



In the Gaps

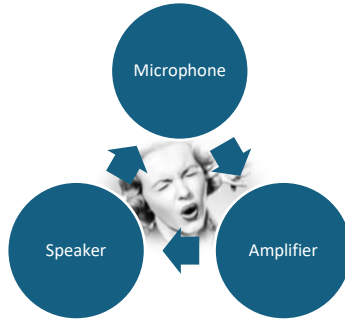
Ares Alternative Credit
Newsletter

SUMMER 2024

The Market Is Squealing Like a Pig

A musician or speaker steps up to a microphone and, suddenly, the room is filled with a [squeal](#) that is piercing and painful. What we commonly call acoustic feedback is also called the Larsen Effect, named for the Danish physicist, Soren Larsen, who discovered it.

The intensity of the squeal is a function of the **proximity** of the microphone to the speaker and sufficient **amplification**. With the right mixture of these components, sound waves **phase together**. Phasing is analogous to a circular reference in a spreadsheet; it is an acoustical reverberation that feeds on itself, producing that ear-splitting squeal.



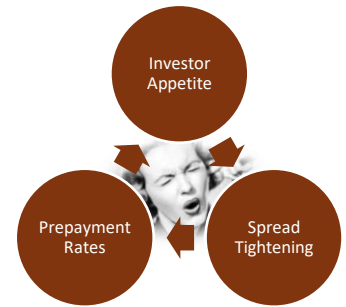
Markets can also experience the Larsen Effect. In fact, we are in the midst of several right now. Rather than sound being amplified and reverberating through a microphone, we have capital being amplified and reverberating through markets.

For example, in today's elevated rate environment, individuals are seeking to lock in today's yields. U.S. annuity sales volumes reached a record high of \$385 billion in [2023](#). Growth is accelerating, with insurance companies originating \$114 billion of new policies during the first quarter and another \$700 billion expected over the next 18 months.

Insurance companies are [deploying](#) that capital into investment grade rated corporate and structured debt. That increased investor appetite has collided with "so-so" supply, causing credit spreads to tighten. Check out page 18 for a view of how elevated demand has impacted credit spreads and relative value across liquid corporates and alternative credit.

The resulting tighter spreads have also triggered a prepayment wave; issuers are taking full advantage of today's surging demand to refinance their debt. For example, fully [half](#) of the entire leveraged loan market in the U.S. has refinanced so far this year. Just about any fixed income product that is proximate to insurance company investment targets is met with overwhelming demand.

Those refinancings and prepayments **amplify** the impact of new capital inflows by returning even more cash to the pockets of asset-hungry insurers that must then be reinvested on top of the new cash inflows from annuity sales. This has elevated insurance company demand for the specific tenors and ratings that are not only needed to replace assets being repaid, but are also needed to match their newly created liabilities.



Stating the obvious, these market dynamics are just miserable. They create the proverbial "race to the bottom" as markets become overcapitalized and begin feeding on themselves. No one wins, except for issuers, who see insatiable demand, and bankers, who stay busy arranging transactions.

One astonishing example of how that amplified demand manifests itself occurred at the end of May on a Subway ABS [transaction](#). Investors' orders for that single transaction, coming predominantly from insurance companies, represented 10% of the total volume of the entire ABS market's issuance year to date. Let that tidbit sink in for a moment.

Lesson #12 of our [Top Fifteen Lessons Learned](#) is "Watch the Flows." This lesson has a direct analog to the Larsen Effect. Once you identify the Larsen Effect in markets, it is a pattern that becomes hard to miss and easier to identify ahead of time. Such behavior is often a precursor to market volatility and credit deterioration as reverberations increase.

“Rather than sound being amplified and reverberating through a microphone, we have capital being amplified and reverberating through markets.”

Today, investors with greater mandate flexibility, access to private origination, and broader platform capabilities are more likely to avoid the Larsen Effect, but only if they exploit those advantages.

Before we dig in, we wanted to address a topic that we are hearing more and more frequently. We want to clear up some confusion caused by some newer entrants into the asset-based credit market on the next page. We will then return to our regularly scheduled programming.

What Exactly Is Private Credit within Asset-Based Credit?

We often get asked questions about some of our peers within asset-based credit and about the similarities and differences among the various pools of capital out there. It can lead to the philosophical question: What exactly is **private credit** within asset-based credit?

Prior to the Global Financial Crisis (“GFC”), the asset-based credit market was pretty simple. It consisted of **two** types of investments and submarkets:

- **Liquid:** Securities that are issued via bank intermediaries, publicly rated, and syndicated across many investors. Credit quality is typically investment grade.
- **Illiquid:** Investments that are bilaterally negotiated, typically executed with a single investor and not rated. Credit quality is typically investment grade.

Historically, illiquid transactions were executed by very large pools of capital at banks (prop desks), GE Capital, CIT Bank, and a handful of private credit investors. In the wake of the GFC, these pools of capital were largely disbanded. These exits caused the capital market for illiquid transactions to become highly fragmented.

During the last ten years, the illiquid side of the market started to reconsolidate around a new generation of larger-scale platforms. This has led to the creation of a new market that now sits *between* the liquid and illiquid market. We call this the private rated market.

As the name suggests, it consists of securities that are bilaterally negotiated, typically executed with a single investor, and have obtained a credit rating. This market is dominated today by a few insurance companies, especially those owned by private equity firms, and alternative managers like Ares.

Issuers who would normally issue a liquid transaction may instead issue an illiquid transaction. Many issuers find this alternative compelling because they can avoid banking fees and capital market execution risks as there is no syndication process.

Investors in the private rated market typically benefit from earning a higher spread on investments (compared to liquid securities). They can also benefit from the opportunity to negotiate terms directly with the issuer.

We think the private rated market is a space to watch for three important reasons:

First, we believe growth in this market will be exponential for the foreseeable future.

Second, we think those insurance companies who participate in private rated transactions will generate higher book yields compared to those who do not.

Third, we think private rated transaction volumes could be significant enough to create scarcity in many sectors where public issuance has been diverted. In other words, investors who have traditionally relied on the liquid market for investments will face more limited issuance volume, and thereby see lower spreads in that market.

Today, we think it’s useful to describe the asset-based credit market as consisting of **three** types of investments:

- **Public Rated:** Securities that are issued via bank intermediaries, syndicated across many investors, and publicly rated. Credit quality is typically investment grade.
- **Private Rated:** Securities that are bilaterally negotiated, typically executed with a single investor, and privately rated. Credit quality is typically investment grade.
- **Nonrated:** Investments that are bilaterally negotiated, typically executed with a single investor, and are not rated. Credit quality is typically investment grade.

So, what exactly is “private credit” within asset-based credit?

Some consider both private rated and nonrated to be “private credit” since both types are bilaterally negotiated and exist outside of a liquid market.

However, the achievable yields and returns between public rated and private rated render them naturally more comparable. They are also tethered to one another: issuers compare capital markets execution to private market execution, and ratings criteria creates highly similar transactions.

Given that, we think of public rated as the asset-based credit market’s *beta* or benchmark product, which nevertheless offers a yield premium to comparably rated corporate bonds.

We think of private rated as this market’s *beta-plus* product, offering excess yield in exchange for illiquidity.

We think of nonrated as this market’s *alpha* generator because one is investing “in the gaps” created by those rating criteria and the market’s other conventions.

The top-down or momentum-minded investor is often hunting in the markets in the early stages of the Larsen Effect. The momentum of today’s “risk-on” markets promises outsized returns. In this edition of *In the Gaps*, the team identified several cases where such a risk-on, top-down approach would have failed or may be setting up to fail now.

We share insights into the alternative credit market’s transportation sectors; and we circle back to the housing and mortgage markets in Canada, Australia, and the U.K. to see how our predictions from 18 months ago are holding up. Finally, we answer some frequently asked questions about alternative credit, also called asset-based credit, given the focus this sector has recently garnered. We’ll also discuss strange times, physics, and even accordions in *The Path Forward*.

Our Charity Spotlight this edition is The Children’s Village. Please take a moment to learn more about this amazing organization and the impact they are having. Finally, for those who missed the Ares investor conference, here are a few video highlights from that event ([Investor Day](#)).

Transportation’s “Long Covid”

Covid led to stimulus. Stimulus led to inflation. Inflation led to higher rates. These factors sent supply and demand on a wild ride. Many sectors were able to adapt and adjust reasonably well. Some sectors could not and today suffer from “long Covid” symptoms.

Long-time readers will recall one of our non-canonized lessons learned about correlation risks in the market; it can appear on either side of the balance sheet in assets or liabilities. Most of the time, investors focus on asset correlations and think of risk primarily from that perspective.

The handful of times where we have seen correlation of 1.0 occurred among asset types that were generally less correlated, but were all dependent on the same sources of capital. When their common liability market fractured, these disparate assets were taken down with it. The GFC is a good example of this.

There is a long-held assumption that transportation assets are alternative credit’s pro-cyclical *beta* plays. These sectors are generally well correlated to one another and to GDP. That correlation was on display throughout most of the pandemic.

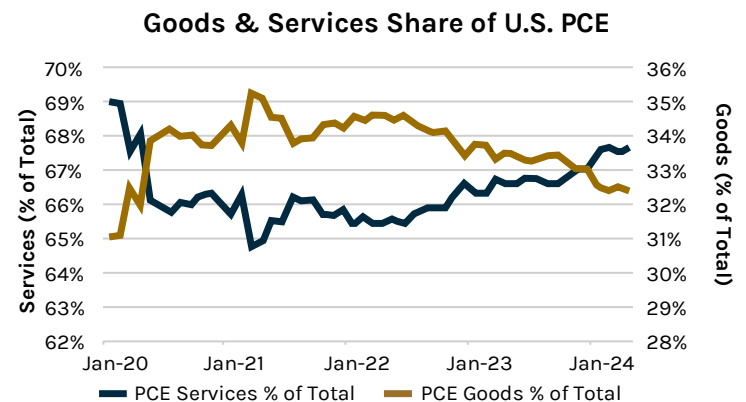
“The handful of times we’ve seen correlation of 1.0 occurred among asset types that were generally less correlated, but were all dependent on the same sources of capital.”

