PERITUS
ASSET MANAGEMENT, LLC

Active Credit

Independent Credit Research – Leveraged Finance – January 2014

OF ELEPHANTS AND RATES

For us there are two proverbial elephants in the room: demographics and what we term resource reality. Much of the developed world is getting older which will continue to impact everything from real estate to interest rates. This is one trend that is not going to change over the next 20 years, yet very little thought appears to have gone into what it means for investors. You will see demography rear its head into much of our thinking. Secondly, resource reality refers to the delusion being suffered that many commodities are plentiful and in over-supply. Our favorite whipping boy is of course oil, but this applies to many of things we dig in the dirt from copper to uranium. China and India alone hold 2.6 billion people and continue to grow in importance, while other nations continue to quietly expand (think Indonesia which now has 250 million people). This means that the U.S. is no longer a price maker, but a price taker of most commodities as demand increases globally.

Here are some major themes on our mind as we head into 2014.

- Stocks defied most people by generating huge returns in 2013, with the S&P up 30% and NASDAQ soaring 38%. How many strategists do you know forecasted that? We know of zero. After five straight years of equity gains, the odds of a cozy 8%-10% return for 2014 (most forecasts I have seen) look improbable. The valuation of the S&P 500, as measured by the Shiller P/E ratio, now stands above 25, a level which has been breached only four times in the last 100 years.[1] Revenue growth remains in hibernation over the past five years and looks punk as we head into 2014. Earnings growth, which has benefitted from cost cutting and refinancing is fading. Our take: buy the rumor sell the news. While domestic data has improved, China is barely growing and Europe is celebrating because they may grow at 1%. We don't see a backdrop for continued equity strength.
- The bond rally which began in the early 1980's is dead. Or is it? The consensus among forecasters for 2014 is that the 10-year Treasury yield will rise by another 50-75 basis points, ending the year in the 3.5%-3.75% area. Once again, a very neat and tidy forecast which means that it is highly unlikely to happen. Our take: demographics, liability driven investing (LDI) and a no growth global world will surprise everyone, taking Treasury yields nowhere or potentially lower in 2014 and confounding most investors, particularly those who poured record amounts of money into floating rate products.
- The delusion of cheap and plentiful energy and industrial commodities continues. WTI oil prices averaged $98 in 2013, the second highest on record.[2] This is against a backdrop of no

[1] According to the Shiller P/E, http://www.gurufocus.com/shiller-PE.php. Data as of January 13, 2014.
[2] Source: U.S. Energy Information Administration ("Today in Energy," January 9, 2014)

demand growth, a U.S. shale oil "revolution" and a theoretically warming relationship with Iran. China and India have 2.6 billion people and a growing appetite for energy and improving quality of life. This trend is firmly in place, along with others, which we anticipate will continue to drive energy and other commodity prices higher.

- In our opinion, indexing will be a losing strategy in 2014 as there is going to be no "trade" or trend to ride. In this environment, we believe that investors should turn to active managers to generate returns and yield will once again become the dominant theme. As most investors continue to use ratings to guide their allocations in fixed income, we instead see the right approach as applying valuation discipline to acquire undervalued bonds and loans, which are primarily available in the secondary market. The domestic high yield bond market is now $1.6 trillion[3] and the leveraged loan market is $1 trillion. This is a massive and inefficient asset class that provides active managers with the ability to generate yield and capital gains potential for investors.

So what if we are wrong on these takes and in fact the stock market continues to move higher, earnings growth and economic growth surprise to the upside and interest rates move up another 100 basis points? Candidly, not much changes in our approach to the market. Under this scenario, spreads in leveraged finance (bonds and loans) would likely grind tighter on the back of the economic strength, potentially absorbing much of the rate increase, and we see active investors continuing to get paid what we view as healthy yields. If this scenario unfolds, we would expect that a portfolio of floating rate loans and high yield bonds could outperform various fixed income alternatives, especially interest rate sensitive options like investment grade, as they did in 2013. Overall, we see this as an acceptable and pretty good downside outcome. Which is why we believe it is unlikely. Keep in mind that high yield bonds have a negative correlation with rising rates, which is why we are sanguine when it comes to rates. As demonstrated below, the high yield market over a 25-year history has had a slightly negative correlation to both the 5-year and 10-year Treasuries.[4]

Risk and returns of various assets

Twenty five-year correlation ended November 29, 2013

	5-year Treasury	10-year Treasury
10-year Treasury	0.94	
LB Aggregate Bond Index	0.88	0.90
Investment-grade bonds	0.68	0.73
High-yield bonds	**-0.10**	**-0.08**
S&P 500	-0.09	-0.08
Wilshire 5000	-0.12	-0.10
Russell 2000	-0.21	-0.18
Gold	0.14	0.13
US Inflation	-0.11	-0.17

Sources:J.P.Morgan;Bloomberg.

[3] Acciavatti, Peter, Tony Linares, Nelson R. Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2013 High Yield-Annual Review," J.P. Morgan North American High Yield Research, December 23, 2013, p. A141.

