The Global Hunt for Yield: Opportunities in Underfollowed Income Stocks

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Please see the Endnotes and Legal Notice and Disclaimers beginning on page 11.

Searching for Yield...but in All the Wrong Places

The need for current income and quality risk-adjusted returns is growing due to a number of macroeconomic and demographic pressures. Pension plans are seeking higher returns to close liability gaps, insurance companies are seeking higher returns to offset the narrowing spread between their assets and liabilities, and more individual investors are entering retirement and seeking higher yields to bridge the savings gap and to supplement income.

At the same time, monetary policy and market dislocations have created unique challenges for investors seeking yield, as traditional investment strategies fall short of providing required returns.

Global central bank policy has driven yields on traditional income-generating securities to historic lows, with zero and even negative rates on approximately $13 trillion[1] in global instruments. With interest rates at all-time lows, investors can no longer rely on traditional benchmark-driven, core fixed-income strategies to meet their fixed-rate and overall return objectives. Fixed-income instruments are under extreme pressure, with treasury, investment grade corporate bonds and municipal bonds all yielding less than 4%.[2]

Meanwhile on the publicly traded equity side, divergent and uncertain monetary policy, fears of slowing growth, currency devaluation and the impact of the energy and commodity price collapse have contributed to heightened and continuing volatility.

Quantitative easing has fueled high asset valuations, and a surplus of excess capital is looking for returns. Many believe that traditional high income equity sectors are either fully priced (utilities, property REITs) or have under-performed due to commodity or business model risk (MLPs).

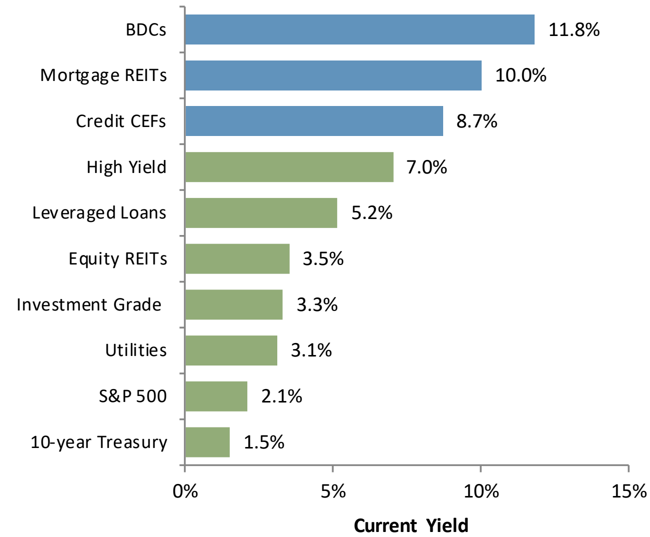
> *“We are dealing with a marketplace where traditional fixed income and global equities are not offering desired levels of return.”*

Alternative Yield Securities Offer Attractive Potential Returns

Despite these challenges, we believe that there are significant opportunities to earn compelling risk-adjusted returns through public funds investing in alternative assets. These funds, or Alternative Yield Securities, include business development companies ("BDCs"), mortgage real estate investment trusts ("Mortgage REITs") and credit-based closed-end funds ("Credit CEFs"). We believe these investments are attractive for the following reasons:

- **Strong Income and Total Return Profile:** Attractive current income and long-term total return potential, dividend stability across market cycles and strong historical returns relative to risk
- **Attractive Entry Point:** Attractive current pricing relative to fundamentals, as well as meaningful valuation discounts to current net asset values due to inefficient markets, informational asymmetries and market misperceptions
- **Diversification:** Broad underlying portfolio investments can reduce concentration risk, and volatility may be reduced by correlation differences across asset classes
- **Efficient Tax Structure:** Potential for reduced tax leakage at the investment level, with additional foreign investor tax benefits

Figure 1: Alternative Yield Securities Provide Attractive Dividend Yields Relative to Other Yield Investments



Sources: Bloomberg, SNL, Factset, Morningstar. Past performance is not indicative of future results. Based on the most recently declared dividend/distribution divided by stock price as of 6/30/16. See Endnotes.

A Snapshot of the Alternative Yield Security Asset Classes

BDCs

Closed-end investment companies required to invest in private U.S. businesses, including by providing financing for small and medium-sized U.S. businesses.

Aggregate Market Capitalization:
$30 billion (53 publicly-traded BDCs)[3]

Profile:

- Access to top alternative managers and a diversified pool of illiquid middle market corporate assets
- Potential for attractive current income and yield through dividend distributions
- Daily liquidity, portfolio transparency with detailed holding information
- Subject to periods of book value and stock price volatility, particularly in down cycles

Mortgage REITs

Pass-through vehicles that invest in loans, bonds and/or securities backed by real estate as well as loan servicing businesses and equity in real estate properties.

Aggregate Market Capitalization:
$60 billion (41 publicly-traded Mortgage REITs)[3]

Profile:

- Potential for attractive current income through dividend yields
- Secured investments in real estate to limit credit loss
- Sensitive to interest rates and subject to periods of book value and stock price volatility

Credit-Based Closed-End Funds

Publicly traded, registered investment companies that invest in liquid senior bank loans, high yield bonds and structured products.

Aggregate Market Capitalization:
$29 billion (63 Credit CEFs)[3]

Profile:

- Attractive current income potential, stable capital structures and liquid investments provide high visibility on equity values
- Can capitalize on longer-term, less liquid securities due to their stable capital structure
- Subject to periods of book value and stock price volatility during market dislocations

> *"We believe that Alternative Yield Securities offer attractive current income and trade at meaningful valuation discounts to current net asset values."*

Why Are These Asset Classes Attractive?

Attractive Total Return Profile and Current Valuation Entry Point

BDCs, Mortgage REITs and Credit CEFs have a range of compelling investment features, as well as attractive current valuations that we believe reflect investor misperceptions of risks and technical factors. From a total return standpoint, they can provide durable and predictable income through dividends and have attractive long term capital appreciation potential. BDC, Mortgage REIT and Credit CEF structures have built-in distribution requirements, which can enhance dividends paid to investors. Given historically low interest rates and exogenous pressures on Alternative Yield Securities, we believe that they are particularly compelling now, with attractive valuation entry points. All three asset classes are currently trading at meaningful discounts to net asset value,[4] which we believe do not generally reflect their underlying fundamental valuation.

Figure 2: Alternative Yield Securities Are Currently Trading Below Historical Price-to-Book Levels

Assuming stock prices revert to historical average levels relative to book value, this would result in total two-year annualized returns of 15.9% for BDCs, 14.3% for Mortgage REITs and 10.9% for Credit CEFs.[6]

Asset Class	Average Price/Book	Current Price/Book
BDCs	1.05x	0.97x
Mortgage REITs	1.02x	0.94x
Credit CEFs	0.96x	0.92x

Source: SNL Financial. Past performance is not indicative of future results. Averages calculated from 12/31/10 through 6/30/16. See Endnotes.

