



PERITUS

ASSET MANAGEMENT, LLC

Market Commentary

Independent Credit Research – Leveraged Finance – August 2011

INSTANT PUDDING

Financial market activity over the past few weeks has been the craziest since 2008; we've seen the U.S. debt ceiling/default scenario, massive declines and subsequent rises in the equity markets, and an S&P downgrade of the U.S. Government bond market. So are we going back into another 2008 style meltdown? Are we once again on the ledge and heading into a depression? What gives? Our conclusions are as follows:

- *The downgrade of the U.S. bond market by S&P is a day late and a dollar short. It is absolutely meaningless. Perhaps some good will come of it politically. But at the end of the day, the U.S. bond market remains the only one large and liquid enough to accommodate the risk-off trade. Whether one calls this the flight to liquidity versus the flight to quality is irrelevant. But whether one believes that the U.S. economy has serious issues or not, it still remains the most robust and creative in the world. A quick check of the world's greatest companies provides some evidence.*
- *The Eurozone is in much deeper trouble than the U.S. economy. They have few world class businesses and limited room to maneuver.*
- *Behavior of equity markets are a result of unrealistic expectations for growth, not a repeat of 2008. In 2008, interbank lending markets froze up and short term rates spiked. There was no liquidity available for banks outside of the Government windows. This is not the case today, as the banking sector is well along in the healing process. Equity issuance and massive spread arbitrage has added significantly to banks' tangible equity and the ability to get rid of bad assets.*
- *The QE 1 and QE 2 stimulus packages did little to change the long term structural issues that will remain headwinds for the global economy. Deleveraging takes a long time. All we have done is push the debt from the private sector to the public sector. But it has not been fixed—there is no instant fix here, but will require time to heal.*
- *U.S. Treasuries are forecasting slow to no growth. This is great news for debt investors but anathema to equity players. In a no growth environment, management focuses on the balance sheet, not the income statement.*
- *The U.S. corporate credit sector remains a port in the storm. We have always believed it was easier to analyze businesses than countries. Management teams did not expand their businesses haphazardly and did not drink the Kool-Aid of a high growth environment. This is why we have had a jobless recovery. Most high yield issuers have already refinanced their debt and corporations sit on record amounts of cash.*
- *Risk and reward in the high yield market are at what we see as unprecedentedly attractive levels. Spread levels in our model portfolio are over 900 basis points above 5*

year Treasuries.¹ This is close to double long term median levels² yet we believe risk (as measured by default) will remain very subdued over the next 2-3 years.

Debt Ceiling/Default

After a game of chicken, the debt ceiling has been raised. The rally off of this news was short lived. Actually it was measured in hours, not even days. That is because there is some rationality setting in. The notion of allowing more unsustainable debt on top of what already exists is no longer getting people excited. Hopefully this leads to substantive discussions on real debt reduction and the notion that the entitlement programs are all going to be restructured. Medicare, Social Security and public pension benefits are the big three in our minds. All are unsustainable and all are very substantive issues. If you want to throw in defense spending I'm okay with that too. The good news is that we actually have levers we can pull to fix things.

How about the downgrade by S&P in the midst of this? Is it meaningful or meaningless? As usual with these guys, a day late and dollar short. If it was meaningful, this downgrade, combined with narrowly missing a default, should have caused the 5 year Treasury to yield about 7% instead of falling to under 1.0%. If people really believe that the U.S. was in jeopardy, investors would be fleeing the U.S. bond and currency market in droves. We have been writing about the behavior of the intermediate Treasury market for the past couple of months, as it had been an early signal of economic weakness. It has been a very accurate indicator, telling us growth projections were insane.

The behavior of the Treasury market is critically important for the future. The reality is that this market has been the beneficiary of the flight out of risk assets. Historically we have called this a "flight to quality" trade but I think it is more accurate to call this a "flight to liquidity" trade. If investors truly feared that the U.S. will default then they would not be plowing money into this market. The reality is that when you look around the world, there is no safe haven currency large enough to absorb these types of money flows. So while Switzerland and, to a lesser extent, Japan, Canada and Australia have benefited in recent times, they are just not big enough to handle significant flows. This will continue to evolve and will be a topic of discussion for us in the near future.

