



Active Credit

Independent Credit Research | Leveraged Finance | October, 2008



Re-Defining Core Fixed Income

The Case for Active Credit Investing

SUMMARY

- *With event risk, duration concerns, credit risk and lack of spread, investment grade corporate bonds as the main asset class in fixed income portfolios makes little sense.*
- *Treasury bonds have provided an excellent hedge in fixed income portfolios due to their flight to quality effect. During times of crisis, gains in these securities have historically helped offset spread widening in other areas.*
- *The leveraged finance opportunity set totals close to \$3 trillion today and continues to grow. Active credit management is now understood to be required to be successful in all corporate credit markets. Every exposure needs to be researched, assessed and valued thoroughly. There are no layoffs in credit even if the assigned ratings are high.*
- *The secondary high yield bond market has experienced dramatic re-pricing. Though both credit quality and liquidity risk are partially responsible, contagion originating in other segments of the fixed income market has exacerbated the downward price movement to spread levels that to us appear completely unjustified. Liquidity premiums have never been this high.*
- *The emergence of secondary trading in leveraged loans due in large measure to unwinding financial leverage has created unprecedented opportunities to buy deeply discounted loans. Deep price discounts combined with secured and senior positions in corporate capital structures and shorter maturities, can make up for the lower coupon paid on loans and add value to fixed income portfolios.*
- *Contagion in structured credit has created an opportunity to purchase select secondary tranches of CLO's at risk/return levels never before seen.*

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Re-Defining Core Fixed Income

The Case for Active Credit Investing

At Peritus, we believe that the fixed income asset class is in the midst of being re-defined. Similar to the recent evolution in equity markets, investors are turning away from their obsession with pigeonholing investment managers in style boxes (i.e. small cap growth, large cap value, etc.) in favor of absolute return philosophies—a “back to the future” process, you might say. Professional money management began with a “just make me money” approach and it appears to be returning to its roots. Against this backdrop, we believe that our fundamental investment philosophy of viewing corporate debt instruments as either AAA or D (that is, if interest is paid on time, a credit is AAA; otherwise, it is in default) will perhaps get some respect. I had the privilege of contributing my thoughts on this matter to the inaugural issue of CFA Magazine five years ago. A copy of that article is posted at the end of this paper. While I felt alone in my views back then, I am confident that I have more company now.

“Core” Fixed Income portfolios have historically been dominated by investment grade corporate bonds along with government and agency securities. To improve upon this, many institutional investors moved to a “Core Plus” model which allows for the inclusion of a small high yield and, in some cases, an emerging market bond bucket. In many policy statements this has taken the form of allowing investment grade managers to throw in a 10% commitment to what we call “the cream of the crap,” otherwise defined as the upper tier (BB) of the high yield market. We find this relatively pointless as spreads available in this market have not been much greater than investment grade paper. Those allowing their core managers a broader mandate are also asking for trouble because the credit and execution skill required to be successful in the high yield market differs dramatically from those firms typically focusing on investment grade bonds.

Though there will always be opportunities to buy select undervalued names, it is our opinion that participation in investment grade corporate bonds as an asset class has become a futile effort. We provide details as to why we feel this way below. ***Instead, we would strongly advise fixed income investors to focus their attention on building a new core model. This new model provides for much higher expected returns through fundamental credit work and offsets both credit and liquidity risk through the inclusion of government bonds.***

Investment Grade Risks: Event, Duration and Credit

The first problem in the investment grade world we see is event risk from private equity sponsors looking to privatize everything in sight. Investment grade bond indentures traditionally have no change of control covenants (poison puts) or, for that matter, any protective covenants with teeth. As a result, when a private equity firm acquires an investment grade debt issuer through a leveraged buy-out (LBO), it has no problem putting more debt ahead of the existing bondholders. This can also be described as “priming” risk. In these situations, the investment grade bond investor is left holding the bag—increased leverage combined with subordination inevitably leads to dramatic ratings downgrades, often into high yield territory, along with substantial price discounts to compensate for the now-inadequate coupon. Those who are forced to sell at this point (many investment grade managers are not allowed to hold bonds rated below BBB) must generally do so at a significant loss and for non-fundamental reasons. All of this begins with a search for spreads of 1-2% over Treasury bonds.

