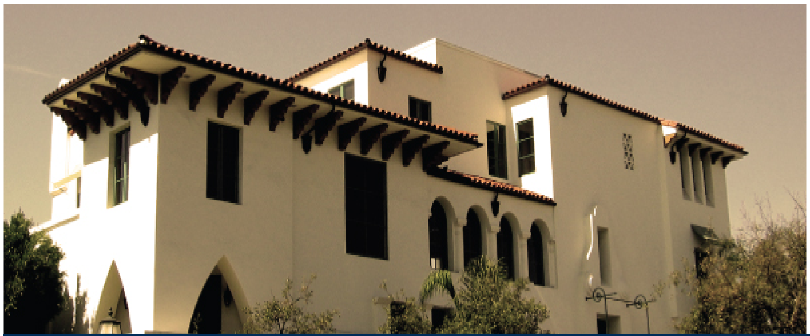


PERITUS

ASSET MANAGEMENT, LLC

Market Commentary

Independent Credit Research – Leveraged Finance – July 2012

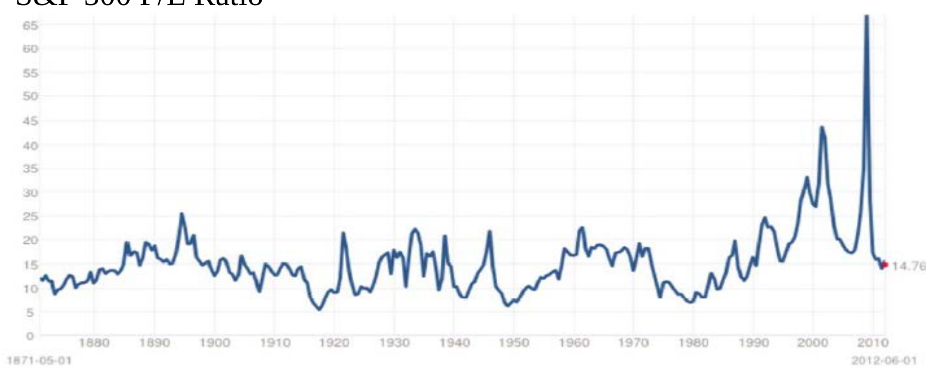
Understanding Alpha versus Beta in High Yield Bond Investing

Investors have come to recognize that there is a secular change occurring in financial markets. After the 2008 meltdown, we have watched equities stage an impressive rally off the bottom, only to peter out. There is no conviction and valuations are once again stretched given the lack of growth as the world economy remains on shaky ground. In another one of our writings ("High Yield Bonds versus Equities"), we discussed our belief that U.S. businesses would plod along, but valuations would continue their march toward the lower end of their historical range. So far, this looks like the correct call. Europe still hasn't been fixed, the China miracle is slowing and, perhaps, the commodity supercycle is also in the later innings.

The amount of debt assumed by the developed world is unsustainable so deleveraging began a few years ago. These are not short or pleasant cycles and both governments and individuals will be grumpy participants in this event. It simply means that economic growth will be subdued for years to come. I have never really been able to understand economic growth rates that are significantly ahead of the population growth anyway…oh yeah, the productivity miracle.

I have written chapter and verse on the history of financial markets and where returns have come from: yield. Anyone with access to the internet can verify that dividends, dividend growth and dividend re-investment are what have driven stock returns over the decades. Unfortunately, the one-time event of expanding P/E multiples over the last twenty years convinced a generation that equity investing was all about "growth" or stock prices going up, and we lost sight of yield.