In the case of Credit CEFs, we can easily see the advantage of below-book valuations when comparing current Credit CEF yields with the yields of their liquid underlying assets – senior bank loans and high yield bonds. We believe that Credit CEF yields are higher than the index yields of their underlying assets primarily due to their attractive below-book pricing level, in addition to other factors such as leverage.

Figure 3: Credit CEF Yields vs Underlying Asset Benchmark Yields

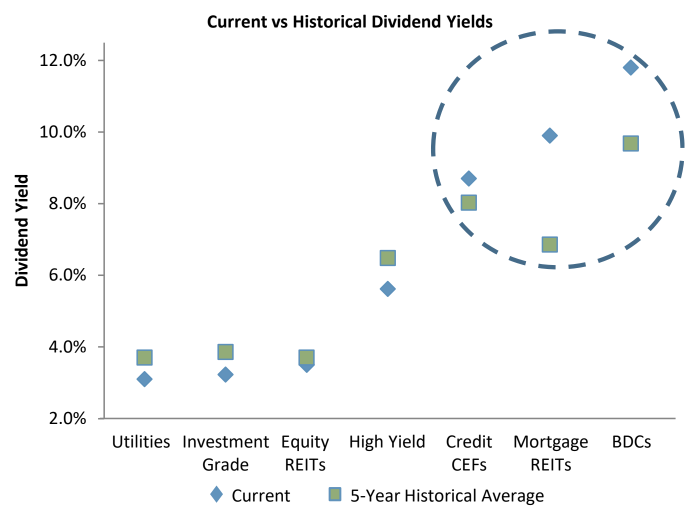
	Yield
Senior Loan Credit CEFs	7.3%
LSTA U.S. Leveraged Loan 100 Index	5.7%
High Yield Credit CEFs	9.3%
Merrill Lynch Master II Index (H0A0)	7.3%

Source: Bloomberg and LCD. As of 6/30/16. Yields for Senior Loan Credit CEFs and High Yield Credit CEFs reflect an average across the group constituents. See Endnotes.

Alternative Yield Securities are also currently trading at higher than average dividend yields. Current yield spreads for Alternative Yield Securities relative to other asset classes indicate that while investors may have exhausted yield in other places, such as treasuries and investment grade corporate bonds, they have not yet fully capitalized on the opportunity for Alternative Yield Securities. Moreover, we believe that other alternative yield assets, such as utilities and Equity REITs, may be overvalued as they are trading above historical average valuations based on dividend yields and price-earnings ("P/E") ratios, while Alternative Yield Securities are tracking meaningfully below historical valuations based on these same metrics.

Figure 4: Alternative Yield Securities Are Currently Trading Above Historical Average Dividend Yields

Assuming dividend yields revert to historical averages due to stock price increases, this would result in total two-year annualized returns of 22.6% for BDCs, 20.2% for Mortgage REITs and 19.3% for Credit CEFs.[6]



Source: SNL Financial and Bloomberg. Past performance is not indicative of future results. Historical average dividend yields calculated from 12/31/10 through 6/30/16. See Endnotes.

> *"Given historically low interest rates and exogenous pressures on Alternative Yield Securities, we believe that they are particularly compelling now, with attractive valuation entry points."*

BDC and Mortgage REIT spreads relative to 10-year treasuries, investment grade corporate bonds and high yield bonds have widened significantly over the past five years,[5] indicating an attractive pricing entry point. We believe that quantitative easing and relative liquidity levels have created these divergences from historical spread correlations, as opposed to changes in fundamental performance.

Figure 5: BDC and Mortgage REIT Dividend Yields are Trading Wider than Historical Spreads to Both High Yield and Investment Grade Bonds

Assuming BDC and Mortgage REIT yield spreads relative to 10-year treasuries, investment grade corporate bonds and high yield bonds return to historical average levels, this would result in total two-year annualized returns of 23.2% and 31.3%, respectively.[6]

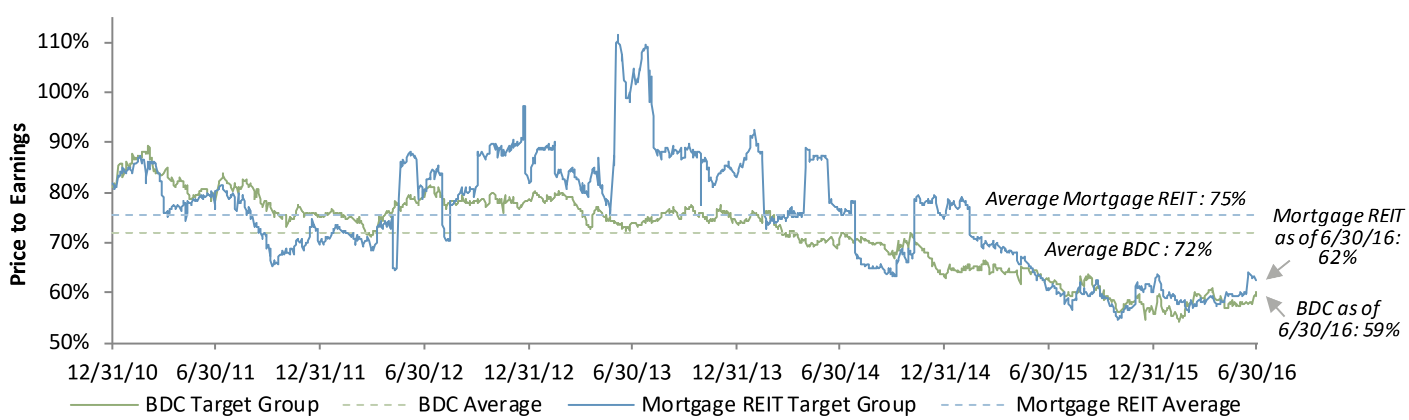
	Average Yield Spread	Current Yield Spread	Current Yield Spread as % of Past 5 Year High
BDC to 10-Year TSY Spread	7.69%	10.29%	83.3%
BDC to BBB Spread	6.06%	8.34%	87.4%
BDC to HY Spread	2.78%	4.46%	94.8%
Mortgage REIT to 10-Year TSY Spread	4.59%	8.50%	69.9%
Mortgage REIT to BBB Spread	2.96%	6.55%	70.1%
Mortgage REIT to HY Spread	-0.32%	2.67%	69.1%

Source: SNL Financial. Past performance is not indicative of future results. Calculated from 12/31/10 through 6/30/16. See Endnotes.

