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# The Power of Floating Rate Credit

**December 2022**

## Executive Summary

Calendar year 2022 has been a volatile one for global capital markets as a combination of elevated inflation, higher interest rates and geopolitical volatility have roiled markets across the globe, leading to sharp declines for global equities. Within fixed income, traditional investment solutions, long viewed as a ballast for equity price volatility, have not lived up to that expectation, exhibiting double digit declines and undermining the "60/40" portfolio construct. As a result, investors have had to look elsewhere for income-oriented solutions that offer a defensive source of yield. We believe this void can be filled by allocating to portfolios comprised of both public and private floating rate credit. In this piece, we aim to explain how floating rate credit investments can serve as the new ballast, mitigating downside risk, optimizing diversification, and enhancing yield within investor portfolios.

**Figure 1: Benefits of Floating Rate Credit**

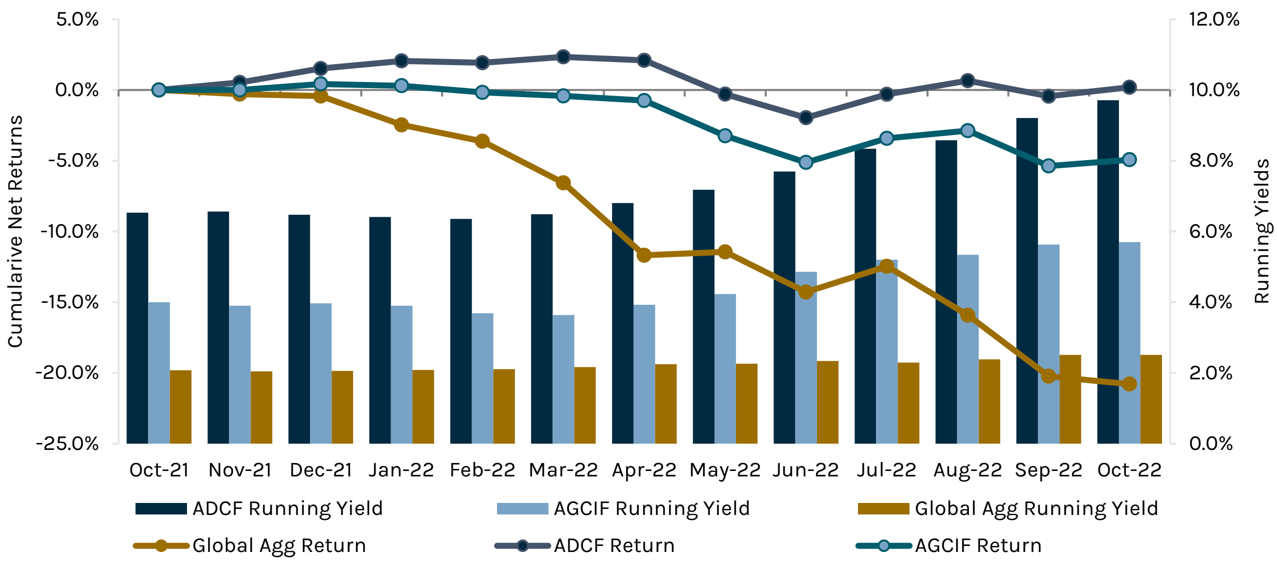
| Attractive Yield | Downside Protection | Enhanced Diversification |
|---|---|---|

## A New Solution for a New Rate Regime

Recent market conditions have proven to be an ideal backdrop for our thesis, largely due to rate hiking regimes that have commenced across the globe; the Federal Reserve (the "Fed") has raised interest rates by the largest six-month quantum since 1981, with the European Central Bank and Bank of England moving in similar, rapid trajectories.

Starting 2022 with a running yield of 2.1% and duration of 8+ years, the Bloomberg Global Agg ("Global Agg") has declined by 20% as compressed fixed rates over the period have done little to mitigate price movements driven elevated rate volatility. Conversely, the Ares Global Credit Income Fund ("AGCIF") and Ares Diversified Credit Fund ("ADCF") entered this calendar year with running yields of 4.0% and 6.5%, respectively, and significantly lower duration profiles relative to the traditional fixed income market due to each of the funds' exposure to senior and secured, floating rate credit. While these portfolios are not immune to mark to market price volatility, their bias towards floating rate credit has served as a more defensive and stable source of income relative to the Global Agg. As shown in figure 2, this enhanced income profile has led to downside protection relative to the Global Agg.