What is interesting to note have been the comments on how the rating agency made a big "mistake" in some of their analysis and conclusions. Are you kidding? First Enron and Worldcom in the early 2000's then the AAA ratings on structured credit leading to the 2008 meltdown, and this is news to people? With printing presses at the ready, the U.S. will never need to "default," we just print more money. Presumably one could argue that is another way to default: just keep printing until effectively the money is worthless. But we are far from that right now. And a final point about the notion of devaluing one's currency to remain "competitive" in export markets: history has **never** taught that a collapsing currency leads to a healthy economy.

¹ The portfolio referenced is the spread to worst (portfolio weighted average yield to worst minus 5 year Treasury rates) for Peritus' model portfolio (approved list of investments) as of August 19, 2011. The model portfolio does not represent actual trading. Depending on the timing, market conditions, use of leverage, portfolio size, and other factors, the actual portfolio could be materially different. Prices and other statistics are subject to change.

² 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 North American High Yield and Leveraged Loan Research. August 12, 2011, p. 30. 20 year median is 517 bps.

With the consensus being the U.S. dollar will continue to plunge, the contrarian in us cannot help but feel a bottom is currently being reached.

The Eurozone versus The U.S.

With that said, we believe that the U.S. economy is on firm footing compared with the European Union. The game today is that the ECB (European Central Bank) will continue to buy bonds from Spain and Italy to try and keep those rates down and the whole European Union glued together. And of course the “restructuring” in Greece has proved successful hasn’t it? What you have to love about America is that all of the dirty laundry is aired before the world. Whether you like it or not, disclosure is pretty wide open.

The same cannot be said for the Europeans. This whole thing smells like a house of cards and remember there are very few great or dynamic companies coming out of the European countries. If we take a quick inventory of the world’s best companies in various industries, what names come to mind? Technology: Apple, Google, eBay, Microsoft, Facebook, Amazon, Intel, Cisco. Consumer Products: Procter and Gamble, Coca Cola, Johnson & Johnson, McDonalds. Pharmaceuticals: Bristol Myers, Merck, Pfizer. This exercise can go on for all industries. Let’s butcher a little Mark Twain here, “The death of the U.S. economy has been greatly exaggerated.” The more I survey the globe the more comfortable I’m getting with the domestic economy even with all its problems.

One final question for everyone: would you rather own France “AAA” Government bonds or U.S. “AA” Treasury bonds? Seems like the current weakness in global equity markets have much more to do with the crumbling Eurozone than the downgrade of the U.S. debt markets.

The Equity Markets

Turning to stock markets around the globe, why did they go into such a tailspin after the debt ceiling was raised and what are they foretelling? We think the only thing the equity markets are telling us is that the expectations that people had were ridiculous. Magically, with a little QE 1 and QE 2 we were going to be completely healed. All fixed, instant pudding.

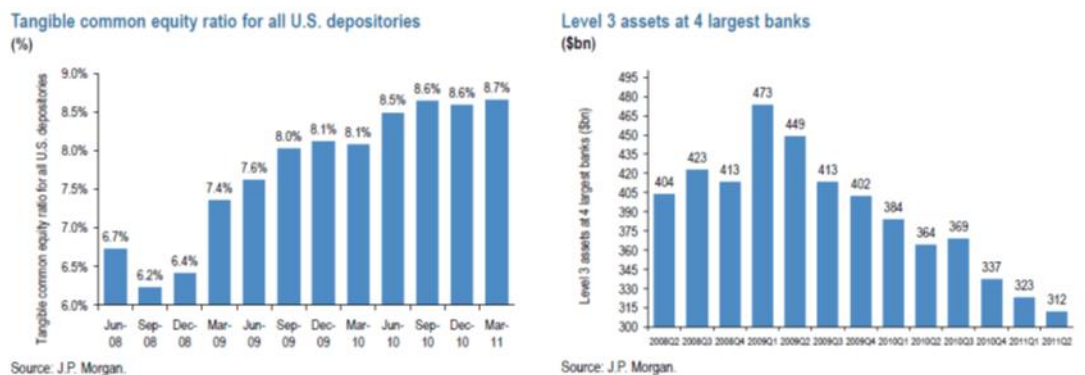
Let’s take a little trip down memory lane. At the end of 2008, the world had stopped. Companies in all industries ceased orders for everything. That worked for about 3-4 months, but as inventories were depleted and shelves were getting bare, it was time to start rebuilding. So as always, this restocking was extrapolated by the sunshine boys (equity players) to believe boom times were once again on their way. Comparisons were looking very good and profit margins were starting to expand.

