ALTERNATIVE
FUND
ADVISORS

QUICKTAKE I March 2022

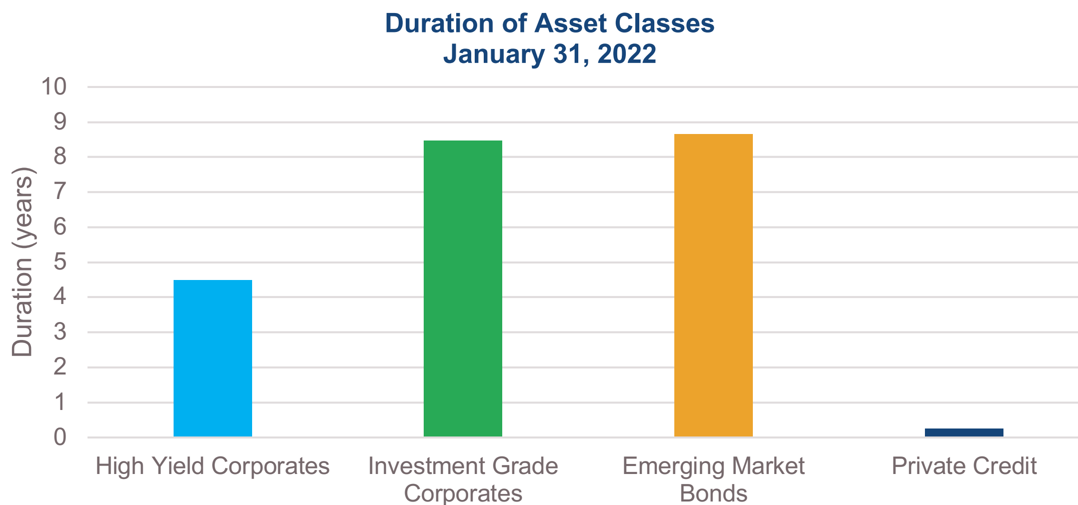
Optimize Your Fixed Income in an Inflationary World

Markets have been buzzing about inflation in the post-COVID world. Significant kinks in supply chains, combined with worker shortages and sharply higher commodity prices, have caused a spike in inflation over the course of 2021 and into 2022, as evidenced by the core Personal Consumption Expenditure Deflator ("PCE"). Recent year-over-year readings of this, the Fed's preferred inflation gauge, are the highest since the mid-1980s. While some of this inflation may be transitory as the economy continues to heal from COVID-induced shortages, there are signs that higher inflation is likely here to stay as workers reassess their bargaining power and companies feel more comfortable raising prices.

Inflation is One of The Greatest Threats to Fixed Income

Source: Bloomberg, Bureau of Economic Analysis

Inflation is typically considered one of the greatest threats to fixed income markets, especially in the current low-rate environment. Given the extended duration in many of the fixed income indices, a modest pickup in yields can cause mark-to-mark losses that overwhelm yield on a one-year horizon. The recent yield increases over the last six months have been painful for fixed income investors. However, the real risk is a sustained increase in inflation. Buying a five-year bond yielding 2% today may seem reasonable, but if inflation averages 3% over that period, an investor can lose approximately 5.5% of their purchasing power over that five-year period.



Source: AFA Calculations, Bloomberg

Note: High-Yield Corporates = Bloomberg US High Yield Corporate Bond Index, Investment-Grade Corporates = Bloomberg US Corporate Bond Index, Emerging Market Bonds = Bloomberg Emerging Markets Sovereign Index, Private Credit = Cliffwater Direct Lending Index. Hypothetical returns calculated based upon the duration of these indexes as of 1/31/2022.