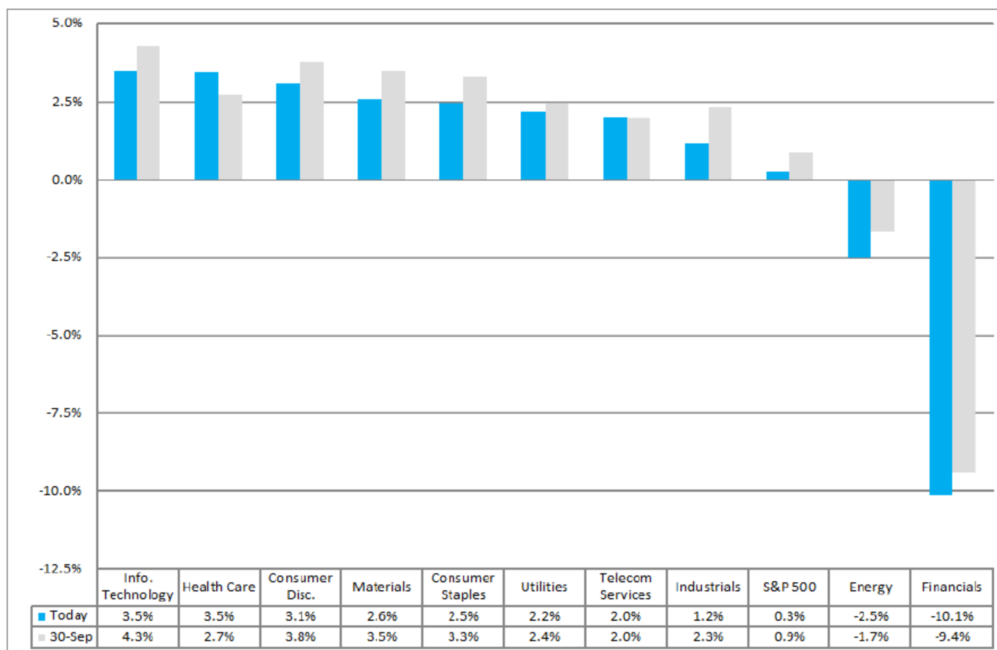
[4] Acciavatti, Peter, Tony Linares, Nelson R. Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2013 High Yield-Annual Review," J.P. Morgan North American High Yield Research, December 23, 2013, p. A157.

Whether we are right or wrong, we beileve the high yield market is positioned well for the year ahead.

EQUITY MARKETS AND THE "GREAT ROTATION"

Turning back to our themes, let's start with the ever popular equity markets. The S&P 500 surprised everyone by jumping 30% in 2013. The reality is that valuation expansion was responsible for over 65% of the move this year, as S&P earnings grew from $96.82 to $107.19.[5] Like many asset classes, many stocks benefitted from the low rate environment and a continuing flood of liquidity. But it's tough to make the argument that fundamentals justify this move. As mentioned, revenue growth is expected to be almost non-existent for the S&P in Q4.[6]

Q4 2013 Revenue Growth



Source: FactSet

Providing further fodder, earnings pre-announcements for Q4 look to be decidedly in the wrong direction:[7]

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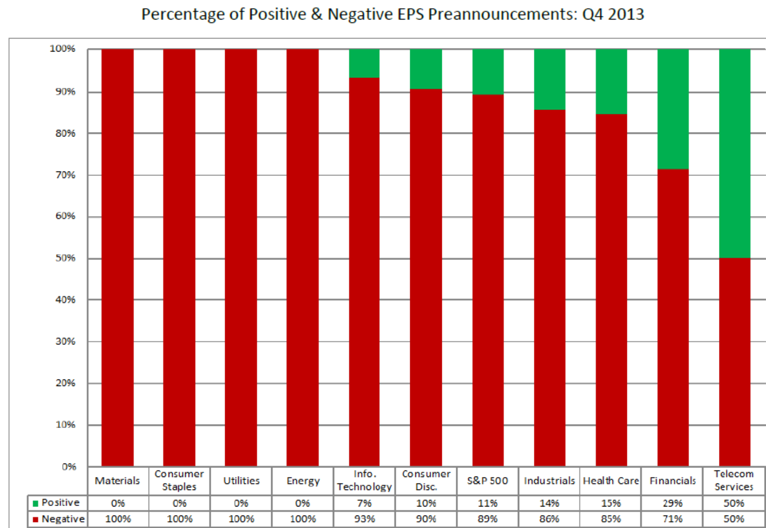
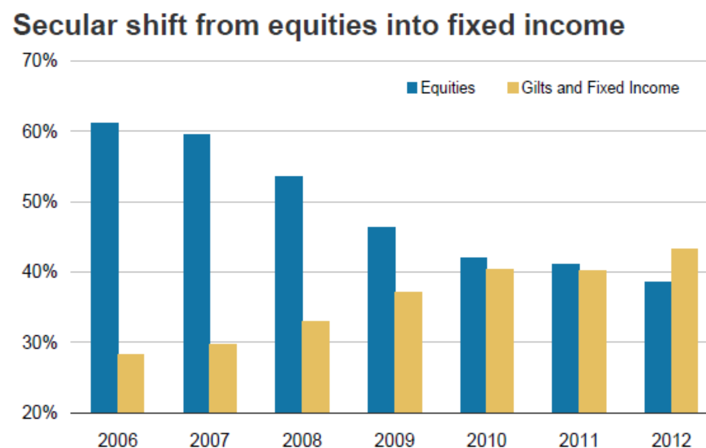
[5] S&P 500 Earnings Per Share data sourced from S&P Dow Jones Indices, http://us.spindices.com/indices/equity/sp-500.
[6] Butters, John, "Earnings Insight," FactSet, December 6, 2013, p. 8.
[7] Butters, John, "Earnings Insight," FactSet, December 6, 2013, p. 6.



Source: FactSet

After five straight years of gains and an overall valuation that is the fourth most expensive period in history[8], how does one justify being long equity indexes in 2014? We see this as nothing but speculation versus investing. What is the investment rationale for the equity indexers heading into 2014? We would view this is a classic case of buying the rumor (and then some) as it relates to an improving economic landscape.

How about the thinking that a "great rotation" from bonds into stocks is under way, which will continue to propel prices higher? This is a great theory and makes for nice headlines, but looks more like wishful thinking by Wall Street. The reality is that demographics are destiny and the shift instead into fixed income from equities is in the beginning innings. The following chart and quote from Morgan Stanley sum it up nicely.[9]



Source: Purple Book 2012, Morgan Stanley Research
Published by Morgan Stanley Research on October 8, 2013

[8] According to the Shiller P/E, http://www.gurufocus.com/shiller-PE.php.
[9] Hamilton, Bruce, Matthew Kelley, Anil Sharma, Andrew Sheets, Anton Heese, and Matthey Hornbach. "Great Rotation? Probably Not," Morgan Stanley Blue Paper, Global Asset Managers, October 8, 2013, p. 13.