But in reality, what we have done is generate substantial profitability through cost cutting and “productivity” (everyone works harder for less money). Now this is not a bad thing at all (particularly for lenders such as ourselves), but don’t confuse this with robust economic growth. There remain too many structural problems for growth to occur. But the stock market is both a beauty contest and popularity contest. And with low interest rates, the chase for returns continues. So don’t get too hung up on these moves. We watched the Quotron (no Bloombergs then) in 1987 as the Dow fell over 500 points but off a base of only around 2240, for a loss of almost 22% in one day! But then as now, it was much more of a stock market event versus an

economic one. Nothing that has come out over the past couple of weeks changes anything. Price expectations were simply out of whack and are being adjusted.

Why This Isn't 2008

So now the environment is loaded with people who think absolutely nothing changed and we are back in a “double dip” recession. We're not even sure what a “double dip” means, sounds like some type of ice cream cone. But let's go backward to go forward. The key to investment success is agnosticism: look for the truth, not for what you want to be true. Did anything really change over the last 2.5 years? Yes it did. The U.S. banking system (and many foreign banks as well) has had a chance to rebuild significant equity, as pictured below³, through share issuance and a massive arbitrage.



If you go back to 2008, the entire financial system was in danger of collapsing. Sources of liquidity for banks (interbank lending and LIBOR rates) froze up and ultimately went away. Though we have written extensively on the subject, the root cause of this was the massive leveraging of AAA credits that turned out to be D. This was caused by Basel II which gave banks tremendous incentive to buy AAA rated assets. So Wall Street created them through securitization. Now securitization isn't bad in itself as mortgages, credit card and auto receivables have been chopped up and sold for decades. But what we did was chop up garbage and pretend it was gold. Think sub-prime mortgages. And the agencies played along as big fees were involved. Nowhere did anyone model defaults for AAA assets, yet they did in fact default. So with the massive leverage against these loans, equity cushions for the banks were wiped out.

Many banks that were on the ropes three years ago have been borrowing at effectively nothing and lending back to the Treasury (buying bonds), capturing huge profits. This in turn allows them to offload lots of bad assets (known as Level 3 assets in the trade) at fire-sale prices and begin a true cleansing process. We are seeing this in California, as many bank-owned residential properties are being sold. Now this hasn't completely run its course, but is well down the path, as we have seen substantive balance sheet improvements over the last couple years.

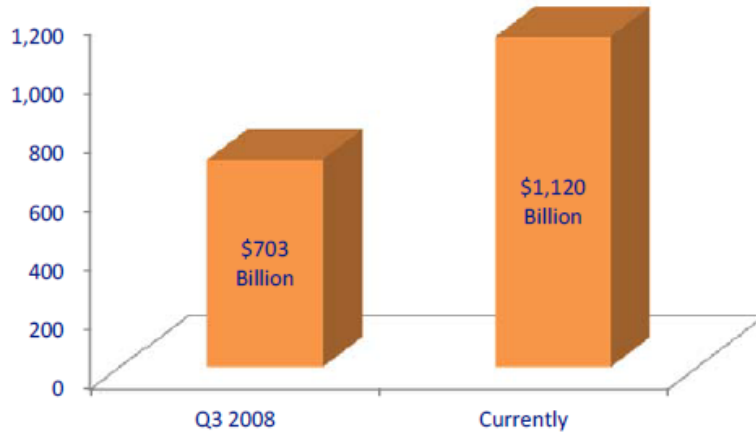
Corporate Credit—Port in the Storm

It is not just the banking balance sheets that have made progress, but those of corporations as well. We have always believed that the analysis involved in making a loan to a company was

³ 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 North American High Yield and Leveraged Loan Research. August 12, 2011, p. 8.

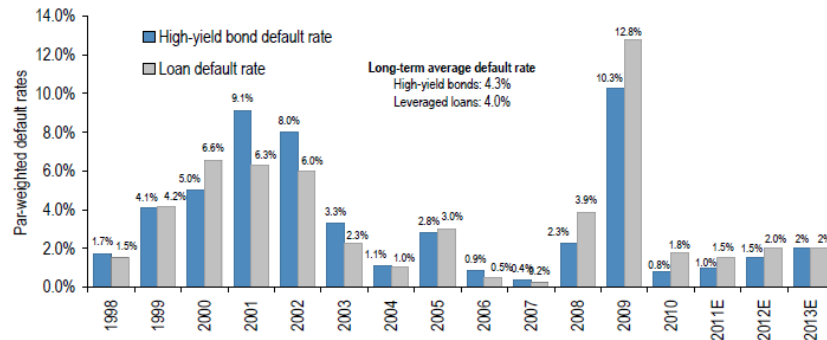
easier than making one to a Government, including municipalities. We are starting to have company, as we have heard that corporate credit is starting to be viewed as a safer haven than government bonds. There is good reason for this thought. Corporate balance sheets have rarely, if ever, looked this good, which by itself tells you that management teams are cautious and final demand tepid. These balance sheets have record amounts of cash, far better than levels seen in 2008, providing them the flexibility to weather the current storm.