Based on a comparison of relative forward P/E ratios, we believe that Alternative Yield Securities are also currently undervalued relative to the broader equity markets. The S&P 500 P/E ratio has climbed precipitously over the last three years, while Alternative Yield Securities' P/E values have declined. We view this as a reflection of the S&P 500's overall price appreciation rather than worsening fundamentals for Alternative Yield Securities, a topic we explore in depth when examining the drivers of the current mispricing environment.

Figure 6: Forward P/E on BDCs and Commercial Mortgage REITs Relative to S&P 500 Forward P/E

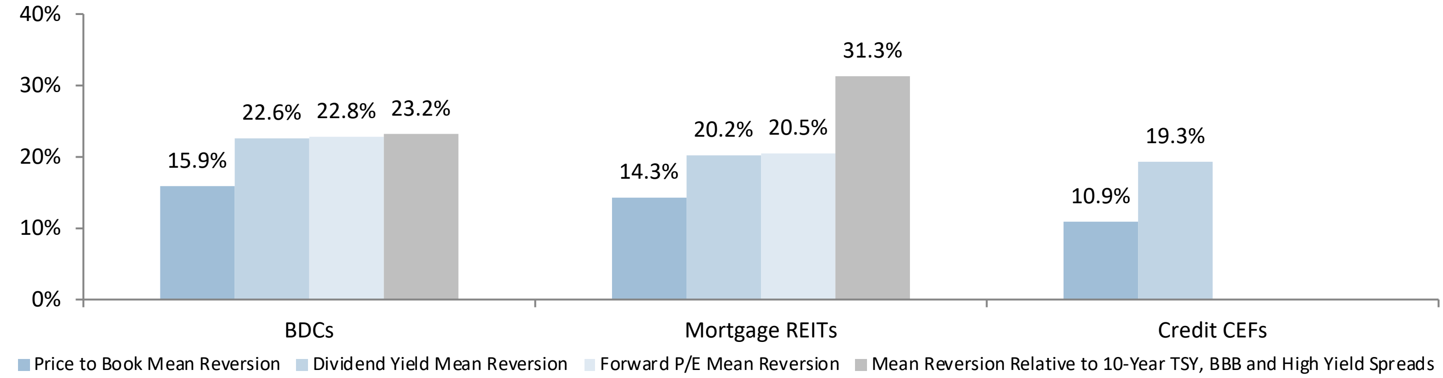
Assuming BDC and Commercial Mortgage REIT stock prices return to average forward P/E levels relative to S&P 500 forward P/E levels, this would result in outperformance relative to the S&P 500 of 22.8% for BDCs and 20.5% for Mortgage REITs.[6]



Source: Capital IQ. Past performance is not indicative of future results. Calculated from 12/31/10 through 6/30/16. See Endnotes.

In short, we believe that the Alternative Yield Securities have attractive current entry prices and strong future return prospects, based on our projections of two-year expected returns as modeled in a variety of ways, including assuming stock prices revert to historical averages for price-to-book values, dividend yields, average S&P 500 forward P/E levels, and average spread levels relative to 10-year treasuries, investment grade bonds and high yield bonds. Furthermore, we believe that industry consolidation trends for underperforming managers may create additional upside opportunities because of the potential positive impact of merger and acquisition activities.

Figure 7: Two-Year Annualized Returns for Alternative Yield Securities Assuming Mean Reversion to Historical Averages

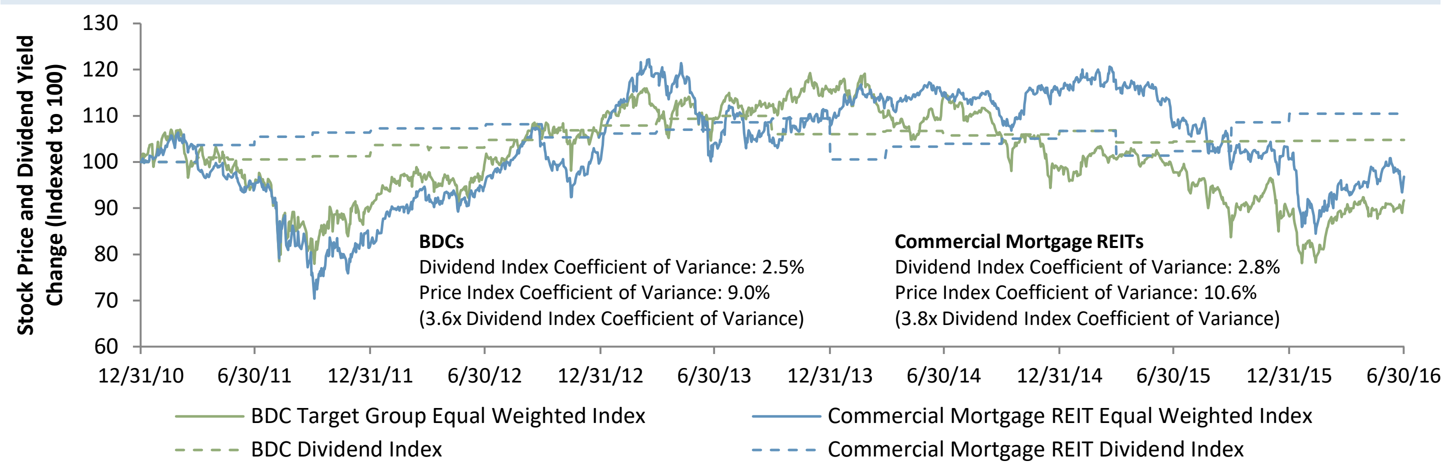


Source: SNL Financial, Capital IQ and Bloomberg. Projected returns are based on historical data for the period from 10/30/10 through 6/30/16 and assumptions as follows: Price to Book Mean Reversion reflects expected two-year annualized returns assuming stock prices revert to historical average levels relative to book value over a two-year period (see Figure 2). Dividend Yield Mean Reversion reflects expected two-year annualized returns assuming dividend yields revert to historical averages due to stock price increases over a two-year period (see Figure 4). S&P 500 Forward P/E Mean Reversion reflects expected two-year annualized returns assuming stock prices return to average forward P/E levels relative to the S&P 500 over a two-year period (see Figure 6). Mean Reversion Relative to 10-Year TSY, BBB and High Yield Spreads reflects an equal-weighted average of expected two-year annualized returns assuming spreads to 10-year treasuries, investment grade (BBB) bonds and high yield bonds return to average historical levels over a two-year period (see Figure 5). Expected annualized returns include both stock price appreciation and dividend yields. There can be no assurance that values will return to historical average levels or that projected returns can be achieved. See Endnotes.

