ARES | ARES AUSTRALIA MANAGEMENT

# Income Solutions in the "Sweet Spot" of Credit

**July 2020**

## Executive Summary


Even before the COVID-19 pandemic rocked global financial markets, Australia was on its way to join the lower yield world. Now, Australian investors in search of stable, current income strategies are facing a challenge as strategies of the past are unlikely to generate the returns and levels of income they once provided.

This can be observed across the risk spectrum with the Reserve Bank of Australia's (the "RBA") cash rate at 0.25% and Australian government bond yields below 1%, all the way up the risk spectrum to Australian banks' equity and their now more uncertain dividends.

We believe solutions to generate higher income and diversification for Australian investors' portfolios exist within certain parts of the global fixed income markets that provide current income and attractive relative yields with downside protection; we call it the "sweet spot" of credit.

To be successful in what we call the "sweet spot," we believe an arduous focus on capital preservation and the flexibility to select the most attractive relative value are key. We believe this can be achieved via our ability to identify attractive relative value in the more senior, higher quality segments of the bond, loan and structured credit markets and shift allocations among these asset classes as appropriate. In addition to maintaining a well-diversified portfolio of senior debt, a 50% allocation to investment grade credit further strengthens the high-quality nature of the strategy.


## The Challenge – Australia Joins the Low Yield World

Until recently, Australian investors didn't have to look too far for attractive yields and income, but the last 24 months have accelerated Australia's participation in the low cash rate and bond yield world.

According to a report published by the ASX in 2018,[1] in the last 20 years through December 2017, Australian cash annualised gross return was 4.6% p.a. Interestingly, cash returned 3.6% p.a. in the last 10 years through December 2017, which suggests a downward trajectory of the RBA target cash rate and term deposit rates (Chart 1).

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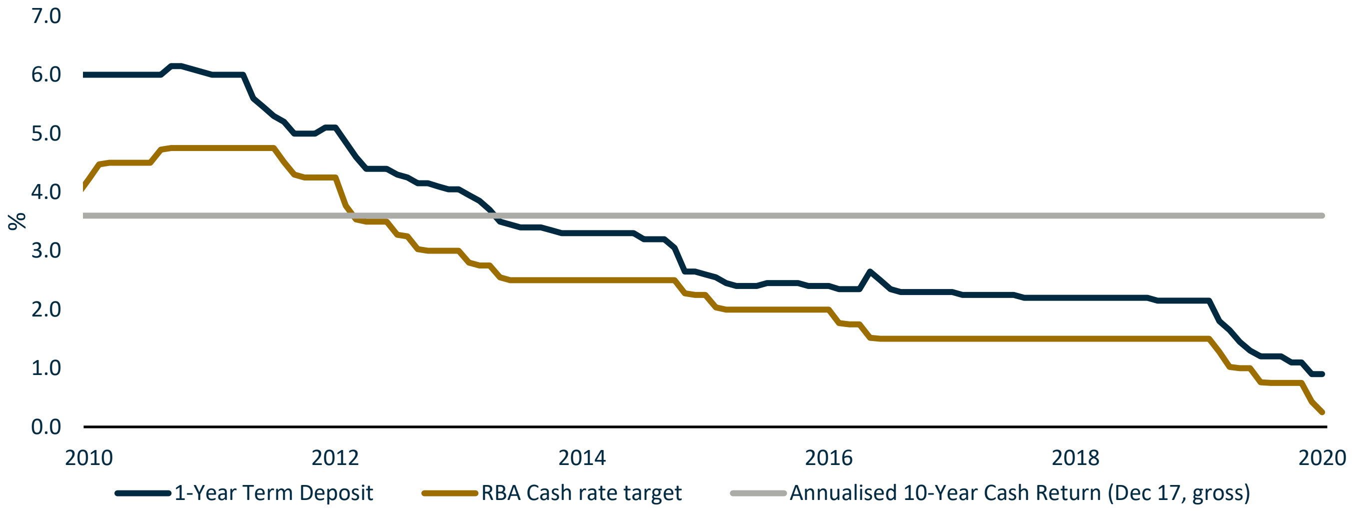
[1] "2018 Russell Investments/ASX Long Term Investing Report" June 2018, https://www.asx.com.au/documents/research/russell-asx-long-term-investing-report-2018.pdf

With the target RBA cash rate currently sitting at 0.25%, we believe that achieving the returns of the past in cash products seems unlikely for Australian investors.

**CHART 1: RBA Target Rate and 1-Year Term Deposit Rate**




Source: Reserve Bank of Australia (RBA), as of May 2020.

