Dynamic Asset Allocation – Critical for Capturing Today's Fast-moving Market Dislocations

For decades, investing in credit instruments has been a way to potentially generate income. This has been historically achievable by determining an investor's risk profile, then maintaining an asset allocation to investment grade fixed income by tracking an index. The composition of the assets generally remained static and was only rebalanced to remain in line with the relevant index.

In the current environment, fast-moving markets and increased volatility are creating difficulties for traditional credit investors.

By broadening the set of potential investments to include credits below investment grade, global credit and alternative credit, investors may be able to access higher yields. However, this universe can also be much more sensitive to market dislocation. Investing with an eye towards adding yield while maintaining a given risk profile can be beneficial. However, it requires a new strategy that provides the ability to play both offense and defense with a degree of alacrity.

Dynamic Asset Allocation

An investment philosophy and process that is centered on dynamic allocation can help a manager capture opportunity. It can also provide for an ongoing defensive posture that can position the portfolio to potentially generate return as markets return to normal.

As the timeframe for these opportunities becomes compressed, the ability to shift a credit allocation quickly towards the entry point and then exit to realize any possible gains is important to generating return. This requires a manager with a global footprint, ability to self-originate deals and access to flexible capital that can be deployed rapidly. It also demands expertise to source and evaluate opportunities in conditions that drive all assets down, regardless of the soundness of their fundamentals. Strong credit selection skills are the backbone of a strategy that seeks to capitalize on market-driven opportunities.

The chart below details the spread movement in the high yield markets over approximately the last 20 years. The spread is the difference between the rate of a given security and a risk-free rate, usually a U.S Treasury. The chart shows that the amount of time the dislocation has lasted has been shrinking and the percentage of return has been growing.

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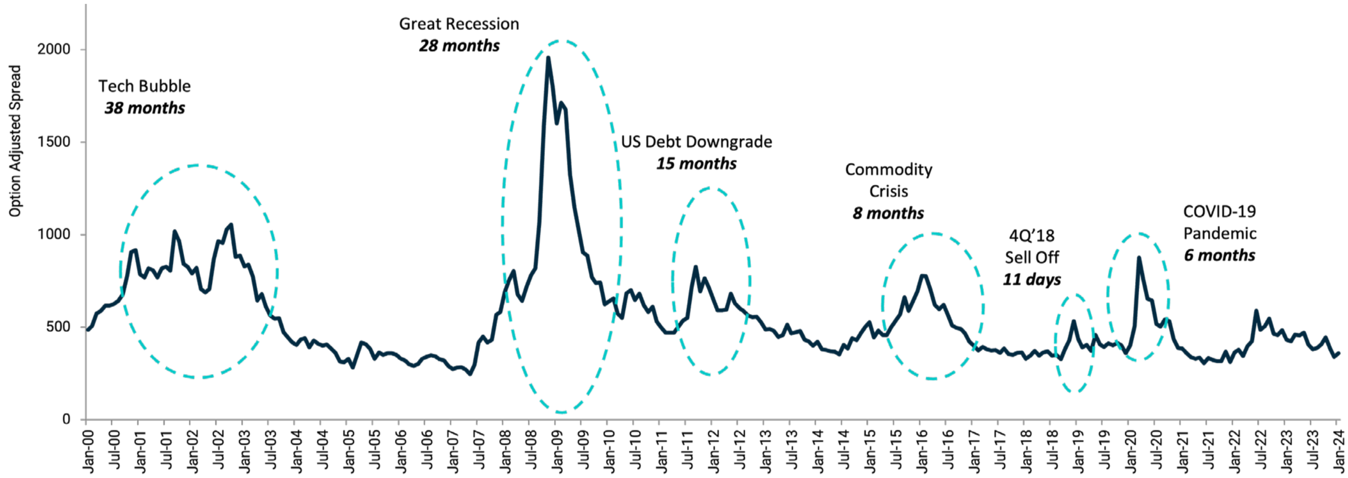
High Yield Market Dislocations: The Opportunity Window is Compressing



Note: As of January 31, 2024. Represents opinions of Ares' investment professionals only and should not be construed as investment advice. For illustrative purposes only.
(1) Dislocation defined as periods when high yield OAS increased above ~700 before returning to historical median of ~500
Source: The BofA US High Yield Master II Constrained Index ("HUC0") OAS from January 1, 2001 through January 31, 2024.

