ARES

In the Gaps

Ares Alternative Credit Newsletter

Second Quarter 2022

Now What?

It is easy to understate how consequential the last few months have been in terms of the impact on financial markets and the broader economy. We believe the impacts are both *real* (measured in terms of changes in rates, returns and risk) and *prospective* (measured in terms of changes in expectations, sentiment and relative value).

Last quarter we focused on consumers and households as important "canaries" in today's economic coal mines. We concluded that those canaries were coughing, a signal that *deteriorating* economic conditions were around the corner. We didn't intend for that edition to be controversial.

In fact, we thought the view we were articulating was relatively obvious. Yet, for some reason, it triggered Street research proclaiming that not only were these canaries happy and healthy, but *improving* economic times were around the corner. Be sure to check out our section on consumer spending and its relationship to economic recessions (page 6); the data might surprise you.

Let's begin, however, with our overall thesis about the economy and markets. That thesis is an important anchoring point as we tackle today's biggest question: ***Now what?*** What might we expect to see as markets and capital recalibrate to a new environment going forward?

Our thesis, as articulated in our previous newsletters, can be summarized as follows:

- Late cycle behavior and risk were clear and present in the months leading up to the pandemic

- The fiscal and monetary response to the pandemic was excessive, causing market distortions and a host of unintended consequences

- Most important, the pandemic's shock was not an economic cycle and the response did not "reset the clock." Rather, we reemerged into the same late cycle environment… except with at least three *new* challenges: high inflation, labor market frictions and a slowing economy

- Denial about these overall conditions (*especially* inflation) was pervasive, leading to continued fiscal and monetary policy missteps

- The "surprise" appearance of inflation triggered a sudden and significant change in sentiment and interest rates, and consequently the rise in costs to finance just about everything

- The combined effects of inflation, higher financing costs, slower economic activity and late cycle risks are only now beginning to be recognized for the recessionary and credit cycle threats that they are. *This was the essential point of our last newsletter*

- These risk factors are present across our markets but are *inconsistently* reflected in value. Why? Because the approaching cycle is still unfolding. While storm clouds have appeared, we don't yet know the coming storm's strength, size or duration

Your view about the economy and markets may differ significantly from ours. We're not aiming to convince you otherwise. Rather, in this edition of *In the Gaps*, we intend to answer a big question: *Now what*? What risks and opportunities do we see developing? Where and when do we think they will materialize?

We'd be remiss not to offer a huge shout out to the entire Alternative Credit Team for their thoughtful insights and contributions. We hope this edition helps frame a complex and evolving environment in a way that inspires confidence.

Why Asset Yields Will Increase

A prerequisite for securitization is a sufficient positive difference between the underlying asset yields and the cost of financing those assets. This is often called the *arbitrage condition*. Banks operate and generate net interest margin on this same principle. The arbitrage condition will be robust whenever the securitization markets are healthy.

For example, the primary CLO market functions because portfolios of corporate loans generating coupons of, say, LIBOR + 350bps can be financed at an all-in cost of LIBOR + 200bps. That 150bps spread difference is a measure of the arbitrage. CLO equity investors receive that difference on a levered basis. In this example, CLO equity investors receive 150bps *times* 12 (leverage ratio), or ~18% cash yield annually.

While primary issuance activity across various securitization markets has been surprisingly strong this year, arbitrage conditions have begun to break down. Financing costs are substantially higher today while asset yields, with few exceptions, have remained relatively unchanged.

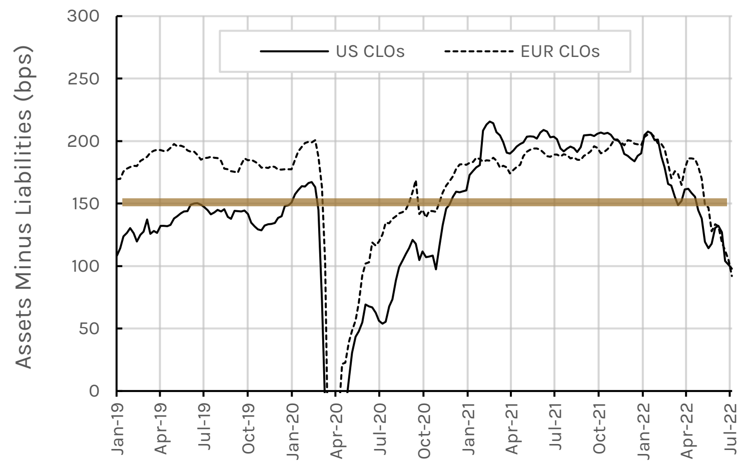
Below are three different windows into that arbitrage condition across three public securitization sectors.

CLOs: Generally speaking, when the spread difference between loans and CLO liabilities is at least 150bps, we find an arbitrage condition that is conducive to new CLO formation, because CLO equity produces strong cashflows.

As the following graph shows, conditions deteriorated such that the spread differential today is less than 100bps (in both the U.S. and Europe). Net of CLO management fees and expenses, a new CLO today generates 2.0%-2.5% in quarterly distributions to CLO equity (normally we'd see double that amount).

This results in reduced interest coverage for CLO debt securities and a greater sensitivity to realized losses in the loan portfolio. That isn't a great fact pattern if you think a recession is around the corner.

CLO Arbitrage Indicator

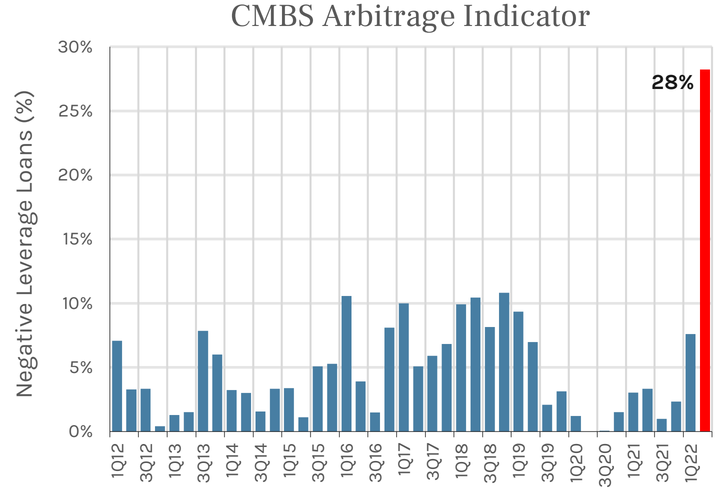


Source: Credit Suisse CLO Research, 11 July 2022.