Moving up the risk spectrum (with risk defined as asset price volatility) in the last 10 years, Australian government and corporate bonds have offered attractive yields, generating higher income and returns than cash, with the same ASX report showing returns of c. 6% p.a. for the 10 years to December 2017.

These attractive returns and levels of income have partly been due to a falling yield environment which generates capital gains in fixed rate bonds. When realised, these gains are distributed as income alongside interest payments.

As illustrated in Chart 2 below, over the last 10 years to March 2020, Australian 10-year government bond yields went from over 5% to below 1%, and in the last 12 months, from over 1.5% in March 2019 to below 1%. This latest drop has driven strong returns and provided the expected counterbalance to riskier assets such as equity in such periods of volatility.

However, looking ahead, with 98% of Australia government bonds currently trading at or above 100% of face value and little room for yields to move further down (although they could go negative!), we believe income generation and outsized returns are unlikely to be what investors have experienced in recent periods.

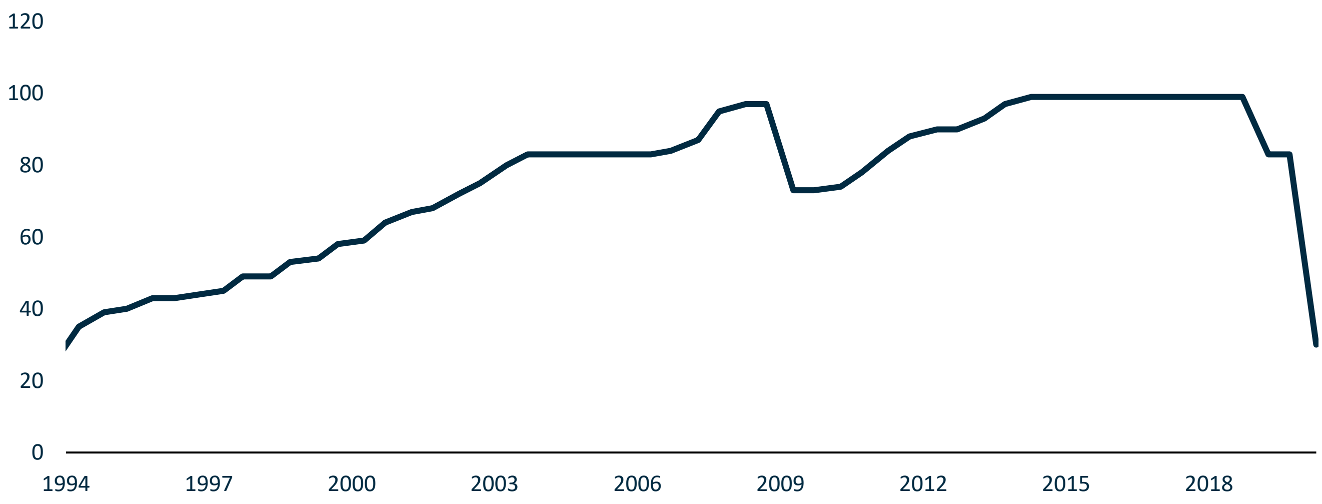
**CHART 2: Australia 10-Year Bond Yield**


Source: Bloomberg, as of 22 May 2020.

Finally, moving all the way up the risk spectrum to equities, Australian investors have enjoyed many years of high and dependable dividend payments from the major Australian banks. For those happy to endure some price volatility going up the risk spectrum, the four major Australian banks have been a reliable source of higher income.

However, in the wake of the COVID-19 crisis and the ensuing economic turmoil, an unprecedented level of uncertainty leaves many questioning the likelihood and reliability of those dividends as the banks employ a more conservative approach to cash management. As an example, NAB decided to cut their next dividend payment by 64%. NAB has not seen such low dividends since 1994; even during the Global Financial Crisis (the "GFC"), dividends did not decrease as precipitously as they have recently (Chart 3). This decision and the uncertainty around what other banks will do, has highlighted to investors that unlike fixed income and credit instruments, shares have no contractual obligation to a fixed level of distribution.

**CHART 3: National Australia Bank (NAB) Dividend Rate per Share (AUD)**




Source: National Australia Bank (NAB), as of May 2020.