Credit performance, yield, and market values across five major transportation asset types (e.g., aviation, rail, trucking, shipping containers and automobiles) were largely in sync and white hot... until recently. Asset values benefited from strong demand and solid underlying credit performance. Sector returns also benefited from an abundance of capital and access to low-cost financing options.

Today, just two of those five sectors remain strong. Two have fallen out of bed, and we believe one is about to. The reasons for these differences reveal much about why pro-cyclical *beta* plays don’t always work even in a generally positive market environment. We will take each asset type in turn for a quick ride on how we see relative value and risk, and why.

Trucks: We will start with trucking because it may be the least familiar to some and possesses some truly unusual industrial dynamics compared to the other transportation sectors.

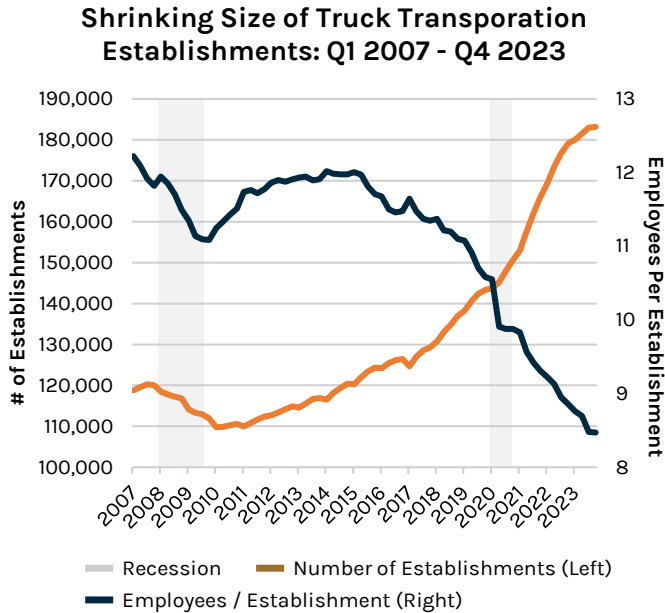
Trucking is a dual market consisting of longer-term contractual rates and spot rates. The chart below shows that during the pandemic, households shifted consumption from services to goods (in the form of cardboard boxes at your front door).



Source: Federal Reserve as of Q2 2024.

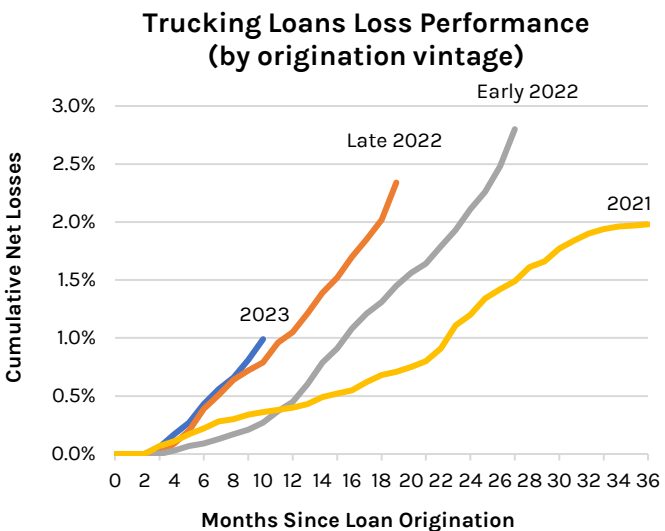
The result was a sharp increase in demand for over-the-road trucking, and a commensurate spike in both spot and contract rates. Increased rates led to record levels of profitability in the trucking industry. The prospect of excess profits attracted more than 40,000 new trucking firms into the sector.

40,000 new entrants not only created far greater capacity to move boxes around the country but also rendered the industry significantly more fragmented: by the end of 2023, the average trucking business employed just eight people (chart below).



Source: U.S. Bureau of Labor Statistics as of Q4 2023.

We believe this development thwarted the industry’s ability to adjust to falling demand coming out of the pandemic, as consumption shifted back toward services. Both spot and contract rates fell precipitously, largely because of excess capacity that was slow to leave the system.



Source: Intex.

Excess profits during 2020-2022 seem to have provided an equity buffer against falling trucking

rates. At the time, they also inflated the perceived creditworthiness (e.g., robust profit margins) of trucking firms in the eyes of lenders.

Trucking enticed banks and non-bank lenders with perceived credit quality that, in many cases, has not lived up to its billing. Truck loan loss curves today (see chart above from a truck loan ABS issuer) tell a story that faithful readers of *In the Gaps* would quickly identify with consumer lenders’ experience of inflated, post-pandemic FICO scores and the resulting poor credit performance.

Consequently, despite growth in the sector overall, trucking is experiencing a credit cycle. Investment challenges emerged out of a risk-on mentality that over-indexed to that macro beta outlook, but failed to account for manifestly low barriers to entry; failed to anticipate the rush of new entrants seeking excess profits; and failed to account for the willingness of those entrants ready to set piles of cash on fire while waiting for a rebound in trucking rates.

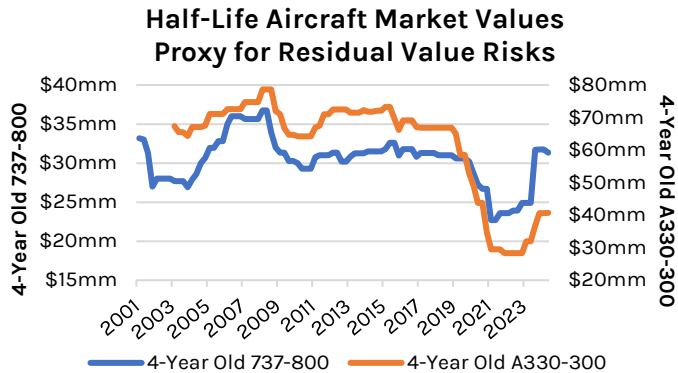
As we speak, capacity is being forced out of the industry with lenders compelled to “literally” take the keys. This situation will certainly sort itself out over time, and supply-demand will regain its balance.

In terms of risk and relative value, we think trucking is best pursued within a much broader context of small business and large-ticket equipment finance. We think the key to successful investing in this sector is to maintain credit discipline in all markets, limit concentration risks, and be keenly aware of the sector’s boom-bust supply-side cycles.

Planes: The market for aviation assets is a victim of its own strength. Gross asset yields for better commercial aircraft (e.g., newer narrow-body aircrafts) have rallied to a historically low range of 8-11%. Factoring in depreciation and management expenses (around 3% annually), net unlevered asset yields land in the 5-8% range.

Those yields are solidly on the low end of historical ranges and reflect strong demand for these planes amid crimped supply. That would not be so bad until you factor in that most aviation portfolios are levered ~2:1. With all-in costs of leverage today between 6-7.5%, we currently have a very weak asset-liability arbitrage condition (even negative in some cases).

From a cashflow perspective, debt service is absorbing the vast majority of those asset yields. Such a condition shifts most of the investment risk into the residual value of planes. To achieve acceptable returns, plane values must hold up or even outperform expectations. One look at the chart below will convince you that this is a risky bet.

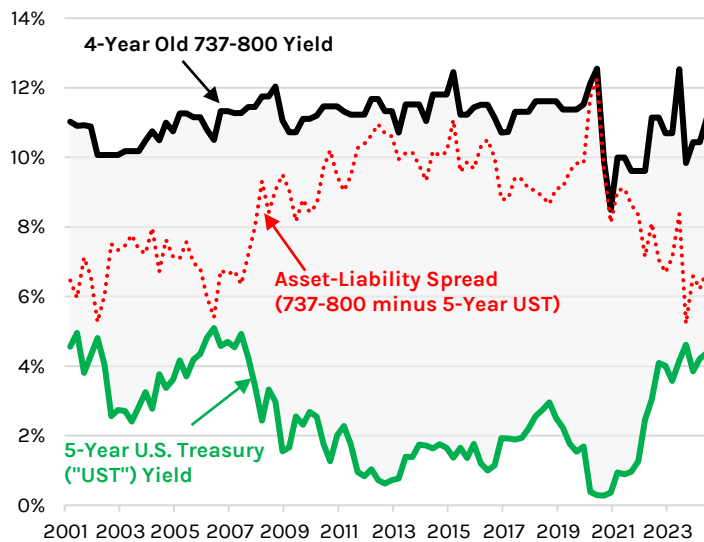


Source: Cirium research as of June 1, 2024.

One can improve today's weak arbitrage condition by targeting aircraft that are older or less desirable and/or by targeting lower credit quality lessees. While that may boost asset yields, and thereby modeled equity returns, we think it mostly just compounds risk in a levered, cyclical asset class.

In our view, a better relative value approach would be to maintain high-quality assets and lessee targets, acquire planes only opportunistically to achieve higher asset yields, and/or wait until more efficient leverage is achievable.