CMBS: A second way to view the arbitrage condition is to note how much of the underlying collateral is generating a yield that is lower than financing costs. In the CMBS market, these are called "negative leverage" loans because the effect of leverage is negative; returns on these commercial properties are *reduced* by leverage rather than increased.

The graph below plots the percentage of negative leverage loans present in U.S. CMBS collateral pools. In normal markets, the average exposure to such loans is about 5%. These tend to be high quality, investment grade properties.

CMBS Arbitrage Indicator

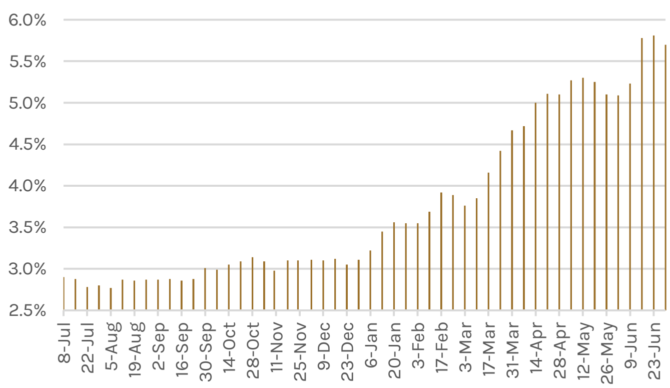


Source: Trepp, Barclays Research.

When arbitrage conditions deteriorate like this, many lower credit quality properties also manifest negative leverage. This presents CMBS B-piece investors the unattractive combination of higher risk at a lower return, and, like CLOs, a greater sensitivity to realized losses in the loan portfolio.

RMBS: We saved RMBS for last because it's one of the few sectors where asset yields (i.e., mortgage rates) have already moved higher in reaction to higher financing costs. Since the beginning of the year, residential mortgage rates have doubled for most borrowers (see chart below). As one of the first sectors to adjust, we think it also indicates the direction of travel for asset yields in other sectors.

30 Year Agency Mortgage Rates



Source: Federal Reserve Economic Data, fred.stlouisfed.org.

A third way to look at arbitrage conditions is to decompose the arbitrage into its primary components. For non-agency RMBS, those components are summarized in the table below. We've circled a few data points to indicate some of the extraordinary changes we've seen in mortgage rates, liability costs and the net difference, or excess spread.

Non-Agency RMBS Arbitrage Indicator

	Oct-21	Jan-22	Feb-22	Jun-22	Jul-22
(a) Mortgage Rate	4.72	4.63	4.56	4.97	7.00+
(b) Debt Cost + fees	1.59	2.49	3.29	4.70	6.01
(a-b) Excess Spread	3.13	2.14	1.27	0.27	0.99

Source: Ares' observations, Bloomberg, Dealer Pricing, Finsight.

The table tells the story. Healthy arbitrage conditions prevailed last year with excess spread above 300bps. As interest rates began to rise in the first quarter, debt costs increased even as mortgage rates remained around 4.6%, causing excess spread to be substantially reduced. June saw the worst arbitrage conditions, with excess spread being barely positive. This contributed to significant challenges across the mortgage market and compelled some originators to shut down or reduce production, and others to shut down their businesses entirely.

Higher financing costs forced mortgage rates higher. For example, rates on non-agency mortgages (e.g., non-QM) are approaching 7.5% today. Meanwhile, liability costs have continued to increase as both rates *and* spreads have climbed. The resulting arbitrage conditions are still too weak for the market to function normally.

This observation should get your attention: solving for the healthy arbitrage conditions (~250bps of excess spread), mortgage rates would need to be north of 8.5% today. *Is the housing market ready for 8.5% mortgage rates?* We think not.

The upward trajectory of asset yields is hopefully as clear to you as it is to us, as are the economic implications. Whether it's a new mortgage, auto loan, small business loan or other form of debt, borrowers of all types should expect to pay a higher interest rate on their debt going forward.

There are also significant implications for asset values and money velocity coming at a time when recessionary risks are concurrently elevated. This echoes two of our favorite *Lessons Learned*:

1. **Asset values are ultimately determined by credit**
2. **Money makes the world go around; credit makes money go around**

The **"Now what?"** with respect to asset yields is that the factors driving financing costs higher are likely to persist for the foreseeable future. To us, that means that asset yields have only one direction to go: higher. Keeping an eye on arbitrage conditions across sectors is important in assessing what adjustments remain. Weak arbitrage conditions can persist for longer than you think they can… or should. In many sectors, there remains a material move *still to come* in asset yields.

A recession would exacerbate today's challenging conditions. Credit spreads could widen significantly more. We would also expect lending activity to shift out of struggling capital markets and into the hands of those alternative credit managers able to provide capital solutions.

Inside the Data

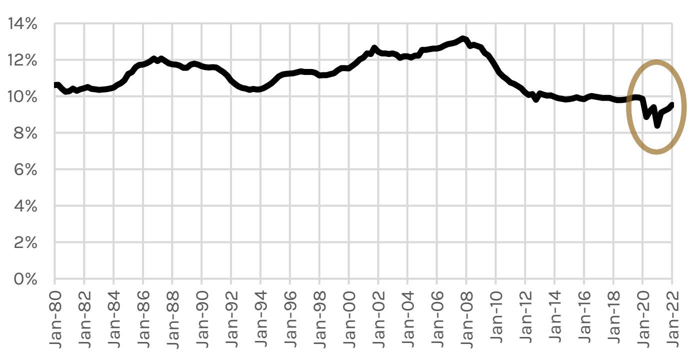
CONSUMERS: PART II

At the risk of belaboring this topic given the focus in last quarter's edition of *In the Gaps*, there remains a fair bit of confusion out there about the state of consumers and households. The data certainly shows that household balance sheets in 2021 looked exceptional on nearly every measure.

