Picking Between Funds Is About Much More Than Big Yields

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed John Cole Scott, President of Closed-End Fund Advisors and Chairman of the Active Investment Company Alliance. Read the Q&A below as John compares two high-yielding offerings from Ares, breaking down the Ares Dynamic Credit Allocation (ARDC) fund and the CION Ares Diversified Credit I (CADUX) fund. He shows that while both could be viable and attractive options for investors diversifying a portfolio into the alternative credit space, there's much more to picking between them than big yields, reasonable expense ratios, discounts, and recent results.

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: John Cole Scott of Closed-End Fund Advisors is here and we're comparing an interval fund with a listed taxable bond fund to help you understand the roles the different structures can bring to your portfolio, this is The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, which is a unique industry organization representing all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. And joining me again today, it's John Cole Scott, he's president of Closed-End Fund Advisors in Richmond, Virginia, which is online at CEFAdvisors.com, but we're about to dig into the

funds using the firm's research, and you can do that for yourself, any fund you're interested in, at CEFData.com. John is also chairman of the Active Investment Company Alliance, which you can learn about at AICAlliance.org. John Cole Scott, great to have you back on The NAVigator.

JOHN COLE SCOTT: It's always great to be here, Chuck.

CHUCK JAFFE: We're talking about two different funds today from Ares, and the similarity that an investor might notice immediately is a good yield, and we're not going to be telling people, "This is your winner, that's the loser," because I know that you use both funds in client portfolios. Specifically, we are comparing ARDC, that's the Ares Dynamic Credit Allocation Fund, and CADUX, that's the CION Ares Diversified Credit Fund I. Let's dig in here by filling everybody in on the funds, and why you want to compare them and why you use both.

JOHN COLE SCOTT: Absolutely. So first, Ares is a relatively well-known asset manager, but for those that haven't dug deep, they have over $309 billion in assets, they have over 500 members on their credit team, and across all of their funds, including these two, over 3,300 different investment portfolio companies. To say they know what they're doing is definitely a fair point. When we look at the first fund, the inception date for ARDC goes all the way back to November 2012, and for CADUX, January 2017. If we look at their asset size, and ARDC's gross asset's about $760 million, about $550 in net, and CADUX is $5.1 billion, but it should be noted like many other interval funds, they have more than one share class like mutual funds can. There are seven different share classes, CADUX is just the institutional share class, the one that's largest and the one that we use for our clients. Neither are really duration-focused funds, but we want to dig beyond just duration and other factors, we really look at what's in the portfolio. They both have a May 31st fact card we got to review for this podcast, ARDC is about 38.5% senior loans, a third corporate bonds, 20% CLO debt, and 9% CLO equity. I can tell you, we've been following this fund for almost its entire life, there's always changes there, but those three sectors of exposure have been consistent through its life of choosing the best piece at the best time through market cycles. CADUX is a lot different, it is 49% US direct lending, 26% of those, syndicated loans, 9% European direct lending, only 6% high-yield bonds, 3% CLO equity, and only 1.4% CLO debt.

CHUCK JAFFE: What we're looking at here is portfolios that again, they generate really attractive yields, like 9+% yields, but they're using different tools to do it. Senior loans and collateralized loan obligations and some corporate bonds for ARDC, the direct lending, which would certainly seem to be a little further up the risk scale, for the CADUX.

JOHN COLE SCOTT: Yeah. I mean, I would say maybe. Looking at the portfolios again, a third of ARDC is level three assets, and about two thirds of CADUX is private exposure, those aren't exactly the same piece, all private is level three, but not all level three is private. And the turnover, imagine, these are actively managed portfolios, markets are changing, through the course of the five years we've been doing this podcast we've had a bunch of interesting periods of time, the turnover is 48% for ARDC and it's 31% for CADUX, there are years where it was over 100% for these funds because there was so much going on. And then leverage, of course leverage is common for taxable bond funds and credit interval funds, it is usually higher for their listed funds, it's 38.5% for ARDC and only 27% for the CADUX fund, very normal across the ecosystem of funds. And the management fees, which is not the most important thing but you can't forget to look at it, it's about 1.5% for ARDC and about 1.25% for CADUX. Volatility, remember closed-end funds are listed, very illiquid but more volatile, interval funds, there's no listing, generally less volatile. Standard deviations are running on a one-year basis, like 3.7 for ARDC and only 1.2 for CADUX, and they also have similar ratios as you go deeper into the volatility review. And then remember, ARDC is a market-listed fund, its actual one-year standard deviation with the market price, the experience investors own, is a 12.1.

CHUCK JAFFE: Let's dig in and talk about discounts, because anybody who's looking at closed-end funds is going to be looking at ARDC and wondering, are we buying it on the cheap?

JOHN COLE SCOTT: So of course CADUX has no discount but ARDC is at about a 1.5% premium, it's the highest premium we've noted in as many years, I doubt it's happened in recent times. And the average for the last three years, which is normal review for us, is an 8% discount, and that range has been negative 15 to the current 1.5% in that three-year period. When we think about ARDC versus a benchmark of other listed funds, we have an index at CEFData, the Taxable Bond and BDC Index, it's currently trading just slightly below net asset value for the benchmark, and the three-year range is a 13% movement, and right now it's trading at a three-year average of 3%. But at a basic level, ARDC has come a lot

further than the average in the last three years because I think they've done a really good job with the portfolio, investor experience, and dividend level.