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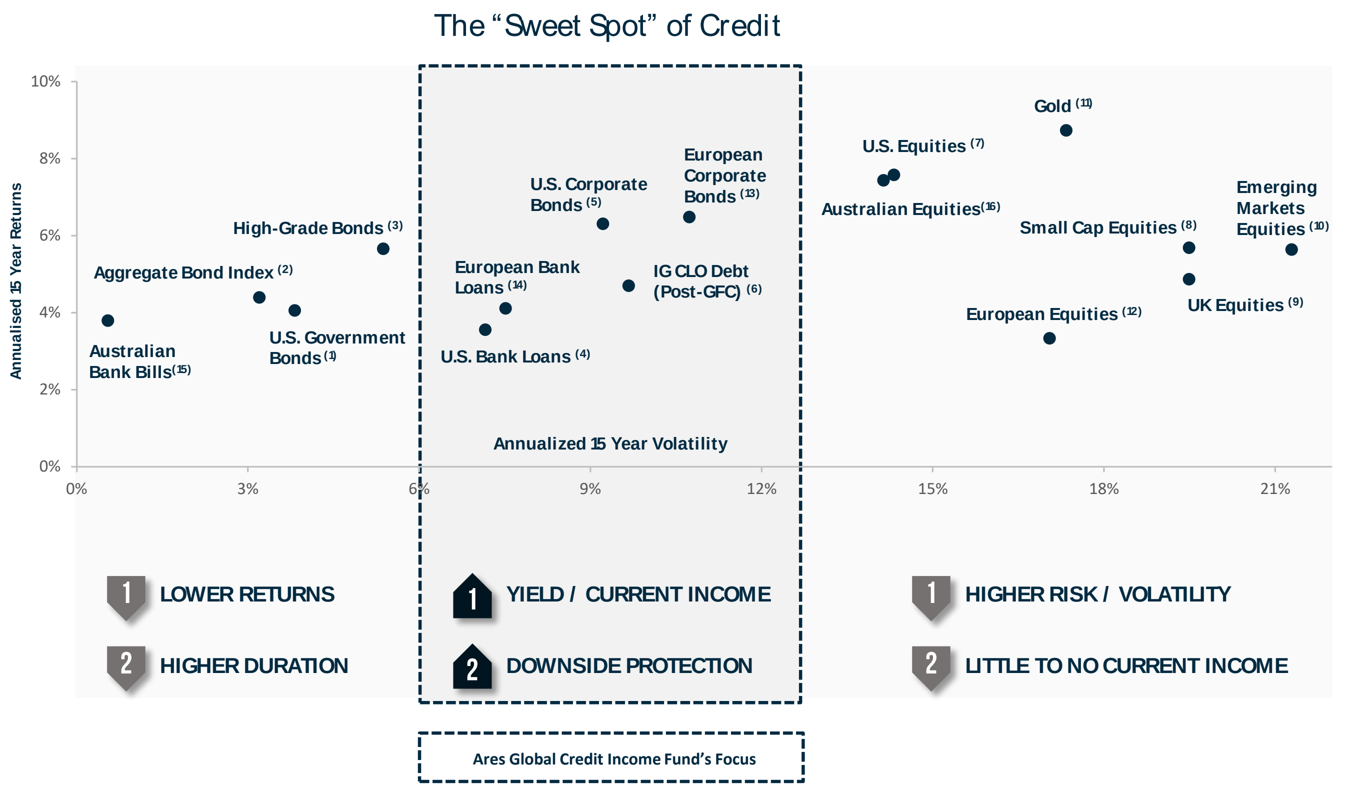
# The “Sweet Spot” of Credit

The challenge posed by low yields is not new for many global investors. Since 2007, the Ares Credit Group has been able to diversify portfolios with asset classes that we believe offer attractive yields and current income within global fixed income markets. We call it the “sweet spot” of credit.

We believe high quality corporate and structured credit presents the most compelling risk-reward opportunity. Our strategy seeks to avoid riskier asset classes (equities) as well as minimizes exposure to the more stressed, lower quality segments of the credit market (CCC-rated bonds and loans), which reduces volatility and default risk, and further takes advantage of the downside protection offered by senior and often secured credit position in the capital structure of corporate bonds and loans and asset backed securities. In tandem, Ares believes this particular focus offers greater opportunities for current income in yield than traditional fixed income and passive strategies.