On the asset side of the ledger, thanks in large part to stimulus, nearly everything was *higher*: household income, home values, savings rates and checking account balances. On the liability side of the ledger, nearly everything was *lower*: outstanding credit card and other consumer debt balances, delinquency rates, loss rates and interest costs.

One particular metric used by consumer lenders to assess credit risk, "debt service payments to income," likewise fell below 10% for the first time in more than forty years (chart below).

Debt Service to Income



Source: Federal Reserve Economic Data, fred.stlouisfed.org.

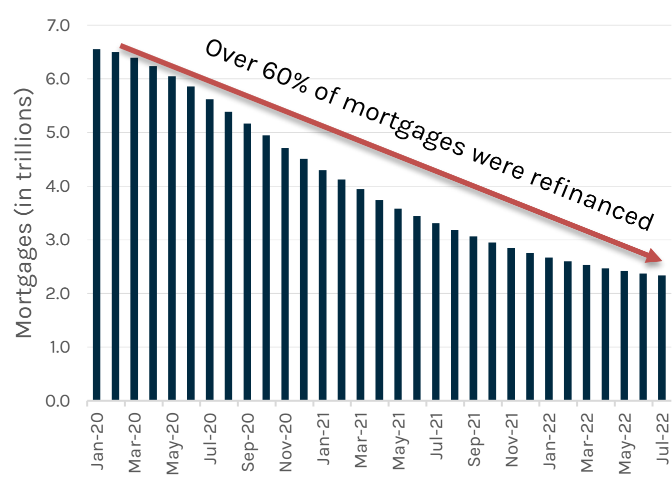
> "There remains a fair bit of confusion out there about the state of consumers and households."

As pretty a picture as that is, it's worth reiterating that household balance sheets were impacted *disproportionately* across income groups, with homeowners benefitting most. Overall household debt-to-income metrics are inherently weighted toward homeowners given the large share that mortgage debt represents when looking at the overall picture of total household debt.

With the precipitous drop in mortgage rates beginning 2Q 2020, the large majority of outstanding mortgages, including $4 trillion of conforming mortgages (see chart below), were refinanced into substantially lower rates. A large portion of these took the form of a cash-out refinancing, which contributed to elevated household spending.

The Refi Wave

(Outstanding Balance of 2019 and Prior Mortgages)



Source: Fannie Mae, Freddie Mac, Ginnie Mae, eMBS, Nomura Securities International.

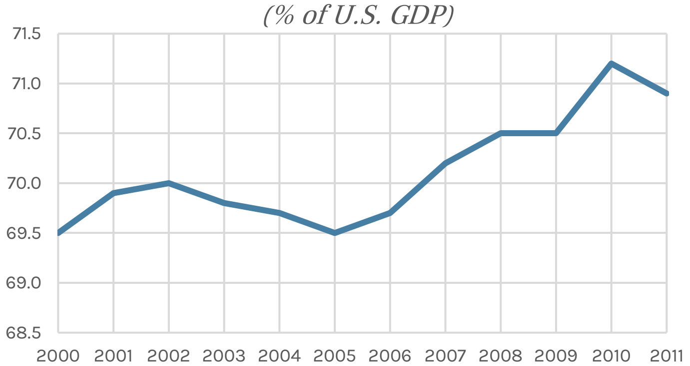
All of this refinancing activity in addition to lower interest rates resulted in a reduction in monthly debt service due to lower mortgage payments, even as absolute debt balances returned to pre-pandemic levels. When one accounts for this "refi effect," consumer debt-to-income ratios remain much closer to levels we have seen prior to other recessionary periods.

Many have recently pointed to continued strength in consumer spending as an indication that the economy is not in jeopardy. They view robust consumer spending as an economic barometer, pointing to continued economic prosperity. When layered with recent observations about lower household debt service expenses and nominal wage growth, the argument goes: we expect continued robust spending by households who are earning more, suggesting recessionary fears are overblown.

That sounds perfectly reasonable, doesn't it? We disagree. We believe consumer spending is *not* a reliable barometer for assessing recessionary and market risks. The clearest proof is to observe what happened to consumer spending during the GFC[i]: **it continued to increase** (see chart below), even as the economy and markets were facing the greatest stresses in several generations.

Personal Consumption Expenditures

(% of U.S. GDP)



Source: Bureau of Labor Statistics.

Those of us who were investing in those early days of the GFC will recall how often the strength of consumer spending was cited as a reason why a recession would be averted… or if one occurred, why it would be brief and shallow.

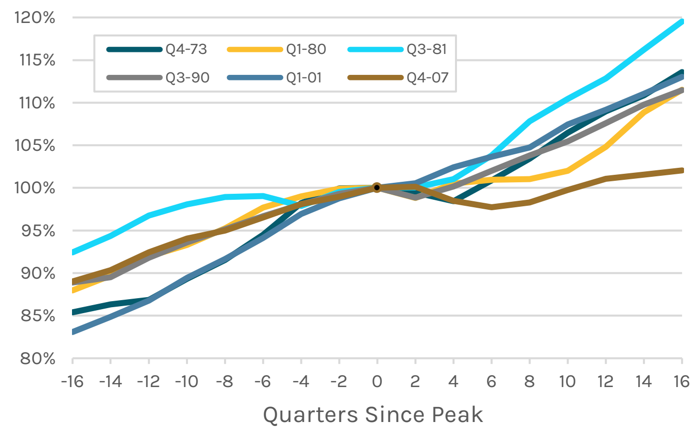
> "Spending shouldn't be your indicator if you are trying to assess recession risks."

However paradoxical or counterintuitive as it may seem, consumer spending is a *lagging* indicator with respect to economic cycles. When one looks at historical recessions over the past fifty years, normalized levels of real personal consumer expenditures have always *increased prior to* recessionary periods (see chart below).

In fact, as you can see in the chart below, except for a short pause during the GFC, personal consumption actually *increased* throughout each of the last six recessionary periods.

Consumer Spending Levels During Recession Periods

(Normalized and Inflation Adjusted)



Source: Federal Reserve Economic Data, fred.stlouisfed.org.