Compelling Risk Profile

Over the past five years, Alternative Yield Securities have demonstrated relatively consistent dividend streams despite price volatility. As Figure 8 shows, dividend volatility for BDCs and commercial mortgage REITs has been minimal relative to price fluctuations in stock values. Dividends have been over 3.5 times more stable than their underlying stock prices. Over the long term, however, stock prices tend to revert to normal dividend levels, underscoring the opportunity for capital appreciation.

Figure 8: BDC and Mortgage REIT Dividends Have Been Over 3.5 Times More Stable than Their Underlying Stock Prices



Source: SNL Financial and Bloomberg. Past performance is not indicative of future results. Calculated from 12/31/10 through 6/30/16. The Equal Weighted Indices reflect the price variation of the BDC Target Group and Commercial Mortgage REIT Target Group, respectively, over time, assuming an equal principal investment in each BDC and Commercial Mortgage REIT. The Dividend Indices reflect the variation of dividends paid over time from the BDC Target Group and Commercial Mortgage REIT Target Group, respectively. See Endnotes.

Furthermore, we are not expecting material dividend cuts based upon the health of current portfolios and current levels of earnings. We believe that Alternative Yield Securities currently have a healthy earnings dividend coverage profile and anticipate that this will hold true in the coming year, based on 2017 consensus earnings estimates. While there are not earnings forecasts for Credit CEFs, we do not anticipate material reductions in portfolio income.

Figure 9: Dividend Coverage by Asset Class

Asset Class	TTM Dividend Coverage	2017E Dividend Coverage
BDCs	101%	104%
Mortgage REITs	104%	106%
Credit CEFs	99%	-

Source: Bloomberg. As of June 30, 2016. TTM Dividend Coverage is trailing twelve month operating earnings (net operating income for BDCs) dividend by last four quarters' dividends. 2017E Dividend Coverage is 2017 consensus estimates versus current dividend levels. See Endnotes.

Alternative Yield Securities also exhibit a strong historical return profile relative to risk. As demonstrated by Figure 10, they offer an attractive value proposition along the risk-reward spectrum, along with significant potential upside assuming returns to historical valuations.

Current underperformance creates a compelling opportunity. While Alternative Yield Security returns have ranged from approximately 5%-9% over the past five years,[7] future returns may be more attractive based on the previously discussed set of mean reversion analyses.

In addition, Alternative Yield Securities have historically been attractive from a capital preservation standpoint. Over the past ten years, investing in BDCs trading below net asset value has consistently provided investors with positive three-year returns.[8] We believe this underscores the power of collecting consistent dividends and why purchase price can act as an effective risk mitigant, with the potential to optimize returns through quality active management. We believe that these dynamics are similar for Mortgage REITs and Credit CEFs, which are also trading at discounted price-to-book values.[9]

Figure 11: Historical Capital Preservation When Investing in BDCs Below Book Value

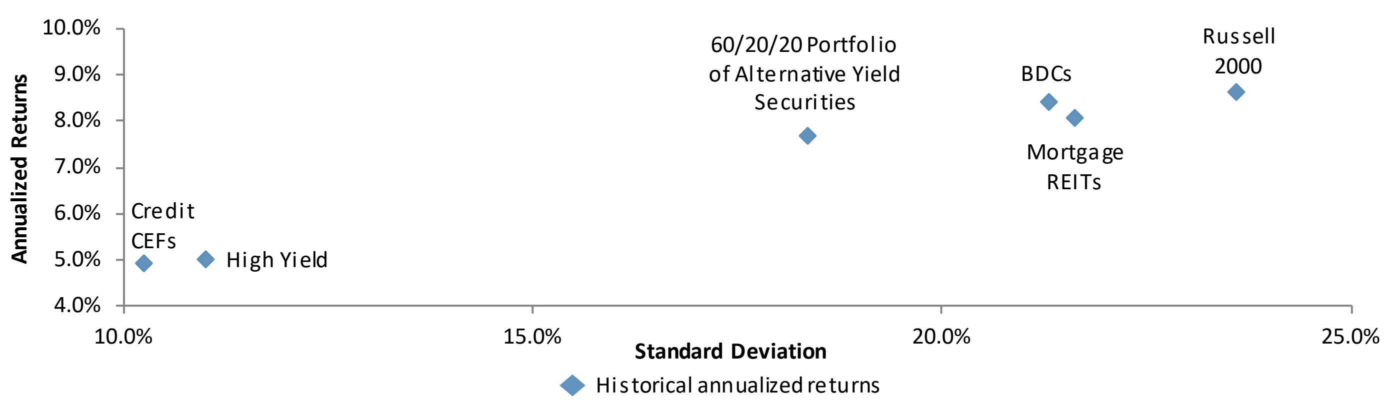
3-year Return Statistics			
BDC P/B Valuation	# of Occurrences	# Positive Returns	% Positive Returns
<70%	184	184	100%
70–80%	42	42	100%
80–90%	225	225	100%
90–100%	328	323	98%
100–110%	341	335	98%
110–120%	595	264	44%
>120%	296	41	14%

Source: Wells Fargo BDC Index. Past performance is not indicative of future results. For the period of 12/31/05 through 12/31/15.

Figure 10: Historical Annualized Returns and Standard Deviations

*Two-Year Annualized Returns Assuming Return To Historical Valuations**

BDCs: 21.1% | **Mortgage REITs: 21.6%** | **Credit CEFs: 15.1%**



Source: Bloomberg. Past performance is not indicative of future results. Annualized returns and standard deviations are calculated for the period from 12/31/10 through 6/30/16.

* Represents projected two-year annualized returns for BDCs, Mortgage REITs and Credit CEFs, which are calculated from historical data for the period from 12/31/10 through 6/30/16 and reflect an equal-weighted average of various projected annualized return calculations based on Price to Book Mean Reversion analysis (for BDCs and Mortgage REITs) as noted in Figure 2, Dividend Yield Mean Reversion analysis (for BDCs and Mortgage REITs) as noted in Figure 4, S&P 500 Forward P/E Mean Reversion analysis (for BDCs and Mortgage REITs) as noted in Figure 6, and Mean Reversion Analysis Relative to 10-Year TSY, BBB and High Yield Spreads (for BDCs and Mortgage REITs) as noted in Figure 5. See Endnotes.

What is Driving the Current Mispricing Environment?

We believe that Alternative Yield Securities' current valuations relative to historical levels cannot simply be explained by fundamentals. We believe that they are also driven by such other factors as investor misperceptions of credit as well as interest rate risk and technical factors, such as limited institutional research coverage and informational asymmetries.

Myths and Facts

Below we explore what we believe are two common investor misperceptions about Alternative Yield Securities. Investor fears of volatile commodity prices, credit and corporate governance issues, as well as the prospect of rising interest rates and potential recession have contributed to volatility and, in our view, overly depressed prices for certain Alternative Yield Securities.

