Published by
Closed-End Fund Advisors

THE SCOTT LETTER: CLOSED-END FUND REPORT

Vol: XVII No. 3 | *A Global View of the Closed-End Fund Industry* | September/October 2017

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Feel free to forward this news-letter to anyone who you believe could benefit from information on closed-end funds or global portfolios.

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– George Cole Scott, Editor-in-Chief

– John Cole Scott, Contributing Editor

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Ares Dynamic Credit Allocation Fund (ARDC): Loan Focused but with Diversified and Tactical Approach to Credit Investing

We interviewed David Sachs, founding member and Partner of Ares Management on August 29th 2017 via telephone to discuss their closed-end fund: ARDC. Ares is generally better known for their $7 Billion public business development company (BDC) ticker "ARCC", however, we wanted to learn more about its CEF cousin and, how it fits into the Ares suite of private and public funds and how it could potentially fit into various investors portfolios.

SL: I would love to get into the background of the manager and the team and also the sponsor.

DS: Ares Management, who is the sponsor, is a 20-year-old alternative asset manager managing (as of June 30) $104 billion of assets, with credit being about $67 billion of that $104 billion. I am one of the founders of Ares and oversaw our tradable credit or liquid credit investment activities from the beginning of the firm in 1997 until January 2009.

David Sachs

The portfolio management team includes Keith Ashton, who co-heads Ares' structured-credit investment activities and has been with Ares since November 2011 when we acquired a boutique investment firm called Indicus, Seth Brufsky, who has been with Ares since March 1998 when I recruited him to join us from Merrill Lynch; and John Leupp. The four of us oversee this portfolio.

I think what's noteworthy is the long tenure of the portfolio management team. I, after graduating from engineering school, have been involved with investment banking and investment management since June 1981. John Leupp, who is the senior high-yield manager here at Ares and helps manage the high-yield securities in this fund, started working with me in the late 1980s when he graduated with his Master's in economics from UCLA.

As I mentioned, Seth joined us in 1998 and while Keith joined most recently in 2011, I have known him since the late 1990s. So, if there is one hallmark of Ares, it is a very consistent team and strategy for managing leveraged credit. We want to be flexible of mind but have long tenure in our portfolio management teams.

SL: As I think about it, when we bucket closed-end funds to different groups, we generally put you in the senior-loan bucket, but you are not a regular senior-loan fund, and sometimes I'm pushed to put you in the multi-sector bucket. But so much of what you do is loan-focused investing. Tell me where the cover has been, where it can go, and how you think about the different possible investment choices in the Ares Dynamic Credit Allocation Fund (ARDC).

DS: Our objective when we thought about ARDC was to come up with a corporate-credit, closed-end fund that would be properly positioned for different points in the credit and interest rate cycles of the market, and therefore we adjust the allocation across three broad asset categories: high-yield bonds, leveraged loans, and collateralized loan obligations (as market conditions permit).

With loans and senior-loan investments being over 50% of the assets in the fund, I can understand why you and others sometimes pocket us into a senior-loan fund. What we are trying to do with the fund currently and for much of its life is to deliver higher asset returns over senior-loan funds without materially greater risk, and especially risk as measured by interest rate risk.

So, the duration of the ARDC portfolio at about one and a half years interest rate duration (2.86 fixed. 1.50 total) is far shorter than the approximately four-year interest rate duration of the Merrill Lynch high-yield index. So, even the high-yield bonds that are in the fund are much shorter in duration than what's typical in the market.

SL: If I remember correctly, ARDC was a merger of two previous Ares funds.

DS: That's correct. It is the merger of two of our funds, ARDC being the older and larger of the two

funds. The primary difference between the two funds is ARMF (Ares Multi-Strategy Credit Fund), which was merged into this fund in 2015, had a broader mandate to invest in securities of CLOs.

ARDC, when we originally brought it to market, only invested in investment-grade debt tranches of CLOs. But as we saw the merit in closed-end fund structures like these of broader investing in CLOs, and given the relatively small size of ARMF, the board of directors of the funds, in conjunction with management, thought the two funds should be merged, which has generated considerable savings in terms of non-investment-management expense, things like audit and other expenses.

SL: How do you approach watching current positions in the portfolio? How do you manage the different analyst groups at the fund?

DS: Well, I think an investor who considers purchasing stock or who holds stock in ARDC gets a very significant infrastructure here at Ares in credit. As I mentioned, over $104 billion; about $67 billion of that is in the credit space, and we have, we believe, one of the largest dedicated teams focused on non-investment corporate credit here and in Europe.

So, in addition to the four of us involved with portfolio management—myself as chairman of the fund but specifically Seth Brufsky, president of the fund, John Leupp, and Keith Ashton—the team is supported by 50-plus professionals, both senior and supporting analysts, who are organized by industry. Analysts are located in the U.S., here in Los Angeles and in New York, and in our London office, because this fund does invest both in corporate credit in the US and in Western Europe. We'd like to note that we do not make investments in emerging markets.