> ***Ageing demographics mean regular income, capital preservation and lower volatility are key***
> *We expect that ageing demographics will subdue the strength of this rotation relative to history and will drive convergence between the Retail market and the retirement market. The reduction in equity allocations for the >60 age bracket over the past decade (based on ICI data for the US market) plus the ageing demographic (consultants estimate that within five years nearly 75% of Retail assets will be owned by retirees or those close to retirement) clearly call into question the sustainability and strength of this rotation back into equities. By the end of the decade, the weight of Retail money will be in decumulation phase, as it is in Japan today. We expect that regular income, capital preservation and lower volatility outcomes will be the key focus of this investor group.*
> Published by Morgan Stanley Research on October 8, 2013[10]

Bottom line is that the "decumulation" phase is just beginning in most developing countries. The statement that **within 5 years, nearly 75% of retail assets will be owned by those retired or near retirement** is almost shocking. Just how much of the world's assets are held by retail? Morgan Stanley recently released a report estimating that approximately $89 trillion of investible assets exist globally and of that about 60% is institutional and 40% retail.[11] This translates to approximately $36 trillion in retail assets globally. Those at retirement age in all countries don't care about Ibbotson charts or expected returns. They want tangible income and principal protection.

DEMAND AND RATES

It certainly appears that the demand for yield and fixed income products is just beginning, not rotating away, on the retail side. Most people intuitively understand this, but the surprise is likely to come from institutional investors as many are now beginning their aggressive move toward LDI (liability driven investing). LDI is being used not only by insurers, but now by the global defined benefit ("DB") plan market. Keep in mind that defined benefit and defined contribution pension plans encompass a significant portion of those institutional assets referenced above. As equities have soared over the past five years, many of these large DB plans have seen their funding ratios come close to 100%. Originally, our thinking was that these plan sponsors would continue to "game" pension accounting keeping equity allocations high. What we mean is that often pension accounting is pure voodoo; "expected returns" of asset classes based on historical numbers enter into the way DB plans have to fund their liabilities. But from all evidence, plan sponsors are choosing LDI as a way to potentially "immunize" this liability rather than roll the dice with equities.

LDI is similar to banks running a fully hedged book. When interest rates rise, the present value of pension plan liabilities fall. But of course when rates rise, most bond prices fall offsetting the liability gains. Conversely, when interest rates fall the present value of liabilities rise offset by a gain in bond prices. Ultimately it is expected that the desire for those running U.S. pension plans

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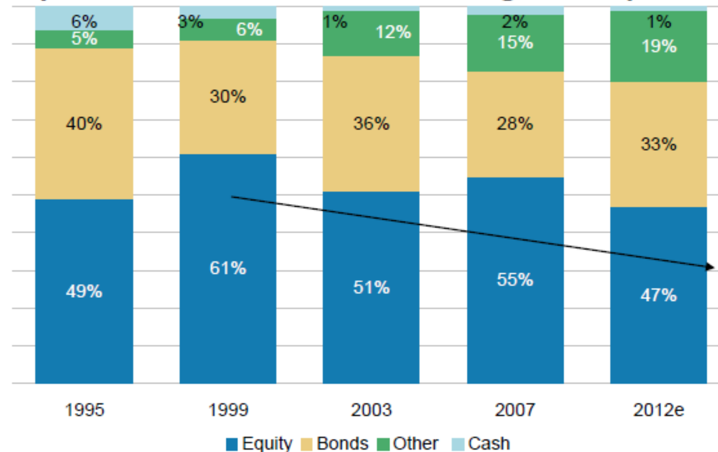
[10] Hamilton, Bruce, Matthew Kelley, Anil Sharma, Andrew Sheets, Anton Heese, and Matthey Hornbach. "Great Rotation? Probably Not," Morgan Stanley Blue Paper, Global Asset Managers, October 8, 2013, p. 20.

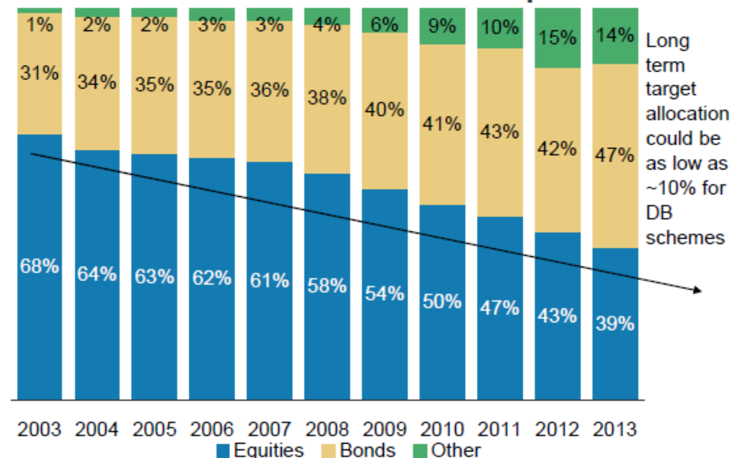
[11] Hamilton, Bruce, Matthew Kelley, Anil Sharma, Andrew Sheets, Anton Heese, and Matthey Hornbach. "Great Rotation? Probably Not," Morgan Stanley Blue Paper, Global Asset Managers, October 8, 2013, p. 15.

to match liabilities will encourage "de-risking," moving away from equities into the fixed income realm. We have already seen evidence of this de-risking globally.[12]



Source: Towers Watson Global Pensions Asset Study, Jan 2013, Morgan Stanley Research. Note Towers Watson estimate for 2012
Published by Morgan Stanley Research on October 8, 2013

For instance, in the United Kingdom, equity allocations have fallen from 68% to 39% over the last decade, and could ultimately fall as low as 10% for defined benefit plans.



Source: Mercer 2013 European Institutional Asset Allocation Survey, Morgan Stanley Research
Published by Morgan Stanley Research on October 8, 2013

[12] Hamilton, Bruce, Matthew Kelley, Anil Sharma, Andrew Sheets, Anton Heese, and Matthey Hornbach. "Great Rotation? Probably Not," Morgan Stanley Blue Paper, Global Asset Managers, October 8, 2013, p. 17, 18.

The point we are trying to make is that demand for bonds and other fixed income asset classes is coming from both the retail and institutional investor and that demand is expected to accelerate as the trend of de-risking away from equities and into fixed income is firmly in place.