## Figure 2: Enhanced Yields Offer Protection in Volatile Markets[1]




Many investment professionals subscribe to the notion that "prices go down, yields go up", but it's worth noting there is more to the story, and that the devil is often in the details. As shown in figure 3, yields on AGCIF and ADCF, both of which have significant exposure to floating rate assets, **have increased to a greater degree when compared to the Global Agg,** despite the reduced volatility shown above.

**Figure 3: Change in Running Yields Year-to-Date[2]**

| | Global Agg | AGCIF | ADCF |
|---|---|---|---|
| **December 31, 2021** | **2.1%** | **4.0%** | **6.5%** |
| **September 30, 2022** | **2.5%** | **5.6%** | **9.2%** |
| ***Change (%)*** | ***+21.9%*** | ***+41.8%*** | ***+42.3%*** |

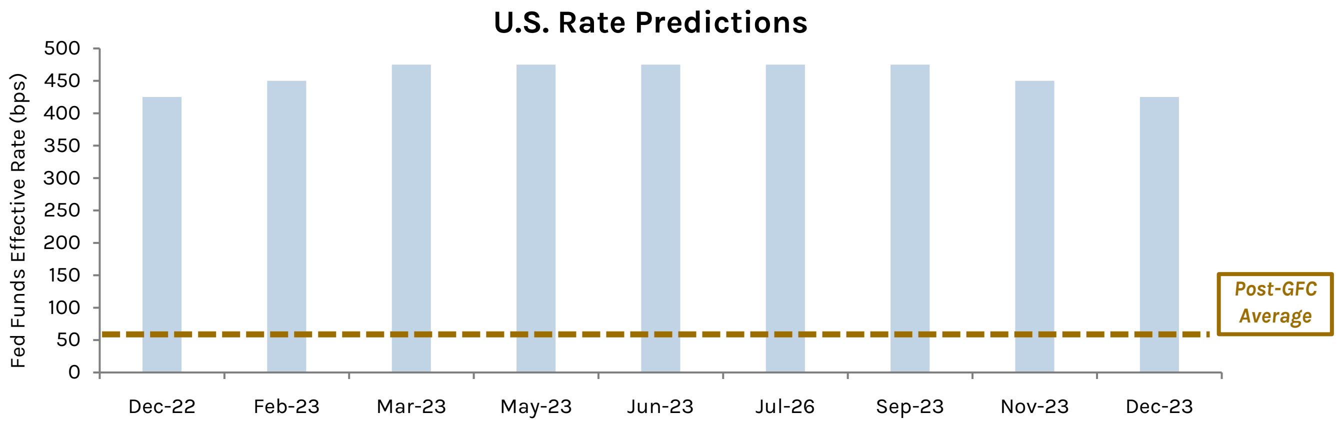
Despite a 20% decline year-to-date, the Global Agg has experienced a minimal 40 basis point pickup in running yields over the same period. Conversely, AGCIF, a liquid alternative portfolio, has declined only 5.8% but has seen a greater than 100 basis point pickup in running yield, all while moving up in credit quality with approximately 60% of the portfolio allocated to investment grade credit. Further, ADCF, which invests in a portfolio of public and private credit, has declined only 1.9% but has seen a +250-basis point pickup in its running yield, while maintaining an interest rate duration of less than one year.

Given the expectation for continued volatility in the months ahead, investing in high income generating portfolios can help to provide a buffer against choppy price movements. In summary, investors in AGCIF and ADCF have benefitted from both downside protection and an enhanced income profile when compared to traditional fixed income solutions mirroring the Global Agg. We believe this dynamic reinforces the diversification benefits of allocating to floating rate credit, but will our thesis continue to play out?

