How Current Events Are Impacting The Capital Markets

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Seth Brufsky, chief executive officer for the Ares Dynamic Credit Allocation Fund. Read the Q & A below as Seth says that conditions since the end of the year have changed from concerns over what the Federal Reserve would do, 'changing the calculus' for how people should and will invest. Brufsky says the focus entering the year was on floating-rate investments, but now that there are lingering concerns about inflation and higher rates that – along with geopolitical concerns – are forcing investors to re-evaluate priorities but also investment options. Brufsky says that fixed-income markets are becoming increasingly attractive in these conditions – particularly in high-yield bonds, but also with some investment-grade securities – because the potential for capital appreciation has grown dramatically.

Seth Brufsky

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CHUCK JAFFE: Seth Brufsky, chief executive officer for the Ares Dynamic Credit Allocation Fund is here and we're talking about how current events are impacting the capital markets, and 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 today it is pointing us towards Seth Brufsky, chief executive officer for the Ares Dynamic Credit Allocation Fund, ARDC, and to get more information on the fund go to AresPublicFunds.com. Seth Brufsky, welcome back to The NAVigator.

SETH BRUFSKY: Thanks Chuck, look forward to talking to you today.

CHUCK JAFFE: Seth, current events are obviously dominating the headlines but these current events are unsettling. I mean, we've got everything becoming an economic event and clearly it is disrupting or changing some of the central bank picture, not just domestically but around the world. What does that force you to do? How much of this is evaluate, how much of this is make change?

SETH BRUFSKY: Thanks Chuck again for having us today. We just want to start off by saying obviously the events and the humanitarian crisis going on in Ukraine is a troubling and saddening situation in the world, and our hearts and thoughts definitely go out to all the people there who are living through that. In terms of the investment environment, it's pretty interesting from how much, how quickly things changed from the end of the year where everything was all about what's the Fed going to do and subsequently what are all the central banks around the world going to do to start the quantitative tightening cycle? Obviously you add in the geopolitical risk of what is happening in Europe and Ukraine specifically, and that changes the calculus and it changes the nervousness of the market, the anxiety of the market and what we're continuing to see. One of the things that is good about the structure of fund that we manage and Ares itself manages, is we're pretty diversified investment platform, and this fund in particular is very diversified so we're really set up to take advantage of the opportunity set as it changes. We cannot forget about what the Federal Reserve is going to be doing. Most people are expecting the Fed to stay the course and raise rates, but also are probably looking for a better signal. But to your point, when you see the geopolitical events affecting what ultimately is going to lead to higher inflation or longer term inflation than might have been expected, that changes the calculus of how people are going to be investing around the world. So one of the things that we kept in mind as we came into the beginning

of the year was to be more floating rate oriented in the portfolio as we were managing it today, with the expectation that the Fed was going to raise rates, that the central banks around the world were going to raise rates and start pulling out the stimulus in the market. But that has really changed, not so much is that being the sole focus, but that's also an added focus today of what the geopolitical risk is going to do to the fundamental picture. Are we going to see supply chain disruptions last longer? Are we going to see inflation last longer? And obviously that's added to a lot of volatility in the market and we are seeing opportunities today that I can guarantee you we weren't expecting to see as we came into the year. Meaning that there is much more convexity in the fixed-rate high-yield market today than there was prior to this.

CHUCK JAFFE: Let me jump in for just a second and talk about some of those opportunities by getting from you a little background on the fund, because at Ares Dynamic Credit Allocation Fund there are basically three different asset classes that you focus on. Talk about each of the asset classes, and if you're seeing those new opportunities, are they concentrated in one area more than another and why?