Bottom line: Spending shouldn't be your indicator if you are trying to assess recession risks. We find credit performance and ever-squishy consumer sentiment to be more reliable barometers. The reason credit performance and sentiment are more useful precursors for thinking about economic cycles is revealed in those same consumption charts above.

In difficult times, the economy becomes increasingly sensitive to household budget decisions and access to credit. Smaller changes in these factors during economically vulnerable periods tend to have a disproportionate impact. To put it in a nutshell: as credit performance goes, so goes the economy.

When it comes to consumers, our "**Now what?**" is: negative real wages, depleting savings and increased borrowing have already started to happen. Credit performance deterioration is next, as we've noted in last quarter's edition of *In the Gaps*. The degree to which credit performance deteriorates will largely define the magnitude, shape and duration of the upcoming credit cycle.

CREDIT PRICING DISPERSION

One of our favorite data visualizations is featured on page 16. Before you jump ahead to gaze upon it, let's first explain what you'll be looking at.

We tend to see two major patterns in the way credit risk is priced during periods of market stress or volatility. We'll call them "low dispersion" and "high dispersion."

Simply said, when the whole market sells off almost monotonically, we tend to see low price dispersion. The sell-off that occurred in late 2018 was a low dispersion event. All credit – good, bad and ugly – experienced a similar magnitude shift. Think of it as indiscriminate selling. Low dispersion events tend to coincide with liquidity shocks, especially of the retail / ETF variety. They also tend to be relatively short-lived.

> "Notably, the tail is relatively diverse – suggesting that fundamental stresses are more broad-based."

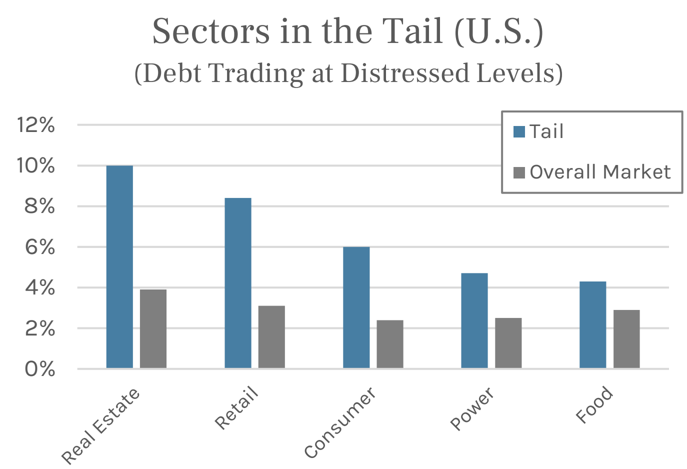
The sell-off that occurred in March 2020 began as a broad market sell-off, triggered by liquidity and forced selling, with relatively low dispersion. What followed was a market grappling with the unknowns of a global pandemic. Investors began aggressively culling their credit portfolios in a discretionary manner. This led to the kind of high dispersion one normally sees in a traditional default cycle, one that reflects fundamental risks.

However, those fundamental credit concerns collided with a tidal wave of monetary stimulus and other liquidity programs. By late March, high dispersion began to migrate into low dispersion – *a highly* unusual development. That sequence of events created a set of unusual opportunities for both relative value and credit-oriented investors.

Which brings us to this year. The sell-off that began in the first quarter was also unusual. The heatmap on page 16 helps visualize what is happening. *Dispersion is growing, even accelerating.*

What was initially triggered by the market's reaction to higher interest rates has taken on new dimension as inflation and recessionary concerns have come to the foreground. A "tail" is emerging in the credit markets comprised of companies that market participants view as most vulnerable.

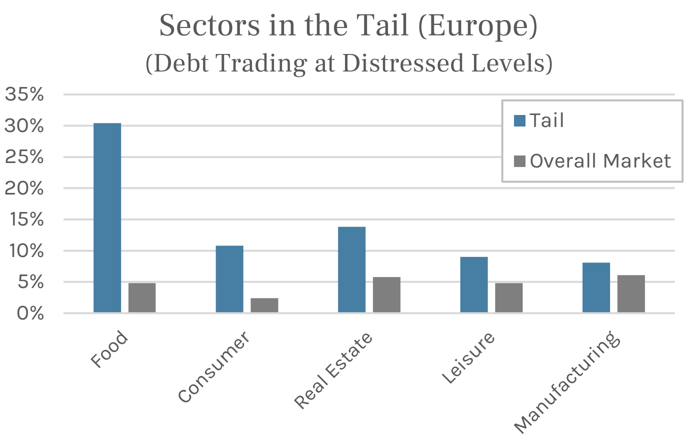
It is often instructive to evaluate the tail of a market for clues into this pipeline of likely credit events. The charts below shed some light on the constituency of that emerging tail right now.



Source: Ares IN*sight* database, June 30, 2022.

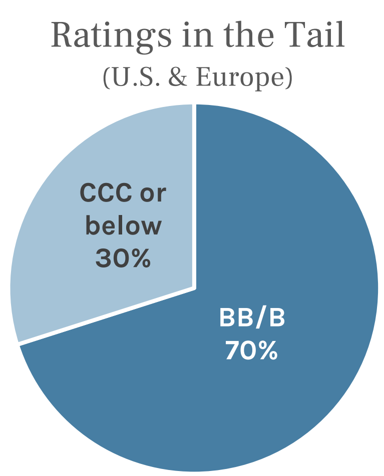
For example, in the U.S., real estate (which represents 10% of the tail but less than 4% of the U.S. market), retail and utility credits are *overrepresented*. Notably, the tail is relatively diverse, suggesting that fundamental stresses are more broad-based than heavily concentrated.

In Europe, the tail is dominated by food, consumer and real estate credits. It is also more concentrated compared to the U.S. Both are important indicators of how the credit cycle may differ between the U.S. and Europe.



Source: Ares IN*sight* database, June 30, 2022.

Note the credit ratings of these tail credits in the pie chart below. As one might expect, the market is well ahead of the rating agencies. In both the U.S. and Europe, approximately 70% of the credits trading at distressed prices today are still rated BB or B. There's your downgrade pipeline.



Source: Ares IN*sight* database, June 30, 2022.