SL: How do you define peer funds or peer investments?

DS: Like yourself, I have struggled about whether this fund should belong in the senior-loan universe of closed-end funds or the multi-strategy universe. From an interest rate duration and interest rate risk standpoint, it's (ARDC) closest to the senior-loan funds, but if you look at the returns we've been able to generate recently, NAV and the income yield of the fund, it's somewhat closer to the multi-strategy or the high-yield funds.

One thing that we are not—not that they are not a good thing—we are not a pure structured-credit or CLO-equity fund. Those are excellent vehicles; however, they'll probably have a little more volatility than the senior-loan category. It would be inappropriate to compare this fund, for example, to Eagle Point or Oxford Lane, which are both structured as closed-end funds and potentially have higher dividend returns. Those are good funds, but they have a different risk profile.

SL: Most people who find your fund through our lens probably are also aware of business development companies (BDCs). Do any investments end up in both Ares Capital Corporation (ARCC) and ARDC?

DS: Not to my knowledge. It would be highly unlikely. ARCC focuses primarily on directly originated middle market loans. As you probably know, to qualify as a BDC, 70% or more of your assets have to be in qualifying assets, and those cannot be outside of the United States, in CLOs, or in larger companies.

"From an interest rate duration and interest rate risk standpoint, it's (ARDC) closest to the senior-loan funds, but if you look at the returns we've been able to generate recently, NAV and the income yield of the fund, it's somewhat closer to the multi-strategy or the high-yield funds."

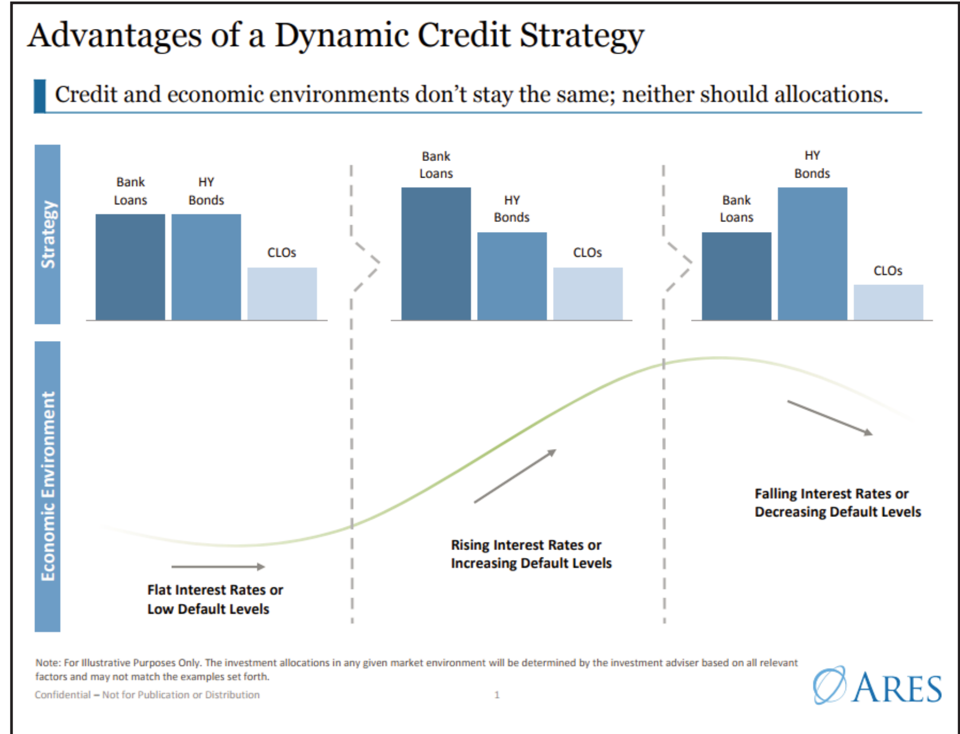
So, this fund is complementary to that but really offers individual investors, or for that matter institutions, exposure to different segments of the credit universe with some international exposure. Where the two funds have some complementary nature is by way of the information that the credit teams in our direct-lending offices have about given industries, companies, or management teams, and subject to not being non-public material information, those insights are shared with the analysts in the liquid-credit team.

So, one of the benefits an investor in Ares funds gets is not just the dedicated people focused on that fund but also the entire Ares investment team across the globe sharing information about industry trends, economies, risks, etc. We think that makes each individual portfolio management team stronger.

SL: Maybe it's a good time to dig a little deeper into the sectors or countries you don't like. Financial services can be a very broad sector, and it seems to be your biggest sector. Discuss how you analyze the sectors and individual names inside that sector.