Visualizing the Asset-Liability Arbitrage



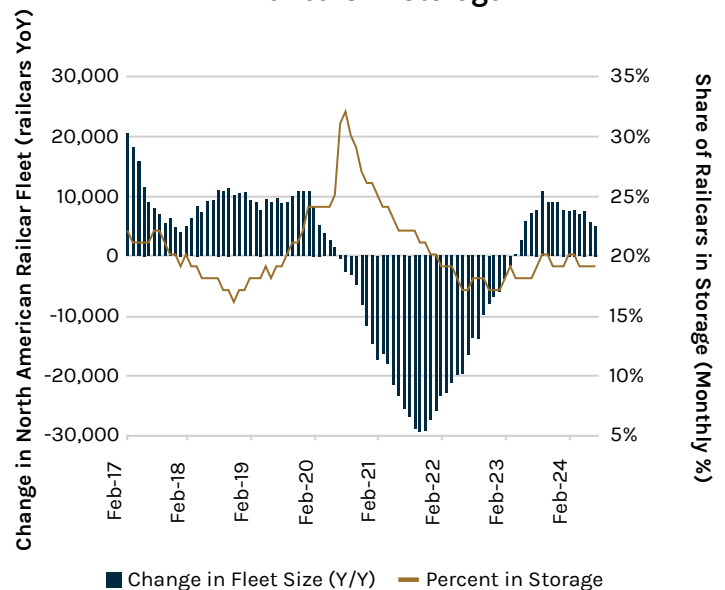
Source: Cirium research as of June 1, 2024.

Over the near term, we would expect asset values to remain firm due to persistent supply-demand imbalances. In fact, we could see asset values for some aircraft types increase from here should overall financing costs restore a healthy asset-liability arbitrage.

Trains: The rail industry did a remarkably good job navigating wild swings in demand during the pandemic. By deftly regulating the supply side of that equation, rail achieved steadier overall asset yields and relatively consistent equity performance.

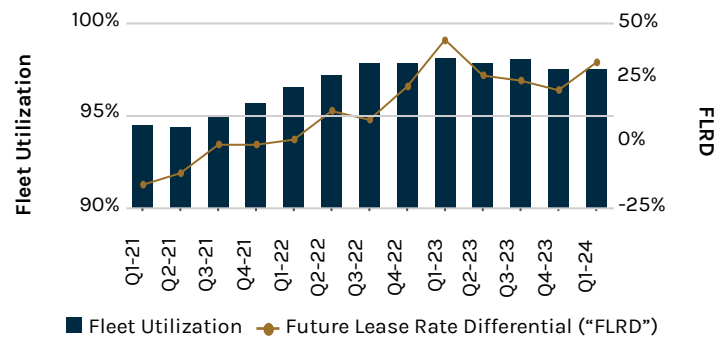
The first chart below shows to what extent and how quickly supply adjusted and readjusted. The second chart below shows the resulting, and relatively stable, asset yields and utilization rates.

North American Railcar Fleet and Railcars in Storage



Source: AAR, Trinity Rail: 2024 Investor Day Presentation.

...Resulting in Higher Lease Rates and Consistent Fleet Utilization



Source: Trinity Rail: 2024 Investor Day Presentation.

Unlike the highly fragmented trucking industry, the rail industry is highly concentrated. Rail is also an asset that tends to be tethered to local and national markets rather than being efficiently moved around the globe, like containers or planes.

Thus, we believe two of the most important factors one must consider when investing in pro-cyclical *beta* sectors are the nature of the sectors' industrial organization and resulting supply-side dynamics. This includes the logistical and financial ease with which supply can be calibrated or relocated based on relative demand.

Those asset yields, relatively stable industry characteristics, and large capital needs render the rail space interesting from an investment perspective. However, its concentrated industrial organization means there are relatively few actual opportunities to pursue with the majors - and considerably higher risk moving down market and away from them.

“The Rosetta Stone for understanding relative value in credit markets is the asset-liability arbitrage condition.”

Automobiles: We won't spill too much ink on this one given that we have already done so [here](#) and [here](#). This is the sector we think is about to fall out of bed, creating potential opportunity.

The crux of the issue is the falling vehicle values at a time of increasing auto loan credit deterioration. That combination tends to lead to better entry points, painful as it may be in the moment. The peak-to-trough change is likely to be significantly worse than what we have seen in the past, given the acute run-up in vehicle prices during the pandemic.

Ironically, perhaps, electric vehicles (“EVs”) seem to be suffering the most. The chart above tells the story. EVs have not held their value compared to gas-powered vehicles (Internal Combustion Engines, or “ICEs”). The downdraft on used car values is hitting EVs much harder than ICEs. We expect to see portfolios with larger exposures to EVs to be the most impacted.

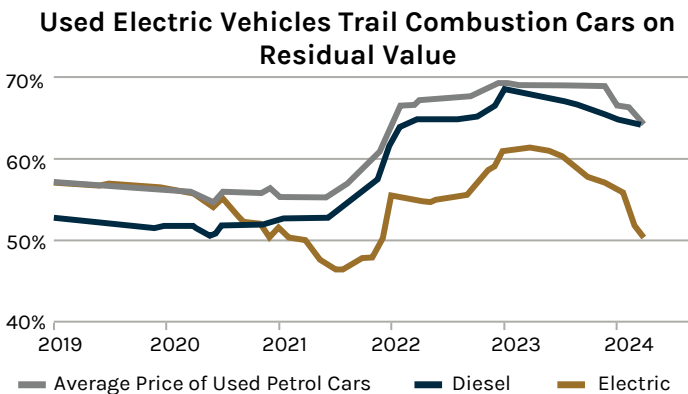
Ultimately, what this means for relative value and risk is that the cost of financing for these assets will increase (wider credit spreads), and leverage will commensurately decrease to provide investors with sufficient cushion to withstand lower used car values.

Credit performance in autos has already started deteriorating, especially for second and third vehicles, while loan amortization has not kept pace with the faster rate of depreciation. More owners are deeply “underwater” on their cars, resulting in higher rates of delinquencies and defaults.

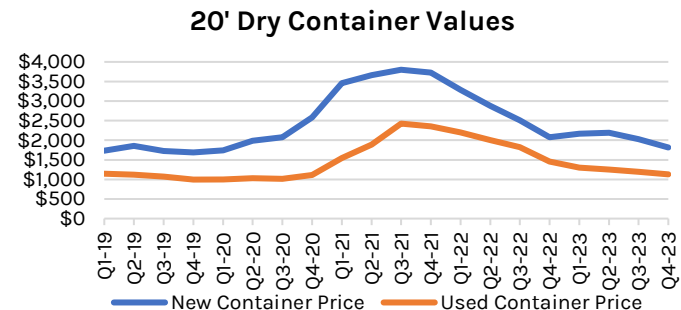
Toss in a pull-back from banks originating auto loans and tighter underwriting standards, and you have all the ingredients for a correction. The auto lending market is large and active, so there is almost always something to look at. Today, it's all about picking your windows for credit and value.

Containers: Like trucking and rail, and perhaps for obvious reasons, shipping containers, which are often found on trucks and railcars, also experienced a spike in demand during the pandemic. Because we're talking about relatively low-tech, low-cost steel boxes with useful lives of nearly twenty years, the real economic value of containers lay in their ability to generate consistent lease cashflows.

Increased demand saw utilization rates approach 100% as excess capacity was drained from the market. Lease rates and container prices doubled, and then some (graph below). Adding to these pressures came a spike in steel prices, which increased the cost to build new containers.



Source: Deutsche Automobil Treuhand GmbH as of Q2 2024.
Note: Data for Germany shown as a percentage of a new car's list price.

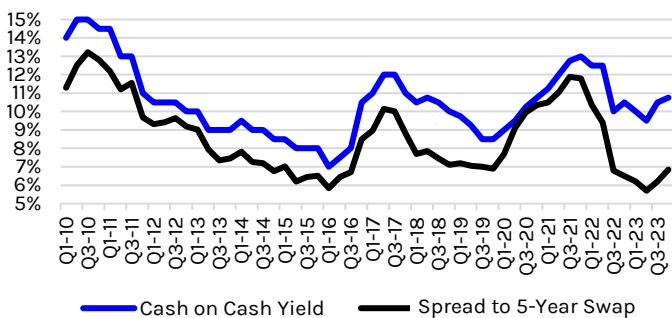


Source: Harrison's as of Q4 2023.

As post-pandemic demand softened, utilization rates and container prices dropped back to more typical levels. Through it all, container supply reacted and adjusted. The graph below plots the resulting impact on container yields, including relative to 5-year swaps.

The most notable development coming out of the pandemic was that cash yields and asset values returned to their long-run average ranges. It happened at the expense of credit spreads, which fell to historically low levels. As we have said before in these pages, the Rosetta Stone for understanding relative value in credit markets is the asset-liability arbitrage condition.

20' Dry Container Cash Yields and Spreads (Unlevered)



Source: Harrison's as of Q4 2023.

Thus, like commercial aviation, liability costs render this sector relatively unattractive right now. This is despite what might otherwise be an attractive entry point from an asset value perspective, which is unlike commercial aviation.

Transportation Relative Value Take-Aways

Trucks: The sector is experiencing a credit cycle due to oversupply and high fragmentation, despite stabilized demand. Opportunities certainly exist, but require a high degree of selectivity.

Aviation: Asset values should remain stable near-term in the face of interest rate reductions. However, higher asset yields and/or lower liability costs are needed to maintain asset and lessee quality, as well as mitigate residual value risks.

Rail: Interesting fundamentals and investment economics. However, there are limited opportunities with the majors which, for risk reasons, is where one would want to focus.

Automobiles: The sector is adjusting to lower auto prices, deteriorating credit performance, and more constrained capital. All this points towards a potentially attractive entry point “down the road.”

Containers: Potentially interesting entry point today given depressed asset values and normalized asset yields. However, like aviation, risk and returns are being driven by liability costs and terms.