The "**Now what?**" with respect to corporate debt is: *watch the tails and how price dispersion evolves.* Those two factors will help frame the breadth and magnitude of credit stresses that are coming.

Office Space

There may be no more confusing market with conflicting data than the market for commercial office space, especially in large cities. Traditionally and historically, cycles in commercial real estate ("CRE") appear with a twelve- to eighteen-month lag following an economic or credit cycle. This lag is relatively predictable as it tends to be a function of lease structures (e.g., rollover dates), relatively extended work out processes and long adjustment periods.

Because 2020 was not a traditional economic or credit cycle, expectations vary widely as to whether we expect a CRE cycle to materialize. However, it seems very clear to us that a tectonic shift of some magnitude did occur in the office space sector. Damage assessments are still in early stages given continued uncertainty about how impactful flexible or remote work will be.

To appreciate the challenges facing the sector right now, consider the following competing or conflicting factors in play, which we've organized in a "Point" and "Counterpoint" manner. Clearly, any broad-based conversation about the prospects for office space would be very difficult right now.

Point	**Counterpoint**
Office space is undergoing a secular shift that reflects greater remote work flexibility	Large companies (e.g., financial institutions and large corporations) are calling or have called their workers back
Younger tech companies are positioning as flexible, even nomadic – the most liberated from the strictures of traditional office space	Established tech companies are leading the pack in terms of leasing the most office space. So far this year, they have taken up over 4mm square feet[ii]
From March 2020 onward, net absorption (move-ins minus move-outs) declined significantly and has even been negative at times… but appears to be reaching an equilibrium	Net absorption at newer office buildings (constructed 2015+) have been firmly positive. Over 20% of leasing has been in that subset, which accounts for only 13% of total office supply
The development pipeline for new office is 2-4x greater today than it was in 2009-2010	Per the above, new office is where demand is strongest and potentially accelerating

Here are a few other observations to further muddy the CRE waters. These observations all seem to suggest to us that a cycle in CRE is not imminent.

- **Dry powder**. CRE private equity is currently sitting on over $150 billion of dry powder.[iii] Additionally, CRE is being actively marketed to retail and high net worth investors as performing well in inflationary environments, contributing to a *growing* base of equity capital for commercial property
- **Aggressive purchases**. Recently, we've seen a number of distressed properties in foreclosure (e.g., hotels, shopping centers) receive bids from equity investors that were sufficient to satisfy the outstanding mortgage in full (i.e., a 100% recovery on the debt). That's not something we have historically seen
- **Cheap legacy leverage**. For the last few years through 1Q 2022, the CMBS market provided access to long term, locked-up debt capital at very low cost. That debt is "assumable," meaning that the next buyer of the related real estate can assume the low cost debt, rather than face a much higher cost of financing anew
- **Recent rent growth**. Properties that are coming up on five- and ten-year loan maturities will face a materially higher cost of financing than what is in place today. However, the rent growth that the market experienced over the past few years has been substantial, and thereby largely offsets expanding cap rates and debt yields. Refinancings, while more costly, will still be economic for the equity in many cases

All of the above suggests that it might be a while before we see valuations and cap rates in commercial real estate adjust. If you focus on the amount of *dry powder* out there looking for opportunities, you might convince yourself that things aren't likely to adjust for quite some time.

If, however, you focus on the *financing* side of the market, which is materially more expensive, you might be convinced that adjustments are imminent given the sector's reliance on leverage.

The "**Now what?**" with respect to commercial office space is: expect a clearer distinction between winners and losers in commercial offices, similar to what has occurred with shopping malls. *Choose wisely*. We also anticipate widespread valuation adjustments as capitalization rates adjust to reflect higher interest rates and financing costs.

The Sound and the Fury

One of our team's top *Lessons Learned* reads: "*Invest in assets and cash flows, the rest is noise.*" That lesson was a big reason we were always a "hell no" when it came to cryptocurrencies and the markets that have developed to capitalize the sector's growth.

We won't waste electronic ink here explaining why crypto is one of a handful of sectors we have designated as "nevers." We are confident that this point is becoming more self-evident by the day. Rather, we wanted to shed a little light on what we believe to be a related dumpster fire: crypto *lending*.

> "An entire sector where the underlying credit is impossible to assess is destined to teach some valuable lessons."

Crypto lending has all the *appearances* of being a credit product, being patterned after other secured debt products… except without the *substance* of a credit product. We often refer to such investments as *lending against air*.

Lending against crypto began around ten years ago, taking the form of margin loans to consumers. A critical difference we see compared to traditional consumer lending is minimal underwriting of the borrower; lenders instead rely on the value of the crypto collateral.

This is strikingly similar to how mortgages to subprime borrowers were made prior to the GFC: *who cares about the borrower when you have the house as your collateral*? It should therefore not come as a surprise that crypto margin lending has expanded to fund mortgages today (e.g., Figure and Milo).

The proliferation of cryptocurrencies (there are over ten thousand today!) has led to the creation of additional consumer and institutional credit products with increasingly obscure currencies as collateral. This has further expanded to "corporate crypto," the debt of crypto-based companies.

> "Many are waking up to the realization that the word collateralized can mean something very different in crypto land."

While we have never deemed crypto credit an investable sector for our strategies, we have closely followed its development – in part for its sheer entertainment value, but mostly for its usefulness as a credit training device. An entire sector where the underlying credit is impossible to assess is destined to teach some valuable lessons when the true risks finally materialize. Such lessons are being learned in real time in the corporate crypto market.

These corporate loans or preferred equity investments look to the balance sheet of a given crypto exchange, market maker or "bank" for financing. These entities rely on the generation of transaction fees (highly volatile) and interest margins (which are impossible to underwrite). Notably no such entity has a track record of managing through a cycle.

Companies like Voyager, Celsius and Blockfi – all considered premier, well-capitalized names just a year ago – demonstrate the ethereal nature of corporate crypto fundamentals. Publicly traded Coinbase last year issued bonds at 3-4% yields which are now trading at deeply distressed prices.[iv]

In one memorable case, we were approached by a crypto company looking to borrow a significant sum against its crypto portfolio. It claimed to us that its asset portfolio was "*delta flat*," by which they meant that it was insulated from crypto price volatility. However, this company recently announced a multi-hundred million dollar loss when a crypto loan they made to a hedge fund suddenly defaulted due to… you guessed it, crypto price volatility.