DS: Well, first of all, I think that financial services shows up as the largest sector because ARDC's investments in CLO debt and equity are assigned to that sector. I actually think that we have relatively few non-CLO investments in the financial services industry.

Relatively few good financial service companies can operate with a below investment-grade debt rating. But we do like the CLO sector, because we view it as a smart alternative way to



Loan Focused Funds

Ticker	Name	Sponsor	Discount	Market Yield	LevAdj NAV Yield	Duration	Beta (S&P500)	RoC % (1yr)	Leverage	Net Assets in millions	Liquidity (90d)
AFT	Apollo SrFlt Rt Fd	Apollo Credit	-7.38	6.47	4.49	2.81	0.08	0.00	33.26	281	918
BGT	BR Flt Rt Incm Fd	BlackRock	-4.16	5.06	3.73	0.43	0.09	0.00	30.02	342	796
BGX	B/GSO Lng-Srt Cr Incm Fd	Blackstone	-6.59	7.72	5.29	0.63	0.15	0.00	36.25	218	984
BSL	B/GSO Sr Flt Rt Trm Fd	Blackstone	-1.02	6.68	4.98	0.44	0.09	0.00	32.90	268	748
EFR	EV Sr Flt-Rt Tr	Eaton Vance	-2.25	5.68	4.08	N/A	0.12	0.00	36.10	558	1.132
EFT	EV Flt-Rt Incm Tr	Eaton Vance	-6.01	5.69	3.95	N/A	0.12	0.00	35.50	617	1.256
EVF	EV Sr Incm Tr	Eaton Vance	-8.12	5.49	3.70	N/A	0.12	0.00	36.20	270	485
FCT	FT Sr Flt Rt Incm FD II	First Trust	-5.74	5.98	4.45	N/A	0.06	8.65	26.80	377	1.087
FRA	BR Flt Rt Incm Stgc Fd	BlackRock	-5.35	5.18	3.78	0.43	0.08	0.00	29.47	556	2.089
JRO	Nuv Flt Rt Incm Opp Fd	Nuveen	1.47	7.22	5.38	0.63	0.17	0.00	36.27	461	1.286
JSD	Nuv Srt Dur Cr Opp Fd	Nuveen	-3.14	7.37	5.20	0.56	0.14	0.00	37.27	180	608
NSL	Nuv Sr Incm Fd	Nuveen	-3.92	7.17	5.02	0.55	0.16	0.00	37.11	266	617
PHD	Pioneer Flt Rt Tr	Pioneer	-5.37	6.10	4.38	0.20	0.06	0.00	31.70	308	803
PPR	Voya Prime Rt Tr	Voya	-8.32	5.56	3.88	N/A	0.05	0.00	31.49	835	1.851
VVR	Invsc Sr Incm Tr	Invesco	-8.83	5.54	3.87	N/A	0.16	9.17	30.37	877	2.115
ARDC	Ares Dynamic Credit Allocation Fund	Ares Management	-8.62	7.72	5.45	1.50	0.27	0.45	29.48	410	1.243
Average			**-4.67**	**6.29**	**4.48**	**0.82**	**0.12**	**1.14**	**31.29**	**427**	**1.126**

Data as of Sept 25, 2017. Data from CEFdata.com

invest in the loan market in the U.S. and Europe. Our CLO allocation is between 25% and 30% of the ARDC portfolio, about 22% or so in debt (primarily BB rated) and approximately 5% in CLO equity. Currently we find that to be very attractive from a risk return standpoint.

Why is that? Unlike senior loans, which can generally be prepaid by the borrower on very short notice, CLO debt offers some amount of call protection. So, in a period as we've had this year where there have been declining interest rate spreads on the senior-loan category, this fund has benefited from the locked-in returns in our BB and BBB rated CLO-bond portfolio.

And specifically, BB-rated CLO bonds we bought in '15 and '16 with coupons in the Libor+ 450 to 550 area (in dollar prices, in the low- to mid-90s) appreciated by 2017 to close to par. We then rotated those BB positions into new issue BB CLO bonds with coupons over 600.

The benefit that we received there was that one we would have lost if that capital had been in the loan market, because if you had bought a loan in 2015 at a given spread and since loan spreads have come in, the company would have refinanced that loan at par, and we would have received at most a 1 point call premium.

In terms of how the portfolio is configured, we are very focused on industries with recurring cash flow and growing opportunities. One of the biggest changes I'd say in the leveraged finance marketplace over the last 20 years is the maturing of the technology sector. That's an industry that 20 years ago most people who bought high-yield bonds or senior loans looked at skeptically because of the rate of change in technology, and now there are so many mature software businesses which generate a lot of their revenue and profits from renewals and maintenance business that we and other managers have found it to be an attractive sector.