We think all these observations and insights reinforce something we say a lot on the team: *no asset class remains interesting indefinitely*. This is a topic we will revisit in *The Path Forward* section.

We employ a simple approach for exploring the opportunity envelope within and across various sectors in our markets. It is surprisingly effective when informed by data and implemented rigorously and regularly.

The approach can be boiled down to a few key questions; these inevitably lead us to areas where we wish to dig in further:

1. *Where are valuations and yields for the assets?*
2. *Is there a healthy asset-liability arbitrage?*
3. *How are risk and value distributed across the capital structure in the sector?*
4. *What is our current timing within the cycle (sector and market) for both assets and liabilities?*
5. *What are the potential impacts of a market dislocation or cycles?*
6. *What kind of structural approach is warranted?*
7. *How do we see relative value (risk and return) compared to other opportunities?*

The Big Questions

Alternative credit is having a moment right now. For the first time in our careers, asset-based credit is almost cool, given we are normally considered the geeky part of alternatives. Admittedly, the pocket protectors have not helped our image much.

Transformational things are indeed happening. Echoing back to the early 2000s and the wider adoption of the internet, seemingly out of nowhere came the innovations and new tools that we could not imagine life without today.

We thought it would be useful if we shared some of the big picture questions most investors are asking about the asset-based credit market.

Q: Why is asset-based credit garnering attention now? What has changed?

A: It's a confluence of several factors and recent developments, but we will focus on just two.

Access: Up until just a few years ago, accessing this market was very challenging. It was considered niche because that is what most investors encountered: small, niche managers and funds that specialized or focused in just one subsector.

Ares was one of the first managers to create and offer funds that had real scale and were broadly diversified across subsectors. Ironically, that meant most of our time was initially spent explaining to investors why we believed funds with scale and diversity were superior to funds that were subscale and niche. Since that time, many others have followed suit. Today, most new alternative credit funds are diversified (vs. niche) although scale is still lacking generally in this market.¹

Familiarity: All that effort by us and others has established a foundation of understanding. More people know what asset-based credit is; they are acquainted with its investment characteristics, its history, and development.

There are fewer misperceptions about what it is and how it behaves. Few investors still perceive it as a random collection of esoteric specialties having little in common. Those misconceptions have been supplanted by greater insight and sophistication. More investors are talking about

asset-based credit as a core allocation in their portfolios rather than as an accent.

There is a lot more than can be said on this topic, and we may return to this in another edition. For now, it seems sufficient to say that alternative credit has come out of the shadows and is (finally!) being appreciated for what it is. As they say, the geeks will inherit the earth.

For those of us who, for the last 25 years or so, have had to watch as eyes glaze over at cocktail parties or at family gatherings when asked what we do for a living, it is all pretty darn exciting.

Q: With so much new capital coming into asset-based credit markets, how has this affected opportunity and competition for assets?

A: There is a common misperception that the asset finance markets are relatively small and niche, and therefore, are quite sensitive to the ebbs and flows of capital. While this can certainly be true of certain subsectors, it is not true of the asset-based credit markets overall.

What we call alternative credit, or asset-based credit, is a very [large](#), \$28 trillion [market](#) that is underpinned by three main pillars of capital.

- **Banks** are the most dominant pillar. More than [\\$12 trillion](#) of individual loans, leases, and financial receivables populate U.S. bank balance sheets today. Most non-U.S. banks hold comparatively small amounts.
- **Securitization or ABS markets** are the pillar that transforms assets into rated securities for institutional investors, especially insurance companies. More than [\\$13 trillion](#) of loans, leases, and financial receivables (~75% of which are residential mortgages) are financed by the securitization markets in the U.S. and Europe today.
- **Private Capital**, a pillar of relatively undetermined size, is comprised of institutional investors like Ares. This pillar includes investments in asset pools and asset-based credit investments by pension funds, insurance companies, sovereign wealth, and other investors who do not require public ratings.

¹ Diversification does not assure profit or protect against market loss.



Overall, we [estimated](#) the asset-based credit market across the U.S. and Europe to be more than \$28 trillion in size.² There is an important, symbiotic relationship among these three pillars. Each brings a different type of capital solution to the asset-based markets. Each faces different constraints and often pursues different economic results.

The alternative credit markets need this trio to function well to meet the variety of capital needs that exist. Looking back over the past 30 years, the **relative** role that each pillar has played has shifted multiple times.

For example, banks and the securitization market emerged from the GFC experience more constrained. Those constraints created an opportunity for private capital to play a relatively larger role. More recently, as the banking industry, especially in the U.S., grapples with new capital and liquidity constraints, both private capital and the securitization market are playing a larger role as this market strikes a new balance among the three pillars.

The proportions are important to keep in mind. Given the combined size of banks and securitization market capital, even small changes in activity by banks and securitization capital can create a very large incremental opportunity for private capital. We are finding that recent events are creating a far more significant need for private capital in alternative credit markets today. We think this marks an inflection point for private capital.

Q: How has the competitive landscape changed recently among managers?

A: The private capital pillar within alternative credit markets has undergone significant change over the past 25 years. In the 2000s, this pillar was dominated by several very large institutions having very low cost of capital and a broad mandate (e.g., GE Capital, bank prop desks, etc.).

In the 2010s, this pillar underwent significant fragmentation as these large institutions disbanded and the underlying teams spun out into individual strategies (specialized, niche, and relatively small).

At the time, it was common for investors to access alternative credit opportunities by assembling a portfolio of these niche strategies, subsector by subsector. There were very few funds or platforms which offered investors a diversified approach. To our knowledge, none offered such an approach with any real scale.

In the past few years, platforms with scale and breadth have started to return, although there are still precious few. Most of what investors face today in terms of strategies and funds accessible to them is still relatively subscale and tends to be more concentrated in a small number of underlying sectors. Thus, private capital is a pillar that is still developing, evolving, and growing.

However, because fragmented capital and niche strategies remain a defining feature of these markets, individual subsectors can certainly be affected by the changing tides of capital. We have seen feast to famine swings wreaking havoc on opportunity and risk. For example, such was the case with consumer lending from 2020 to 2024.²

Finally, the competitive landscape looks very different based on target transaction size. We generally find the market for smaller transactions to be the most competitive—and often the most aggressive. As transaction size increases, competition tends to thin out quickly.

Q: How do asset-based credit and corporate direct lending compare and contrast?

A: Generally speaking, they share many of the same traits. Both are credit investments

² Source: Ares observations.

whereby the underwriting focus is on protecting principal and assessing the consistency of credit performance under stress. The economics of both are largely based on current yield. Investors are generally responsible for conducting their own research, analysis, and due diligence.

Notwithstanding those common features, the differences are significant. There is a stark difference in the granularity of the underlying credit exposures. A well-diversified corporate direct lending portfolio may comprise 100 underlying credit positions. A well-diversified asset-based credit portfolio may easily exceed 1,000,000 underlying credit positions (on a look-through basis) because each investment is, in turn, backed by its own underlying asset portfolio.

In corporate direct lending, it is necessary to look to the earnings and valuation of the underlying company because at maturity (or another realization event), those fundamentally determine the outcome. In asset-based credit, one looks instead to the cashflows arising from the underlying pool or portfolio of assets. The analysis is therefore oriented around the consistency of those cashflows across time and on their resiliency under stress.

While covenants play an important role in both markets, asset-based credit investments are more covenant-heavy than a typical corporate loan. These include a host of covenants tied to the cashflow and credit performance of the underlying pool or portfolio of assets, and also include corporate-style covenants imposed on the counterparty.

Finally, asset-based credit investments typically benefit from certain structural features, such as bankruptcy-remote vehicles and cashflow waterfalls which hardwire intercreditor rights and prevent lender-on-lender violence. In most cases, the investments are self-liquidating and do not depend on a market take-out or refinancing event for a return of principal.

Q: What are the most common mistakes in making asset-based credit investments?

A: While we would argue that the very nature of asset-based credit investments (e.g., granular portfolios, diversification, and self-amortizing investments) mitigates many of the risks

common to other types of credit products, investments can go badly and lose money.

The most common mistakes we see fall into one of six categories.

1. **Asset and liability mismatches:** The most obvious examples are the use (abuse?) of so-called “repo” leverage, where investors leverage long-dated assets using short-term, mark-to-market leverage, and lack the liquidity or capital to defend that position should markets dislocate. Other common examples are funds which promise investors short-term liquidity but invest in illiquid, longer-dated assets.
2. **Aggressive structuring:** This is a more common mistake with small transactions where the counterparty lacks capital themselves to provide sufficient “skin in the game.” The investor is often enticed into lending at a much higher loan-to-value, or LTV (also called advance rate), in exchange for a higher return and/or equity participation in the counterparty. This leaves the investor vulnerable to the double whammy of deteriorating credit performance and a capital- or liquidity-stressed counterparty. That usually ends just the way you would expect.
3. **Overreliance on asset values vs. cashflows:** In many transactions, the cashflows generated by the underlying assets are sufficient to repay all, if not most, of the investment. In some transactions, the assets’ cashflows are relatively meager and the investor is instead dependent on the assets’ terminal value or market value to repay the investment. In the latter case, credit or value deterioration can present a major threat to principal, especially if the assets are leveraged. In the former case, capital is far more protected even if asset values suffer.
4. **Confusing Return on Equity (“ROE”) with Return on Assets (“ROA”):** This is a topic about which we have written before. This mistake is most likely to occur when the cost of leverage is very low (e.g., 2021). In that environment, investors may be tempted to purchase assets with low intrinsic yields in

order to generate reasonable equity returns by financing those assets with even lower cost leverage. The (hopefully) obvious risk is the impact on both asset values and returns should financing costs increase in the future. The market for music royalties is a great example of this dynamic playing out in real-time right now.