Although the current state of credit markets has effectively closed down the private equity firms, this is temporary. They still have cash, continue to raise more money and they will eventually spend it. Thus, event risk remains and with more leverage and more downgrades, the high yield universe will continue to expand. The question is not whether you will own non-investment grade debt but whether you wanted to.

While we have considered event risk, let us not forget interest rates or duration issues. See the corresponding chart showing the yield on the 10-year Treasury bond from 1962-present.¹ Interestingly, the yield in 1962 of 3.86% is approximately the yield today in October, 2008. For 20 years yields steadily climbed to peak around 16% in 1982 and over the next 20 years fell to below 4% in 2003. Yields had started to climb back after 2004 but have re-traced lower over the past year because of the current credit crisis. This “flight to quality” concept is important and will be discussed shortly.



¹Source: United States 10 Year Treasury Note as reported by the Chicago Options Exchange, ticker TNX, October 2008

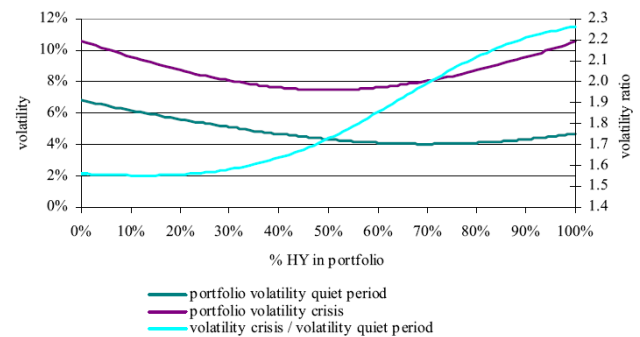
So the question that we are compelled to ask is where exactly are we headed? It is our opinion that rates have nowhere to go but up. With the massive trade and budget deficits and the need to continue to print money to “fix” the financial system, continued dollar weakness is likely. This means that foreign monies will demand higher rates to deal with likely losses on the currency. There is another simple principle that perhaps is being overlooked: supply and demand. Since recently observing that the banks have destroyed hundreds of billions of dollars of equity capital, we know that this money is not available to be loaned into the real economy. So the supply of money will be impaired for a few years while demand is likely to grow. The price of money (measured in this case by rates) should inevitably go up.

This is massively important in studying both historical and expected returns for high grade fixed income. Just how much of the 5.7% annual return of the Lehman Brothers Aggregate Index² over the past 10 years came from a decline in interest rates? Fixed income managers who expect rates to rise typically adjust their duration (interest rate sensitivity) by shortening to lower the perceived risk. The problem with this solution is that short rates are around 3% which doesn’t go very far in meeting actuarial or other return boogies. We will provide our solution to duration and returns later on.

Flight to Quality-The Treasury Hedge

The primary reason we can offer for the inclusion of high grade (government) bonds in a fixed income portfolio today is because of their “flight to quality” effect on a portfolio. Simply put, panics lead people to buy safety driving down rates and increasing the value of government bonds. The chart on the right taken from a recent working paper from a European Business School³ demonstrates this more fully.

Figure 5: Volatility during the quiet period and during a crisis, and volatility ratio: U.S. portfolios (GVT and HY bonds)