Technology is about 7.5% of the portfolio, and that's something that we definitely like. On the other hand, an industry that we have been staying away from in general is the overall retail industry; with Amazon and with a lot of other changes in the environment, we are not sure we are getting paid for the risk in most retail credits.

SL: Just speaking for the value change positions, we are talking about a 90% turnover in the last 12 months. Is that something you envisioned to be a normal experience for the investment, or have there been more changes recently than you typically would expect?

DS: We are not sure where that 90% came from. We have a calculated number as of July 31 of 69%, which still is probably higher than it would be historically in an Ares' portfolio. I think a lot of that is due to many higher coupon loans and bonds being sold over the last year or being refinanced. So, I'd say the voluntary turnover is probably something between half and two-thirds of that number.

SL: When we think about the unrated parts of the closed-end fund that we buy for clients, fixed-capital structure, it's the right bucket to put the unrated stuff. And so, we really like to focus on that because one of the benefits of the fixed-capital structure is the cheap permanent leverage. It's active management, and it's the ability to have illiquid underlying investments because there is no fear of redemption pressures. I always like to talk about the unrated portion of the portfolio, because it helps us think about when managers and funds put the right guts or some of the right guts in the best use of the closed-end fund wrapper.

DS: The benefits of CLO equity, especially as we manage that activity here at Ares, are the fact that you have a structure typically where the investment period for the assets is longer than the call period on the liabilities. So, by owning CLO equity, you have created some positive optionality for yourself as an investor.

Let me elaborate. Typically, CLOs, even when they have a 10-to-12-year final life, have a four- or five-year so-called reinvestment period. And what that means is, if an asset held by the CLO alone pays off, the manager can reinvest that principle into another loan as long as it's in the first four or five years. Remember that most CLOs are done where the debt structure or the liability structure on the right side is callable at the end of two years.

So, if you have a period as we have right now where the spreads of AAA tranches of CLOs—which is 50% of the right side of the balance sheet of a CLO—that spread has declined significantly in terms of basis points over the last 18 months. The CLO manager can refinance the AAA tranche, lower the cost of borrowing and therefore increase distributions on the CLO equity. So that optionality benefits us.

On the other hand, if you are in a period where the spreads on loans go up, you have the chance to reinvest cash flow over those four or five years without having to pay more on your liabilities. As you noted earlier, not all the assets in this fund work with these others. Also, CLO equity does trade, and there is an active market, but it's not like trading a BB bond and, therefore, a closed-end fund is an ideal structure to hold that type of investment.

SL: Let's focus a little more on what generally drives a lot of the behavior of investors: that search for income. The way we track your undistributed net investment income and the earnings coverage, both are pretty solid. You've got some good trends and some (as of last reporting period) coverage from NII of your distribution. How do you and your team think about those data points, recognizing that no data point is individually a perfect data point?

DS: As primarily a fundamental credit shop, when we look at the individual companies that are underlying the portfolio, we are very much fundamentally driven. And it's the same for the monitoring of the income and likely forecast of the income of the fund. So, we start bottom up. We look at where LIBOR is, and we look at the forward curve for LIBOR. We look at the current spread on the different components of the portfolio, meaning what spread over LIBOR in

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the loan portfolio, what spread over LIBOR in the CLO debt portfolio, what is the coupon and yield to worst and measures like that are on the fixed-rate high-yield bond portfolio.

On at least a monthly basis we take those inputs on the portfolio and do a number of sensitivities. One is just looking at what the projected monthly income of the fund is, NII, using flat LIBOR, and then we do a sensitivity looking at the 90-day LIBOR forward curve, and then we look at sensitivities, LIBOR goes down 10 basis points, up 10 basis points, and some more sensitivities to make sure that we do our test on a risk-adjusted basis to have a portfolio that can meet the dividend rate we've promised to our investors.

SL: One way we account for discounts and leverage in closed-end funds is leverage-adjusted NAV yield. So, for your current policy of, say, 10.5 cents a month, economically that means 7.7% based on recent marketplaces, but with discounts and leverage that's 5.45%. Again, not being in any of your seats, 5.5% economic return on your net assets does not sound crazy hard in closed-end-fund land to hit.

DS: I understand the logic of that and how that allows you to compare apples to apples. Our objective is to provide investors with as stable an income flow as we can, and I think one of the things that's noteworthy is if you go back and look at the dividend history of the fund, it is a bit stronger than some. In fact, from the inception of ARDC until the end of 2012, we were able, because of the diversified nature of our asset mix, to maintain the initial dividend (which was 11.7 cents a month) much longer than some other funds that were brought to market within a month before or after ARDC's IPO due to our asset mix and portfolio strategy.