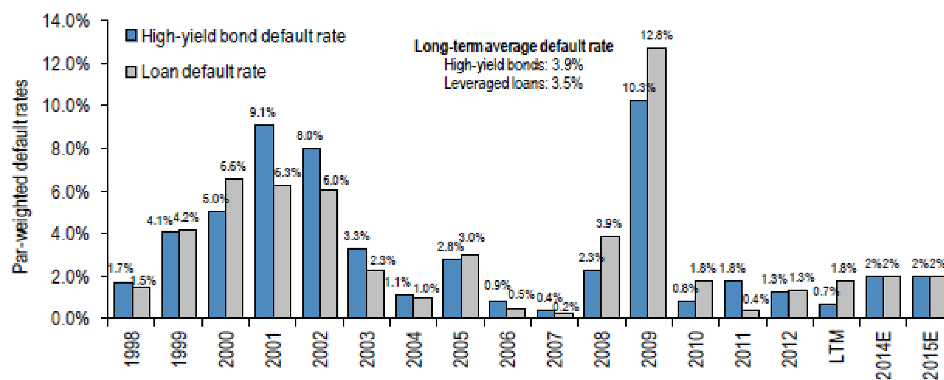
While there are many critics arguing that current Treasury rates are being suppressed by QE, we don't think this argument holds water. Currently the Federal Reserve, through its QE mechanism, is acquiring about $40 billion of Treasuries monthly. While this is not insignificant, the reality is that the Treasury market is approximately $11.5 trillion. The key is that the bid to cover ratios for these Treasury auctions are not 1 or below 1, meaning there is a bid for these securities above and beyond the Fed. Additionally, other countries not involved with QE programs have lower 10-year rates than the U.S., including Canada, Germany, Switzerland, Japan and France. The UK's rate is identical to that of the U.S. and amazingly, both **Spanish and Italian 10 year rates are now below 4%!**[13] We find it very hard to believe that participants in the U.S. Treasury market are being "fooled" by the Fed's QE programs, particularly after the Fed has said they are exiting the QE business in 2014.

We expect the demand for Treasuries and other fixed income securities to remain strong, and even accelerate as demographics become more of a factor. We would expect that this, along with the economic headwinds, will constrain rates going forward.

CURRENT STATE OF CREDIT MARKETS

As we had previously stated, helped by a negative correlation to Treasuries, whether rates go up or not in the year ahead, we believe that the high yield market is positioned well. Importantly, the overall fundamentals of the high yield market look very strong going into 2014. Default rates are forecasted to be below their long term averages for at least the next couple of years.[14]

Default rates below 2% through 2015 are half their long-term average



Source: J.P. Morgan.

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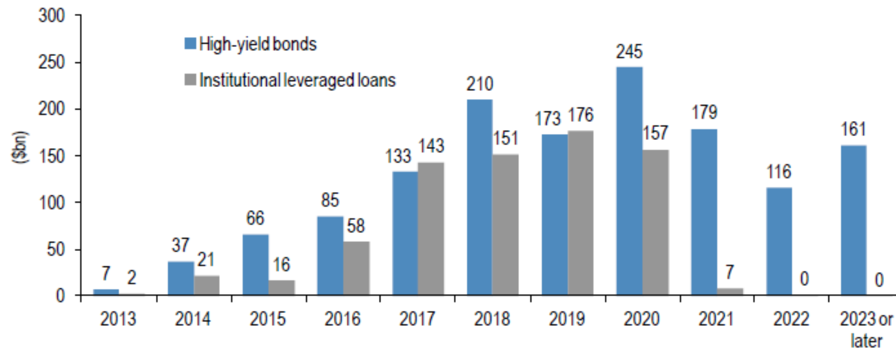
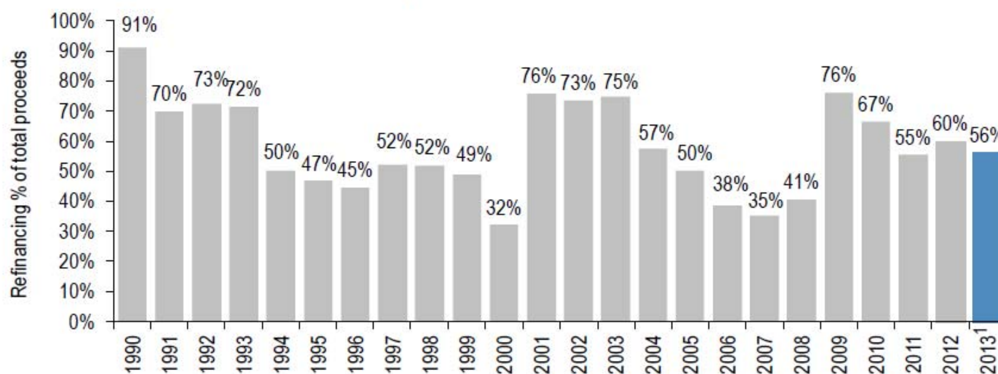
[13] Data sourced from Bloomberg, as of January 7, 2014.

[14] Acciavatti, Peter, Tony Linares, Nelson R. Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2013 High Yield-Annual Review," J.P. Morgan North American High Yield Research, December 23, 2013, p. 14.

We concur with this forecast as leverage multiples remain reasonable, companies, helped by a wide open primary market, have excellent liquidity and maturities are very minimal over the next 2-3 years.[15]

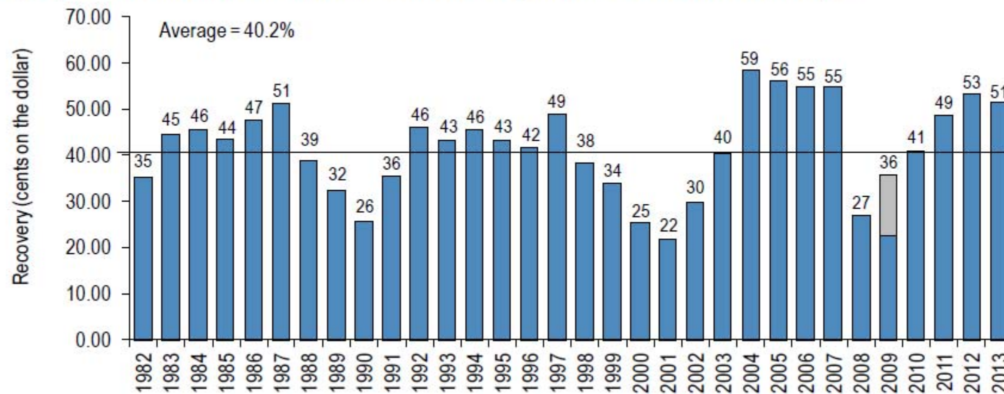


With a record breaking amount of issuance in the high yield space over the past couple years, a very important factor in determining the overall quality of the market is use of proceeds. While there has been some pick-up of what we consider "bad use of proceeds" such as dividend deals, far and away the market has been all about refinancing, allowing companies to lower their interest cost and extend maturities.[16]