S&P 500 P/E Ratio[1]



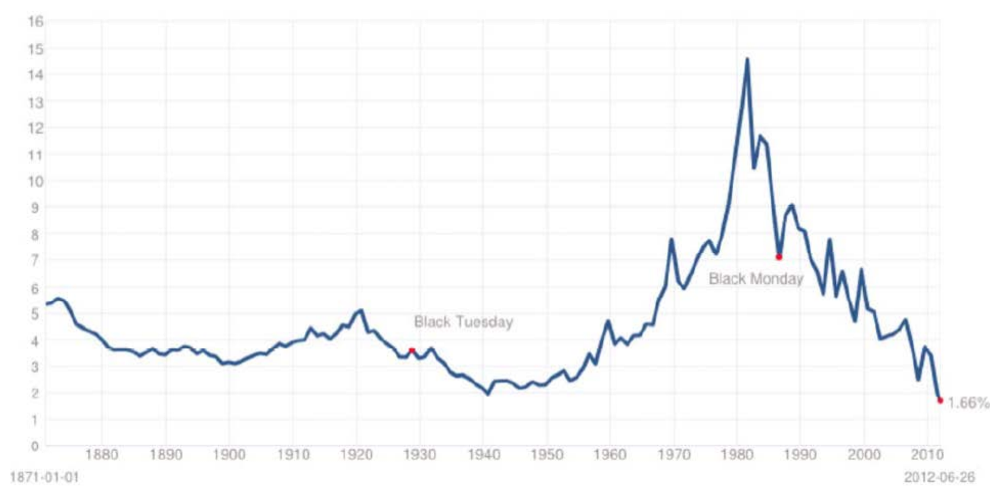
[1] http://www.multpl.com/s-p-500-dividend-yield/.

In the early part of the prior century, yield, paid out via dividends, was indeed the focus in equity investing. Yet it began to change in the 1960's, when management teams convinced investors that the companies should retain all the earnings so that they could re-invest in their business and grow them rather than pay out these earnings in the form of dividends. The argument was it was more "tax efficient" and would be good for investors. What is wrong with paying out the earnings and subjecting capital decisions to the discipline of the market? If you want to expand or make an intelligent acquisition, there will always be capital available. And couldn't investors re-invest those dividends if they chose to?

While all of these issues are important, there is another elephant in the room: demographics. After being led down the garden path for the last 25 years with those wonderful Ibbotson charts (stocks always go up in the long run!), investors are now significantly older and wiser, but unfortunately none the richer. The institutional investment landscape, which consists of the large defined benefit plans, both corporate and government, is in liquidation. These pension schemes became too expensive and many have either frozen these benefits in place (no new participants) or are staring at incredible funding gaps that will either be negotiated with the retirees (benefit cuts) or bailed out by the taxpayers. Importantly, participants have gotten older and are now retiring either with lump sum payouts or some type of annuity payout. These gigantic plans have been an important part of the continual and growing bid for equities for several decades. Yet, they are now on the offer side of the game, liquidating assets, never to be replaced. So the equity game is left to the traders and gamblers, creating volatility for its own sake, and who wants to play in that poker game unless you own the casino?

Unfortunately, there is another hard reality to deal with. The 30 year decline in interest rates is also coming to a bottom. Though I am not in the camp that yields necessarily have to rise dramatically from here, there is little room to fall a whole lot further.

10-Year Treasury Interest Rates[2]



[2] http://www.multpl.com/interest-rate/

This means that most fixed income investors will likely at best earn the coupon on their securities and nothing more. Ask yourself this question: Would you lend the U.S. Government your money at 1.6% for 10 years? I wouldn't and neither should you.

So investors are caught between a rock and a hard place. Pension plans have to eventually meet their expected returns or they will be ponying up more and more cash to shore up these plans. Most of these plans place their expected annual returns at around 8%. With 10-year Treasury bond yields around 1.6%, and the equity markets yielding around 2%, how is it they plan to deliver this? And what about individual investors? How do they generate some type of tangible return to pay their bills and keep ahead of the game?

Our answer is high yield bonds. We have spent a great deal of time over the years discussing the benefits of investing in both the high yield bond and leveraged loan markets. In our whitepaper, *The New Case for High Yield,* we lay out the case that the high yield asset class produces tangible cash flows and has half the risk of equities, yet has outperformed equities over long periods of time even without adjusting for risk.[3] Yet there remains a stigma associated with high yield or euphemistically, "junk bonds." Somehow, people believe they are "risky" compared with "high quality" stocks. We would encourage people to read the aforementioned paper to educate themselves and get the joke. Simply put, bondholders sit on top of equity (seniority in the capital structure) and get paid before equity holders, regardless of the rating.