So-called stablecoins enticed lenders with assurances that their assets were fully collateralized by cash or cash equivalents. Many investors presumed the risk in such collateralized assets were akin to AAA-rated securities, government bonds or money market funds. Many are waking up to the realization that the word *collateralized* can mean something very different in crypto land. It can actually mean "algorithmically collateralized," which is just a fancy way of saying "not really collateralized," as lenders to TerraUSD (and, by extension, Luna) just learned.

The bottom line for us is that credit investing is ultimately about the actual substance and risk of your collateral. In alternative credit, that substance consists of assets that can be diligenced and contractual cash flows whose resilience can be tested and quantified. The rest is truly noise. Unfortunately for many crypto lenders, it's the infuriating sound of avoidable losses – the worst noise of all.

The Path Forward

Indicators and other evidence of pending stress and economic recession, many of which we've highlighted in these pages, have arrived at our doorsteps. The fundamental question we've asked in this newsletter has been "**Now what?**" As we proceed along the path forward, we do so with eyes wide open to navigating risk and a playbook designed for times like these.

Inflation driven by excess stimulus has clearly proven insidious; it is not the hoped-for transient phenomenon driven by supply chain frictions or even Russia's war on Ukraine. Monetary and fiscal policymakers have had their collective feet on the gas pedal.

As we see often repeated throughout history, the vicious cycle of escalating inflation, nominal wages and rising interest rates is rapidly spreading, undermining any hope that a "hawkish tone" and minor rate adjustments will have any real impact. To regain control, policy makers are now compelled to entertain increasingly draconian steps. It's now become a matter of choosing from among the least worst options. The situation is akin to driving a car that catches fire just as its brakes fail. To address both problems at once, policymakers have decided to veer off the road and drive into a lake; they'll figure out an egress and afterward attempt to salvage the car.

The coming rate increases alone will be impactful. More impactful, perhaps, will be the increases to regulatory capital for "systemically important" banks. JPMorgan recently announced that regulators will require its Tier 1 ratio to be at least 12.5% by 1Q 2023.[v] That is well above where it stands today and what investors were told to expect just two months ago.

The combined impact of higher rates and capital requirements will have a significant impact on the availability of credit, and a pronounced effect on the economy. Given the political landscape, we might expect a strong fiscal policy reaction to blunt the recession's impact; one that is likely to introduce a host of new unintended consequences.

While no one has an operating crystal ball, we do have the benefit of a playbook that helps us execute in challenging environments. The priority is always to focus on our downside protection and risk mitigation – underwrite as if the recession begins today. From there, we follow value as it evolves across the market, typically beginning with liquid markets and ultimately arriving in illiquid markets, as below. This is part of our "Now where?" playbook.

- **First – Liquid Market Opportunities**. Nearly always, liquid markets are the first to adjust as they are the most responsive to changes in rates, credit spreads and expectations of increased credit stress. Execution risks increase and a growing number of issuers become unable to access traditional markets. These adjustments began earlier this year and are ongoing

  Liquid markets are also vulnerable to episodic volatility and dislocation, often driven by forced selling and liquidity shocks. These episodes open windows of opportunity that can be especially attractive albeit usually short-lived. While we have already seen some of that this year, we believe there is more volatility coming

- **Second – Semi-Liquid Opportunities**. One of the natural consequences that execution challenges in the liquid markets brings to alternative credit is a growing number of opportunities in what we call the "semi-liquid" market. These tend to be larger transactions that would have normally achieved an efficient capital markets execution in good times, but now seek a private capital solution. This semi-liquid part of the market has started to become active in the last few weeks. In today's higher rate, higher spread environment the semi-liquid opportunity can be a significant source of compelling relative value. Fortunately, these windows of opportunity for semi-liquid investments can remain open longer than liquid opportunities

- **Third – Illiquid Opportunities**. The window for liquid opportunities is traditionally short (three to six months), but can have multiple windows, similar to during the GFC. The window for semi-liquid and illiquid opportunities is much longer and can last for years. The next part of the playbook is simple; buy portfolios of assets or lend against them when you are at potentially peak spread and default levels. Underwriting assuming severe stress allows for upside opportunity if either rates or spreads come in or defaults or performance improve. Even as illiquid markets tend to be last to adjust, they often provide the best opportunities for downside protection and upside optionality, as they can be structured, underwritten and executed on a bilateral basis

It's not necessary to try to make the call when inflation will end, or when rates or spreads will peak. What matters, in our view, is appreciating the patterns that materialize during cycles so one can anticipate "Now what?" and thereby anticipate "Now where?" to look for value and risk. For example, the pattern is relatively consistent with respect to spreads: credit spreads tend to peak before credit defaults peak; *ergo*, the playbook says to stay patient.

As alternative credit investors, we approach recessionary environments and credit default cycles with a few different advantages. Given where things stand today, it is timely to reiterate two of them in particular.

Diversification and granularity: One advantage we have as alternative credit investors is the fact that our investments are based on asset pools with underlying diversity and granularity of risk.[vi] That allows us an ability to impose scenarios in our underwriting that reflect severe stresses (typically in excess of the historically worst experience we've observed), and thereby substantiate that our principal remains intact, even in those scenarios. The ability to stress test investments in this manner allows us to proceed with confidence even during periods of uncertainty.

Cash flows, not valuations: When investing in pools of assets we are generally not required to make a bet on valuations driven by terminal values such as exit prices or multiples. Rather, we are generally looking to cash flows and self-amortizing structures. When investments are designed with front-loaded, high velocity cash flows, that self-amortizing profile can be the greatest source of downside protection.

As a bonus, and as we've mentioned before, high cash-on-cash returns can provide substantial protection against high inflation and rising interest rates. In those environments, yields and spreads tend to adjust at different times across different sectors and asset classes. Reinvestment "risk" can therefore become a reinvestment "opportunity" given the resulting shifts in relative value.