Finally, recovery rates on defaulted bonds remains above 50%.[17] Multiplying the expected default rate of 2% by the recovery rate of 50% equals an expected loss rate of 1% on the defaulted bonds.

[15] Acciavatti, Peter, Tony Linares, Nelson R. Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2013 High Yield-Annual Review," J.P. Morgan North American High Yield Research, December 23, 2013, p. 26.
[16] Acciavatti, Peter, Tony Linares, Nelson R. Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2013 High Yield-Annual Review," J.P. Morgan North American High Yield Research, December 23, 2013, p. 59.
[17] Acciavatti, Peter, Tony Linares, Nelson R. Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2013 High Yield-Annual Review," J.P. Morgan North American High Yield Research, December 23, 2013, p. 73.



We view this potential loss rate as the primary "risk" in the high yield space and what investors should be focused on, rather than rates. By this account, the loss rate should be exceedingly manageable over the next couple years.

While we are on the subject of risk, why do most investors think high yield or junk bonds are riskier than stocks? People often don't understand that bonds and loans sit above the equity in a company's capital structure. Over the past 25 years (which encompasses arguably the best equity markets in history), the historical numbers show that the returns are about the same as stocks with nearly half the risk, as measured by volatility.[18]

Sharpe ratios of different asset classes over different periods

	Average annual returns						Average annual volatility						Modified Sharpe Ratio [1]					
	1 yr.	3 yr.	5 yr.	10 yr.	15 yr.	25 yr.	1 yr.	3 yr.	5 yr.	10 yr.	15 yr.	25 yr.	1 yr.	3 yr.	5 yr.	10 yr.	15 yr.	25 yr.
Fixed Income																		
5-year Treasury	-2.03%	2.87%	3.84%	4.62%	5.10%	6.45%	2.73%	3.37%	3.89%	4.28%	4.52%	4.52%	-0.74	0.85	0.99	1.08	1.13	1.43
10-year Treasury	-6.89%	3.27%	3.80%	5.02%	4.92%	6.87%	6.03%	7.18%	8.08%	7.56%	7.67%	7.29%	-1.14	0.46	0.47	0.66	0.64	0.94
JPMorgan MBS Bond Index	-2.48%	1.90%	3.92%	4.72%	na	na	2.80%	2.26%	2.40%	2.80%	na	na	-0.88	0.84	1.63	1.69	na	na
Aggregate Bond Index	-1.51%	4.07%	5.94%	5.01%	5.50%	6.98%	3.16%	3.58%	3.61%	3.56%	3.66%	3.84%	-0.48	1.14	1.64	1.41	1.50	1.82
Investment-grade bonds	-0.62%	5.43%	9.99%	5.82%	6.29%	7.75%	4.73%	4.41%	5.61%	5.81%	5.54%	5.21%	-0.13	1.23	1.78	1.00	1.13	1.49
Leveraged loans	5.46%	5.81%	13.73%	5.27%	5.14%	na	1.72%	3.88%	7.45%	8.35%	6.95%	na	3.17	1.50	1.84	0.63	0.74	na
High-yield bonds	**9.07%**	**10.59%**	**20.45%**	**8.97%**	**7.78%**	**9.12%**	**4.85%**	**5.99%**	**8.73%**	**9.79%**	**9.09%**	**8.30%**	**1.87**	**1.77**	**2.34**	**0.92**	**0.86**	**1.10**
Equity																		
S&P 500	30.30%	17.73%	17.60%	7.69%	4.90%	10.23%	8.61%	12.48%	15.81%	14.68%	15.54%	14.78%	3.52	1.42	1.11	0.52	0.31	0.69
Wilshire 5000	29.39%	18.20%	18.58%	7.76%	5.33%	10.09%	9.17%	13.21%	16.29%	15.25%	16.06%	15.10%	3.20	1.38	1.14	0.51	0.33	0.67
Russell 2000	40.99%	17.89%	20.97%	9.15%	8.62%	10.23%	10.88%	17.11%	21.01%	19.67%	20.62%	19.08%	3.77	1.05	1.00	0.47	0.42	0.54

Note that high yield has outperformed investment grade bonds on a returns basis in every period listed above. What is surprising about this is that it includes the two worst periods for high yield in history: the 2002 "TMT" (telecom, media and technology) nuclear winter and the 2008 financial crisis. It also arguably includes the best period of time for interest sensitive sectors, such as investment grade debt. One of the most popular institutional strategies is to build a "core plus" fixed income portfolio consisting of 80-90% investment grade and a dash of high yield

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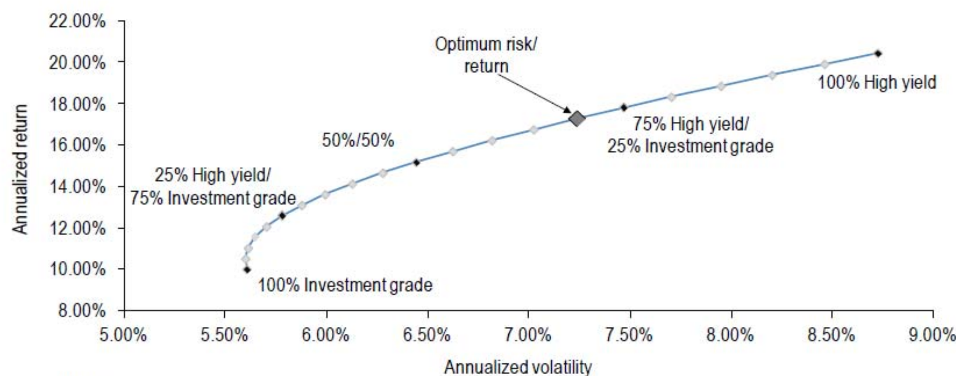
[18] Acciavatti, Peter, Tony Linares, Nelson R. Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2013 High Yield-Annual Review," J.P. Morgan North American High Yield Research, December 23, 2013, p. 115.

and/or emerging market debt. Interestingly, it seems that a much more appropriate “core” should consist of high yield with a sprinkling of investment grade:[19]



Given the yield advantage offered by the high yield market versus investment grade, on top of a projected loss rate of 1%, we can begin to understand why a 70/30 allocation in favor of high yield makes intuitive sense.