It appears that some of this message is getting through to investors, as they have been pouring monies into the high yield asset class over the last two years. This discussion paper is meant for those who already have committed to the high yield market, though we hope it is helpful for the non-evangelized as well. It is specifically directed at the investors who have poured tens of billions of dollars into the asset class through high yield index-based exchange traded funds ("ETF's") and mutual funds, as we feel that is a hazardous strategy, especially in today's environment.

Dangerous "Beta" Strategies

I dislike jargon and buzzwords. Wall Street has an addiction to them, so I will do my best to speak plainly. The title of this paper uses the word "alpha" and "beta." The way I want to define them in high yield is that beta is simply the market return and alpha refers to the true value of active management—the return generated beyond the beta. What we have seen is a bunch of product/strategy launches that have beta masquerading as alpha. Surface knowledge in investing is a very dangerous thing. In high yield debt markets it can be deadly. Below we profile some of the most popular strategies that investors have been fed.

Indexing

Let's gets to the heart of the debate immediately. Indexing is at the core of the alpha/beta argument. It is easy to see why the popularity of this process has exploded, particularly in the ETF space. In our own whitepaper, *The New Case for High Yield*, the basic data on the asset class is compelling. What this has led to is an attempt to capture this appealing data with a one

[3] See footnote 7.

of everything approach. While this might be a very rewarding strategy in the periods immediately after the high yield market had blown up (1990, 2002, 2008), this presupposes one has a crystal ball on the timing of the market.

Ultimately, we do not view this asset class as a spread or beta trade, but rather an opportunity, when done correctly, to earn excellent yields regardless of the overall environment or market cycle. **It is active management, with its focus on credit selection, that allows the investor to lower risk and position the portfolio for any given market cycle. Trying to time the market is difficult at best and leaves the investor open to missing that valuable coupon income. Volatility is not the enemy in high yield, defaults are**.

In the case of indexing, credits and issuers are bought irrespective of their quality and future prospects. For instance, credits resulting from large leveraged buyouts (LBO's) remain a very significant part of the game. While we are actually favorably inclined to lend to LBO's when they are correctly structured, as we discuss further below, many of the massive legacy buyouts from 2006-2007 remain problem children from a credit perspective. We believe that many of these names will suffer some type of default or distressed exchange in the coming years. Yet they are a significant percentage of the indexes and must be purchased by these funds.

At the core, buying a bond is essentially making a loan. It would make sense that you would want to analyze what the company does, who is receiving the loan and if they have the means to pay it back. Didn't we learn our lessons from the mortgage disaster? Playing the odds by having a large, diversified bucket of subprime paper didn't work. It won't in high yield either.

"Cream of the Crap" Strategy

One of the most popular and confusing strategies in the high yield asset class involves the notion of "high quality" high yield. Specifically, this means sticking with credits rated no lower than BB. So while the world's regulators look to try and downplay or remove credit ratings from their regulations, somehow investors are going to be well served by focusing purely on ratings? If you assume similar credit metrics, would you rather lend money to a BB rated steel producer heading into a massive global slowdown or a single B rated domestic food producer? Ratings have a bias towards size and longevity, and have demonstrated on numerous occasions to be backward looking, while markets are forward looking. So the defacto strategy here is to outsource the credit analysis to the rating agencies. This has proven to be a failed strategy time and again.