Recessions are an inevitable consequence of value, capital and liquidity distortions. Market volatility, credit cycles and the uncertainty they bring is the reason we have a playbook. One of our *Lessons Learned* is "*Cycles are easy; timing is hard.*" Stated another way, the hard part is trying to accurately predict the top or bottom of a given economic cycle, and then trying to express that timing view without having *theta* crush you. There is another way… and, we think, a better way: by remaining patient and oriented around true relative value, you can proceed without the need for an operating crystal ball.

We have emphasized patience. We see a lot of stress approaching. We also see a very interesting opportunity set developing just on the horizon. It's hard to not get a little excited about the potential for alternative credit to get very interesting. Patience is now truly key.

We have a favorite movie clip we like to send around to our team in markets like this. It's a scene from the movie *Braveheart*. It takes place at the onset of the Battle of Stirling. The English cavalry is galloping towards William Wallace and his men (who have a few surprises in store). As the thunderous sound of their approach is growing, William Wallace stands patiently, yelling above the din for his troops to "Hold!... Hold!!... Hold!!!"

That scene captures the sense of anticipation that our team is feeling more and more, with our own surprises in store for all that is approaching from every direction in our markets. Few things are as powerful in such markets than a tactical approach with a relative value lens. Opportunity is at our doorsteps. Stick to the playbook, stay flexible, stay patient and most of all: protect against the downside.

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Charity Spotlight of the Quarter

RIP MEDICAL DEBT

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're spotlighting RIP Medical Debt ("RIPMD"), an organization focused on helping individuals who have taken on significant debt from medical expenses. The NYC-based non-profit was founded in 2014 by former debt collection executives, Craig Antico and Jerry Ashton. The charity takes on donations to buy large bundles of debt at significant discounts. The debt is subsequently erased without tax consequences to donors or recipients. To date, RIP Medical Debt has relieved over $6.7 billion of medical debt and helped over 3.6 million individuals and families. As alternative credit investors who regularly invest in consumer receivables (including healthcare receivables), RIPMD's mandate fits well with Ares Alternative Credit and our charitable tie-in.

HISTORY

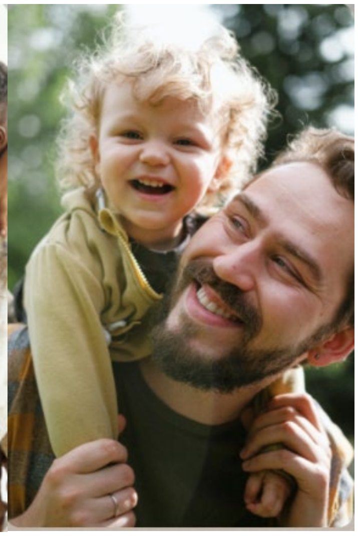
After decades of working in the debt collection industry, the charity's founders decided to use the skills and knowledge that they had developed to pivot to public service. They began purchasing portfolios of debt, eliminating the burden on individuals who had already possibly experienced medical hardship, and erasing the burden on their credit history. One of RIPMD's first large public endorsements came in 2016 when John Oliver did a segment on his talk show "Last Week Tonight," wherein he donated $60,000. The charity was then able to turn this into $14.9 million of medical debt forgiveness. Subsequent high-profile sponsors have included NBC, Telemundo and Trae Young. In December 2020, MacKenzie Scott donated $50 million to the cause, the largest donation in the organization's history.

IMPACT

Medical debt's effect is much greater than just the financial obligation. Reportedly half of U.S. adults report skipping care due to concerns about costs. Further, 60% of African American, Hispanic and low-income adults report delaying healthcare. The mental and emotional anguish caused by this obligation can take a toll on several aspects of one's life. Wage garnishment and collection litigation increases the economic vulnerability of a group of people who are already suffering. When RIP Medical Debt relieves these liabilities, they are able to not only reducing the debt burden but also repairing the credit scores and economic security of individuals, providing significant emotional relief.

> "Thank you so much RIP Medical Debt! I've been working to pay off [this debt] for over 5 years now to no avail.
>
> Once that debt was removed from my credit, my score went up and I was able to get a credit card…
>
> Having a little bit off my credit has opened up different possibilities. It's just been looking great here ever since. I have a lot of friends in the same position as myself, a lot of us are struggling every day and it helps us feel like we aren't alone in this world."
>
> **Justin**
> Recipient

On average, $1 donated to RIP Medical Debt relieves $100, allowing each donor's contribution to go a significant way towards relieving a substantial amount of financial obligation. Given about 23 million people in the U.S. owe an estimated $195 billion in medical debt, the organization's mission has been well received by its beneficiaries.



TARGET PROFILE

RIP Medical Debt focuses on individuals who earn less than 4x the federal poverty level and whose debts equate to more than 5% of their annual income, allowing the charity to target those who are most severely impacted.

The organization's website includes a stream of testimonials from debtors who had their medical debt paid off. The plethora of touching stories is a testament to the charity's effectiveness and impact.

POLICY WORK

Outside of its day-to-day operations, the organization focuses on policy work. RIP Medical Debt strives to inform and deepen policy conversations about improving the healthcare financing system, in an effort to make it more equitable and affordable. The top priorities that guide their policy work include:

1. Affordable and comprehensive coverage: Providing equitable access to affordable health coverage that covers the services people need and lowers out-of-pocket costs
2. Easy access to and enrollment in financial assistance programs: Helping providers communicate clearly and proactively enroll patients in financial assistance programs
3. Banning extraordinary collection actions and monitoring of medical debt: Ending harmful practices and monitoring medical debt and its impacts

RIP Medical Debt's mission and model is unique in that it combines the generosity of donors with the founders' debt industry expertise to produce a high volume of debt relief. This impact is further compounded by the awareness generated by the stories of their beneficiaries and the discussions these have spurred.

> "I was in the E.R for multiple days because the infection became systemic and they needed to give me intravenous antibiotics.
>
> I've accumulated a lot of medical debt. I had this story in my head that I would never be able to pay for it so I should just lay down and accept it. The most suffocating part is the shame you feel. You feel like a failure.
>
> When I got those letters in the mail I just cried. I need to qualify to buy a home in the next few months…I am beyond touched and beyond grateful for your kindness and empathy."
>
> **Sheila**
> Recipient

Q&A WITH ARES

Q: How old is the debt you are typically purchasing?