ACTIVELY MANAGING CREDIT

So now that we have established the attractiveness of the high yield asset class, let’s get back to our take that true active management will be a dominant theme in 2014. Most know that active management in equities is all about the future earnings/cash flow of a particular business/industry and what you pay for that stream, but how does one define active management in credit? As I pour through the various strategy pieces coming out for 2014, it is absolutely mind numbing to see how many people still want to break out the opportunity sets in corporate credit (bonds and loans) by rating. Really? Worldcom, Enron, Lehman Brothers and then the mortgage/CDO crisis wasn’t enough in the past decade? In five years we’ve gone from trying to eliminate and ban ratings back to using them to allocate monies? Do stock investors wake up and build a portfolio based on ratings? Do stock investors even know or care what their company’s credit rating is, and if the equity investor (who is the lowest on the capital structure food chain) isn’t paying attention to ratings, why do fixed income investors still think they have value?

While we remain confused by this ratings driven methodology, it is crucial to the “alpha” opportunity. If most investors restrict their allocations by ratings, naturally, this creates inefficiencies. One very specific example involves loans. Much of the loan market is purchased by “CLOs” (collateralized loan obligations). These CLOs have significant restrictions based on

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[19] Acciavatti, Peter, Tony Linares, Nelson R. Jantzen, CFA, Rahul Sharma, and Chuanxin Li. “2013 High Yield-Annual Review,” J.P. Morgan North American High Yield Research, December 23, 2013, p. 120. This chart demonstrates how adding high yield bonds to a portfolio of entirely investment grade bonds can impact risk, as represented by annualized volatility, and/or increase return to the “optimum risk/return” of 70% high yield bonds and 30% investment grade. It is at this “optimum” point that the highest return per unit of risk is achieved over the period. Past performance is not indicative of future results.

ratings. We know this first hand as we ran two collateralized bond obligations ("CBOs"). So if a loan is downgraded (or even put on watch for downgrade), many of these CLOs must sell these loans. With fewer buyers in the secondary market, active managers are often able to buy loans at a discount to par. And the same sort of opportunity exists in the bond market, where managers and portfolios have structural limitations restricting them from holding certain ratings categories.

While on the subject of credit ratings, it is pertinent to talk about credit risk. As many are under the perception that lower rated bonds indicate weak investment prospects, we would argue that is not at all necessarily the case. One of the things that investors need to be aware of is that ratings methodologies favor both size and longevity of companies. Both of these factors are in the rear view mirror. From our perspective and experience there is nothing forward looking about ratings, yet isn't the future all that matters in investing? This is at the core of the credit ratings arbitrage available to debt investors in the secondary market. There is a complete and total disconnect on risk. Ratings can be downgraded for a whole slew of reasons, many of which are temporary or purely historical in nature.

DIGGING IN THE DIRT

Active management is not only seeking to capitalize on the structural inefficiencies in the high yield market, but also digging into specific credits and industries to identify attractive opportunities. This begins with understanding value. When you buy a bond or loan you are lending a company money. As lenders, we would want our companies to generate free cash flow, which can allow for enterprise value below the debt or a margin of safety. In addition, or alternatively, we would want the company to have ample asset value that more than covers the value of the bonds. By itself this isn't all that difficult. However, the alpha comes from acquiring these securities at prices that can provide lenders with very attractive rates of return. We would refer to this as low price relative to expectations or undervalued situations.

One of the more popular themes in the last year was the death of commodities and the commodity super-cycle. Much of the focus was on gold, as it experienced its first loss since 2000 and what a loss it was. More continuing noise was on the energy front, where both oil and natural gas were in "revolution" mode, with the U.S. becoming energy self-sufficient…blah, blah, blah. Interestingly enough, market prices didn't get that memo and appear to be saying something entirely different. Natural gas prices finished the year up nearly 30% to almost $4.50 and oil prices (WTI) averaged $98 for 2013, the second highest on record.[20] Keep in mind this is against the backdrop of no global economic or demand growth.

Energy is one industry that we have done a great deal of work on and have found what we view as attractive and undervalued opportunities in this misunderstood space. Below are a few broad thoughts on energy markets:

- There appears to be a disconnect between energy "reserves" and the ability to extract these oil and gas resources economically. Without a return on capital and the ability for these companies to generate free cash flow, production will shrink or prices will need to rise. In the last few years, there have been literally hundreds of billions of dollars raised by companies active in the "shale" basins. So while the money is flowing, nobody is worried

[20] Source: U.S. Energy Information Administration ("Today in Energy," January 9, 2014)

about the sustainability of any of these business models. Yet, many "conventional" production companies don't generate free cash flow at current prices. The following RBC valuation table of Canadian production companies is instructive:[21]