**CHART 4: The “Sweet Spot” of Credit**

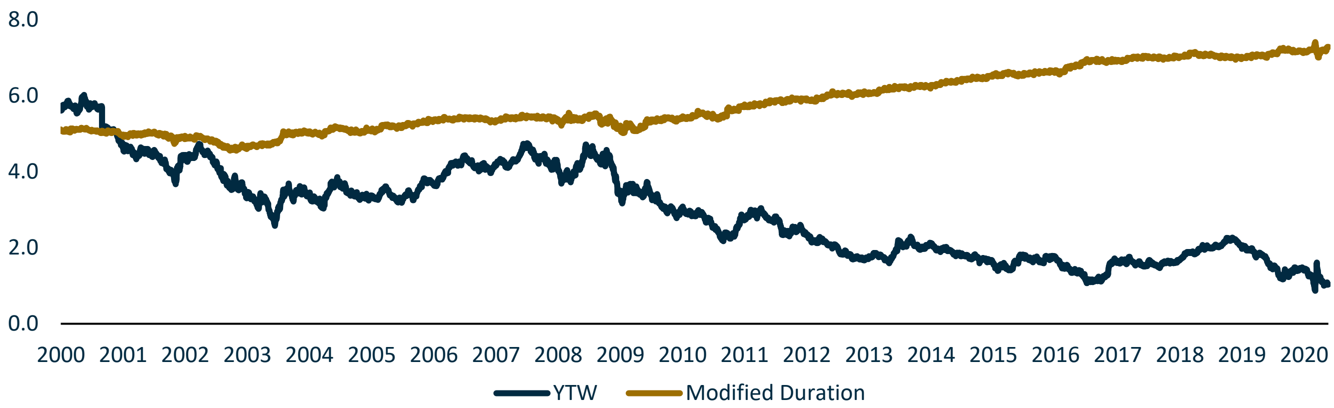



Source: JPM Morgan High Yield Annual Review. As of March 31, 2020. **Please refer to pages 9-11 for Index Definitions and an important index disclosure.**

(1) 5Y Treasury Bond. (2) Bloomberg Barclays US Aggregate Bond Index. (3) JPM JULI High Grade Index. (4) Credit Suisse Leveraged Loan Index. (5) JPM US HY Index. (6) JPM CLOIE BBB Post-Crisis. Annualized return since 2012. (7) S&P 500 Total Return. (8) Russell 2000. (9) FTSE 100. (10) Dow Jones EM Stock Index. (11) IAU US Equity. (12) EURO STOXX 50. (13) ICE BofA Euro High Yield Index. (14) Credit Suisse Western European Leveraged Loan Index. (15) Bloomberg AusBond Bank Bill Index. (16) S&P/ASX 200.

Within global fixed income specifically, falling yields accelerated by the recent sell-off in risky assets resulted in past performance favouring higher interest rate duration assets (Chart 5). For example, U.S. government bonds and high-grade corporate bonds that have higher interest rate duration risk than bank loans or investment grade CLO debt have outperformed (higher return and lower volatility). But, with government bond yields at or close to historical lows, the potential return and current income generation from the lower end of the risk spectrum seems challenged.

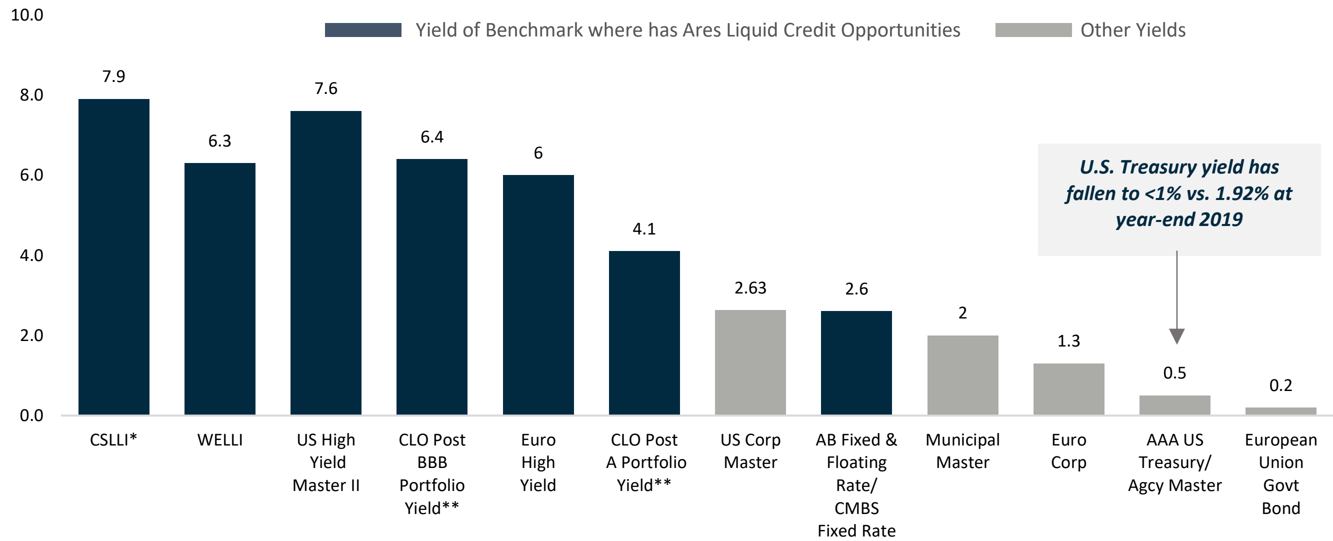
**CHART 5: Bloomberg Barclays Global-Aggregate Index (Unhedged US$) Yield Versus Duration**