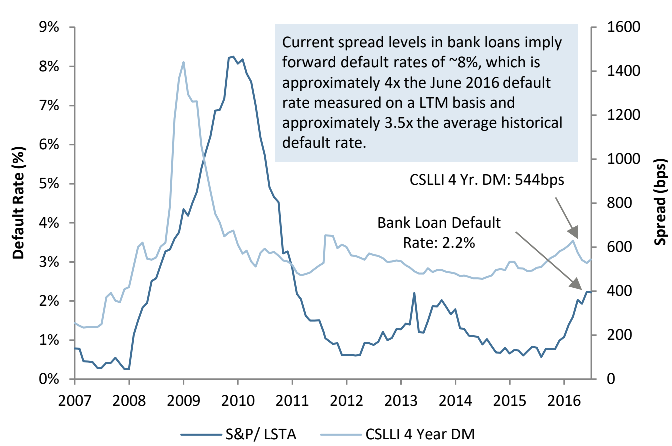
Myth #1: Alternative Yield Securities' Underlying Assets Are Too Risky

Our analysis of fundamentals offers several data points to the contrary.

- Credit CEFs:

  If we view spread purely as an expression of default risk, we see that current Credit CEF spread levels not only adequately cover the current rate of defaults but also can support more than four times higher default rates, a significant cushion from a risk pricing standpoint.

Figure 12: Recent Default Rates and Spread Levels for Non-Investment Grade Bank Loans



Source: Credit Suisse/S&P LSTA. For the period from 12/31/06 through 6/30/16. JPM implied default rate methodology (actual spread - excess spread, divided by the historical recovery rate of the asset class). Forward default rate calculation uses June 30, 2016 spreads.

- BDCs:

  On average, BDCs have generated an annualized loss rate of 0.43% since IPO compared to a 0.58% average annualized loss rate for bank commercial and industrial loan portfolios over comparable time periods. In addition, the outperformance has been broad-based, with 70% of the 27 largest BDCs having loss rates better than bank loan loss rates.[10]

  Non-accruals for middle market loans have recently trended moderately higher (2.86% as of March 31, 2016, compared to 1.67% in the first quarter of 2015), primarily reflecting oil and gas-related loans.[11] However, notwithstanding modestly higher non-accrual levels, we believe that current discounted valuations of certain BDCs are at extreme levels, which we believe assume an unlikely scenario where all energy investments are realized at a complete loss. Even with a total write-down of all oil and gas exposures, the anticipated average impact to BDC book values would only be around 7.5%, and we believe that the strength of expected 2017 earnings dividend coverage would be sufficient to weather such an improbable impact.[12]

- Mortgage REITs:

  We believe that positive supply-demand imbalances are currently driving higher-than-average spreads on commercial mortgage loans rather than any deterioration in default rates. As Figure 13 demonstrates, CMBS BBB- spreads have widened above historical averages over the past several years, while loan-to-value ("LTV") ratios have decreased over the same period. CMBS security structures also continue to be advantageous, with expanding enhancement levels, increased debt service coverage levels and limited speculative underwriting.

Figure 13: CMBS BBB- Spreads vs LTV Ratios

Source: J.P. Morgan, Pricing Direct. For the period from 1/1/12 through 6/30/2016.

As previously discussed, we believe that the primary drivers of BDC and Mortgage REIT spread widening (as compared to 10-year treasuries, investment grade bonds and high yield bonds) over the past five years (see Figure 5) are the impacts of increased monetary stimulus and higher relative liquidity of high yield and investment grade corporate bonds, as opposed to changes in fundamental performance.

Myth #2: Alternative Yield Securities are subject to significant interest rate risk.

While some investors fear that higher risk-free rates will negatively impact yield investments, we believe that BDCs, commercial mortgage REITs and the Credit CEFs (senior loan and hybrid credit CEFs) should actually benefit from rising rates. All of these segments are "asset sensitive" because they tend to have a majority of their assets in floating rate loans (where current yields rise with rising rates), while the majority of their funding is locked-in with fixed rates. Active managers examine interest rate sensitivity profiles in order to control for risk and capitalize on opportunities from sound rate structures.

Interestingly, investors are simultaneously concerned about both interest rate increases and an economic slowdown affecting credit quality. Basic macroeconomics and market history suggest that it is unlikely that these two scenarios would occur at the same time. Yet, we see BDCs, Mortgage REITs and Credit CEFs trade on both economic and interest rate news.

Figure 14: Assets/Liabilities Table

	Assets		Capital Structure	
	Floating	Fixed	Floating	Fixed
BDCs	66%	34%	19%	81%
Comm. Mtg REITs	74%	26%	39%	61%
Hybrid Mtg REITs	36%	64%	32%	68%
Agency Mtg REITs	16%	84%	10%	90%
Senior Loan CEFs	100%	0%	30%	70%
Hybrid Credit CEFs	37%	63%	30%	70%
High Yield CEFs	7%	93%	25%	75%

Source: Company reports, Wells Fargo, KBW. BDC data as of 9/30/15 filings, CEF data as of 12/31/15, REIT data as of 3/31/16.

Technical Factors

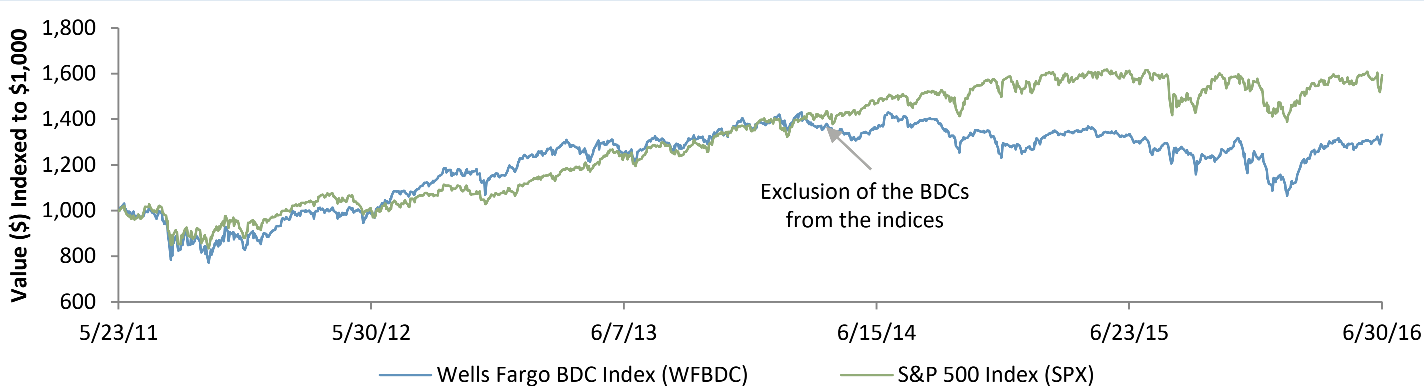
Lack of Institutional Ownership and Research Coverage

Unlike many other sectors, Alternative Yield Securities are generally retail-owned and not heavily covered by institutional research (approximately 40%, 35% and 20% institutional ownership for Mortgage REITs, BDCs and Credit CEFs, respectively). We believe that investors, generally speaking, lack familiarity with these structures and the performance of their underlying assets. As a result, we believe these stocks trade inefficiently and frequently deviate from their intrinsic value. In addition, macroeconomic events can reduce liquidity for these stocks, enhancing trading opportunities.