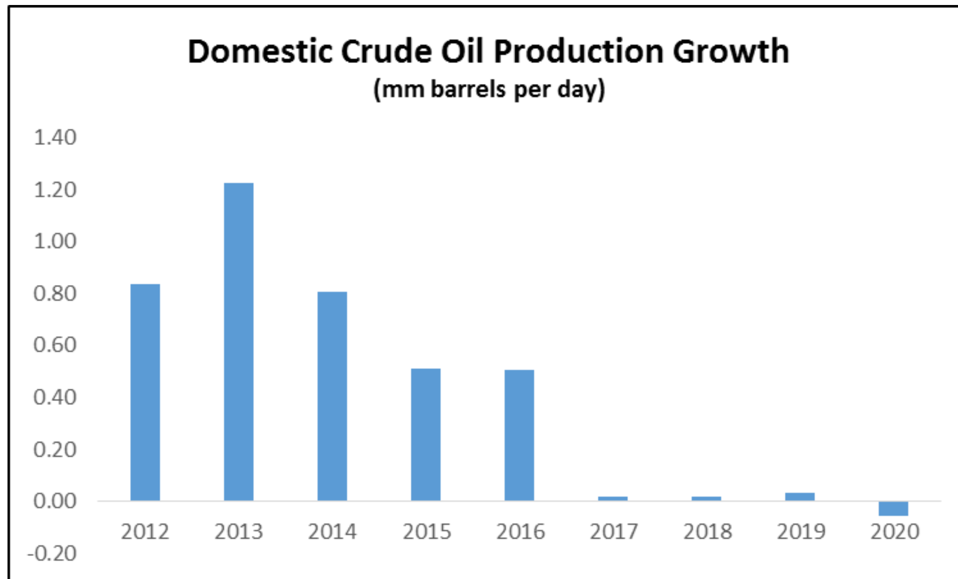
	FD Cash Flow $ / share			Dividends $ / share			Simple Payout Ratio (Dividends Only)			Effective Payout Ratio (Dividends + Capex, excluding DRIP)		
	2013E	2014E	2015E	2013E	2014E	2015E	2013E	2014E	2015E	2013E	2014E	2015E
Juniors: < 15,000 boe/d												
Arcan Resources	$0.39	$0.32	$0.35	$0.00	$0.00	$0.00	0%	0%	0%	110%	117%	118%
Argent Energy	$1.11	$1.15	$0.93	$1.06	$1.05	$1.05	93%	89%	111%	271%	150%	187%
Donnycreek Energy	$0.14	$0.41	$0.65	$0.00	$0.00	$0.00	0%	0%	0%	397%	159%	111%
Kelt Exploration	$0.25	$0.68	$0.78	$0.00	$0.00	$0.00	0%	0%	0%	nmf	204%	179%
Longview Oil	$1.45	$1.49	$1.48	$0.60	$0.48	$0.48	41%	32%	32%	98%	115%	108%
Manitok Energy	$0.54	$0.85	$1.25	$0.00	$0.00	$0.00	0%	0%	0%	212%	150%	111%
Painted Pony Petroleum	$0.61	$0.72	$0.83	$0.00	$0.00	$0.00	0%	0%	0%	269%	234%	165%
Parallel Energy	$0.73	$0.75	$0.72	$0.60	$0.60	$0.60	80%	78%	82%	106%	112%	120%
Santonia Energy	$0.20	$0.21	$0.22	$0.00	$0.00	$0.00	0%	0%	0%	232%	116%	132%
Storm Resources	$0.31	$0.45	$0.57	$0.00	$0.00	$0.00	0%	0%	0%	270%	203%	169%
Tamarack Valley Energy	$1.11	$1.34	$1.58	$0.00	$0.00	$0.00	0%	0%	0%	146%	104%	99%
TORC Oil & Gas	$1.65	$1.80	$1.85	$0.21	$0.54	$0.54	12%	29%	29%	174%	103%	103%
Average: < 15,000 boe/d							**19%**	**19%**	**21%**	**208%**	**147%**	**133%**
Intermediates: < 50,000 boe/d												
Advantage Oil & Gas	$0.49	$0.76	$1.04	$0.00	$0.00	$0.00	0%	0%	0%	201%	192%	113%
Birchcliff Energy	$1.20	$1.36	$1.48	$0.00	$0.00	$0.00	0%	0%	0%	143%	142%	154%
Crew Energy	$1.49	$1.78	$2.04	$0.00	$0.00	$0.00	0%	0%	0%	123%	113%	103%
Legacy Oil and Gas	$1.98	$2.16	$2.20	$0.00	$0.00	$0.00	0%	0%	0%	106%	102%	107%
Lightstream Resources	$3.54	$2.93	$2.65	$0.96	$0.48	$0.48	27%	16%	18%	130%	108%	109%
Long Run Exploration	$1.95	$2.10	$2.14	$0.00	$0.37	$0.40	0%	18%	19%	112%	93%	104%
NuVista Energy	$0.66	$0.92	$1.12	$0.00	$0.00	$0.00	0%	0%	0%	304%	209%	181%
Paramount Resources	$0.76	$2.44	$5.12	$0.00	$0.00	$0.00	0%	0%	0%	nmf	209%	95%
Perpetual Energy	$0.43	$0.54	$0.60	$0.00	$0.00	$0.00	0%	0%	0%	146%	93%	89%
Trilogy Energy	$2.57	$2.63	$3.24	$0.42	$0.42	$0.42	16%	16%	13%	145%	129%	135%
Twin Butte Energy	$0.53	$0.63	$0.60	$0.19	$0.19	$0.19	36%	30%	32%	108%	87%	90%
Vermilion Energy	$6.46	$6.60	$6.94	$2.40	$2.58	$2.60	37%	39%	37%	117%	121%	117%
Whitecap Resources	$1.92	$2.11	$2.29	$0.62	$0.68	$0.68	32%	32%	29%	96%	92%	89%
Average: < 50,000 boe/d							**11%**	**12%**	**11%**	**144%**	**130%**	**114%**
Intermediates: > 50,000 boe/d												
ARC Resources	$2.87	$3.32	$3.48	$1.20	$1.20	$1.20	42%	36%	34%	138%	124%	115%
Baytex Energy	$5.19	$5.53	$5.53	$2.65	$2.64	$2.64	51%	48%	47%	137%	117%	120%
Bonavista Energy	$2.52	$2.75	$2.91	$0.89	$0.84	$0.84	35%	30%	29%	130%	125%	120%
Crescent Point Energy	$5.46	$5.68	$5.64	$2.76	$2.76	$2.76	50%	48%	49%	131%	125%	122%
Enerplus	$3.80	$3.87	$4.27	$1.08	$1.08	$1.08	28%	28%	25%	118%	124%	109%
Pengrowth Energy	$1.08	$1.05	$1.21	$0.48	$0.48	$0.48	44%	46%	40%	182%	190%	163%
Penn West Exploration	$2.26	$1.88	$1.91	$0.82	$0.56	$0.56	36%	30%	29%	116%	127%	124%
Peyto Exploration	$2.97	$3.96	$4.31	$0.88	$0.96	$0.96	30%	24%	22%	157%	130%	127%
Tourmaline Oil	$2.82	$4.84	$6.18	$0.00	$0.00	$0.00	0%	0%	0%	185%	127%	99%
Average: > 50,000 boe/d							**35%**	**32%**	**31%**	**144%**	**132%**	**122%**
Average							**20%**	**20%**	**20%**	**166%**	**137%**	**123%**