A quick snapshot below gets to the point. The worst performing credits so far in June 2012 are listed in the chart provided by Morgan Stanley. We are not trying to data mine (picking out statistically irrelevant data to justify our thesis) but point out the pure insanity of basing an investment strategy on ratings. Looking at this list, there are as many poor performing credits among the BB rated names as the CCC rated names.[4]

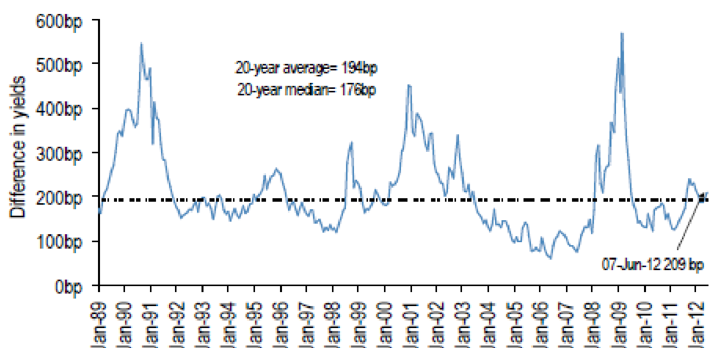
[4] Richmond, Adam and Jason Ng. "High Yield Credit Strategy Leveraged Finance Chartbook," Morgan Stanley, June, 12, 2012, p. 31.

Worst Performing Bonds

Rank	Ticker	Coupon	Maturity	Rating	6/11/2012	MTD Return	YTD Return
1	ALISCI	10.250	2/1/2015	Caa2 / CCC-	33.30	-20.4%	-12.9%
2	PCX	8.250	4/30/2018	B3 / B	43.34	-18.8%	-50.7%
3	ATPG	11.875	5/1/2015	Caa2 / CCC-	46.11	-12.7%	-23.3%
4	TXU	6.500	11/15/2024	Ca / CC	43.00	-9.9%	19.3%
5	KWK	7.125	4/1/2016	B3 / B-	81.50	-9.6%	-14.3%
6	CZR	10.000	12/15/2018	/ CCC	69.00	-7.6%	6.4%
7	MOMENT	11.500	12/1/2016	Caa2 / CCC	75.50	-7.1%	0.4%
8	JCP	7.625	3/1/2097	Ba1 / BB	76.90	-7.0%	-8.6%
9	AMGFIN	5.750	9/15/2016	B3 / CCC	74.88	-6.8%	7.6%
10	TCMCN	7.375	6/1/2018	Caa2 / B	79.50	-6.3%	-8.7%
11	GEN	7.875	6/15/2017	B3 / B	87.12	-5.7%	-8.5%
12	NAV	8.250	11/1/2021	B1 / BB-	98.75	-5.6%	-3.4%
13	VC	6.750	4/15/2019	B2 / B+	96.00	-5.3%	-0.8%
14	FCH	10.000	10/1/2014	B2 /	108.00	-5.2%	2.1%
15	CNC	5.750	6/1/2017	Ba2 / BB	97.75	-5.1%	-0.3%
16	MNI	5.750	9/1/2017	Caa2 / CCC	75.31	-5.0%	13.4%
17	LINTA	8.250	2/1/2030	B3 / BB	100.00	-4.7%	3.4%
18	ALUFP	6.450	3/15/2029	/ B	69.88	-4.7%	-2.7%
19	AEE	6.300	4/1/2020	Ba2 / BB-	78.55	-4.6%	-20.6%
20	BILOLF	9.250	2/15/2019	B3 / B-	107.06	-4.4%	8.1%
21	AHG	12.375	11/1/2014	B3 / BB-	94.73	-4.3%	6.2%
22	X	6.650	6/1/2037	B1 / BB	81.15	-4.2%	5.4%
23	USG	9.750	1/15/2018	Caa2 / B-	102.00	-4.1%	21.8%
24	HCA	7.500	11/6/2033	B3 / B-	94.75	-4.0%	6.0%
25	JRCC	7.875	4/1/2019	B2 / B	57.40	-3.9%	-20.8%

An additional problem for this strategy involves the starting yield. Because of the popularity of the BB game, historical yields on these names start some 200 basis points below single B names.[5]

Spread between bonds rated BB and B



One of the key variables in high yield investing involves the excess coupon or yield that an investor receives. The BB strategy appears to be something that has the worst of all worlds, with much lower beginning spreads/yields and the same credit and liquidity risk as the rest of the high yield market. It sounds good as a marketing strategy, but not as an investment strategy.