Nonfinancial companies in the Standard & Poor's 500-stock index holdings of cash and short-term investments⁴



Additionally, the debt markets, including our high yield corporate bond market, have been on full throttle for the last two years. That means anyone that has needed to refinance and could, has done so. Maturities left that need to be refinanced in the next few years are minimal and companies have plenty of liquidity. Management teams in most industries have not expanded or drank the Kool-Aid of growth. That is why we are in a jobless recovery. So while the air is coming out of the balloon on expectations for growth, corporate fundamentals remain superb. This means that defaults (our main risk factor in high yield investing) will likely continue to be subdued for the next few years regardless of economic growth.⁵

High-yield and loan default rates to remain low for the next 3 years



Source: J.P. Morgan.

⁴ Data sourced from "In Carnage, Cash Comforts."

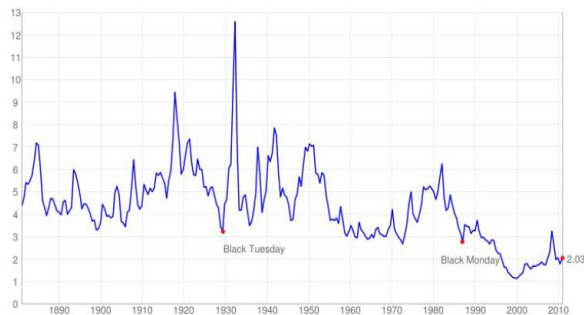
⁵ Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, Alisa Meyers, and Rahul Sharma. "Credit Strategy Weekly Update: High Yield and Leveraged Loan Research." J.P. Morgan North American High Yield and Leveraged Loan Research. August 5, 2011, p. 10.

One final point on defaults. During 2008, all businesses were stress tested beyond anything that we have ever seen before. Sales fell by 40-50% over several quarters for many companies. Businesses that made it through that gauntlet have demonstrated the ability to be able to maneuver through just about any economic environment. Fortunately, memories of those days have not completely faded away and management teams are running their companies more conservatively.

Out of Equities into High Yield

While this low to no growth environment is anathema to equity players, it is a terrific environment for debt investors. Equity markets remain at best fairly valued and according to folks like Robert Shiller dramatically over-valued, as price-earnings ratios are well above historical averages despite the current economic state.⁶ Investors for years have refused to believe that there is a direct correlation between yield and returns, though long term data has proven otherwise. History has been misconstrued as the last 20 or 30 years, but in fact we have over 130 years of yield and dividend information for the U.S. equity markets. If we start in 1880, it was not until 79 years later, in 1959 that yields on stocks fell below those on bonds.⁷

S&P 500 Dividend Yield



10 Year Treasury Rate



This early yield data makes intuitive sense. Equities are the most risky piece of the capital structure (first loss we like to call this) so to entice investors to hold stocks, companies had to offer attractive yields.

Then from 1959 to the present, the gigantic hoodwinking called “retained earnings” kicked into gear. Investors in stocks were told by management that rather than paying out their earnings or free cash flows, it would be best for all concerned if they just kept these earnings and re-invested them for the stockholders. Now we have spent our careers analyzing public securities and can unequivocally state that value destruction is much more prevalent than value creation by most of the corporate management teams out there. Most businesses do not generate rates of return above their cost of capital and most acquisitions fail to deliver the “synergies” that are promised by empire builders.

So if yield is no longer the driver of returns and value in equities, just where is value now coming from? There is an investment strategy known in our trade as “capital arbitrage,” or “cap-

⁶ Price-Earnings Ratio data available at <http://www.econ.yale.edu/~shiller/data.htm>, data as of August 15, 2011.