Our dividend at 11.7 continued a year longer than other funds not because we were paying returns on capital, it's just that we had a differently configured portfolio. Having said that, if someone were to go back and look at what we all thought at the end of 2012, we thought that the Fed would have raised rates much sooner and, of course, we had Bernanke and the taper tantrum in late May and early June of '13, and then with the weakness of the economy, the Fed was much later and much slower to raise rates.

Having said that, right now the portfolio is very well positioned to benefit from the rise or increase in LIBOR, and that's why we've been able to raise the monthly dividend recently from 10.25 cents to 10.5 cents, and we are hopeful that we'll have the possibility of raising it again as market conditions merit.

SL: What are your current thoughts on being able to do those small changes to the policy over time? Some other funds will do what they'll do—regular policy and then a special towards the end of the year to meet their requirements. Do you guys discuss that on the board meetings?

DS: We definitely discussed it. The first really significant discussion, as you might imagine, was the end of '13, because '12 was a relatively short year for the fund (the fund went public in late 2012) and we had a considerable amount of income in excess to what we had distributed. As you probably know, the rules do allow you to roll that over to the next year or, of course, you can make a special distribution.

> ***"Special dividends are great but are probably forgotten two weeks after they are received."***

We felt that the bulk of our investors were buying these funds for the monthly income, and we prefer that we be able to maintain a stable dividend for as long as possible. So, it's our view that the special dividends are great but are probably forgotten two weeks after they are received and that, from the standpoint of building and maintaining the core investor base for the fund, being able to maintain the dividend rate longer was more important. It's possible in the future the board will reach a different conclusion, but that has been our conclusion each time we've discussed it.

SL: As we've noticed, you have a very tiny return to capital over the last three years. Obviously, it's so small, your dividend is not that aggressive. Your net-asset-value performance easily fills in your net-asset-value yield from what we are seeing in the data. Do you have any perspective on what's driving those little tidbits of return to capital?

DS: I think at a point in 2016 we were slightly underearning the dividends because, frankly, I think the Fed moved slower than we thought to raise LIBOR. Rather than changing the dividend so frequently, we maintained the dividend at one point, I think in early '16, and it caused a little bit of return to capital. But our objective is to have the distribution be primarily 95%-plus in any given year of income.

One of the things we are quite proud of is, if you look at the cumulative distributions we've made since 2012, we rank quite well compared to other funds, and then if you compare our NAV today to some of the other funds, we have 50–75 cents greater NAV than for some other closed-end funds that came to market at about the same time as the ARDC IPO. So, we are delivering value to the investors, both in current income but also in maintaining and trying to build the NAV.

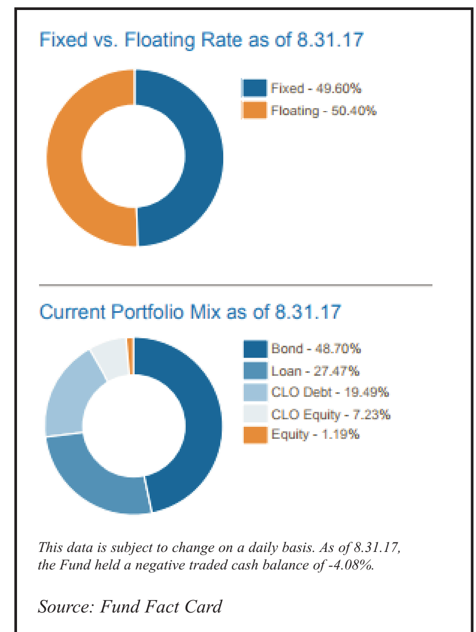
SL: I would recognize that. It's interesting that with closed-end fund data, there was a time where people only wanted positive UNII balances, and then a bunch of funds had long-term surpluses and because of the way that's calculated they had huge cuts, and so you had to explain to people that positive UNII is not always good. And, in the same way, return to capital isn't always bad. It sometimes just happens when you don't know interest rates perfectly.

DS: I think it would be inappropriate for our board—and I'm only one board member—inappropriate to say we are never going to return to capital as part of the distribution. You, your readers, and the investors know better than we do, but the people we've met who are long-term holders of these types of securities are looking for that consistent payout and don't want to see an erratic dividend policy.

SL: If you could do a public service announcement for every current shareholder, shareholder to be, and financial advisor, what's the one thing that you or your team have to constantly correct or hammer in as to why your fund is or isn't this or that?

DS: I'd say that there is better understanding today than there was years ago. Our investors and potential investors understand the benefits of structured credit and, specifically, collateralized loan obligations, because following the financial crisis nine years ago, many investors, especially individual investors, saw acronyms like CDOs on the front page of newspapers and not just of the business page, but politicians talked about CDOs as well.

Those were structured-credit vehicles that held subprime mortgages, investment-grade bonds, and other types of securities. CLOs are a



This data is subject to change on a daily basis. As of 8.31.17, the Fund held a negative traded cash balance of -4.08%.