Technical Anomaly in BDC Sector

The BDC sector in particular has additionally been pressured by technical factors surrounding the exclusion of the group from the Russell 1000 and 2000 Indices in Spring 2014. The sector was excluded for technical reasons related to fund accounting and disclosure rules, and not for reasons related to fundamental operational performance. However, as Figure 15 highlights, the removal of BDCs from the indices contributed to stock underperformance and deviation from historical trends relative to the broader market. We note that BDC industry fundamental operating performance (the ability to make prudent underwriting decisions) was not impacted at all by this index change. Instead, the index removal simply eliminated a portion of the institutional investor base (passive funds), which resulted in a downward adjustment in valuations. In our opinion, once new investors recognize the opportunity to gain access to the reliable income streams from these stocks, the valuations will adjust upward toward historical levels and be closer to what we believe is their intrinsic value.

Figure 15: BDC Index Exclusion and Performance



Source: Bloomberg Finance L.P.

Active Portfolio Management Can Reduce Volatility, Enhance Diversification and Maximize Returns

To take full advantage of the opportunities in Alternative Yield Securities, we believe it is necessary to rely on an experienced manager or active investor that can identify relative value within these asset classes. Since the companies are not homogeneous, stock selection is critical to discern significant risk and return differences across individual stocks. To generate alpha, we believe that investors need an active, well diversified strategy, with appropriate risk mitigation techniques to address volatility and interest rate changes.

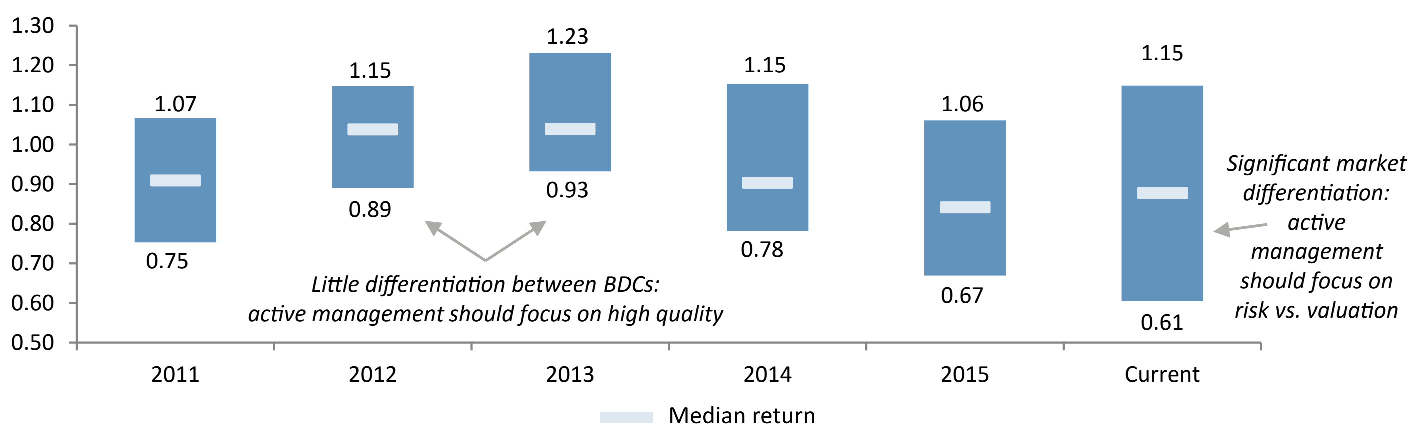
We believe that BDCs, Mortgage REITs and Credit CEFs provide excellent opportunities broadly, but there are wide dispersions historically among individual stocks within these industries:

- Publicly traded BDCs have averaged an annual 7.3% return over the past five years;(13) however the top five performing publicly traded BDCs averaged a 21.5% annual return while the bottom five publicly traded BDCs averaged a -3.7% annual return.
- Commercial mortgage REITs have averaged 8.5% annual returns over the past five years,(13) with the top five mortgage REITs averaging a 15.2% annual return while the bottom five mortgage REITs averaged a 0.0% annual return.
- Credit CEFs have averaged 3.4% annual returns over the past five years,(13) with the top five CEFs averaging a 6.4% annual return while the bottom five CEFs averaged a 1.4% annual return.

Within the BDC sector in particular, the market has not always distinguished properly between managers, even though business models, loan portfolios and underlying fundamentals can differ meaningfully. In these times, it is beneficial to rotate towards high-quality BDCs, as equity prices do not effectively differentiate between varying risk profiles. However, as shown in Figure 16, current market values are pricing in significant differentiation within the BDC sector. In this type of environment, investors should instead focus on the relative difference between portfolio risk and purchase price to determine if valuation discounts are overdone or if the investment is a potential value trap.

> *"In this market environment, we believe that stock selection is essential and requires experienced, active management."*

Figure 16: BDC Market Differentiation: Price-to-Book Valuation Ranges for Externally-Managed BDCs



Source: Bloomberg. P/B as of each year end and 6/30/16. Externally-managed BDC group includes: GBDC, NMFC, ARCC, TCRD, HRZN, BKCC, PSEC, SLRC, PLFT, SUNS, GLAD, TICC, MCC, PNNT, AINV and FSC.

In order to adequately assess the attractiveness of securities, managers must utilize deep research capabilities and industry relationships to gain insight into the quality of Alternative Yield Securities' underlying portfolios and management teams. Quality managers and active investors are also well versed in technical financial analysis to differentiate between companies and understand the likely effects of industry and market catalysts. In addition, managers and active investors must identify and avoid situations where discount valuations are appropriate due to investment performance, which can reduce profitability and return on equity. To protect against interest rate risk, managers and active investors should examine the relationship between fixed and floating rates in a company's capital structure and its portfolio assets' interest rates.

Importantly, active managers and investors can take advantage of diversification benefits across Alternative Yield Securities to reduce volatility and interest rate risk, enhancing Sharpe ratios.