---

[5] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, Alisa Meyers, and Rahul Sharma. "Credit Strategy Weekly Update: High Yield and Leveraged Loan Research." J.P. Morgan, June 8, 2012, p. 30.

Sector Strategy

The next interesting concept is to break the high yield market into sectors. When I hear the word sector, I immediately think of industry groups. But sectors in this case do not reference industry groups or fundamentals, but typically involve ratings categories or maturities. I remain dumbfounded by the proliferation of high yield "sector" ETF funds launched within the last year. An example is this recent announcement.[6]

> The new funds are the BulletShares High-Yield ETFs with target maturities of 2016, 2017, and 2018, according to the firm. The three funds trade on the NYSE Arca under the respective tickers BSJG, BSJH, and BSJI. These fixed-income defined-maturity funds can be used to ladder exposure to the asset class, according to the firm.
>
> The BulletShares ETFs track indices of approximately 56-200 high-yield corporate bonds with effective maturities in the same calendar year as each fund's maturity, with maturity dates ranging from 2012-2018 at this time. Indeed, the 2012-2015 target date funds were already in market, having started on Jan. 25, 2011. Tickers are BSJC, BSJD, BSJE, and BSJF, respectively.

So these are term trusts where bonds are separated into portfolios by maturity. I have no particular knowledge of these calendar years but it does seem to me that there is an awful lot of legacy leveraged buyout paper maturing during this timeframe. As mentioned above, we believe that many of these highly levered credits have dramatically increased default risk. Despite that, this just seems like a very strange way to invest in the high yield asset class. Laddering portfolios in the Treasury market, where you are dealing with a single issuer, I get, but in high yield? It just doesn't make sense.

Risk-On, Risk-Off

This is another one of my favorite misnomers. High yield is considered a "risky" asset. Well I'll bet the efficient markets folks can describe what that means, but I'm personally not sure. If we have an asset that produces significantly higher returns than equities, and does so with half the risk[7], wouldn't this be considered a much less risky asset?

Average Annual Returns	1 Year	3 Year	5 Year	10 Year	15 Year
S&P 500	5.42%	16.38%	0.21%	5.33%	4.77%
Credit Suisse High Yield Index	7.30%	15.99%	7.73%	9.76%	7.15%

Average Annual Volatility	1 Year	3 Year	5 Year	10 Year	15 Year
S&P 500	18.16%	16.10%	19.20%	15.84%	16.52%
Credit Suisse High Yield Index	9.09%	7.64%	13.07%	9.87%	9.17%

[6] Fuller, Matt, "…Investments launches 3 new BulletShares HY ETFs," Standard and Poor's Leveraged Commentary & Data, https://www.lcdcomps.com/lcd/index.html, April 25, 2012.

[7] Credit Suisse High Yield Index data sourced from Credit Suisse. S&P 500 index data sourced from Bloomberg, using a total return including dividend reinvestment. Average Annual Return calculations are based on monthly returns. Average Annual Volatility is measured by the index standard deviation, calculated by annualizing monthly returns. All data for the period ending 6/30/12.

But be that as it may, what makes no sense is that people are trading the high yield ETF's weekly or monthly. Isn't the attraction of the asset class a significantly higher yield/coupon than other investment alternatives? This strategy involves trading in and out of a high yield fund based on an ability to time the "risk" trade. In essence, high yield is an all or nothing trade. Its attractiveness just varies based on the short-term risk measures. This type of philosophy suggests there is no way to separate your performance from the market, which is true with indexing, but certainly not with active management.

<u>Fallen Angels</u>

While definitely an odd sounding strategy, the definition of a "fallen angel" is a bond/loan that was originally rated investment grade (BBB- or higher from S&P and Baa3 and higher from Moody's) and now has been downgraded to a ratings category considered high yield, or "junk." When I started in the business in 1984 almost the entire high yield market consisted of fallen angels. The original issue high yield game was just getting going. Today, this concept is to buy these downgraded names on the notion of them once again getting back to investment grade status. To us, this remains a dubious strategy. Markets are anticipating machines. This is where the whole notion of buy the rumor, sell the news comes from. So the idea of a bond moving higher after even after an upgrade is questionable. Upgrades are rare events and can take a long time in coming and it has also been our experience that achieving an investment grade status is often not a priority of management teams.