5. **Inadequate infrastructure:** Operational infrastructure may be the most underrated component of asset-based credit platforms. The investments themselves are high-touch and data-intensive when things are going well. Toss in a few curveballs, and transactions can quickly swamp inadequate resources. The counterparties in these investments face the same reality. We often find that smaller and newer counterparties tend to lack the resources (e.g., people, capital, technology) that is required. They are often still assembling the car as they drive it down the highway. Inadequate platform infrastructure introduces risks that are incredibly hard to mitigate and for which investors are generally not compensated.

6. **The Arb:** As discussed and described above, a healthy asset-liability arbitrage condition allows for risk and value to be appropriately, *and dare we say fairly*, distributed across the capital structure of a transaction. A weak or broken arbitrage creates a situation where risk and value can shift or concentrate in one part of the capital structure at the expense of the other part(s). Mistakes are made when investors are compelled (by mandate or other restriction) to continue investing in the part of the capital structure where risk has shifted without a compensating quantum of value.

Affected mortgage payments were projected to increase significantly by doubling in many cases. We submitted that this dynamic would negatively impact housing prices and consumer credit performance and, at least initially, be unexpectedly inflationary as the cost of housing increased.

A year later, those rate resets have started to play through all of these markets. The impact is largely as predicted but with some notable, if not counter-intuitive, surprises in the data.

We will start in Canada, a housing market that is among the worst in the developed world in terms of affordability. While that is not new news, the added impact of rate resets is leaving a more substantial mark.

Consider the following statistics from the **Toronto** housing market (which represents ~25% of the entire Canadian market):



Median Home Price (\$CAD):	\$1,172,745
Average Down Payment:	\$234,549
Down Payment in Months of Savings:	289
Median Individual Annual Income:	\$97,257
Average Mortgage Payment Today:	\$6,680
Average Mortgage Payment in 2021:	\$4,116
Mortgage Payment as % of Pre-Tax Income:	82.4%
Homeownership Rate:	65%

Source: NBC: Housing Affordability Monitor 2024 Q1, NBF Economics and Strategy, Bank of Canada: Financial Stability Report 2024, and Ares observations.

According to the Bank of Canada, ~50% of the mortgages taken out before rates began to rise have reset, and borrowers are paying a meaningfully higher mortgage payment. By the end of 2026, virtually all mortgage holders will go through a rate reset cycle. The median payment is ultimately expected to increase by a staggering 54%.

Bank of Canada notes, “most borrowers will need to make adjustments, sometimes significant, to ensure they are able to continue to pay their mortgage... borrowers may be able to smooth the impact of payment increases by drawing on savings or home equity.”

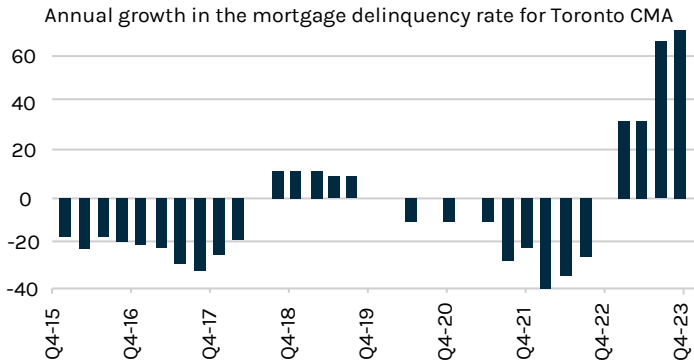
Yes, they really **said** that homeowners should borrow against their home equity to pay their mortgage. The chart below is only starting to tell the story of the developing impact on mortgage credit performance. Housing is **cooling** with slowing sales and slower price appreciation. The music will

Painful Adjustments

In our [Winter 2023 edition](#) published a little more than a year ago, we expressed concern over mortgage credit performance and housing markets in the U.K., Canada, and Australia. That concern was based on the prevalence of floating-rate mortgages and the magnitude of looming rate resets.

continue to play, however, so long as Canadian household savings and liquidity hold out.

Toronto Mortgage Delinquencies Are Rising at an Unusually Fast Rate



Source: Equifax, CMHC, and Better Dwelling as of Q4 2023.

Let's move south to Australia, where unusual market conditions in the early 2020s saw borrowers flocking toward mortgages with a two- to three-year fixed-rate period (normally the Australian market is dominated by pure floating-rate mortgages).

During the past two years, this bulge of fixed-rate loans has been resetting into a higher, variable rate. The following statistics from **Sydney** (representing ~20% of the Australian market) parallel what we see in Toronto.



Median Home Price (\$AUD):	\$1,156,020
Average Down Payment:	\$231,204
Median Individual Annual Income:	\$88,920
Down Payment in Months of Savings:	312
Average Mortgage Payment Today:	\$5,670
Average Mortgage Payment in 2021:	\$3,436
Mortgage Payment as % of Pre-Tax Income:	77%
Homeownership Rate:	64%

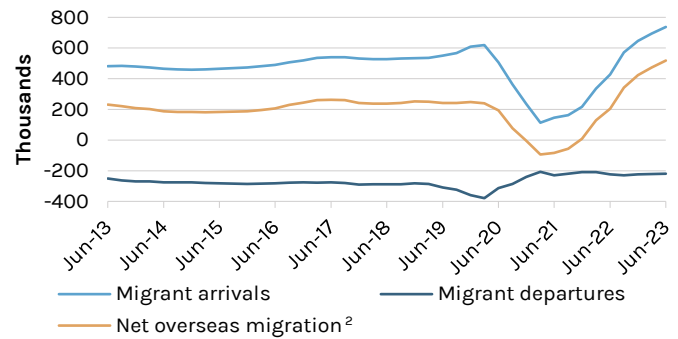
Source: RBA.gov, ABS.gov, CoreLogic, and Ares observations.

At this point (through December 2023), over 80% of Aussie mortgages have reset into higher rates with an average increase of ~320bps. That increase would have been even higher if not for COVID-era government subsidies that fueled competition in the mortgage market, resulting in lenders passing only 75% of the base rate increase onto borrowers.

Notwithstanding all of that, home prices in Australia have been resilient largely due to net immigration (chart below) combined with housing shortages. While pre-existing homeowners have benefited from an increase in their home equity

values, the financial hurdle facing new home buyers seems daunting. Not surprisingly, the trend for prospective Aussie homebuyers is to rent for longer.

Overseas Migration Australia 2013-2023¹



1. Estimates from September quarter 2022 onwards are preliminary.
 2. Net overseas migration is calculated by the number of migrant arrivals minus the number of migrant departures.
- Source: Australian Bureau of Statistics, Overseas Migration 2022-23 financial year.

As a corollary, much of the Aussie rental market is owned by individuals. Increased housing values and sharply increasing rents in this constrained housing market have been a net positive contributor to those individuals' liquidity and wealth which, in turn, provides further support to housing values.

Which brings us to the U.K. Like we saw in Australia, at this point more than 80% of U.K. mortgages originated before 4Q21 (prior to rate increases) have since reset into higher mortgage payments. That monthly payment has increased an average of 61%.

Like Toronto and Sydney, London represents ~22% of the U.K.'s housing market but otherwise has different nominal and relative characteristics per the table below.



Median Home Price (GPB):	£501,880
Average Down Payment:	£127,320
Down Payment in Months of Savings:	344
Median Individual Annual Income:	£44,370
Average Mortgage Payment Today:	£2,081
Average Mortgage Payment in 2021:	£1,292
Mortgage Payment as % of Pre-Tax Income:	56%
Homeownership Rate:	47%

Source: HM Land Registry (U.K. Gov), Halifax/Lloyds Banking Group, Office for National Statistics (U.K. Gov), Zoopla, and Ares observations.

Several things jumped out at us as we dug into mortgage and housing data across the U.K., Canada, and Australia. **First**, while homeowners in all three

countries experienced similar mortgage payment reset impacts, Canada and Australia also saw homes increase in value. The U.K. did not.

In fact, the median home price in the U.K. peaked in 2021. As rates increased, prices weakened. This is exactly what you would expect to happen and what should have happened in Canada and Australia but did not.

The main reason why the housing market behaved differently in Canada and Australia is *immigration*. Canada and Australia top the [list](#) of larger countries with the highest net immigration. U.K. certainly saw immigration, but, in proportion to its population, did not have nearly the impact on the cost and availability of housing as in Canada and Australia.

This situation has been relatively devastating for the U.K.'s Buy-to-Let, or BTL, market where individuals purchase a second or third home to rent out. In the face of higher expenses and falling home prices, these private landlords have recently [turned](#) to selling their rental homes, putting even more pressure on the availability of rental housing.

Second, digging deep into inflation data in the U.K., we saw something very unexpected. Mortgage interest expense has a tiny 3.7% weight in the U.K. CPI formula. That is not a typo. Mortgage interest increased an average of 61% and nominally about £800 per month—that impact is crammed into a 3.7% weight in the U.K.'s reported inflation. You can read more about that [here](#).

The impact of increased housing costs has started to appear in the places one might expect. As they say: the money has to come from somewhere! Mortgage delinquencies have started to increase coming off historical lows from 2022 (chart below). Discretionary spending, observed through retail sales and other data, is likewise off. In short, U.K. households are feeling the cashflow pinch.

The biggest household balance sheet difference we see is that U.K. homeowners have not benefited from having their home equity increase in value (a form of illiquid savings). At least the U.K. government isn't encouraging homeowners to borrow against that home equity to make their mortgage payment.

In Canada and Australia, where homeowners have benefited from growth in home equity values, there is evidence to suggest that these homeowners are using their *liquid* savings to bridge their higher household expenses and spending patterns.