Since Alternative Yield Securities typically invest in broad underlying portfolios, they tend to have limited single-name risk exposure. Some Alternative Yield Securities can additionally offer correlation benefits relative to equities, bank loans and high yield bonds. Figure 17 below shows a correlation matrix of the three asset classes and their sub-sectors relative to each other as well as the S&P 500, investment grade bonds and high yield bonds over the past five years. Of particular note, the agency Mortgage REIT sub-sector provides an extremely low correlation rate to all other industries.

Figure 17: Industry Correlation Coefficient Matrix

					REITs			CEFs		
Correlations	**LQD**	**HYG**	**S&P 500**	**BDCs**	**Agency**	**Commercial**	**Hybrid**	**Sr Loan**	**Hybrid**	**High Yield**
Investment Grade Bonds (LQD)	100%									
High Yield Bonds (HYG)	80%	100%								
S&P 500	80%	82%	100%							
Alternative Yield Securities — BDCs	70%	95%	80%	100%						
Agency MTG REITs	20%	8%	1%	3%	100%					
Commercial MTG REITs	69%	93%	84%	92%	3%	100%				
Hybrid MTG REITs	78%	92%	77%	87%	17%	92%	100%			
Sr Loan CEFs	62%	84%	61%	84%	15%	84%	90%	100%		
Hybrid CEFs	61%	85%	53%	84%	19%	81%	87%	96%	100%	
High Yield CEFs	63%	81%	46%	75%	31%	68%	79%	83%	91%	100%

Source: Bloomberg. For the period from 12/31/10 through 6/30/16.

We believe that a well-constructed, diversified portfolio of Alternative Yield Securities can dampen credit market volatility and mitigate interest rate risk. As you can see in Figure 18, a hypothetical diversified Alternative Yield Security portfolio invested 60%, 20% and 20% across BDCs, Mortgage REITs and Credit CEFs, respectively, over the past five years generates a higher Sharpe ratio than any of the single industry categories. Hedging techniques can also reduce volatility through index shorting and options trading on credit-based indices.

Figure 18: Portfolio Diversification Benefits

	Total Return	Annualized	Standard Deviation	Sharpe Ratio
60/20/20 Portfolio of Alternative Yield Securities	**50.07%**	**7.66%**	**18.35**	**2.40**
BDCs	55.75%	8.39%	21.30	**2.34**
REITs	53.02%	8.04%	21.63	**2.20**
Credit CEFs	30.10%	4.90%	10.24	**2.34**
High Yield	31.39%	5.09%	10.46	**2.25**
Russell 2000	57.40%	8.60%	23.06	**1.90**

Source: Bloomberg. Past performance is not indicative of future results. For the period from 12/31/10 through 6/30/16. See Endnotes.

Conclusion

We believe that income-seeking investors should consider investing in BDCs, Mortgage REITs and Credit CEFs for the following reasons:

Value Proposition of Alternative Yield Securities

- Can generate attractive current income in the continuing low interest rate environment
- Potential for long-term capital appreciation
- Current valuation provides attractive entry point
- Attractive risk profile, with historically consistent dividend streams, healthy earnings dividend coverage and demonstrated capital preservation benefits
- Favorable industry dynamics

In order to achieve attractive total returns and reduce volatility, a successful manager or active investor in Alternative Yield Securities must have the ability to:

- Analyze underlying investment portfolios to determine asset quality
- Analyze the risk profile of each business
- Utilize diversification and risk mitigation strategies

About Ares Management, L.P.

Ares Management, L.P. is a publicly traded, leading global alternative asset manager with approximately $95 billion of assets under management as of June 30, 2016 and more than 15 offices in the United States, Europe and Asia. Since its inception in 1997, Ares has adhered to a disciplined investment philosophy that focuses on delivering strong risk-adjusted investment returns throughout market cycles. Ares believes each of its three distinct but complementary investment groups in Credit, Private Equity and Real Estate is a market leader based on assets under management and investment performance. Ares was built upon the fundamental principle that each group benefits from being part of the greater whole. For more information, visit www.aresmgmt.com.

Endnotes

(1) Source: *Wall Street Journal*, "Black Hole of Negative Rates Is Dragging Down Yields Everywhere," July 10, 2016.
(2) Source: Bloomberg, 6/30/16.
(3) As of June 30, 2016.
(4) Source: SNL Financial, as of 6/30/16.
(5) Source: SNL Financial, for the period from 12/31/10 through 6/30/16.
(6) There can be no assurance that values will return to historical average levels or that projected returns can be achieved. Total annualized returns include stock price appreciation and dividend yields over a two-year period.
(7) Source: Bloomberg, for the period from 12/31/10 through 6/30/16.
(8) Source: Wells Fargo BDC Index, for the period from 12/31/05 through 12/31/15.
(9) Source: SNL Financial, 6/30/16.
(10) Source: Wells Fargo and Company reports. As of 3/31/16. Represents the 27 largest BDCs by market capitalization.
(11) Source: LCD, an offering of S&P Global Market Intelligence.
(12) Source: Company reports, Wells Fargo, KBW. BDC data as of 3/31/16 filings.
(13) For the period from 6/30/11 to 6/30/16.

Projected returns represent gross returns and are not a reliable indicator of future performance. No guarantee or assurance is given that such projected returns will be achieved or that an investment will not result in a loss. No representation is being made that any account will or is likely to achieve returns similar to those shown. Projected annualized returns are shown on a gross basis and do not include any management, performance or transaction fees. Referenced projections on annualized returns are not intended to provide a projection or targeted price as to any specific BDC, Mortgage REIT or Credit CEF but rather a range of returns assuming historic valuation and dividend investment returns.

Figure 1: BDCs reflects a BDC Target Group including BDCs with market capitalization greater than $300 million. American Capital, Ltd (ACAS) is excluded from this analysis because it does not currently pay a dividend. Mortgage REITs reflects a Mortgage REIT Target Group consisting of commercial mortgage REITs with market capitalization greater than $300 million. Credit CEFs reflects a selected group of credit-based CEFs, which are a subset of the available credit-based CEFs, with a minimum fund size of approximately $200 million. High Yield reflects the Merrill Lynch HY Master II Index. Leveraged Loans reflects the Credit Suisse Leveraged Loan Index. Equity REITs reflects iShares US REIT ETF Index. Investment Grade reflects Investment Grade Corporates (LQD). Utilities reflects the Utilities SPDR Index (XLU).