⁷ <http://www.multpl.com/s-p-500-dividend-yield/>, data as of August 9, 2011. <http://www.multpl.com/interest-rate/>, data as of August 18, 2011.

arb” for short. This involves analyzing a company’s securities and figuring out where the value is. Let’s say that we believe XYZ business is worth 5x the company’s EBITDA, or earnings before interest, taxes, depreciation and amortization (used as a comparable measure between companies and industries). Now let’s say this EBITDA is \$100 million. So we value the enterprise at \$500 million. If the company has bank debt of \$200 million and bonds of \$300 million the entire value is eaten up by the debt which ranks senior to the equity. So if the equity is trading for \$300 or \$400 million, to us it is worthless. Why is it trading for such value then? Maybe the market expects growth of that EBITDA to \$150 million over the coming year or two. But when that growth doesn’t materialize, the equity price should trade down. So the trade might be to short the stock and buy the bonds, particularly if the debt is trading at discounted values.

Our personal belief is that the entire stock market is now a cap-arb play. Equities have been forecasting growth that is not going to happen, so they are forced to adjust trading prices to reflect this reality. Yet in the example above we don’t believe that the \$100 million of EBITDA is going to \$50 million, as happened in 2008. As bondholders, we don’t care about growth; as long as this steady EBITDA of \$100 million allows the company to continue to pay its bills and the company has a good liquidity cushion (cash and/or borrowing capacity), then bondholders are in a good position. Inventories are rational and companies have plenty of powder to survive any slowdown. It is the joy of being bondholders not stockholders. Our returns come from not being wrong; we don’t have to be right. Equity players have to be right about lots of things including growth, market psychology, perception of value, etc. But as bondholders we get paid everyday our interest accrues as the company survives. Renting money is a smart business. Just ask the banks.

Over the past 20 years we have seen stock markets soar in the 1990’s with the internet bubble and then again in the 2000’s as interest rates collapsed. Yet through it all stocks not only underperformed high yield, they were almost twice as risky based on standard deviation or volatility, as charted below.⁸

Risk/Reward Profile of Various Assets: 1992 – June 2011

January 1992 - June 2011	Annualized Total Return*	Annualized Standard Deviation*	Return /Risk	Highest Annual Return	Lowest Annual Return	Annual Median Return	Number of Positive Return Years	Number of Negative Return Years	Sharpe Ratio*
U.S. 30 Day TBill	3.12%	0.54%	5.76	5.65%	0.09%	3.69%	19	0	0.00
U.S. Govt 5-7 Years	6.62%	5.20%	1.27	18.93%	-3.59%	7.93%	16	3	0.70
U.S. Govt 10+ Years	7.81%	10.01%	0.78	32.28%	-13.26%	7.96%	15	4	0.51
ML Mortgage	6.50%	3.12%	2.08	17.07%	-1.60%	6.99%	18	1	1.10
ML ABS	5.47%	2.51%	2.17	15.96%	-8.37%	5.55%	18	1	0.94
ML Corp	7.01%	5.82%	1.20	21.53%	-6.83%	8.72%	16	3	0.70
Barclays US Agg Bd USD	6.41%	3.98%	1.61	18.47%	-2.92%	6.54%	17	2	0.84
AAA Corp	6.29%	5.82%	1.08	21.42%	-3.64%	6.63%	16	3	0.57
S&P 500	8.23%	16.22%	0.51	37.58%	-37.00%	10.88%	15	4	0.39
Russell 2000	9.33%	21.49%	0.43	47.25%	-33.79%	18.33%	13	6	0.38
DJ Wilshire 5000	8.51%	16.61%	0.51	36.40%	-37.33%	12.62%	14	5	0.40
JPM Emerging Markets	12.48%	15.44%	0.81	48.99%	-25.69%	11.86%	15	4	0.68
MSCI EAFE	6.03%	17.97%	0.34	39.17%	-43.06%	11.55%	14	5	0.25
Gold	7.72%	16.24%	0.48	31.92%	-21.41%	4.32%	13	6	0.36
U.S. Inflation	2.56%	1.20%	2.13	4.08%	0.09%	2.67%	19	0	-0.46
FTSE NAREIT All REITS	10.64%	21.31%	0.50	38.47%	-37.34%	18.31%	15	4	0.45
Credit Suisse High Yield Index	8.75%	8.82%	0.99	54.22%	-26.17%	11.92%	16	3	0.68
Credit Suisse Leveraged Loan Index	6.07%	5.84%	1.04	44.86%	-28.75%	6.75%	18	1	0.53

*Monthly Data

Source: Credit Suisse, Bloomberg, Ibbotson Associates

⁸ Blau, Jonathan, Daniel Sweeney, Janet Young, and Karen Friedlander. “2011 Leveraged Finance Mid-Year Outlook and Review.” Credit Suisse Global Leveraged Finance, July 28, 2011, p. 62. Risk as measured by standard deviation.