Source: RBC Capital Markets, empahsis added

When one includes dividends and capital expenditures, the average company spent $1.66 per $1.00 of cash flow, making them significant cash users. Forecasted cash flows and price levels still do not get them to breakeven over the next couple of years. We are seeing this sort of situation pervasive throughout North America.

- Turning to U.S. shale production, decline rates on these wells are extreme, meaning more and more holes need to be punched to keep production flat. Since the easiest oil is produced first, the future is likely to be worse than the past. Even the Energy Information Administration ("EIA"), which has been overly optimistic on many fronts, forecasts minimal growth after 2016.[22] In essence the current rate of production and growth is unsustainable.

[21] Harvey, Michael P. Eng., Mark Friesen, CFA, and Shailender Randhawa, CFA. "RBC Canadian Energy: Junior/Intermediate E&P: Weekly Review and Valuation Tables," RBC Capital Markets, December 30, 2012, p. 7.
[22] Source: U.S. Energy Information Administration, data as of January 13, 2014.



Source: U.S. Energy Information Administration

- The marginal cost of a new barrel of production will continue to increase, meaning high prices are here to stay. Fracking a single well requires up to 5 million gallons of water. Given that many of these shale basins are in arid areas, water availability and logistics make them increasingly challenging and expensive. New wells will likely be more expensive and less productive. Those forecasting a massive decline in prices because of this unconventional production are missing the point: if you can't generate an economic profit production stops or prices rise.
- Saudi Arabia and Russia are the largest oil producers, each with about 11 million barrels per day of production. Together they represent over 25% of global production.[23] The Saudi's have stated they want $100 oil to pay for their internal "welfare" state. Russia is in the same domestically-challenged boat. Throw in other significant producers such as Libya, Iran, Iraq, Venezuela and Nigeria and ask yourself whether these countries will magically get it together and bring in foreign capital and expertise to grow production? Not likely.
- Forecasted production growth is absolute fairy dust. One has to look no further than Brazil or Kazakhstan for evidence of this. Both countries were forecasted to be producing significantly higher amounts of oil than they are today. Resources and reserves do not equal production. Unconventional resources such as shale oil and oilsands suffer from a lack of homogeneity. Simply put, each zone is very different than the other. The Bakken is a very good example where wells just a few miles apart have massively different production profiles, making growth forecasts impossible.
- Natural gas was up nearly 30% in 2013. Weak pricing over the prior few years has generated significant demand from the electric utility industry, chemicals, fertilizers and others who benefit from cheap inputs. While shale production remains robust, a gradual globalization of gas prices is underway as liquefied natural gas (LNG) exports in both Canada and the U.S. become realized, driving domestic prices higher.
- King Coal is dead. Or so some think. Contrary to popular myth, global coal fired power is growing rapidly with over 600 GW of capacity being built by China alone in the next few

[23] Source: U.S. Energy Information Administration, data based on 2012 annual levels, as of January 16, 2014.

years. This will require over 1.8 billion metric tons of new annual coal production. To put this in perspective, the U.S. is the second largest coal producer with approximately 1 billon short tons of production.[24] Domestic production and inventories have both shrunk rapidly over the last two years as natural gas replaced coal in power generation. This trend is in the process of reversing which should lead to much higher coal prices in the years ahead. This has already begun to show up in the Powder River Basin. Long live the King!

In summary, unconventional resources have become conventional. The overall quality and access to these "new conventional" energy reserves is declining, increasing costs for all producers and we expect to ultimately keep prices elevated.

CONCLUDING THOUGHTS

We enter 2014 with a great deal of caution. The economic consensus appears to believe that the "recovery" is in the beginning stages and the global all clear sirens have sounded. This does not pass our smell test. But even if one were to drink this flavor of economic Kool-Aid, you would ignore the fact that financial assets have dramatically outperformed the real world of earnings and economic growth. After five straight years of equity gains and a Shiller P/E of 25,[25] isn't the good news already baked in, and then some? We think it is. We do not believe that equity indexes will reward investors in 2014.

Turning our attention to the fixed income markets, the consensus here appears to be Fed tapering will lead to higher interest rates across the board. While this may happen in the short run, we question the sustainable nature of another 50-75 basis point move in the 10-year Treasury. After bottoming in May at around 1.6%, the 10-year Treasury has already almost doubled in yield. Countries that have no QE programs across the globe have lower yields on their government bonds. As demographics take hold, demand is likely to increase from both retail and institutional investors. No great equity rotation looks to be in the cards.

We see the high yield market as positioned well in the year ahead. Within this market, we feel fundamental opportunities exist among the energy food chain. Additionally, secondary loans expand the investment universe and provide an opportunity to extract value from forced sellers for technical reasons. Finally, under a slow growth umbrella, M&A activity is likely to pick up. Slow to no growth industries offer consolidation opportunities. We have already seen evidence of this in the first week of the new year. Since high yield bonds have change of control covenants ("poison puts") that allow the holder to "put" the bond back at par or $101, acquiring these below par can lead to capital gains as well.

The conclusion is that financial markets are likely to be trendless in 2014. True active management in all asset classes will be required. We see real potential for high yield bonds to outperform various fixed income asset classes and give equities a run for their money. Our main focus remains on the future fundamentals of our portfolio and prospective investments, not whether or not rates rise.

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[24] Source: U.S. Energy Information Administration, data as of December 12, 2013.
[25] According to the Shiller P/E, http://www.gurufocus.com/shiller-PE.php.

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