Source: Bloomberg, of April 30, 2020. **Please refer to pages 9-11 for Index Definitions and an important index disclosure.**

Our focus is therefore on the asset classes that currently offer higher relative yields. These higher yields are largely derived from the credit spreads these securities pay on top of government bond yields. These spreads compensate investors for the additional risk that they take by investing in credit. As of the date of this letter, credit spreads in bank loans and corporate bonds are wide by historical standards, partly due to elevated fears around default risk for credit instruments and uncertainty in general which has pressured technicals. We believe this environment presents ample opportunity for managers looking to take advantage of inefficiently priced segments of the fixed income markets. And, while dynamic allocation across asset classes is certainly a distinctive feature of Ares' strategy, we recognize that falling yields is a global trend across developed and emerging markets and seek to opportunistically allocate across regions.

**CHART 6: Relative Yields Across Asset Classes**




Source: ICE BofA Indices, S&P Capital IQ, Credit Suisse Leveraged Loan Index, JPM CLOIE Indices, as of May 20, 2020.

Note: Yield to worst data is being presented unless otherwise noted. Post-Crisis period defined as period beginning January 1, 2010 to present day. *Represents the yield to three-year call. **JPM CLOIE data only goes back to December 2011. **Please refer to pages 9-11 for Index Definitions and an important index disclosure.**

In other words, current income and potential returns are attractive in the sweet spot of credit, but to fully optimise the strategy, we believe managers must be focused on minimising default risk.

## Protecting the Downside[2]

While outperformance is certainly a key component of successful investing, as a steward of investor capital, Ares places an equally important emphasis on downside protection and capital preservation. A heightened focus on portfolio positioning, volatility and duration are of particular importance during times of stress and economic uncertainty.

Default risk analysis is fully incorporated into Ares' investment process, which employs rigorous monitoring of credit performance with the robust use of data analytics to identify potential downgrade candidates. This focus has resulted in Ares experiencing significantly lower defaults in its broadly syndicated bank loan and high yield bond strategies since inception during times of stress. At the height of the GFC fall-out in 2009, U.S. high yield bond and loan markets saw default rates rise close to 11% and 15%,[3] respectively, while Ares' flagship bank loan fund and U.S. High Yield composite[4] have experienced fewer than 4%. Ares' European portfolios performed similarly, with its flagship European high yield

[2] References to "downside protection" or similar language are not guaranteed against loss of investment capital or value.

[3] J.P. Morgan Default Monitor, as of June 1, 2020.

[4] Performance for High Yield Bonds is represented by the U.S. High Yield Composite, which includes all actual, fully discretionary, fee-paying, separately managed portfolios that primarily invest in U.S. high yield fixed income securities.

portfolios experiencing a 3.4% default rate during the GFC versus the market's 13%. During the same period, Ares' flagship European loans portfolios experienced 0 defaults.[5]

Independent of the fund's 50% allocation to investment grade credit, Ares expects to maintain a higher concentration of double B-rated loans and bonds and will opportunistically consider single B-rated debt with strong fundamentals and the potential for upside. In current market conditions, we believe our ability to significantly under-default the market will again prove critical to capitalising on opportunities available in the sweet spot of credit.

## The Opportunity Set Has Broadened Amidst Uncertainty, Volatility and Bifurcation in the Credit Markets

Our investment process places a strong emphasis on relative value analyses to identify optimal risk-adjusted investment opportunities. In this uncertain, volatile and bifurcated environment our process has highlighted the following opportunities within the sweet spot of credit.

Volatility and uncertainty around corporate defaults have pushed credit spreads (Option Adjusted Spreads or "OAS") in the high yield bond market ("HY") to levels not seen since 2009. As it has become increasingly rare to see spreads widen past 800 bps, it is interesting to note that HY OAS have only been wider than 600 – 800 bps c. 20% of the time since 1996. [6]

Additionally, when loan and high yield spreads widen past 800 bps, if they were to return to their historical averages in the next 12 or 24 months, potential returns in that space may be significant as illustrated below.