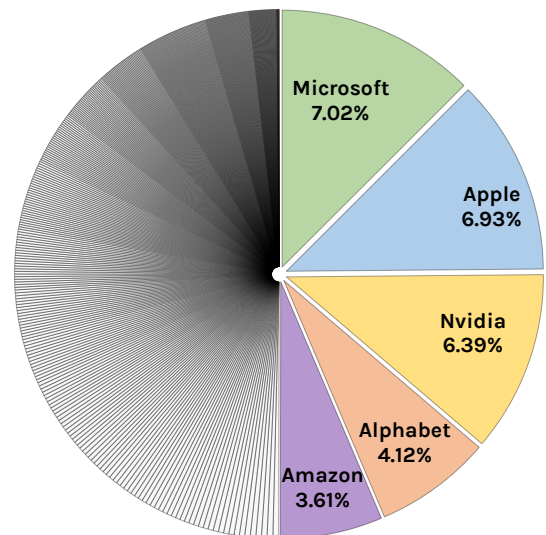
Thus, even as overall household savings appears robust (and even growing), the constituency of that savings is shifting from liquid to illiquid. This is a topic we plan to dig into further and will revisit in a future edition.

“ Just five companies have market caps equal to over 13% of the entire global stock market, and 25% of the entire U.S. stock market.”

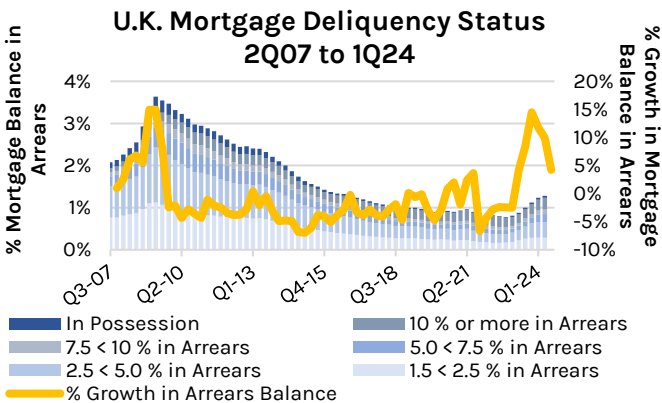
Is the Stock Market Still Relevant?

One of our recent ponderings involved the public equities market, specifically some of the major stock market indices. Admittedly far afield from our home turf of asset-based credit, there are always lessons and insights that can be applied from one market to another.

S&P 500 Index Company Exposures
Exposure to Top 5 = Exposure to Bottom 405



Source: S&P 500 as of July 19, 2024.



Source: Bank of England: Financial Stability Report 2024 Q2.

Take the S&P 500 index. As stated on S&P's [website](#), "The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities." That is an argument for relevancy: what happens within that index matters as it is indicative and reflective of the market and the largest engines in the economy.

Within that index, the largest five companies are **equal** in weight to the bottom 405 companies. Those same five companies have market caps equal to over 13% of the entire global stock market, and 25% of the entire U.S. stock market.

When markets and perceptions of the economy vis-à-vis these barometers are affected by this level of concentration in such few companies, it begs a few questions:

Q: How relevant are these market indices to the real economy when they are so heavily concentrated (and correlated to the same AI thesis)?

A: We would argue that they are not anymore.

Q: How can one apply concepts like historical correlation, volatility, valuation metrics, etc. to today's market risk when the constituency today is so radically different from the past?

A: We would argue that you cannot, which does not inspire confidence in traditional risk models.

Q: Where do we see analogous shifts in other markets, in those markets' barometers and fundamental risks as a result of tectonic shifts in constituents and correlations?

A: We would argue that similar tectonic shifts have already occurred in the realm of sovereign and public debt and are emerging in banking.

When you look at the stock market today, that long-established investment axiom comes quickly to mind: "**Past performance may not be indicative of future results.**"

The Path Forward

We live in strange times.

We have a stock market that is irrelevant to the broader economy and driven by five companies (per previous chart). We have an inverted yield curve and elevated rates that have turned pension deficits into surpluses, but have also caused bank failures, increasing both loan losses and net interest margin

destruction. We have very low corporate default rates, but very high distressed exchanges and decade-high numbers of bankruptcy filings.

We have annuities selling like Taylor Swift concert tickets, accelerating capital inflows into insurance, amplifying demand for all things investment grade, and igniting a rally and massive refinancing wave year-to-date. We have private equity firms still struggling to return capital to Limited Partners and the real estate office market still holding its breath for rates to decrease and capital to return.

In every corner of the market there are clear winners and losers. Most of those fates can be traced to the impact of higher interest rates and persistent inflation (the economic equivalent of "long Covid"). Business models and industrial dynamics either adapted well and won, or could not and lost. The transfer of economic value over such a short period of time has been nothing short of breathtaking.

Strange times indeed. Stranger yet is one phenomenon that has also emerged, persists today, and continues to baffle many. It is captured in the following question:

[In a world where one can earn 5% in government bonds, 7-8% in investment grade corporate bonds, and 10-12% \(taking relatively little risk\) in private credit... why are equity-like returns of 15-25% so hard to find today without going way out on the risk curve?](#)

If you look at realistic return expectations across most asset classes, they are all crowded into a very tight range of 7-15%. We hear frequently from investors who, from 2012 to 2022, became quite accustomed to a much broader span of returns... where the premium one could achieve moving across the spectrum of credit and liquidity was much more meaningful than it is right now.

Returns are more compressed today, like an accordion, into a relatively tight range. It is a point of bewilderment and frustration for many, but the answer is simple: physics.

Money makes the world go around, and credit makes money go around. It is one of our top Lessons Learned. We have talked a lot about the "asset-liability arb" that has been broken in many asset classes over the last couple of years. Asset yields should always be greater than liability yields; that differential, or arb, is what drives excess returns. If the asset-liability arbitrage is weak or

non-existent, you should own the liability, not the asset.

This is not only true within alternative credit (or asset-based credit), but it is true in almost every asset class that exists: from infrastructure to private equity, from commercial real estate to direct lending, from sovereign debt to public equities. We would argue the main exception to this rule would be venture capital because you just should not leverage an asset (using that term loosely in this case) which has no cash yield.

The asset-liability arbitrage is the same force that drives any difference between ROA and ROE. You cannot have an ROE greater than your ROA unless your liability costs are less than the ROA. While that may be a simple axiom, it is fundamental to investing and risk.

Almost everything has an ROA or an asset yield. Within private equity and infrastructure, ROA is the unlevered cashflow yield. In asset-based credit, ROA is the yield generated by the portfolio of loans, leases, or financial receivables. In commercial real estate, ROA is your cap rate if you have benchmarked correctly (actual cashflow vs. theoretical).

ROAs can vary widely, but generally range from 5-12%. The mass of the ROA bell curve centers around 7-10%. In finance, way too much time is spent looking at ROEs or IRRs—those are simply **outputs**. The driver, or the main **input**, is ROA or unlevered/asset yields.

Four years ago, the accordion was expanded. Returns ranged from 2-25% (which coincided in most cases with spreads, given near-zero interest rates). So why didn't all returns move higher, and why didn't that entire return distribution simply shift, by the change in interest rates? Why did the accordion compress? Physics. It is simply friction, or resistance.

If ROAs are around 7-10% in a low-rate environment, by applying some reasonable leverage, one can drive ROEs or IRRs to 20% because that asset-liability arbitrage is healthy and robust. By contrast, in a high-rate environment like we have today, not only is leverage less available, but lenders themselves are looking to achieve 7-10%. That condition erodes the asset-liability arb, compressing the accordion, and creating ROEs in a tighter 7-13% range. Lower rates expand the accordion; higher rates compress it.

Imagine a private equity investment as just one example:

- A new investment is made and funded on a subscription facility at low rates, boosting IRR.
- The underlying company is levered with low-cost debt, creating higher excess cashflow.
- Because interest expenses are low, the company can take on more leverage while maintaining robust interest coverage ratios.
- Excess cashflow fuels capital expenditure (“capex”) and research & development (“R&D”), driving new growth and/or creating dividends to pay down debt or to distribute to investors.
- Low rates drive valuation multiples higher on potential exits.

High rates are friction. I love all things about the Olympics, but especially track events (as a direct result of being born in Eugene, Oregon, aka “Track City U.S.A.”).

Imagine the 100-meter dash but where the runners benefit from a 50mph tailwind. It would appear that all runners had become Usain Bolt. Now, imagine all the runners sprint (no wind this time)... but must wear a training parachute.



Remember from high school physics class: friction or resistance impedes velocity. The coefficient of friction in markets is interest rates.

In a higher rate environment, that same private equity investment would have:

- Higher subscription facility costs, reducing the IRR impact;

- Higher interest expenses resulting in less leverage to maintain interest coverage ratios;
- Less excess cashflow available to fund capex and R&D;
- Reduced or eliminated dividends or recapitalizations; and
- A flat or lower valuation multiple upon exit.

A good private equity investor can try to mitigate or offset these frictions by driving excess growth. Yet, those growth opportunities were also there in a low-rate environment—growth requires capital. Growth therefore experiences the friction of reduced cashflow to fund R&D and capex.

We have experienced a lot of volatility and disruptions in the last four years. Covid, excess stimulus, and inflation all lead to higher rates, and thus, more friction in the market. The economy is showing more signs of “dying flowers” vs. “green shoots” right now. Whether we grow slowly, slip into a recession, or muddle along, interest rates are poised to come down... and therefore so is friction.