SETH BRUFSKY: So the three asset classes that make up the strategy are, one, bank loans, below investment-grade bank loans primarily, global high-yield bonds, and then also structured credit in the form of collateralized loan obligations both in the terms of the debt tranches and in terms of the equity tranches. When you look at today's market, obviously the floating rate assets, which are the leveraged loans and the CLO securities were very attractive coming into the beginning of the year with the expectation that rates were going to go higher. So obviously you want to take advantage of the fact that as rates go higher you're getting paid a higher coupon associated with the bank loans and the CLO debt and equity investments. And then on the flip side, high-yield bonds tend to be fixed rate, so very similar to investment grade, as rates go up the price of those securities go down overall. So that was the game plan coming in, but now that we're seeing concerns surrounding the fundamental environment and how inflation's going to affect these companies and fundamentally how things will change, the fixed-rate markets are actually becoming relatively attractive as well from the sense that there's a lot of convexity or capital appreciation built into high-yield bonds and in some cases investment-grade fixed-rate securities. So there's no one asset class that I would call out saying, "Hey, this looks really cheap compared to the others." I would say having the

base of the floating rates assets with the expectation that rates are going to go up is a positive, but also being able to take advantage of a market and fixed-rate market, the high-yield bond market, where prices are trading significantly below par versus where they were just three or four months ago provides a capital appreciation opportunity. So the dynamic nature of the strategy lets us take advantage of shifting around our asset allocation amongst those three different asset classes today.

CHUCK JAFFE: Obviously this is a strategy you pursue whatever the times are. But from your standpoint to some extent, do you lick your chops a little bit more as an active manager in times like this?

SETH BRUFSKY: Yeah, absolutely, because your opportunity set is so big. I mean, we generally look at this opportunity set being nearly a $6 trillion opportunity set, and in times like this, even when there's more uncertainty you can go up in quality. As an example, you can go up in quality because a lot of those BB rated bonds, and in some cases BBB rated bonds which are the upper ends of our rating spectrum that we can invest in, have traded down due to rates. So the price of a BB 5% coupon bond three months ago may have been par to par 1.05, today because rates are higher and there is more uncertainty, that bond might be trading in the low to mid 90s as an example. And we're able to go out and buy that bond knowing that we're improving the credit quality of the overall portfolio while at the same time picking up more yield and more opportunity to actually create some capital appreciation. Which is something honestly that we haven't seen since the middle of 2020 as the Federal Reserve and central banks around the world were pumping stimulus into the economy and created a lot of liquidity. So we are licking our chops from that sense, that the opportunity set is a lot more interesting for us to move around capital today, both from an income and from a capital appreciation opportunity.

CHUCK JAFFE: Obviously inflation is a wildcard economically and for investors. How much in these times with heightened inflation, if it remains persistent, does that become a bogey or benchmark for you? I mean, obviously people are looking for high yield, they're expecting to be able to generate returns above inflation, but inflation is beyond what anybody has really expected for ages, decades. So how much does that increase the challenge for you? Or is that the kind of thing that the market's going to react and respond and the opportunities are all still there, you don't mind having inflation low or high as the benchmark?

SETH BRUFSKY: Well, inflation is never a great thing for the markets, I'd probably start there just from the macro 101 perspective. But I think what it really does is actually magnify the relative value of these asset classes versus say an investment-grade or Barclays Agg type of portfolio because they get affected by inflation significantly more just because they are very low coupon fixed-rate long-duration assets. These asset classes that we've been talking about actually provide the opportunity, one, to take duration out nearly completely by going into a floating-rate instrument, so you're actually getting the benefit as I mentioned before of rising rates, therefore rising coupons, therefore rising yields and returns. Or at the same time, if you're able to buy some high-yield bonds and actually pick up some convexity and some capital appreciation, that's a strong opportunity as well. So while inflation is never a good thing, what you're seeing in these markets is that on a relative basis versus a lot of other asset classes and equities as well, just given the valuation dynamic and the volatility associated that inflation brings in, on a relative basis these asset classes actually become even more attractive than they have been. I would argue than they have been over the last several years.

CHUCK JAFFE: Seth, really interesting. Thanks so much for joining me on The NAVigator to talk about.

SETH BRUFSKY: Thank you for having us.

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