**CHART 7: Forward Returns When Loan Spreads Are Between 600-800 bps**

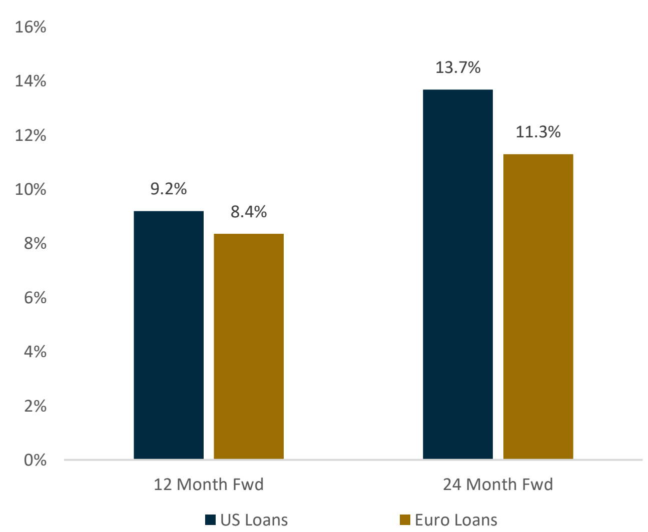
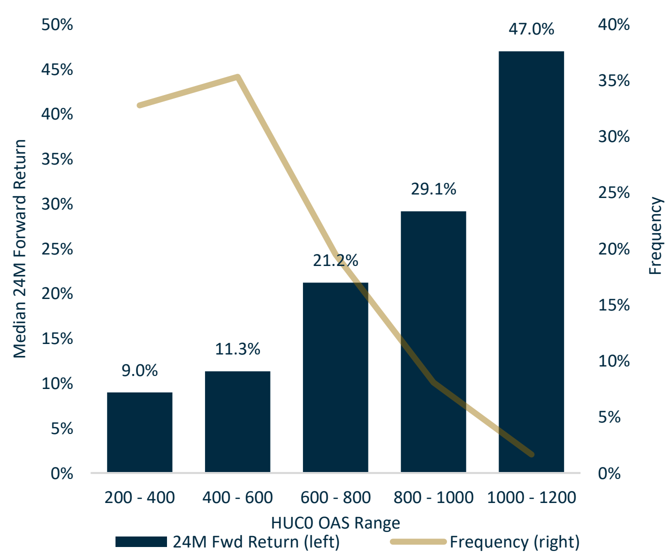



**CHART 8: Median 24M Forward Return Potential vs Frequency**




[5] Past performance is not indicative of future results.

[6] ICE BofA US High Yield Constrained Index (HUC0), as of June 2, 2020.

Chart 7 Source: Credit Suisse Leveraged Loan Index. As of May 29, 2020. The forward return potential shown here represent Ares's view on the potential range of returns. The returns are illustrative and do not represent the returns to any investor.

Chart 8 Source: ICE BofA HY Indices, as of May 29, 2020.

For illustrative purposes only. Projections and forward-looking statements are not reliable indicators of future events and there is no guarantee that such activities will occur as expected or at all.

Alternative credit provides multiple ways to find value and protection in different market conditions. CLO Debt in particular has consistently provided a premium to corporate yields across rating classes, ranging from 3.5% for single-A tranches to 9.3% for double-B rated tranches.[7] Most recently, shorter-dated, de-levering deals that have substantial loss protection have been attractive, and we are also starting to see strong value in clean, post-COVID-19 issuance. Regardless of the market environment, the Ares approach to investing with full transparency to the underlying assets allows for the ability to sift through a variety of available investment opportunities to find the assets that best provide the combination of current income with loss protection, which we can combine with loans and bonds to build a portfolio that meets our investors' needs.

## Conclusion

We believe the "sweet spot of credit," comprised of corporate and structured markets, offers a compelling opportunity for Australian investors seeking diversification and stable current income in varied market environments. To be successful in the so-called "sweet spot," we believe an arduous focus on capital preservation and the flexibility to select the most attractive relative value are key. We believe nimble and flexible style of portfolio management with the ability to dynamically allocate across asset classes when shifts in relative value occur is important. Further, we believe the ability to identify and unlock value especially in currently volatile and bifurcated markets is a strength. Finally, with capital preservation as a key characteristic of the strategy, managers should be intently focused on finding those opportunities with optimal downside protection and lower volatility.

[7] Source: J.P. Morgan CLOIE, as of June 4, 2020.

# Index Definitions

**The Bloomberg Barclays Capital Global Aggregate Bond Index ("Barclays Global Agg")** measures the performance of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers. To be included in the index, bonds must be investment grade using the index credit quality classification methodology (middle rating of Moody's, Fitch and S&P). The currency must be freely tradeable and convertible and not exposed to exchange controls that are designed to encumber its buying and selling by foreign investors. There must be an established and developed forward market or non-deliverable forward (NDF) market for the local currency such that foreign market participants can hedge their exposures into core currencies. Inception date: January 1, 1990.