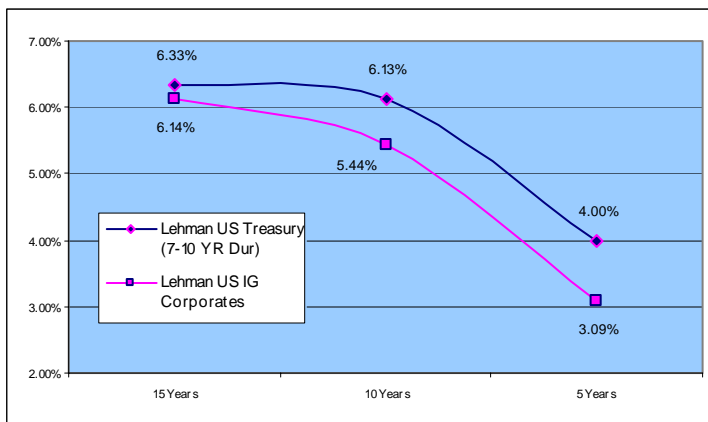


The purple line shows portfolio volatility during a crisis period. Note that a portfolio consisting of 50% high yield and 50% government bonds is approximately the low point in returns volatility. It appears a natural hedge exists. Crisis periods tend to see massive spread widening in the high yield market and this is hedged by Treasury bonds. **What this strategy does not employ is high grade corporate bonds.** There are two reasons. First, high grade corporate bonds would have limited liquidity so there is really no “flight” available. Secondly, a “quality” effect is not observed. In crisis, all corporate spreads widen including those whose bonds are rated BBB and higher.

Before leaving the \$4.8 trillion “high grade” (rated BBB or higher) bond market, I would like to make several observations. I have spent my 24 year career baffled by this market and why anyone invests money there. Though we have spoken briefly about event and duration risk, there are so many additional problems finally being exposed. Since financials represent 43%⁴ of the investment grade universe, this “trust me, it’s safe” market is finally being blown sky high. The beginning of the end for the concept of “investment grade” began back in 2002 when *Enron* and *Worldcom* (both highly rated) inflicted great pain and little recovery on their bondholders. Now, the banks, financial insurers, investment banks and mortgage companies and their A to AAA ratings are being completely exposed. We had

previously written about MBIA and the 14% yield it paid on its “AAA” surplus notes just a few months ago. Does anyone remember when *General Motors* and *Ford* were highly rated companies? There are no “lay-ups,” “no-brainers” or “relative values” in corporate credit. Every single company and security needs to be analyzed to determine its creditworthiness and protective covenant package to properly assess if it is worthwhile to own.

Graphically our views can be expressed by the chart to the left⁵ which shows returns for the Treasury market vs. the high grade corporate market. The facts speak for themselves.



²Source: Lehman Brothers

³Source: M. Briere and A. Szafarz, *Crisis-Robust Bond Portfolios*, , December 2007, Working Paper 07/030, Center Emile Bernheim Research Institute in Management Sciences.

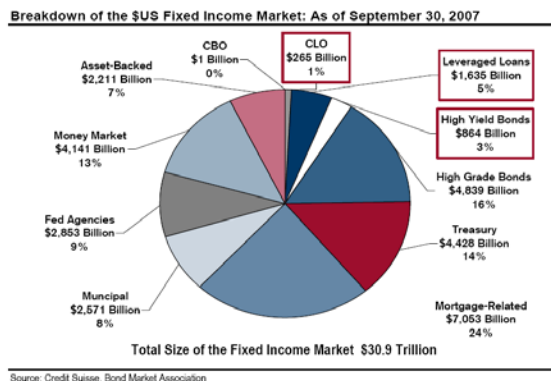
⁴Source: 43% of the Lehman Brothers U.S. Corporate Index, as of February 29, 2008.

⁵Source: Lehman Brothers—US Treasury 7-10 YR Duration Index, Lehman US Investment Grade Index.

The New Core Assets: High Yield, Leveraged Loans and Structured Credit

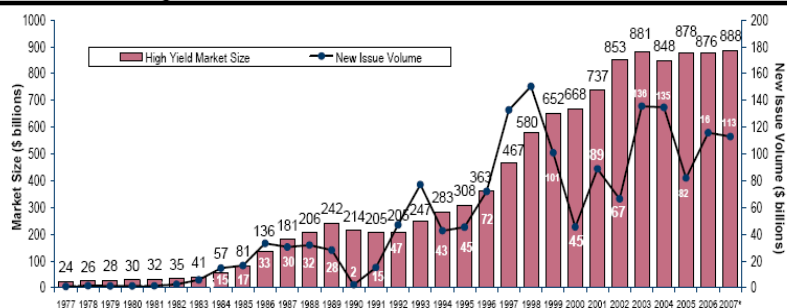
So if we eliminate high grade corporate bonds and instead include a portion of US Treasury bonds as a natural hedge, what might a core fixed income portfolio look like? Consider the chart⁶ breaking down the US fixed income market to the right:

