can take a view on the loan market and express that view very precisely by choosing which CLOs that we invest in. And so it creates a whole array of options and choices that we get to use in a credit strategy and in a credit fund like ARDC, to express that view as precisely as we can as an additional lever that we can pull inside of a strategy that's focused on corporate credit to begin with.

CHUCK JAFFE: But let's help the audience understand what this does in terms of where the rubber meets the road. What's performance been? Because I can figure out a million different ways to check the performance of the stock market, but I don't think there's anybody out there that'd go, "Yeah, I can figure out what CLOs make or how they performed in 2020."

KEITH ASHTON: That's one of the greatest parts of why we invest in CLOs in ARDC and generally as a firm. And that is we tend to see, and it's been true for 20 years, we tend to see better credit performance in CLOs than we do generally in the market. And let me put some numbers to that; 2020 was a fairly consequential year for so many reasons, but it was also a year in which we saw an increase in corporate defaults, something I'm sure you've noted before. And if we were to simply compare and say, "Okay, we've got funds that invest in loans over here," like it'd be ETFs or mutual funds or other types of funds, closed-end funds, and then we have CLOs, which are a different type of loan fund. And if we were to simply compare the two groups, the CLOs and the non-CLOs, and ask the question, where did we see more defaults, more underlying loan defaults occur? And what's fascinating, and I think very important, is that we tended to see far more defaults occurring in non-CLO loan portfolios than in CLO loan portfolios. For example, whereas CLOs as an institutional class of investors, if you group them all together they represent 60% or so of the entire corporate loan market. So they're a big part of the loan market, but they only held approximately 15% of any of the

defaults. Think about that for a second. They have a 60% market share in the loan market, but only had 15% of the default market share. They under defaulted by a major factor relative to other types of loan funds. And if you get that, you understand a little bit about why we prefer and like to include CLOs in our strategies, because we tend to find better credit performance overall, particularly in times of higher default rates. And that's been true for many cycles going back decades.

CHUCK JAFFE: Would that mean that there's a bit of a misconception perhaps a lingering memory of the 2008 Financial Crisis where nobody was talking about CLOs, they were talking about CMOs, collateralized mortgage obligations, or CDO, collateralized debt obligations. And if you watched *The Big Short*, you kind of came away going, "I don't know if I want any of those things." Is that part of the problem or is that part of the opportunity?

KEITH ASHTON: I think it's both. There continues to be some confusion out there because we have the unfortunate circumstance of things starting a 'C' and ending with an 'O', and everybody associates that with *The Big Short*. And you're exactly right, that CDOs, and particularly those that invested in subprime mortgage products had a terrible time. The vast majority of them, if not nearly all of them defaulted. Whereas CLOs that invest in corporate loans, rated, publicly syndicated corporate loans, companies you know, had no defaults during the Financial Crisis. And that's an important distinction, and the unfortunate circumstance of the initials is part of that misconception. But it performed radically differently than other things that begin with a 'C' and end with an 'O'. So part of what's happened since the financial crisis, is I think there's been greater financial literacy in terms of understanding those differences, there's been a great support generally for CLOs in the institutional market. There are hundreds of institutional investors that participate in this market, and I think some of that misinformation or misunderstanding has started to go away. And that's particularly true on the institutional side, which is why I think, Chuck, your show and this information is important to get out more broadly. Because we really do think it's a source of potential value for investors.

CHUCK JAFFE: That being the case, even in your portfolio you have to make a decision of how much you want this to be. So obviously you're not suggesting that everybody goes, "Hey, this is the entire thing," because it's not even all of your fund. So in terms of a credit strategy, what's a reasonable portion of a diversified credit strategy for CLOs to have?

KEITH ASHTON: The answer to that depends a little bit on who the manager is. Let me just paint a picture for you. So as I mentioned, there's about 1,500 different CLOs out there. You can think of them like mutual funds, as if I were to say there were 1,500 different mutual funds out there that invested in loans. And all of them a little different, different managers, different underlying portfolios. So I think one of the challenges that investors face in engaging in the CLO market is figuring out, analyzing and differentiating one from another. And I think that takes a special type of resources, there's a lot of different information you have to figure out. It's all available by the way, the transparency in the CLO market is everything you'd want it to. Every single month you get a list of everything the CLO owns, anything they bought or sold, what the manager's doing, how they're doing on all their tests. It's a very transparent market but it's an overwhelming market sometimes for the amount of data that's coming at you. So my answer to the question is, if you have the ability to really do this work, analyze, differentiate one from another, then CLOs can play an important valuable role in a credit strategy. And the way we think about it with respect to ARDC is we look at it as a compliment to what we're doing as direct investors in the loan market and as direct investors in the high-yield corporate bond market. And we look at relative value across those three legs of the tripod if you will, rather than just between loans and corporate high-yield. Because that will tell you perhaps weather you want to favor loans versus bonds. That could be a duration question, that could be a yield question. CLOs present a different set of opportunities and a different relative value equation. And very often we find that they're highly contributive to yield, to performance because there are inefficiencies and ways that that market behaves that we think can be very creative to a strategy. Again, if you have the foundation and the platform to do it, what we'd say, the right way. The appropriate way with the right amount of resources.

CHUCK JAFFE: Keith, great stuff. Thanks so much for joining me to talk about.

KEITH ASHTON: You're very welcome, it's been a pleasure. Thanks again, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I am Chuck Jaffe, please check out my show on your favorite podcast app or at MoneyLifeShow.com. To learn more about interval funds, 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.

Thanks to my guest, Keith Ashton, portfolio manager for the Ares Dynamic Credit Allocation Fund. Go to AresPublicFunds.com for more information on the firm and its funds. The NAVigator podcast is new every Friday, subscribe on your favorite podcast app and join us again next week to learn more about investing with closed-end funds. Until then, stay safe everybody.

Recorded on April 8th, 2021

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