Active versus Passive

While we remain highly motivated about finally seeing some excellent entry points into the high yield bond and loan markets, we advise against the passive approach. The notion of lending to every company under the sun in this environment makes absolutely no sense to us whatsoever and never has. We have warned investors about the land mines lurking in the passive funds, particularly those leveraged buyouts from the golden years of 2006 and 2007. Last week saw just a small example of what awaits investors owning these bonds. We have profiled First Data in an investor letter from a few years ago describing the ludicrous amount of leverage on this company. Note its performance from the week:⁹

<u>High-yield bonds</u>			
<u>Week</u>			
<u>Losers</u>	<u>Price</u>	<u>Change</u>	<u>Industry</u>
BAC Capital Trust XI 6.625% Trust Pfd Secs 36	80.28	-20.90	Financial
GMX Resources 11.375% Sr Nts 19	75.00	-19.00	Energy
Radian Group 5.625% Sr Nts 13	75.00	-15.00	Financial
Radian Group 5.375% Sr Nts 15	62.00	-14.00	Financial
Hawker Beechcraft 8.500% Sr Nts 15	42.75	-13.50	Industrials
Hawker Beechcraft 8.875% Sr Toggle Nts 15	42.75	-13.50	Industrials
First Data Corporation 11.250% Sr Sub Nts 16	79.75	-13.25	Technology
ARD Finance SA 11.125% Sr Sec Nts 18	89.00	-13.00	Paper/Packaging
First Data Corporation 12.625% Sr Nts 21	87.50	-13.00	Technology
Norske Skogindustrier 6.125% Sr Nts 15	62.00	-13.00	Paper/Packaging

Note: Based on the JPMorgan Global High-Yield Index.
Source: J.P. Morgan.

While default rates are expected to remain low for the overall asset class, there are still plenty of bad businesses and, more importantly, bad balance sheets that need to be steered clear of. Many of these need to “grow into” their capital structures which is a nice way of saying default/restructuring is highly likely.

Conclusion

As we look ahead, we see plenty to be concerned about—we are in the midst of a prolonged stagnant economy and Europe is facing mounting issues—however we believe the end result is a resetting of expectations and re-pricing of global equity markets rather than anything economically devastating. Credit bubbles, and the resulting deleveraging, take a great deal of time to heal and this time is no different. There is no instant fix. But with the transfer of debt to public balance sheets from private ones (thanks to QE’s 1 and 2), we see corporate credit as more desirable than Government paper.

Within corporate credit, we believe the high yield market is now offering an unprecedentedly attractive risk/return profile. In an environment of low yields, be it continued low dividend yields on equities or historically low rates on Government debt, we see the yields offered by high yield corporate bonds as ample and appealing to investors. The spread (to worst) level in our

⁹ 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 North American High Yield and Leveraged Loan Research. August 12, 2011, p. 35.

model portfolio is over 900bps above the 5 year Treasuries.¹⁰ This is almost double the long term median around 520 bps¹¹, yet we believe risk (as measured by default) will remain subdued over the next couple years. Corporate credit remains the port in the current storm for investors and we view an actively managed high yield bond portfolio as offering the best risk/return profile within this market.

Peritus I Asset Management Disclosure:

Although information and analysis contained herein has been obtained from sources Peritus I Asset Management, LLC believes to be reliable, its accuracy and completeness cannot be guaranteed. This report is for informational purposes only. Any recommendation made in this report may not be suitable for all investors. As with all investments, investing in high yield corporate bonds and other fixed income securities involves various risks and uncertainties, as well as the potential for loss. Past performance is not an indication or guarantee of future results. Historical performance statistics and associated disclosures available upon request.

¹⁰ The portfolio referenced is the spread to worst (portfolio weighted average yield to worst minus 5 year Treasury rates) for Peritus' model portfolio (approved list of investments) as of August 19, 2011. The model portfolio does not represent actual trading. Depending on the timing, market conditions, use of leverage, portfolio size, and other factors, the actual portfolio could be materially different. Prices and other statistics are subject to change.

¹¹ 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 North American High Yield and Leveraged Loan Research. August 12, 2011, p. 30. 20 year median is 517 bps.