Corporate debt CDO's, leveraged loans and high yield bonds total almost \$3 trillion and this number continues to grow, mainly through ratings migration. These segments, which we collectively referred to as the "leveraged finance universe," equate to approximately 57% of the high grade corporate bond market. Yet many consultants and plan sponsors still consider this an "alternative" asset class. We would argue that it now more accurately represents the concept of corporate credit and we further believe that substantial returns can be realized through active portfolio management within this universe of opportunity.



The high yield bond market alone is approaching \$1 trillion domestically. In retrospect, trends in the credit cycle appear reasonably predictable. Record issuance is followed by fundamental credit problems that, in turn, lead to spread widening and a dramatic retrenchment of issuance. From 1991-1996, the high yield bond asset class produced very attractive returns, which caught the attention of investment management consultants. Yet the asset class remained relatively small, with only \$363 billion outstanding at the end of 1996. As the bar chart⁷ below illustrates, that was about to change.

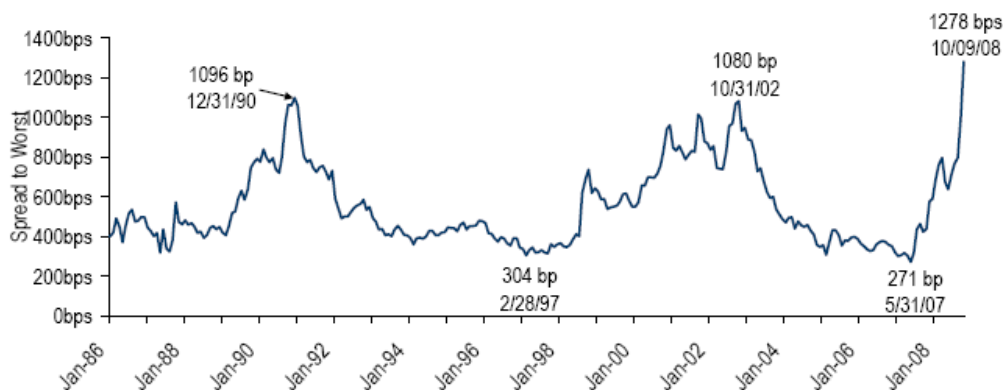
Growth of the High Yield Market



Source: Credit Suisse

burst, investors woke up from the dream to learn that credit fundamentals again ruled the day. Default rates⁸ soared and issuance plunged. Note below⁹ that spreads ultimately blew out to around 1,000 bps for the major indices back in 2002 and they have actually moved through these old highs over the past week:

Spread of the Credit Suisse High Yield Index



Source: Credit Suisse

⁶Source: Credit Suisse, 2008 Leveraged Finance Outlook and 2007 Annual Review, January 18, 2008.

⁷Source: Credit Suisse, 2008 Leveraged Finance Outlook and 2007 Annual Review, January 18, 2008, page 18.

⁸Source: Credit Suisse, 2008 Leveraged Finance Outlook and 2007 Annual Review, January 18, 2008, page 213.

⁹Source: Credit Suisse, Leveraged Finance Market Update, October 10, 2008, page 2.

We believe that markets have entered a period where the disparity between high yield fundamentals and the pricing of high yield bonds is now at all-time highs, resulting in investment opportunities not seen since the post-telecom/technology era. Dissimilarly, however, high yield bonds were not the engine powering the over-leveraged bubble we find ourselves bursting from, though current pricing of high yield bonds suggest that they were. This is not to say that a recession (which we believe we are in) will not affect the fundamentals of most companies in the high yield sector. However, we do not believe that the high yield indices will suffer default rates of greater than 10%, as was the case in 2002.