Source: Fund Fact Card

subset of that. Whereas, there were tremendous issues in the CDO market overall, starting with the fact that if you take subprime mortgages and you diversify them by state, the diversity doesn't give you anything, because if a whole bunch of them default in Florida and then a whole bunch default in Nevada, you still have got credit problems.

The benefit of the CLO asset class is the underlying-asset senior loans have proven themselves to be a very strong credit asset with a very low default rate over a long period of time. The benefit of CLOs is that CLO managers tend to buy the better-quality loans in the loan market, but the weak loans often go to special-situation funds or hedge funds or stressed funds, and CLOs actually offer investors a lot of benefits.

Those benefits include the fact that CLOs allow us to make fixed-income investments in the loan market with some degree of call protection and less repricing risk over the short term than individual loans.

SL: Maybe it's a good time to talk about current use of leverage. We clock you in just under 30%, which is not in the high end of things. Talk about how you've used leverage both in terms of type and how much of it and how the fund and board think about use of leverage going forward.

DS: Ares' management has a general policy that we don't like buying assets, whether liquid or illiquid, using short-term leverage. So, any of the investment pools that Ares has had over time, including this closed-end fund, to the extent they have used leverage, have always utilized committed-term leverage. We don't do margin debt. We don't do overnight repo's or things like that.

We've typically had a two-year credit facility with a bank for this fund and we rolled the renewal well before it matured each year. That, we feel, provides us excellent funding flexibility. We are able to borrow in this fund in a number of major currencies at the same spread over LIBOR.

So, to the extent our portfolio managers see an investment in London through our London team in a loan that's denominated in euros or [pounds] sterling or bonds denominated in one of those currencies (or, for that matter, Swedish krona or the Canadian dollar), we are able to do what I call a natural hedge by borrowing in that currency and matching funds to that investment.

Our view on leverage is, while we have had leverage over 30% occasionally, we do not think, given the inherent volatility in the markets, it's probably appropriate to run the fund for any sustained period much over the 30% or 30.5% area. We want to provide a cushion in case there is a downdraft in asset value so that we have time to reduce leverage and stay compliant.

We also recognize that unless we really cannot find anything to buy, the economics of the fund dictate that we should have leverage of 25% or greater. In general, the fund has operated between 25% and 30.5%. That's where I think 95% of the time or 90% of the time we've been.

SL: Where do you think markets may go the rest of this year and into 2018? What are your feelings on credit markets and global economies?

"Benefits include the fact that CLOs allow us to make fixed-income investments in the loan market with some degree of call protection and less repricing risk over the short term than individual loans."

DS: With the proviso that Ares as a firm does not like to base our investment strategies on macro: We start with the bottom up. We will want our portfolio composite to have more than adequate resources to service debt whether the economy is doing lousy, good, or great. Having said that, we start bottom up and, of course, then overlay some macro viewpoints.

Our macro viewpoint is informed by the thousand-plus companies that Ares has investments in across the platform in different industries across the world, and right now we are seeing good conditions in both the US and Western Europe for most industries (not all). And we see most of the companies in our portfolio with more than adequate liquidity without tremendous need for capital expenditures and, therefore, we think we are in a fairly positive credit environment.

On the other hand, we've recently seen markets where high-yield spreads were very tight as they were earlier in the year and loan spreads were also on the tight side. We like the fundamental credit characteristics of the market going forward through the remainder of 2017 and into 2018. We are cautious from a market appreciation standpoint in all of these markets.

Therefore, we're constantly looking at the portfolio for the weaker, more speculative companies, because if capital is leaving the high-yield market or loan market, it's those triple-C and more speculative credits, even if they can pay their interest, where the market price of those loans and bonds will probably decline more and impact the NAV of the fund. So, we are positive but, given the amount of appreciation we've had in the market, are cautious about market price performance from here.

We do expect the Fed to continue to gradually increase short rates. It remains to be seen what the impact will be if they do go forward with the end of quantitative easing, what impact that will have on the longer end of the treasury curve. But we are not overly worried about that.

SL: As a company that used to have good financials goes through rough patches, what's the approach of the fund to investments that don't go as planned?

DS: I think the approach is a matrix of a couple items. One is, if we own a bond that is in default or about to default or goes into workout, we are doing an analysis of the value we could liquidate that position for compared to what we think the future value is—and, therefore, what kind of IRR are we giving up by selling it? We are not overly concerned if we have one or two bonds that represent a very small percentage of the fund that are not in accrual. So, first and foremost, it's fundamental value. Depending on the size of the restructuring, the markets will be more or less efficient about how that defaulted bond is priced.