**JPMorgan US Liquid Index ("JULI")** measures the performance of the investment grade dollar denominated corporate bond market. The JULI focuses on the most liquid instruments with the objective of making the index a fair and true representation of the investable market. To be included, instruments must be liquid, USD denominated investment grade corporate debt and a bullet security paying a non-zero coupon semi-annually. Excludes convertibles, refundables, extendables and perpetuals. Aggregate level total return is calculated as a market-weighted average of individual bond level returns. Previous day weights are used to aggregate current day returns. Performance and statistics are available by individual issuers, for sectors and sub-sectors, and maturity buckets (dating back to 31-Dec-1999).

**Credit Suisse Leveraged Loan Index ("CSLLI")** is designed to mirror the investable universe of the $US-denominated leveraged loan market. The index inception is January 1992. The index frequency is daily, weekly and monthly. New loans are added to the index on their effective date if they qualify according to the following criteria: 1) Loan facilities must be rated "5B" or lower. That is, the highest Moody's/S&P ratings are Baa1/BB+ or Ba1/BBB+. If unrated, the initial spread level must be Libor plus 125 basis points or higher. 2) Only fully-funded term loan facilities are included. 3) The tenor must be at least one year. 4) Issuers must be domiciled in developed countries; issuers from developing countries are excluded.

**JPMorgan Domestic High Yield Index** is designed to mirror the investable universe of the U.S. dollar domestic high yield corporate debt market.

**JP Morgan U.S. CLO Index ("CLOIE")** tracks floating-rate CLO securities in 2004-present vintages. Additional sub-indices are divided by ratings AAA through BB, and further divided between pre- and post-crisis vintages. CLO 2.0, or post-crisis vintages, include deals issued in 2010 and later. CLOIE utilizes a market-value weighted methodology. Inception date: July 15, 2014.

**Standard & Poor's 500 ("Domestic")**, often abbreviated as the S&P 500, or just "the S&P", is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. The S&P 500 index components and their weightings are determined by S&P Dow Jones Indices.

**Russell 2000** is an index measuring the performance of approximately 2,000 smallest-cap American companies in the Russell 3000 Index, which is made up of 3,000 of the largest U.S. stocks. It is a market-cap weighted index.

**Financial Times Stock Exchange 100 Index ("FTSE 100")** is a share index of the 100 companies listed on the London Stock Exchange with the highest market capitalisation. It is seen as a gauge of prosperity for businesses regulated by UK company law.

**Dow Jones Emerging Markets Index** is designed to measure 95% of the market capitalization coverage of stocks traded in emerging markets. Included in the Dow Jones Global Indices family are a wide range of regional, country, size-segment, and sector indices. The indices are float-adjusted market capitalization (FMC) weighted, with caps applied to certain indices within the family to ensure diversification among companies within those indices.

**iShares Gold Trust ("IAU")** seeks to reflect generally the performance of the price of gold.

**EURO STOXX 50 ("SX5E")** is a market capitalization-weighted stock index of 50 large, blue-chip European companies operating within Eurozone nations. Components are selected from the Euro STOXX Index, which includes large-, mid- and small-cap stocks in the Eurozone.

**The ICE BofA European Currency High Yield Constrained Index ("HPC0")** tracks the performance of EUR and GBP denominated below investment grade corporate debt publicly issued in the eurobond, sterling domestic or euro domestic markets. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million or GBP 100 million. Original issue zero coupon bonds and pay-in-kind securities, including toggle notes, qualify for inclusion in the Index. Callable perpetual securities qualify provided they are at least one year from the first call date. Fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. Contingent capital securities ("cocos") are excluded, but capital securities where conversion can be mandated by a regulatory authority, but which have no specified trigger, are included. Other hybrid capital securities, such as those issues that potentially convert into preference shares, those with both cumulative and non-cumulative coupon deferral provisions, and those with alternative coupon satisfaction mechanisms, are also included in the index. Equity-linked securities, securities in legal default and hybrid securitized corporates are excluded from the index.

**Credit Suisse Western European Leveraged Loan Index ("CSWELLI")** is designed to mirror the investable universe of the leveraged loan market of issues which are denominated in US$ or Western European currencies. The issuer has assets located in or revenues derived from Western Europe, or the loan represents assets in Western Europe, such as a loan denominated in a Western European currency. Loan facilities must be rated "5B" or lower. That is, the highest Moody's/S&P ratings are Baa1/BB+ or Ba1/BBB+. Only fully funded term loan facilities are included and the tenor must be at least one year. Minimum outstanding balance is $100 million and new loans must be priced by a third-party vendor at month-end. The index inception is January 1998.

**Bloomberg AusBond Bank Bill Index ("BAUBIL")** is engineered to measure the Australian money market by representing a passively managed short term money market portfolio. This index is comprised of 13 synthetic instruments defined by rates interpolated from the RBA 24-hour cash rate, 1M BBSW, and 3M BBSW.