A: From care providers we purchase debt that is as young as one to two years old. There is more variability in the secondary market, this year fourteen year old debt is the most seasoned we've bought. There is good reasoning to purchase and abolish older debt, especially given the variable statutes of limitations state-by-state.

Q: If the loans are purchased in the secondary market, how do you choose which ones to relieve?

A: The beneficiary must be earning at or less than 4x the federal poverty level and their debt must equate to more than 5% of their annual income. We do not accept requests to relieve debt. We treat ourselves as a "debt whale," not focusing on any one loan at a time. The portfolios we purchase can be massive, and can be regionally specific or much broader in geographic scope. Finally, we try to filter out individuals that we have good reason to believe can pay.

Q: Are there any side benefits when relieving medical debt?

A: For those whose medical debts are relieved, the relief is a gift from a detached and disinterested third party, RIPMD, as an act of generosity, so relief of the debt does not count as income to the debtor. We will not file a Form 1099-C with the IRS.

Q: How many employees do you currently have looking for debt?

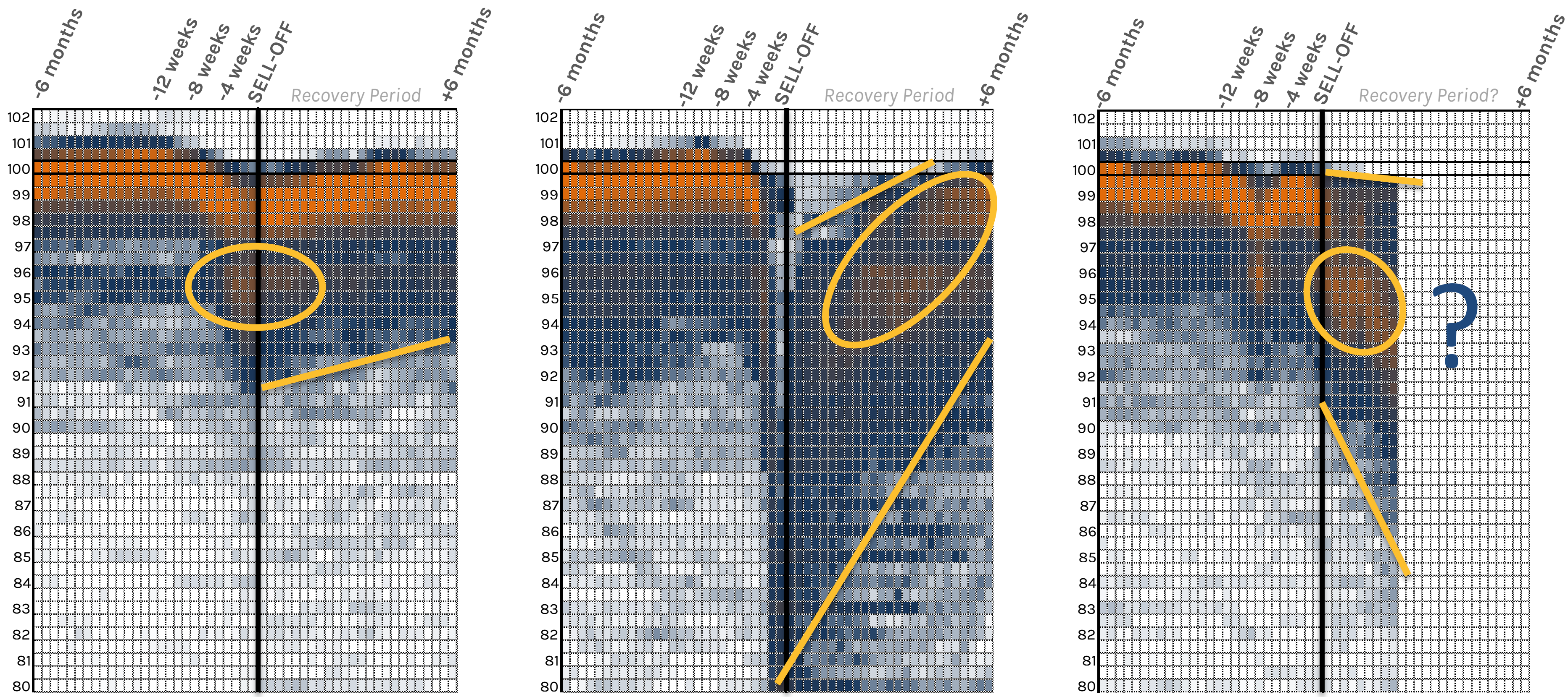
A: We currently have about four to five employees in our debt operations team, whose purview is sourcing medical debt.

Q: What is one of your most important lessons learned?

A: We were initially focused heavily on acquiring as much debt as we could from the secondary market and had much stricter restrictions on what debt we would relieve. We have since increased the threshold on the federal poverty limit in order to reach the lower middle class.

FOR ADDITIONAL INFORMATION, PLEASE VISIT [WWW.RIPMEDICALDEBT.ORG](http://www.ripmedicaldebt.org)

U.S. First Lien Corporate Loan Price Dispersion During Market Dislocation



2018-2019

Low dispersion, rapid recovery, small tail

COVID-19

High dispersion initially, rapidly becoming low

2022

Expanding dispersion and growing tail

Source: Ares INsight database, June 30, 2022.

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Graphs are shown for illustrative purposes only.

REF: TCA-00859

Endnotes

[i] Note: Great Financial Crisis ("GFC") is defined as the period just prior to and following the credit market dislocation of 2008.
[ii]Source: Seeking Alpha. Urgent Warning About Office REITs, June 3, 2022.
[iii] Source: Morgan Stanley. Dry Powder Deployed, May 4, 2022.
[iv] Source: Barron's. Coinbase Bonds are Sinking. Blame the Crypto Crash and Creditors' Concerns, May 12, 2022.
[v]Source: Bloomberg. JPMorgan Halts Share Buybacks as Earnings Miss Estimates, July 1, 2022.
[vi]Diversification does not assure profit or protect against loss.