CHUCK JAFFE: Now let's dig into that dividend level, dividend history, the yield, and also, well, if ARDC is trading at a premium but it has historically traded at a discount, do you wait to sort of see it get back on the cheap?

JOHN COLE SCOTT: Right now the indicated yield for ARDC is about 9.5%, and it's about 9.25% for CADUX. We do a common thing at CEF Data and CEF Advisors, we take out the impact of discounts and/or leverage for any fund to get down to what the manager has to hit to the meet the board of directors policy, and right now it's 6.9% leverage-adjusted NAV yield for ARDC and it's 7.23% for CADUX. It's interesting, looking at the dividend history for ARDC, its dividends basically are higher than they were back in the day. We did note that in '16 and in 2020 they had lowered them the way you probably would when you're getting thrown a lot of tough markets, but they're still showing dividend coverage that's about 112%. And as we think about CADUX, its dividends are less consistent because it doesn't have that listening, so there's no shareholders mad if it goes down 0.1% or up 5%. They basically pay what they have, and that's a really unique feature for an interval fund, versus closed-end funds try to model what they can hit easily with coverage, or sometimes over pay in other areas, but this fund in our collection has never over paid, the board and the team does not like that. But your question about pricing is important, I would say that it is harder to have a fresh position in this fund, but it's also a fund that it's liquid enough you can change your mind on. We've reduced our ownership at the firm because we're more tactical than some investors, as you know, some of your listeners trade actively, some trade by calendar year, and some trade by decade or maybe presidential election campaign.

CHUCK JAFFE: Let's talk about performance, because they both have done reasonably well on the short term, the intermediate term not bad, but they're both in areas where the market's been hammered and closed-end funds or anything in the space has struggled if you look out long enough.

JOHN COLE SCOTT: So in looking at the performance, I'd say the one-year for ARDC is impressive because it was a deep terrible discount a year ago, it's up 34% total return, it's three-year for market price is 6.4% annualized. CADUX on the NAV basis, which is the only way to own it, is up 12% in the last year, and for perspective, ARDC's NAV is up 17% and

change in that same time period CADUX is at 7.2%, a little higher but about the same. Very different trajectories for these funds, even at the NAV level, because I told you the investments were actually very different. And looking at March of 2020, a very good time to review performance on the down side, CADUX was down 14%, ARDC's NAV was out 27%. Now they recovered relatively quickly like most things, but that can show you on the deep down side that there's less volatility and less general down side in the interval fund, which is partially because of the asset allocation and partially because of less leverage.

CHUCK JAFFE: Do you like one better than the other? I know you use both, but do they play well together in the same portfolio? Or at this point, because you could go in either direction and be okay, is there one you distinctly prefer over the other now?

JOHN COLE SCOTT: So today I would say if you're putting fresh money to work, we'd be overweight the CADUX fund. One of the concerns of these interval funds is that you can't get out, liquidity is every 90 days, not every day. Even the month after COVID's pullback, they didn't even hit the 5% number that's basically the base case for the funds, and the board can go to 7% if they need to, they've never even got the 5%. And the other fund of course, trades, you can probably get two to five million in a week if you're a large owner, you could go 100,000 shares a day if you're a regular owner, that's the average trading. So I'd say, a fresh position, looking at this manager and this type of allocation, it's a nice time to be in CADUX. But remember, if we get a bump or bruise, it may take 90 days, but you could put a redemption for some or all of CADUX, and then maybe rotate into an Ares. Because if market's have gone down, discounts have probably widened, even if not to levels we saw a year ago.

CHUCK JAFFE: Both of these, even though you currently favor CADUX, options given the current conditions, but will they be more or less attractive when we wind up seeing rate cuts and the rate environment changes?

JOHN COLE SCOTT: So remember, these are not only duration-centric, Ares is a credit manager, and so good credit managers always have grumpy days, we talked about it last week and looking for the problems, just want to get paid back. So it depends, are you an investor that cares about the dividend? Because at a basic level, there's more cushion in ARDC for consistent dividends, and if you can handle the volatility you may ignore that. But if you're more of a total return investor that wants less volatility, then I think you'll do much

better through bumpier markets in the CADUX. It really comes down to what type of investor are you and how are you using this fund to meet your investment objectives? Because there's lots of different funds for lots of different needs.

CHUCK JAFFE: John, I learned a lot. Thanks so much for joining me on The NAVigator, we'll talk to you again soon.

JOHN COLE SCOTT: Always great to be here, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I am Chuck Jaffe and I'd love it if you'd check out my hour-long weekday podcast by going to MoneyLifeShow.com or by searching for it wherever you find great podcasts. To learn more about closed-end funds, interval funds, and business-development companies check out AICAlliance.org, that's the website for the Active Investment Company Alliance, they're on Facebook and LinkedIn @AICAlliance. Thanks to my guest, John Cole Scott, he's the president of Closed-End Fund Advisors in Richmond, Virginia and the chairman of the Active Investment Company Alliance, the firm is online at CEFAdvisors.com and you can dig into their data at CEFData.com, and John's on Twitter or X @JohnColeScott. The NAVigator podcast is available every Friday, make sure you don't miss an episode by following along on your favorite podcast app. We'll be back next week with more closed-end fund talk, until then, happy investing everybody.

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