Private Credit as a Potential Yield Enhancer

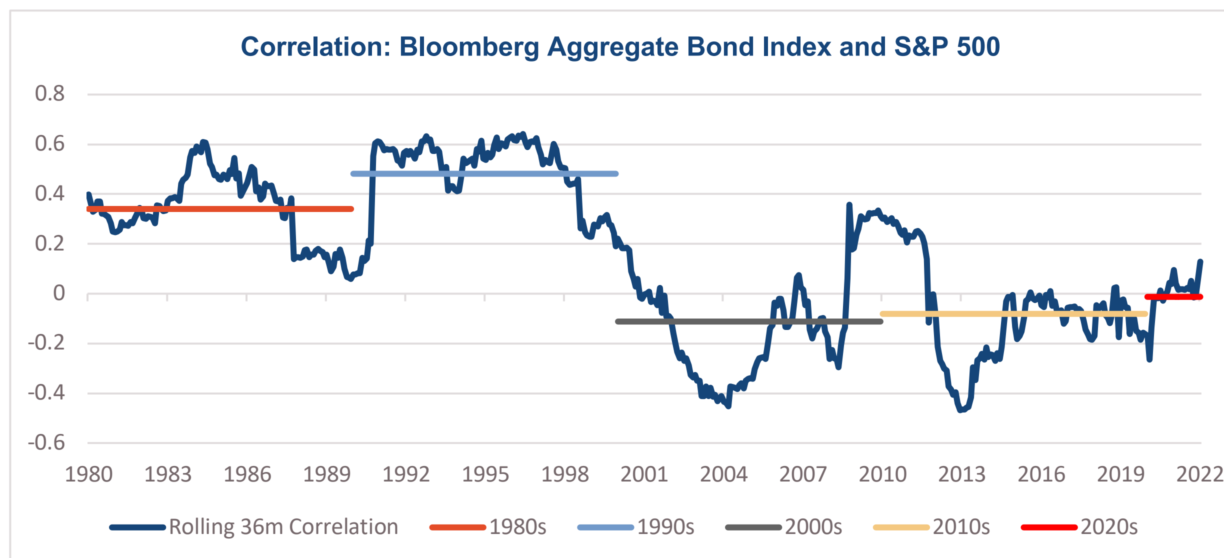
So how does an investor maintain income while shielding their portfolio from the negative effects of higher inflation? At AFA, we believe that private credit strategies, when implemented correctly, provide an attractive option for investors seeking to maintain purchasing power in an inflationary world. Here are three reasons for our assertion:

- **Short Duration**: Many private credit strategies such as bridge or asset-based loans are typically between six months and three years long, which makes them relatively insensitive to interest rate moves. Should yields rise, the strategy can quickly reinvest any proceeds into a new higher-yielding instrument.
- **Floating Rate**: Many private credit strategies are also floating rate: their interest rate adjusts with rates at the front end of the yield curve. Consequently, Fed rate hikes can quickly translate into yield increases on many of these private credit holdings without enduring mark-to-market losses.
- **Improved Credit Profile**: Since private credit strategies are often secured by real assets, their credit profile typically improves with inflation because the value of the loan collateral often increases. Consider the example of a bridge loan strategy that finances an apartment building over an 18-month period. Inflation will likely increase the absolute value of that

apartment building over time, which in turn reduces the credit risk to the lender because a more valuable asset now backs the loan.

Duration May No Longer Hedge Stocks

Given the view that higher inflation may threaten traditional fixed income, can an investment-grade bond portfolio still act as a hedge to a stock portfolio? We do not think that is necessarily the case. While markets in the 1980s and 1990s experienced high but ultimately falling inflation, the 2000s and 2010s experienced tame inflation that ran below 2% for 72% of the months. With the scars of high inflation healed and the wounds largely forgotten, markets have no longer viewed inflation as a risk to asset prices. This dynamic has meant that the relationship between bonds and stocks, which was firmly positive in the 1980s and 1990s, turned notably negative in the new millennium.



Source: Bloomberg, AFA Calculations
Correlations calculated utilizing monthly returns and a 36-month lookback window

Over the last few decades, when stocks have rallied, bonds have generally struggled, with the opposite occurring during stock selloffs when investors flock to high-quality bonds. In these scenarios, rates were largely a proxy for the risk environment in the absence of inflation risk.