**S&P/ASX 200** is recognized as the institutional investable benchmark in Australia. Index constituents are drawn from eligible companies listed on the Australian Securities Exchange. The S&P/ASX 200 is designed to measure the performance of the 200 largest index-eligible stocks listed on the ASX by float-adjusted market capitalization. Representative, liquid, and tradable, it is widely considered Australia's preeminent benchmark index.

**The ICE BofA US High Yield Master II Constrained Index ("HUC0")** contains all securities in The ICE BofA US High Yield Master II Index but caps issuer exposure at 2%. Index constituents are capitalization-weighted, based on their current amount outstanding, provided the total allocation to an individual issuer does not exceed 2%. Issuers that exceed the limit are reduced to 2% and the face value of each of their bonds is adjusted on a pro-rata basis. Similarly, the face values of bonds of all other issuers that fall below the 2% cap are increased on a pro-rata basis. In the event there are fewer than 50 issuers in the Index, each is equally weighted and the face values of their respective bonds are increased or decreased on a prorata basis. Accrued interest is calculated assuming next-day settlement. Cash flows from bond payments that are received during the month are retained in the index until the end of the month and then are removed as part of the rebalancing. Cash does not earn any reinvestment income while it is held in the Index. The Index is rebalanced on the last calendar day of the month, based on information available up to and including the third business day before the last business day of the month. Issues that meet the qualifying criteria are included in the Index for the following month. Issues that no longer meet the criteria during the course of the month remain in the Index until the next month-end rebalancing at which point they are removed from the Index.

**The ICE BofA US High Yield Index ("H0A0")** tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one-year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $100 million. Index constituents are capitalization-weighted based on their current amount outstanding times the market price plus accrued interest. Accrued interest is calculated assuming next-day settlement. Cash flows from bond payments that are received during the month are retained in the index until the end of the month and then are removed as part of the rebalancing. Cash does not earn any reinvestment income while it is held in the index. The index is rebalanced on the last calendar day of the month, based on information available up to and including the third business day before the last business day of the month. No changes are made to constituent holdings other than on month end rebalancing dates. Inception date: August 31, 1986.

**The ICE BofA US Distressed High Yield Index** is a subset of ICE BofA US High Yield index including all securities with an option-adjusted spread greater than or equal to 1,000 basis points.

**The HFRI Fund Weighted Composite Index ("HFRI")** is a global, equal-weighted index of over 1,400 single-manager funds that report to HFR Database. Constituent funds report monthly net of all fees performance in US Dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

**The ICE BofA BB US High Yield Index ("H0A1")** is a subset of The ICE BofA US High Yield Index including all securities rated BB1 through BB3, inclusive.

**The ICE BofA Single-B US High Yield Index ("H0A2")** is a subset of The ICE BofA US High Yield Index including all securities rated B1 through B3, inclusive.

**The ICE BofA CCC & Lower US High Yield Index ("H0A3")** is a subset of The ICE BofA US High Yield Index including all securities rated CCC1 or lower.

**ICE BofA Global High Yield Index ("HW00")** tracks the performance of USD, CAD, GBP and EUR denominated below investment grade corporate debt publicly issued in the major domestic or eurobond markets. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of USD 250 million, EUR 250 million, GBP

100 million, or CAD 100 million. Cash flows from bond payments that are received during the month are retained in the index until the end of the month and then are removed as part of the rebalancing. Cash does not earn any reinvestment income while it is held in the index. The index is rebalanced on the last calendar day of the month, based on information available up to and including the third business day before the last business day of the month. New issues must settle on or before the calendar month end rebalancing date in order to qualify for the coming month. No changes are made to constituent holdings other than on month end rebalancing dates.

**The MSCI ACWI** is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International (MSCI) and is comprised of stocks from 23 developed countries and 24 emerging markets.

**ICE BofA US Corporate Index (C0A0) ICE BofA US Corporate Index** tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one-year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million. Cash flows from bond payments that are received during the month are retained in the index until the end of the month and then are removed as part of the rebalancing. Cash does not earn any reinvestment income while it is held in the index. The index is rebalanced on the last calendar day of the month, based on information available up to and including the third business day before the last business day of the month. New issues must settle on or before the calendar month end rebalancing date in order to qualify for the coming month. No changes are made to constituent holdings other than on month end rebalancing dates.

**ICE BofA Developed Markets High Yield Index ("HYDC")** is a subset of ICE BofA Global High Yield Index including all securities with a country of risk that is a member of the FX G10, all Western European countries, and territories of the U.S. and Western European countries. The FX G10 includes all Euro members, the US, Japan, the UK, Canada, Australia, New Zealand, Switzerland, Norway and Sweden.

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