The last four years have not been easy to navigate. It has been like a cycle every year. It included a Covid-induced market dislocation and recession, trillions in monetary and fiscal stimulus, the liability-driven investment, or LDI, liquidity crisis, persistent inflation, and rapid interest rate increases. Such environments are why we always focus on downside risks and capital protection, and always with a relative value lens.³ That is our true north through both calm and choppy waters.

It may not feel like it in a market that has had such an aggressive rally year-to-date, but with friction about to be reduced, many of these headwinds will start to become tailwinds. We believe the opportunity set is about to widen.

Central banks are the accordion players. As they lower rates, a healthy asset-liability arbitrage

should return more broadly. Credit will make money go around. The friction of high interest rates leads to pain and reducing that friction typically ushers in broader-based opportunity. The upside to ROEs and IRRs should return, and the upper bound should increase. Importantly, the lower bound of returns should also go down.



Across asset-based credit, we have the benefit of being able to pivot from the liability to the asset and into what we perceive to be the best relative value given conditions and opportunity. The key, we think, is understanding where the physics are helping or hurting, creating your own weather (opportunities) when markets are less interesting, and always steering to our true north.

Our true north will stay the same: downside protection with a relative value lens while searching for sources of upside optionality that will allow us to benefit from that tailwind when the winds shift.⁴ The Olympics Games will soon be a memory, but we certainly sense that this market’s Olympics are just getting started.

³ References to “downside protection” or similar language are not guarantees against loss of investment capital or value.

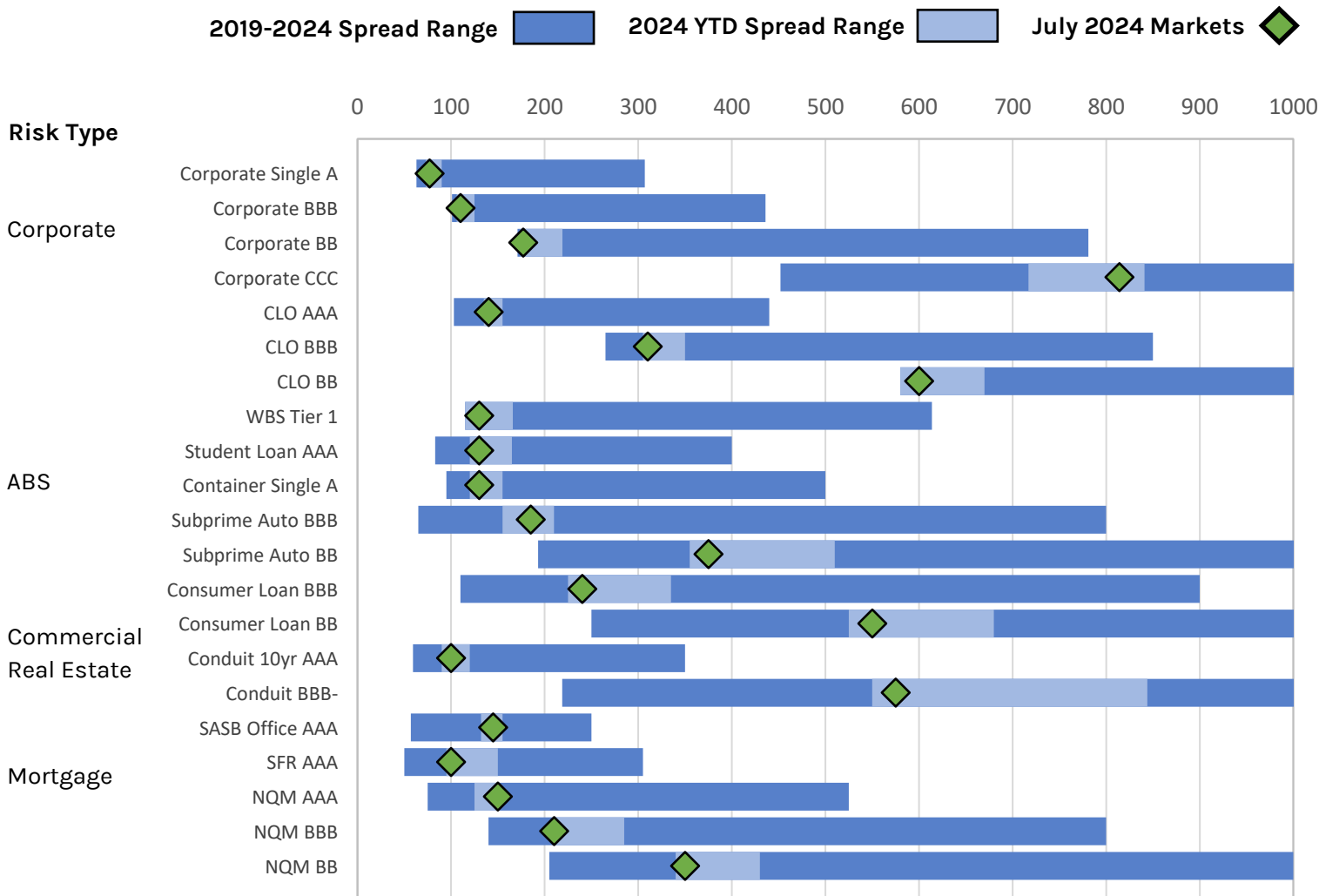
Elevated Demand Has Impacted Credit Spreads and Relative Value across Credit Markets

As noted from Page 2, the chart below plots credit spreads across major sectors and rating categories.

The dark blue shading shows the range of spreads that were observed from 2019 through 2024. The light blue shading shows the range of spreads year-to-date in 2024. The green diamonds plot where credit spreads are currently observed.

Generally speaking, the “tightens” of the markets since 2019 occurred during 2021 (with rare exception).

Credit Spreads Across Markets 2019 - 2024 YTD



Sources: Citi Research, Wells Fargo Trading Desk Spreads, JPM Research, Guggenheim, and Ares.

Alternative Credit's

TOP

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Lessons Learned

True growth as an investor only begins when you embrace your mistakes and seek to continuously improve (kaizen) from your mistakes. More than 17 years ago, Joel began writing down lessons he learned from deals, life, economics and more. Over time that exercise expanded to our Ares teams as part of a year-end process of personal and collective reflection.

- 1. Investing at its core is pattern recognition:** Investors are often measured by IRR or MOIC's. However, in the end, we are built by our set of experiences across a volume and variety of investments and investment types. Sheer volume is not the ultimate measure. Rather, it's learning the common patterns that lead to good and bad investments—those "lessons learned" form our ability to spot the best opportunities and avoid the pitfalls.
- 2. Buy assets and cash flow, the rest is noise:** FOMO on the "next big thing" is often the pathway to the next big bubble. In credit, we are measured not by our wins but by avoiding losses. We believe sticking to fundamentals and ignoring the noise is the only path to long term returns. While compounding has been called the eighth wonder of the world, it can't overcome high severity losses (which often begin by ignoring rule 2).
- 3. Visualize the cash flows to understand drivers and risk:** The best way to think about stressing an investment starts with laying out its cash flows month by month. The ability to see whether the cash flows are front loaded vs. back loaded, sporadic vs. steady, or short duration vs. long duration will allow you to understand what underlying characteristics you need to stress to really test resiliency. All returns are not created equal, and some may appear to provide similar IRRs but can be miles apart on risk.
- 4. Alignment is a tool that drives structure, risk and probabilities:** If you start looking at an investment with the mindset of solving your goals, you have already lost. Seeking to first understand the goals of your counterparty is the key to accomplishing your goals. Structure that aligns their interests with your interests will improve outcomes more than traditional financial metrics. If you don't understand your counterparty's incentives and motivations, you simply don't understand the investment.
- 5. Pyramids and flywheels - dissect the model:** Lawyers do not make partner due to their execution and billings—they make partner by leveraging themselves and the billings of others. Every business has a leverage model. Understanding that model is critical to identifying its key drivers. The flywheel that drives an asset or a business to that next level of growth can be both a strength and a weakness. Identifying what it is, and how it works, is essential.
- 6. Wash, rinse, repeat (cycles):** History and finance are inextricably intertwined, woven together by humans and emotions. While every cycle is different, they all "rhyme." For that reason, we believe our best indicators about the next cycle can come from studying the past—and importantly, not just the last cycle. Learning to view investing through the lens of cycles also trains you to zoom out, looking at the world not quarter to quarter but decade to decade. True perspective and improvement as an investor begins with learning from both history and cycles.
- 7. Patterns are easy; timing is hard:** Awareness of cycles doesn't mean it's easy to time them. Investors with short horizons due to capital constraints or redemption structures are forced to manage monthly or quarterly and must stay relatively invested. Having patient capital and staying patient allows investors avoid "timing" markets. If you know you are at the end of a cycle, stay patient. Alpha begins with patience, often the hardest thing to have as an investor.
- 8. Risk is exponential. The market often prices it as linear:** Investors focus on the valuation but often ignore where they are investing along the risk curve. Imagine a company worth 10x with leverage through 6x including a second lien that starts at 2x. Compare this to a company with the same 10x valuation and leverage, but a second lien that starts at 4x. The market often prices both seniors and second liens within bps of each other even though the risks are dramatically different. Analyzing investments by unit of risk and by attach/detach allows you to see mispricing and inefficiencies. Credit investing is about avoiding losses; the best way to avoid losses is to take less risk for similar returns.
- 9. Find the box. Avoid it. Create your own:** Banks, insurance and securitization markets are all defined by accounting rules, regulations and rating agency criteria. Most funds have buckets and baskets that limit their abilities. All that capital must live within those boxes as defined. Buckets and baskets are often the pathway to beta. Being aware of these boxes and playing "in the gaps" allows you to find great relative value often with lower risk and better returns.
- 10. Money makes the world go around; credit makes money go around:** All assets—from cars to companies—are valued not by the equity markets but by the availability of credit. The arb between assets and liabilities (credit) is economics' version of gravity, and gravity always wins in the long-term. It is why default cycles and economic recessions are just a story of credit expanding and contracting.
- 11. Always have a learning curve:** The greatest thing about being an investor is that the market is always changing and the learning never ends. However, like any craft, once you stop learning or improving you should quit...immediately. Improvement can be a new asset class or studying history or biographies to see the patterns from the past. The key is intellectual curiosity balanced with intellectual flexibility. Being "good enough" can never be end of learning.
- 12. Watch the flows:** There are three pillars of the credit markets: banks, ABS and insurance. The interaction of those pools of capital, along with inflows/outflows, drives the supply and demand balance. If you want to know what will happen to the leveraged loan markets, look at CLO issuance levels: the flows are often directly correlated. If you want to see when the market will rebound after a large correction, watch for the loosening of regulation, bank lending guidelines, new ABS issuance or inflows into annuities. You are watching the green shoots begin. The universe is ruled by supply and demand. Watching the flows is looking through the telescope.
- 13. Time is your most precious resource:** Finding balance in your schedule is the key to finding balance as an investor. You need time to read, whiteboard, vet investments, talk to the market, etc. The hardest transition for investors as you get more senior is that you have more to do with less time. Failing to prioritize your time is like failing to diversify: it will end badly.
- 14. You need real partners (in life and business):** The best decision and investment I ever made in my life was the decision to commit to Michelle, my wife of over 22 years. She balanced me when I didn't even realize I needed balance and makes me a better person every day. In business and investing it is important to have true partners. The best way to avoid echo-chamber thinking is to have partners whom you respect and who have no qualms disagreeing with you. A bad partner can be your ruin, but good partners improve you every day.
- 15. Don't be an a\$\$hole:** The simplest of rules yet the one most often broken. I frequently measure people by how they treat service workers, probably because I spent years as a busboy. In finance, as much as you need ego to have confidence to move forward, you need humility to realize how lucky you are to have been given the opportunity and the seat. If you don't stay humble, you deserve to be humbled...and the market will often oblige.