Figure 2: BDC Target Group includes BDCs with market capitalization greater than $300 million. Mortgage REIT Target Group consists of commercial mortgage REITs with market capitalization greater than $300 million. The selected group of Credit CEFs shown is a subset of the available credit-based CEFs, with a minimum fund size of approximately $200 million. Average Price/Book is calculated for the period of 12/31/10 – 6/30/16. Total two-year annualized mean reversion returns are calculated assuming that the current Price/Book returns to the average Price/Book level over a two-year period, which results in price appreciation of 8.2% for BDCs, 8.6% for Mortgage REITs and 4.4% for Credit CEFs. We annualize the price appreciation and add the current dividend yield in Figure 1 to calculate the annualized total returns. There can be no assurance that values will return to historical average levels or that projected returns can be achieved.

Figure 3: The selected groups of Senior Loan Credit CEFs and High Yield Credit CEFs are a subset of the available credit-based CEFs, with a minimum fund size of approximately $200 million.

Figure 4: Utilities reflects the Utilities SPDR Index (XLU). Investment Grade reflects the iShares investment grade corporate bond fund (LQD). Equity REITs reflects the iShares US REIT ETF Index. High Yield reflects the Merrill Lynch HY Master II Index. BDCs reflects a BDC Target Group including BDCs with market capitalization greater than $300 million. American Capital, Ltd (ACAS) is excluded from this analysis because it does not currently pay a dividend. Mortgage REITs reflects a Mortgage REIT Target Group consisting of commercial mortgage REITs with market capitalization greater than $300 million. The selected group of Credit CEFs shown is a subset of the available credit-based CEFs, with a minimum fund size of approximately $200 million. Average historical dividend yields are calculated for the period of 12/31/10 – 6/30/16. Total two-year annualized mean reversion returns are calculated assuming that the current dividend returns to the average historical dividend yield over a two-year period, which results in price appreciation of 21.6% for BDCs, 20.4% for Mortgage REITs and 21.2% for Credit CEFs. We annualize the price appreciation and add the current dividend yield in Figure 1 to calculate the annualized total returns. There can be no assurance that values will return to historical average levels or that projected returns can be achieved.

Endnotes (continued)

Figure 5: Uses Mortgage REIT Target Group dividend yield and bond yield from Merrill Lynch BBB Bond Index (C0A4) and Merrill Lynch High Yield Master II Index (H0A0). Mortgage REIT Target Group consists of commercial mortgage REITs with market capitalization greater than $300 million. BDC Target Group includes BDCs with market capitalization greater than $300 million. ACAS is excluded from this analysis because it does not pay a dividend. Average historical spreads are calculated for the period of 12/31/10 – 6/30/16. Total two-year annualized mean reversion returns are calculated assuming that the current dividend yields return to average spread levels relative to 10-Yr, BBB and HY over a two-year period. We assume that the current 10-Yr, BBB and HY yields remain unchanged. We calculate the price appreciation for mean reversion for 10-Yr, BBB and HY and use an equal weighted average price appreciation, which results in average price appreciation of 22.8% for BDCs and 42.6% for Mortgage REITs. We annualize the price appreciation over a two-year period and add the current dividend yield in Figure 1 to calculate the annualized total returns. There can be no assurance that values will return to historical average levels or that projected returns can be achieved.

Figure 6: BDC Target Group includes BDCs with market capitalization greater than $300 million. Mortgage REIT Target Group consists of commercial mortgage REITs with market capitalization greater than $300 million. Excludes NorthStar Realty Finance given significant volatility surrounding its merger with Colony Capital Inc. Average forward P/E ratios are calculated for the period of 12/31/10 – 6/30/16. Total two-year annualized mean reversion returns are calculated assuming that the current forward P/E ratio returns to the average historical ratio over a two-year period, assuming the S&P 500 forward P/E ratios are unchanged. This results in price appreciation of 22.0% for BDCs and 23.6% for Mortgage REITs. We annualize the price appreciation and add the current dividend yield in Figure 1 to calculate the annualized total returns. There can be no assurance that values will return to historical average levels or that projected returns can be achieved.

Figure 7: Mean reversion analyses are derived from Figures 2, 4, 5 and 6. Please see those endnotes for detail on the calculation of the mean reversion analyses. There can be no assurance that values will return to historical average levels or that projected returns can be achieved.

Figure 8: The BDC Target Group includes BDCs with market capitalization greater than $300 million. The Commercial Mortgage REIT Target Group includes companies with a market capitalization greater than $1 billion excluding NRF due to limited data and its pending acquisition by CLNY.

Figure 9: BDC Target Group includes BDCs with market capitalization greater than $300 million. American Capital, Ltd. (ACAS) is excluded from this analysis because it does not currently pay a dividend. Mortgage REIT Target Group consists of commercial mortgage REITs with market capitalization greater than $300 million. The selected group of Credit CEFs includes credit-based CEFs with market capitalization greater than $200 million.

Figure 10: Price to Book Mean Reversion reflects expected annualized returns if stock prices revert to historical average levels relative to book value over a two-year period. See Figure 2. Dividend Yield Mean Reversion reflects expected annualized returns if dividend yields revert to historical averages due to stock price increases over a two-year period. See Figure 4. S&P 500 Forward P/E Mean Reversion reflects expected annualized returns if stock prices return to the average forward P/E relative to the S&P 500 over a two-year period. See Figure 6. Mean Reversion Relative to 10-Year TSY, BBB and High Yield Spreads reflects an average of expected two year annualized returns if spreads to 10 year treasuries, investment grade (BBB) bonds and high yield bonds return to average historical levels over a two-year period. See Figure 5. Expected annualized returns include both stock price appreciation and dividend yields. There can be no assurance that values will return to historical average levels or that projected returns can be achieved.

BDC Target Group includes BDCs with market capitalization greater than $300 million. Mortgage REIT Target Group consists of commercial mortgage REITs with market capitalization greater than $300 million. The selected group of Credit CEFs shown includes credit-based CEFs with market capitalization greater than $200 million. The 60/20/20 Portfolio of Alternative Yield Securities reflects a weighted portfolio, with 60%, 20% and 20% attributable to the BDC Target Group, Mortgage REIT Target Group and the selected group of Credit CEFs, respectively, as defined above. High Yield reflects the iShares High Yield Corporate Bond Fund (HYG).

Figure 18: BDC Target Group includes BDCs with market capitalization greater than $300 million. Mortgage REIT Target Group consists of commercial mortgage REITs with market capitalization greater than $300 million. The selected group of Credit CEFs shown includes credit-based CEFs with market capitalization greater than $200 million. The 60/20/20 Portfolio of Alternative Yield Securities reflects a weighted portfolio, with 60%, 20% and 20% attributable to the BDC Target Group, Mortgage REIT Target Group and the selected group of credit-based CEFs, respectively, as defined above. High Yield reflects the iShares High Yield Corporate Bond Fund (HYG).

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