But there is one enormous flaw in this ointment of buying fallen angels that should be understood. **<u>Bonds that were originally issued with an investment grade rating tend to have terrible covenant protection!</u>** Most importantly, these credits lack a change of control covenant. So that means private equity can simply come in, layer on debt ahead of you and destroy your rating and price. There is no better example of this than the proposed leveraged buyout of Bell Canada a number of years ago[8]:

Bell Canada Bondholders May Sue Over Buyout

> Bondholders of Bell Canada Inc. are preparing a lawsuit against the company's parent BCE Inc. in connection with last month's agreement for Canada's largest telecommunications company to be acquired by a consortium led by the Ontario Teachers' Pension Plan in a leveraged buyout, press reports said. "While equity shareholders appear pleased with the $42.75-a-share price tag, the bondholders have suffered since rumors of a potential takeover first surfaced in late March, with the benchmark 6.1%-coupon 2035 bond down about 23%," Canada's National Post newspaper reported. The deal was valued at C$51.7 billion, including debt. *<u>Bondholders of leveraged-buyout targets have seen investment-grade bonds descend to junk grade amid market fears of the huge debt private-equity firms use to finance their buyouts; shareholders usually receive large premiums.</u>* The lawsuit, some speculate, could be the first of many to come: "This sort of thing may become more common," said BMO Nesbitt Burns analyst Michael Gregory. Toronto-Dominion Bank said Tuesday it would put up C$3.8 billion, including C$500 million of equity, to finance the deal in exchange for a 7% stake in BCE.

[8] Lerner, Susan. "Bell Canada Bondholders Sue Over Buyout," Seeking Alpha, July 18, 2007. Emphasis added.

Most of these large fallen angels end up in the high yield indexes by virtue of their downgrades. What this means is that passive funds that track such an index must purchase these bonds irrespective of their credit metrics. A very recent example is helpful. Nokia (the once tech darling from Finland) has fallen upon very hard times.[9] Their bonds have been cut to BB+ by S&P and have entered high yield territory. Interestingly, Moody's still has them as investment grade (Baa3). What does Mr. Market think? Well the bonds are priced in the mid $70's, indicating substantial distress, so those ratings don't appear to be much help.

STANDARD &POOR'S Leveraged Commentary & Data

Nokia bonds fall as company revises outlook, outlines cost cuts

Nokia 5.375% notes due 2019 are quoted at 76.5/77.5 this morning, down from trades in the low 80s earlier in the week, according to market sources and trade data. Longer dated 6.625% notes due 2039 changed hands at 76 and 78, down from trades in the 80-82 range. Shares of Nokia were off roughly 17% by late this morning, at $2.32.

The company issued an early warning about second-quarter results, noting that "competitive industry dynamics are negatively affecting the Smart Devices business unit to a somewhat greater extent than previously expected." Operating margin for non-IFRS Devices & Services is now expected to be below the first quarter level of negative 3%, whereas previous guidance had it at similar to below that level. Management expects such competitive dynamics to have a negative impact in the third quarter as well.

A recent fallen angel, Nokia bonds are rated BB+/Baa3/BB+. S&P and Fitch in April lowered the ratings on the credit and the unsecured bonds from BBB-. S&P left the outlook as negative to reflect potential for another downgrade if Nokia fails to stabilize revenue and margins and

Let's get this straight. According to this report, their operating margin is **NEGATIVE 3%!** Here we have a business that is hemorrhaging, operates in a brutally competitive world with Apple, Android and Blackberry and yet they remain highly rated? The fallen angel and cream of the crap buyer here in BB-land shouldn't get too comfortable.