The other thing that enters into it is our view on the industry. Do other Ares portfolios hold that investment, and what role does Ares intend to take in restructuring? I'd say that if it's a small position and our analysis shows the return we are

8 Merrill Lynch industry classifications weighted by market value. These values may be different than industry classifications in certain regulatory filings.

Top 10 Holdings[9] as of 8.31.17

Holding	%
Builders FirstSource, Inc.	1.30%
Anglo American, PLC	1.17%
GCP Applied Technologies, Inc.	1.16%
Cablevision Systems Corporation	1.12%
THL Credit Wind River 2015-2 CLO Ltd.	1.05%
Fortescue Metals Group Ltd	1.04%
Immucor, Inc.	1.02%
Vizient, Inc.	1.01%
Tegna, Inc.	0.99%
FTS International, Inc.	0.98%

9 Market value percentage may represent multiple instruments by the named issuer and/or multiple issuers being consolidated to the extent they are owned by the same parent company. These values may be different than the issuer concentrations in certain regulatory filings.

Source: Fund Fact Card

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going to earn on the positions that defaulted is about the same as selling and just buying a new B bond or we are only going to earn slightly more by holding on, we are likely to sell it, because it is an income fund and we are more likely to sell in situations where Ares as a whole is not a material player in the restructuring.

Risk is a function of knowledge, and there are a lot of smart people operating in the loan markets, high-yield markets, and stressed-debt markets. Ares has one of the largest and very experienced teams, but there will come times where other investors have better information. Just because we don't know as much about an industry, we may feel we are at an informational disadvantage. That's not a good place to be. So often times if we can get fair value, we exit.

On the other hand, there are times, because Ares overall has a network of people across the US, Western Europe, and China, that we feel we have an advantage, and those are the situations we are more likely to hold through restructuring because we think we can earn "excess" returns.

SL: We've talked a lot of the important work of the net-asset-value side of the closed-end fund—the leverage, the investment approach, winners/losers—but you're common-equity holders and a company that derives its value from the net-asset value. How do you think about connecting with and identifying new equity shareholders? How have you engaged the closed-end fund community or new shareholders?

DS: Our board and management is very focused on shareholder value. The senior members of the management of the fund, myself included, own hundreds of thousands if not millions of dollars of the fund. In some cases, it is millions, others hundreds of thousand dollars. So, we believe in, as I say, eating our own cooking.

The fund has from time to time in the last couple of years, with the full support of the board and following a healthy discussion, purchased shares in the open market because when the fund was trading at a 15–17% discount to NAV, we thought the fund was misunderstood and the best investment we could make was to buy some of the shares in the market.

In terms of connecting with investors and potential investors, with the help of Destra, our investing servicing partner, we have tried to be as available as possible for conferences to meet with research analysts who cover the closed-end fund space. We've done a number of non-deal roadshows over time, tried to go out and see some of the handful of institutional players in the market, people who look at discounts from closed-end funds and buy from time to time.

I think the biggest challenge that Ares faces is that we are relatively new to this space. We are not Nuveen, we are not BlackRock and, therefore, if someone did not learn about the fund on the IPO of ARDC or ARMF, it's a little episodic; a Destra wholesaler being in the office at Wells Fargo or Merrill Lynch or Morgan Stanley on the day that a financial advisor is trying to solve a portfolio problem for a client and the Destra person says, "Well, have you looked at this?"

I think it's part of the value proposition that your publication serves. Wall Street is good at times at taking closed-end funds public, but most of the major firms don't devote a large amount of their research resources or publish on firms even if they were the manager of the IPO.

> ***"I think we probably worry about the most is the intersection of geopolitical and financial system risks, because I think we have done a good job of the micro risks of specific companies and changes there."***

SL: Yes, and this is a comment I get from regular data clients on the West Coast or other places. And if you look at coverage even by Morningstar, which has done good historical coverage and which bought our closed-end fund data provider in 2008 to improve their resources, they no longer have an analyst with the name closed-end fund in their title. So, we have tried to step up a little bit, but we also stay in touch with a lot of different folks as far as what they are seeing and doing in the space.

DS: Our view is that as time goes on and our performance stands for itself, it will not be easy but easier to highlight the fund and get attention. Meaning over time you can show people both your NAV performance and your dividend performance. Hopefully, that will become known.

SL: What real concern drives your risk management for the fund?

DS: The thing I think we probably worry about the most is the intersection of geopolitical and financial system risks, because I think we have done a good job of the micro risks of specific companies and changes there. But what 2008–2009 taught all of us is that the system-wide risks are tough to really stay ahead of.

So, we are more focused on them as an organization, trying to understand how these companies would fare if they were cut off from the banking system. Certainly, we don't expect any huge negative surprises, but probably many are concerned about how China continues to make a transition from an export industrial-capital-goods-producing economy to a consumer economy. Those are the type of things we talk about and how they would impact the portfolio.

SL: What good books have you read lately?