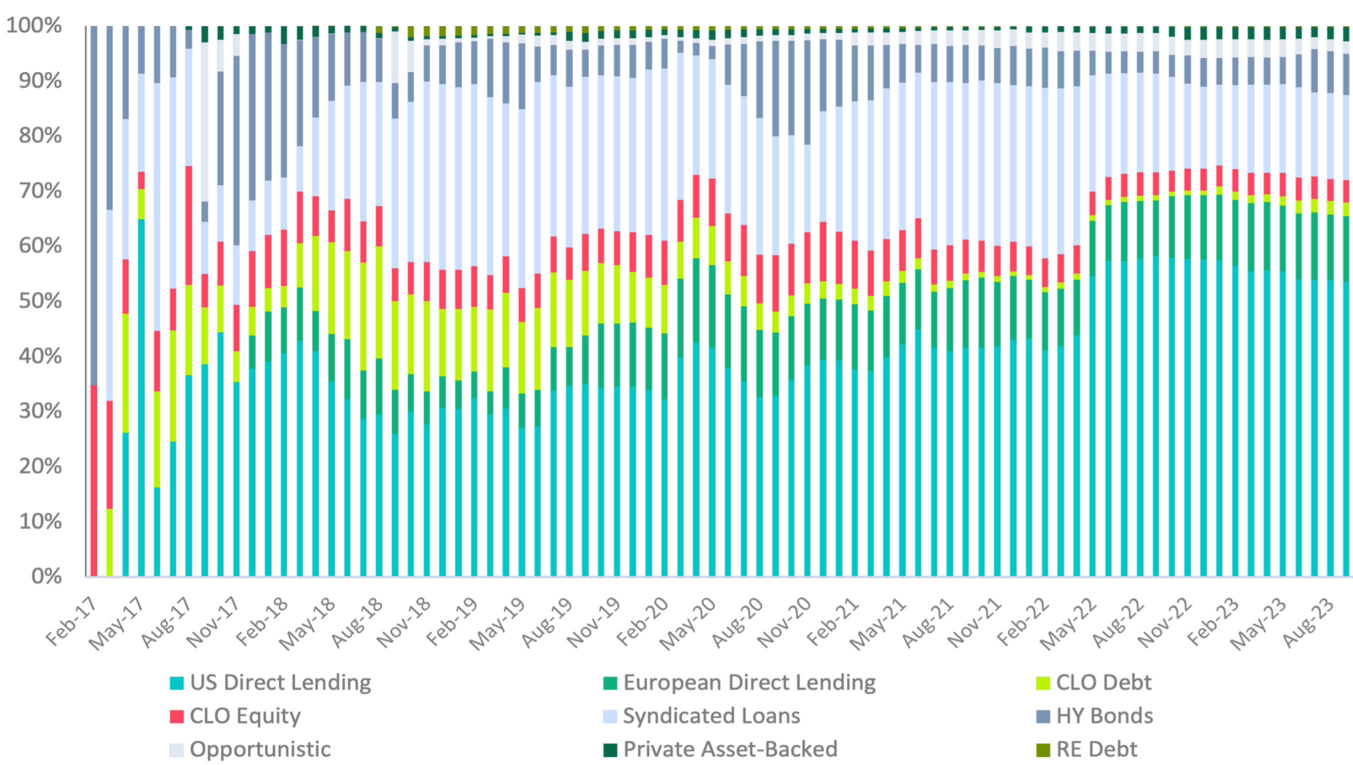
An Expanded Opportunity Set

Dynamic allocation demands a broader spectrum of potential investments. A credit portfolio that is constructed to take advantage of relative value opportunities should have the ability to access a diverse range of assets and geographies.

The larger allocations may trim or increase depending on market and economic conditions. The smaller allocations represent the ability to capitalize on inefficiencies caused by temporary market or economic situations, industry or sector driven events, even company or asset-specific situations.

But it's not just an ability to play offense – dynamic allocation means that the manager can move quickly to position the portfolio to mitigate downside risk as markets evolve.

Hypothetical Dynamic Asset Allocation



The hypothetical allocation above serves to illustrate the potential changes a dynamic allocation can undergo over time. It is not representative of a manager or strategy.

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Conclusion

Dynamic allocation is a modern response to seeking yield. Utilizing both traditional and alternative strategies can assist in building a portfolio that stays within risk parameters to potentially generate income and help to mitigate market downturns.

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