Real Risk, Real Alpha

None of these concepts make any sense to us. Investing in the high yield bond and leveraged loan markets is all about capturing significant yield. Buying a bond or loan means that you are lending money to a company. So to a lender, the risk is not getting paid back. None of the

[9] Hemingway, Jon. "Nokia bonds fall as company revises outlook, outlines cost cuts." Standard and Poor's Leveraged Commentary & Data, https://www.lcdcomps.com/lcd/index.html, June 14, 2012.

aforementioned "strategies" deals with the real risk: that of default. It seems that it would be very prudent to focus your time on assessing the credit fundamentals to avoid defaults and to maximize return versus risk, and then letting the coupons do their magic of providing tangible income.

Beyond Coupons

Fortunately, there is much more to the story than just clipping coupons. Bonds tend to be confusing to many investors. What many people don't realize is that bonds trade like equities and have some price volatility (though much less comparatively). So value investors in bond-land get an opportunity to purchase bonds at a discount to par ($100) on a regular basis. Why? It is for the same reasons that stocks move up and down: there are more sellers than buyers. This can occur due to a market correction, a specific issue with a company or someone just looking to exit a position.

Let's take a look at a recent announcement (EnergySolutions from June 11th)[10] that profiled this type of opportunity.

STANDARD &POOR'S **Leveraged Commentary & Data**

EnergySolutions debt slides, shares plunge after co. cuts guidance

The company's 10.75% notes due 2018 changed hands five points lower, at 96-96.25, trade data show. Market-making is sparse, but one quote relayed by a source is at 96/98. The $300 million issue of BB-/Caa1 senior notes date to August 2010 issuance via J.P. Morgan, Credit Suisse, and Citi, and were quoted at 101.25/102.25 going out last week, sources note.

EnergySolutions reduced their earnings guidance and caught the market off guard. These bonds have fallen even lower (to around $85), which is a far cry from the $102 area a week prior. While we have no position in this name, we will certainly be doing further work to determine if there is value in EnergySolutions at current prices.

What is important for investors to understand about value investing in bonds versus stocks is that we have a natural exit strategy in that we have a maturity date with a price of par ($100). Value investing in the equity business means that you can own a cheap stock and it can stay cheap forever. Most importantly, the analysis on bonds is entirely different than stocks. Why? Our returns don't depend upon beating expectations or earnings growth or great stories or any of that nonsense. What we care about is the company's ability to pay its bills, including our interest payment, until that maturity date, or an earlier refinancing or call. So our analysis centers on our core philosophy: **CREDIT IS EITHER AAA OR D!** What we mean by this is that if we believe that the company can pay all its bills for the foreseeable future, then it is an AAA credit to us. If we believe it cannot, we put it in the "D" camp, which means we feel it has a high likelihood of default and we will choose not to invest in it.

[10] Fuller, Matt and Kerry Kantin, "EnergySolutions debt slides, shares plunge after co. cuts guidance," Standard and Poor's Leveraged Commentary & Data, https://www.lcdcomps.com/lcd/index.html, June 11, 2012.

Credit Analysis

At the heart of determining what is AAA versus D is undertaking fundamental credit and valuation analysis, and it is this credit analysis that is the crux of being an active bond investor. The point of this paper is not to get into specifics on the credit evaluation process, but rather provide investors a framework for why active management is essential in high yield investing. With that said, credit analysis is a negative art. What we are looking to determine is that under stressed circumstances, the business will be in a position to pay its bills. Stress testing involves modeling for reduced revenues and/or increased costs and, most importantly, testing the company's ability to generate cash under all of these scenarios. Cash flow from operating activities minus capital expenditures is our definition of free cash flow. If a company generates free cash flow, it indicates there is business (equity) value below us. This means there is a margin of safety.

Historical financial analysis has its limitations. When we buy a bond or a loan, we are investing for the future. The numbers tell us what happened in the past. What our work is all about is determining what the future looks like. There are really three possible outcomes.

1. The future and the past look to be similar.
2. The future looks much worse than the past.
3. The future looks much better than the past.