Today, we are concerned that that this relationship may once again invert, with stocks and bonds moving in the same direction and markets viewing inflation as a serious risk to the economy. Bonds may sell off due to continually hot inflation, and equities—especially those most sensitive to a lower-for-longer Fed path—may follow suit. Therefore, we believe it's prudent for investors to re-evaluate fixed income portfolios to prepare for a scenario where stocks and bonds move in tandem, instead of hedging against one another.

Closing Thoughts

At AFA, we are confident that a private credit strategy is well positioned to provide attractive returns in an inflationary environment. We believe returns will outpace inflation due to the short duration and floating rate of the cash flows, along with the improved credit profiles as asset values inflate. Further, multi-asset portfolios may benefit from the inclusion of private credit as stock-bond correlations increase in an inflationary environment.

DISCLOSURES AND INDEX DEFINTIONS

Past performance does not guarantee future results. Index performance is not indicative of fund performance. To obtain fund performance click here.

Investors should carefully consider the Fund's investment objectives, risks, charges, and expenses before investing. This information is included in the Fund Prospectus and a copy may be obtained by calling 800-452-6804 or by contacting us here. Read the prospectus carefully before you invest.

Investments in debt securities typically decrease when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower rated and non-rated securities present a great risk of loss to principal and interest than higher rated securities.

An investment in the Fund involves a high degree of risk. An investment in the Fund should be viewed only as part of an overall investment program and you should invest only if you can sustain a complete loss of your principal. Please read the prospectus carefully. An investment in the Fund is subject to, among others, the following risks:

The Fund is not intended as a complete investment program but rather the Fund is designed to help investors diversify into private credit investments.

The Fund is a "nondiversified" management investment company registered under the Investment Company Act of 1940. Since the Fund is non-diversified, it is subject to higher reduction of capital and volatility than a fund more proportionately allocated among a large number of securities.

An investment in the Fund involves risk. The Fund is new with no significant operating history by which to evaluate its potential performance. There can be no assurance that the Fund's strategy will be successful.

The Fund may use leverage its investments by "borrowing." The use of leverage increases both risk of loss and profit potential. The Fund is subject to large shareholder transaction risks which may cause the Fund to sell portfolio securities at times when it would not otherwise do to so satisfy large shareholder redemptions.

Shares of the Fund are not listed on any securities exchange and it is not anticipated that a secondary market for shares will develop. Shares are appropriate only for those investors who can tolerate a high degree of risk, do not require a liquid investment.

There is no assurance that you will be able to tender your shares when or in the amount that you desire. Although the Fund will offer quarterly liquidity through a quarterly repurchase process, an investor may not be able to sell or otherwise liquidate all their shares tendered during a quarterly repurchase offer.

The Fund's investment in private credit companies is speculative and involves a high degree of risk, including the risk associated with leverage.

The Fund has an interval fund structure pursuant to which the Fund, subject to applicable law, conducts quarterly repurchase offers for no less than 5% of the Fund's Shares outstanding at NAV. While the quarterly repurchase offer is expected to be 5%, the amount of each quarterly repurchase offer may be 5% to 25% subject to approval of the Board of Trustees (the "Board" and each of the trustees on the Board, a "Trustee"). It is also possible that a repurchase offer may be oversubscribed, with the result that shareholders may only be able to have a portion of their Shares repurchased. There is no assurance that you will be able to tender your Shares when or in the amount that you desire.

Bloomberg US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. It includes Treasuries, government-related and corporate securities, MBS (mortgage backed securities: agency fixed-rate pass-throughs), ABS (asset-backed securities) and CMBS (commercial mortgage-backed securities: agency and non-agency). **Bloomberg US Corporate High Yield Bond Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. **The Bloomberg USD Emerging Market Composite Bond Index** is a rules-based, market-value-weighted index engineered to measure USD fixed-rate sovereign and corporate securities issued from emerging markets. **Cliffwater Direct Lending Index** seeks to measure the unlevered, gross of fee performance of U.S. middle market corporate loans, as represented by the asset-weighted performance of the underlying assets of Business Development Companies (BDCs), including both exchange-traded and unlisted BDCs, subject to certain eligibility requirements.