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Charity Spotlight of the Quarter



KEEPING CHILDREN SAFE AND FAMILIES TOGETHER

Ares is committed to investing in global health and education to help save lives and drive equality. Ares and the Team's portfolio managers have committed to donate a portion of carried interest profits for certain of the Team's flagship funds to global health and education charities. Given Ares' focus on investing with purpose, each quarter, we will highlight a non-profit organization with a track record of delivering value per charitable dollar contributed. Note Ares is not endorsing the non-profit organization, nor has Ares donated to the highlighted charity at the time of this publication.

This quarter, we are spotlighting The Children's Village ("CV"), a New York area-based charitable organization that focuses on providing critical educational, health, and community support to at-risk children in the U.S.

Through its various programs focused on community and school-based programs and housing, CV reaches 20,000 children, teens, and families each year, including 4,000 youth on a daily basis. The organization serves three populations of children; children separated from family due to (1) child welfare (foster care), (2) juvenile justice involvement, and (3) victimization by human trafficking. With operations centered at a main campus in Dobbs Ferry, New York and staff spread throughout the U.S., CV provides a holistic suite of interventions that help the most at-risk children with education and health resources and ultimately progress to receive an education, reunite with families, and achieve their potential.

Background

Founded in 1851, The Children's Village is one of the oldest charities in the United States. The organization was founded as the New York Juvenile Asylum, providing residential care for orphans and delinquent children in New York.

In 1856, the New York Juvenile Asylum established its Washington Heights campus, which provided a childcare service to 1,200 boys. In 1901, the organization moved operations to a 277-acre farm in Dobbs Ferry, New York.

The Children's Village was the first childcare agency in the country to establish a psychiatric clinic on its

campus. During the 1920's, CV opened the National Training School for Institution Executives and Workers, which eventually became part of the New York School of Social Work.

Most recently, Inwood House, a charity founded in 1830 with a specialization in serving pregnant and parenting teens and providing teen pregnancy prevention and leadership education, merged with The Children's Village in 2016.

Today, the Dobbs Ferry campus continues to be the CV's main site of operations, where CV provides short-term treatment and family reunification services for 400 children of all ages. In addition to the residential program, the campus is also the site of the Greenburgh Eleven Union Free School District, a New York State public school district offering K-12 classes on-site that is directly funded by the state (vs. through property taxes). CV works closely with the school administrators, who oversee the admitting and teaching of ~100-150 students from across New York City and any nearby suburbs who are referred out of their home school to The Children's Village for various reasons, including behavioral issues.

In addition to the Dobbs Ferry campus, the organization serves in 42 NYC schools, providing foster homes for over 200 teens, and helps an additional ~20,000 children in non-residential programs.

Children and youth eligible for CV's aid are identified by schools and government agencies that have CV as a top partner to intake children. Children are screened for human and sex trafficking and attempts are made to establish family connections.

“We believe that there are three keys to a child’s success: education, work, and lifelong relationships.

To that end, we are passionate about education and have high expectations for our students. We help youth develop the attitudes and skills needed to enter the workforce successfully. And we believe that one strong adult relationship is a game changer for any child. We help reunited families and sometimes we help create new families through adoption. You are never too old to be loved!”

Jeremy C. Kohomban, PhD
*President and CEO,
The Children’s Village*

Impact

The Children’s Village’s key programs highlighted here focus on offering education, health, and community support to at-risk children in the U.S. The programs are funded primarily via government grants, which comprise ~93% of CV’s budget and are typically funded on a per-head basis.

Residential Programs

The CV’s residential initiatives are designed to offer short-term housing and counseling support for youth in foster care, the juvenile justice system, and homeless teens. Some programs offer temporary shelter to assist youth in conflict with their families by providing them access to counseling, group meetings, and other resources. Between 2022-2023, 129 young people from the residential program found permanent housing and are living independently. CV’s primary programs include:

1. **Close to Home** – Provides local alternative to detention with short-term residential treatment for teens involved in criminal behavior. Treatment focusing on health, education, relationship and work skill development.
2. **Temporary Shelter** for Survivors of Human Trafficking – Provides survivor support,

temporary housing for youth aged 12-17. Approximately 90% of youth move to safer situations with most returning to their families. Additional support provides 18 months in a shared apartment with support for those with no home to return to, allowing them to continue their education, work, and save for independence.

3. **Beautiful and Affordable Homes** – Providing almost 350 residences for local families and young people. Located in Westchester County and NYC, the apartments available for young residents come with wrap-around services including budgeting, work, and education issues.

Community and School-Based Programs

The Children’s Village offers various school-based and community support programs, including no-cost transformative mentorship that targets high-risk youth. The organization’s programs emphasize interactive group work and one-to-one journaling to shift youth’s mindsets and behaviors to prevent reincarceration or entanglement with the justice system.

The most prominent program is **Arches**, part of the NYC Young Men’s Initiative since 2012, which serves youth on probation, ages 16-24, in selected areas. Arches provide mentorship, education, community engagement, employment services, goal setting, and uses of social media, music, or film. It has significantly reduced recidivism, with felony reconviction rates 69% lower 12 months and 57% lower 24 months after starting probation, especially for ages 16 and 17.

The **Peer Leaders** initiative is a school-based program to develop future leaders by training students on various teen-related topics. Working with schools in New York City, the program includes a 4-week summer training with over 60 hours of instruction and social activities promoting family engagement, healthy relationships, and providing health referrals. Peer Leaders attends a weekend retreat at the Berkshires Camp to experience leadership and team-building exercises, illustrating the impact of their new roles within the community.

Additional initiatives include after-school programs for kids and teens at the **Drew Hamilton Center**, which is operated in conjunction with the NYC

Department of Youth and Community Development and the NYC Housing Authority. Located in Harlem, the community center serves as a hub for children and families, offering a variety of educational and recreational activities. During the summer, the center runs a free camp for children ages 5-12 with activities like swimming, sports, and field trips.

Inwood House - Pregnant/Parenting Teens Program

Inwood House has been a key provider of comprehensive services for pregnant and parenting teens and pregnancy prevention education in New York City since 1830. Now part of The Children's Village, the Inwood House Division aims to enhance young parents' self-worth, improve the health of both parents and their babies, and support high school education and workforce entry through food, shelter, clothing, counseling, education, and medical care. The program offers health education workshops in classrooms, small group mutual-aid discussions, and individual counseling for students in New York City. The program serves more than 25 schools and reaches close to 2,000 students in middle and high schools.

Key Statistics (2022-2023)

- 129 young people found permanent housing and are living independently.
- 2,998 students in over 30 New York City public schools received services including individual and group counseling, crisis services, afterschool programming, and educational support.
- 90% of young people in our treatment programs lived with family and did not require psychiatric hospitalization.
- 237 families received family support services directly in their homes.
- 94% of mentees in our transformative mentoring programs avoided re-arrest.
- 217 teens found a loving family.

Key Financial Highlights (2023)

- The Children's Village raised \$144.3 million of revenue in 2023, of which 93% (~\$135 million) came from the government and 3% (~\$4 million) came from individual, foundation, and corporate contribution.
- Total expenditures were \$144 million, of which 88% (~\$126 million) was spent directly on the program.
- In 2023, CV spent 25% (~\$36 million) of the operating expense on foster and adoptive family program, 21% (~\$30 million) on juvenile justice support, and 13% (~\$19 million) on medical and mental health services and therapy.

FOR ADDITIONAL INFORMATION, PLEASE VISIT [THE CHILDREN'S VILLAGE WEBSITE](#).

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