# Looking Ahead

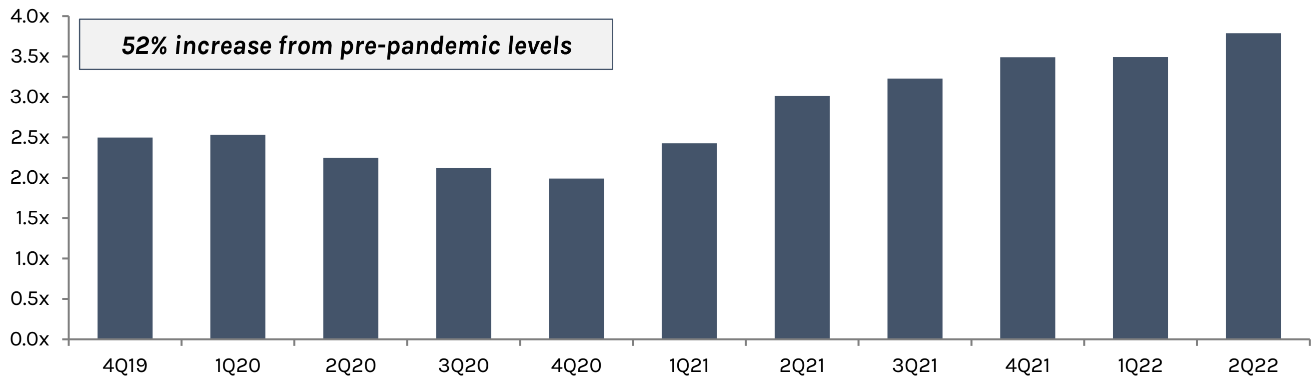
While central banks may moderate their pace of interest rate hikes, and eventually pause or reduce, the post global financial crisis ("GFC") world of low to negative sovereign rates appears to be in the review mirror. As figure 4 illustrates, futures markets in the U.S. predict the Fed will keep rates significantly above post-GFC levels over the next twelve months.

**Figure 4: Futures Market Predicts Rates Will Remain Above Post-GFC Average[3]**




While higher rates are often viewed as favourable for credit investors, you might be wondering… "doesn't this mean higher liabilities for borrowers?" While the definitive answer to that question is "yes", it is worth noting that companies entered this period with elevated interest coverage ratios relative to history, meaning they have a greater ability to service their debt. Further, a lack of near-term maturities mitigates a potential liquidity crunch, and we believe will help maintain a relatively benign default environment moving forward.

**Figure 5: Sub-Investment Grade Interest Coverage Ratios[4]**




In closing, floating rate credit is a powerful solution for investors looking for stable, defensive sources of income given their elevated yield profile, downside protection characteristics and diversification benefits. As the era of low sovereign rates across the globe comes to an end, investment solutions anchored in floating rate credit are poised to benefit from the go-forward market environment and serve as the new ballast within investor portfolios.

# Index Disclosure & Definitions

Index Disclosure: Indices are provided for illustrative purposes only and not indicative of any investment. They have not been selected to represent appropriate benchmarks or targets for the strategy. Rather, the indices shown are provided solely to illustrate the performance of well known and widely recognized indices. Any comparisons herein of the investment performance of a strategy to an index are qualified as follows: (i) the volatility of such index will likely be materially different from that of the strategy; (ii) such index will, in many cases, employ different investment guidelines and criteria than the strategy and, therefore, holdings in such strategy will differ significantly from holdings of the securities that comprise such index and such strategy may invest in different asset classes altogether from the illustrative index, which may materially impact the performance of the strategy relative to the index; and (iii) the performance of such index is disclosed solely to allow for comparison on the referenced strategy's performance to that of a well known index. Comparisons to indices have limitations because indices have risk profiles, volatility, asset composition and other material characteristics that will differ from the strategy. The indices do not reflect the deduction of fees or expenses. You cannot invest directly in an index. No representation is being made as to the risk profile of any benchmark or index relative to the risk profile of the strategy presented herein. There can be no assurance that the future performance of any specific investment, investment strategy, or product will be profitable, equal any corresponding indicated historical performance , or be suitable for a portfolio. The information related to the various indices is sourced from the providers' websites. Ares is not responsible for any historic revision made to the indices.

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.

# Endnotes

1.Note: As of October 31, 2022. Sources: Ares, Fidante, Bloomberg. ADCF and AGCIF performance provided by Fidante. Net Returns are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures. Past performance is not a reliable indicator of future performance. Running yields for both ADCF and AGCIF are based on recent market conditions and is subject to change based on future market conditions at the time of investment and may differ materially from that set forth herein. The running yield of ADCF is represented by the running yield of the CION Ares Diversified Credit Fund. ADCF primarily invests in a diversified portfolio of global liquid and illiquid asset classes via its investment in the CION Ares Diversified Credit Fund (Underlying Fund). The Fund also invests in cash and foreign exchange hedging instruments. In this report, where we refer to the Fund's investments we generally do so on a 'look-through' basis; that is, we are referring to the underlying assets that the Fund is exposed to through its investment in the Underlying Fund.

2. Sources: Federal Reserve, CME FedWatch As of November 13, 2022.

3. Source: JP Morgan Credit Strategy.

# Disclaimer