Once we have determined what we believe the future of the business looks like, we then need to compare this with the price of the security. The separation of the business from the security's price/yield is something investors often fail to do. It's not that difficult to purchase the stock and/or bonds of great businesses, but this tends to be a losing strategy for investors as market valuations are fully or overly reflective of these great fundamentals. Financial markets are counter-intuitive. Value investors such as Peritus believe that money is made through a contrarian philosophy. This really can be translated as buying securities that have low expectations or are misunderstood for some reason. The goal being that the surprises come in the form of upside, not downside. Said another way, there are very few bad bonds but plenty of bad prices, and to be successful you must determine what is the right price/value.

In addition to thorough credit work and assessing the future, we employ some additional subtle thinking to generate alpha. Two areas of where this is evident is in analyzing LBO's and insider equity purchases.

Private Equity Can Make for a Great Footstool

Investing in the bonds or loans of private equity-sponsored leveraged buyouts is a very interesting opportunity in both the leveraged loan and high yield bond markets. This is not meant to be a blanket statement. In fact, we have been extremely vocal about our disdain for many of the incredibly over-leveraged deals that were done in 2006 and 2007, at the height of the last LBO mania. As discussed earlier, to us, many of these companies remain the living dead. We feel that there is a "D" in their future either through some type of out of court exchange or a more formal Chapter 11.

With that said, there are also tremendous advantages to debt holders in LBO deals that are financed correctly. You have a single (or small group) of control shareholders who are very focused on the success of these transactions. When changes are necessary they can happen quickly. But the most important issue here involves the game itself. Equity commitments in these deals are typically 25-30% of the purchase price, a far cry from the good old days back in 2005-2007 when 10-15% was the norm. So today, their ability to extract their investment through dividend recapitalizations or other shenanigans is difficult. This means they are in essence a prisoner of the deal. The only exit strategy is the sale of the business or perhaps an IPO, which are of course credit positive events from our perspective (they trigger a change of control, call or clawback). Private equity players are in the business of making money, so are highly motivated to hit one of these exit strategies.

Insider Equity Purchases

On the opposite end of the ledger to the buyout game, most of the high yield market today consists of bonds of publicly traded companies. This is a dramatic change from 25 years ago when the market consisted mainly of smaller private placement securities. What today's public market allows us to do is to track a great deal of real time information. One of the things we pay close attention to in our out of favor strategies is insider buying of their stock. Given that management teams are generally well incented through stock options, actual buying of shares tends to strengthen our case that this situation is worth doing some work on or potentially buying. However, it is only one check mark on the due diligence roster and by itself is not enough.

Summary and Conclusion

Though it is apparent we have a dog in this fight, we cannot help but feel the golden age of high yield investing is before us. It is our opinion that there is today a unique and temporary point of entry into the market to capture incredible yields. Absent a global meltdown, which we do not foresee, we expect that the current yields available will ultimately compress as demand continues unabated from every angle. A decade of terrible equity performance coupled with demographic/secular changes will continue to drive investors toward yield based investing. While dividend investing certainly has its place, dividends are optional, not contractual, payments and remain the first loss for investors. Additionally, if valuations continue to compress, stock prices will likely fall regardless of their yields.

High yield bonds produce the tangible yield investors need and desire and have become virtually the only place to turn to for yield in this prolonged low-rate environment. However, we believe the true opportunity for investors is the alpha available via active management. On top of the yield, there is the potential for capital gains, and active management, with its extensive credit analysis, is able to identify which are opportunities versus sucker's bets. And while it is apparent that the high yield asset class has begun to receive some respect, unfortunately, investors of all stripes from advisors to institutions to individual investors are not dealing with the core issue of the asset class: the risk of default. Playing the statistics of the high yield market through beta or indexing, or embracing some of the "strategies" based on ratings or maturity, we expect will ultimately be a loser's approach to the space. With the credit selection process, active management allows the investor to manage that default risk and make the trade a permanent one.

Cycles continue to exist and active management is required in high yield investing because saying no in the credit process is enormously important.