DS: The book that has had the biggest impact on me over the last couple of months is The Soul of the First Amendment by Floyd Abrams, who is the Dean of the First Amendment Legal Bar. It's about the First Amendment and the importance of it, and it's a uniquely American thing.

So that for me is the essence of one of the key freedoms of why people come to the United States. It's not just the economic freedom that they feel to make a go here where they might not have made it in another country. It's not just the so-called religious freedom. It's all centered to me in the fact that it may be very detestable to me to have the Nazis marching when I was in a university nearby in Skokie, Illinois, but I think a lot of people died in our armed forces, and if I had been drafted I would have been defending that right to free speech. So, to me, that would be the book I would say has had the biggest impact.

SL: David, thank you for your time and best wishes.

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Portfolio Managers' Review

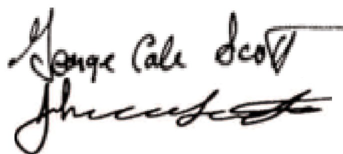
Closed-end funds had a choppy, but positive quarter with +1.05% gains in July, -1.58% losses in August and +0.40% MTD gains (9/27/2017) for a QTD gain of +0.70%. Results are based on our **12 Major Sector Index** (www.CEFdata.com/index) containing the 7 most liquid funds for the 12 major sectors of CEFs. YTD, this index is up +9.3% on a total return basis, with an average narrowing of discounts this year of -2.46%. During September we added 6 more indexes to our system for a total of 33 CEF/BDC indexes which allows us to better benchmark our firm as well as peers.

Discounts are -2% less than their 5-year average across most CEF sectors or groups. Looking at equity and taxable bond indexes, over the past three years of discount data, most sectors are trading 55% to 75% between their 3-year discount peak and valley. We see that discounts are no longer "easy to find" and suggest looking for bruised CEFs (after a dividend cut of 10%+) and over-weighting lagging sectors.

Three areas where we see value include (1) **Sr. Loan funds**, down -0.7% QTD and +0.60% YTD, (2) **Business Development Companies (BDCs)**, -2.6% QTD and +1.1% YTD. We believe BDCs have more upside in the next 3-6 months than **Sr. Loans** on a risk adjusted basis. For tax focused income investors, tax-free CEFs are up about +1.9% QTD and +7.2% YTD as measured by our **National Muni Index**. We believe (3) **MLP Funds**, down -2.8% QTD and -3.9% YTD can provide a nice, low correlation exposure to reduce the duration risk for the Municipal bond CEFs (average duration is 9.7 for national funds, but mid 10's for NY and Cali funds.) MLP funds show an average of -1.4% discount to NAV, 9.8% yield and 78% of the past year's distributions classified as return of capital (RoC) which is normal and expected for MLP funds.

A good source for funding these sectors may be **International Equity funds** which are up +6% QTD and +26% YTD and **Convertible Bond funds**, which are up +1.5% QTD and +14.5% YTD. Another trend we have noticed is that **Multisector Bond Funds** (+3.5% premium and 1 Year NAV TR of +14.8%) and **Hybrid /Balanced Funds** (-4.2% discounts and 1 year NAV TR of +12.1%) have both generally tighter discounts and better 1-year NAV total returns than our **Taxable Bond and BDC index** (-2.5% discounts and +9.3% 1- year NAV TR) and **Global Equity Index** (-6% discounts and +8.9% 1 year NAV TR). This suggests that wide mandate managers may be able to outperform constrained managers in the current market environment as well as investors may allow a smaller discount or premium to NAV for some of these funds.

We spent time in September, at The BDC Roundtable in DC as well as the CEF Association meeting in Chicago staying in touch with our institutional clients, peers, analysts and fund sponsors. In October we will be in NYC for back-to-back events held by Destra and Nuveen to gain further perspective into their funds as well as spend time with the CEF analysts and other focused firms in the space. We look forward to some tactical swaps in our client accounts next quarter as we being to prepare for tax loss selling in mid-to-late November.



CEF Advisors' Quarterly CEF/BDC Research Call
4:15pm EST
October 10, 2017

Register for session or replay
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This issue of The Scott Letter is dedicated to the memory of David Aldo Geracioti of Brooklyn, NY. (May 18, 1963, to September 3, 2017) May his spirit soar. He was a friend; both personally and professionally. He pushed us to be better journalist, always had an opinion and brought joy to every conversation. A proud father to Grace and David, whom we discussed regularly over dinner. He revived Registered Rep. magazine in 2001, a publication for financial advisors, which he guided for nearly 12 years. For those interested, there is a memorial about David on Weathmanagement.com.

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Note: All data referenced is from CEFA's CEF Universe data dated September 25, 2017 unless otherwise stated.

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The Scott Letter Online
is published by

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Hybrid (High) Income
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