Though they may not be in the eye of the storm this time, it is important to note that high yield bond investors did, indeed, stray from a disciplined and prudent course, as is usually the case at the top of a credit cycle. Not by financing business plans, but by accepting abnormally low coupons of 7-8%. So, as the cycle turns and investors once again demand to be paid more for risk, bond prices are falling and adjusting yield levels accordingly. In many cases, we believe that the declines are more significant than the fundamentals justify. This has created an issue that we feel is unique to this cycle. Issuers have the luxury of lower interest rates on the debt balance, which should be reflected in better credit metrics, such as interest coverage tests.

Leveraged Loans: The Answer to the Duration Conundrum?

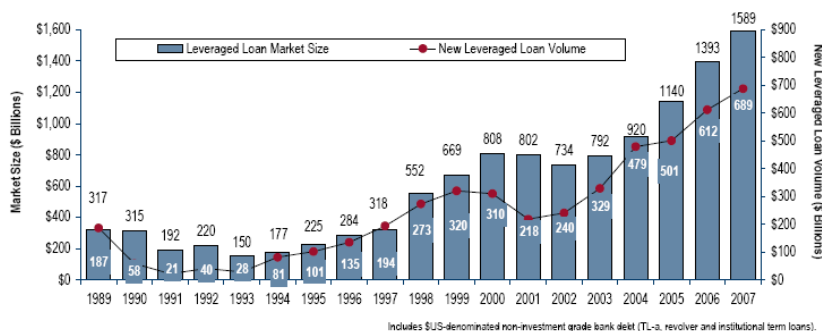
We believe that the current “credit crisis” has not only created opportunities in the high yield market, but also in the leveraged loan market. The leveraged loan is a close cousin of the high yield bond. Leveraged loans are loosely defined as loans rated below investment grade. As the chart at the right¹⁰ shows, growth in this segment has been spectacular, driven primarily by demand for product by collateralized loan obligations (CLO’s).

Ordinarily, leveraged loans are not of much interest to absolute return investors, such as Peritus, who generally seek unlevered, double-digit returns. Leveraged loan debt ranks high in seniority and is typically secured, so spreads tend to be small (as low as 150 bps over 3 month LIBOR) and discounts miniscule (in fact, premiums often prevail).¹¹ Even in a changing interest rate environment, loan prices tend to remain in a narrow band around par because loans carry floating rate coupons that reset regularly. If we believe that rates are headed higher, the effective duration of loans are very low based on their floating rate coupons.

Like the high yield bond market of the late 1990’s, the leverage loan craze of 2005 through 2007 demonstrated that quality and supply are inversely proportionate. Much of the credit bubble was inflated by loans carrying leverage statistics that greatly exceeded historical norms.¹²

In addition to deteriorating fundamentals, supply and demand technicals are also at all time distortions. As the credit bubble rolled on, deals became increasingly large, while investment banks became increasingly bold. In the waning months of this exuberance, banks underwrote massive amounts of debt with the intent of off-loading it “in due course” to investors. But the bubble burst quickly and investor demand dried up virtually overnight. Investors in loans have traditionally applied aggressive leverage to their strategies to facilitate returns and that availability of leverage quickly ceased. The unwind has been perpetuated by the domino effect; that is, margin calls driving the selling, which of course is being forced by the banks themselves. So there is tremendous internal pressure on the banks to free the capital currently tied up in loans, which in turn pressures pricing in the secondary loan market.

Growth of the Leveraged Loan Market



Source: Credit Suisse, LPC

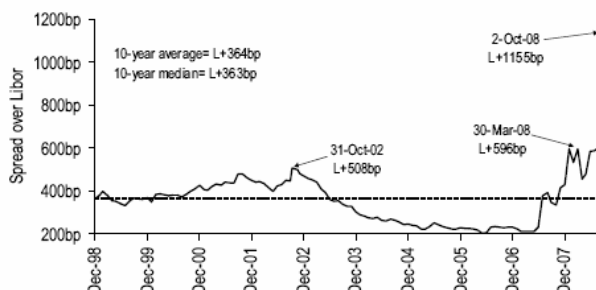
¹⁰Source: Credit Suisse, 2008 Leveraged Finance Outlook and 2007 Annual Review, January 18, 2008, page 88.

¹¹Source: Credit Suisse, 2008 Leveraged Finance Outlook and 2007 Annual Review, January 18, 2008, page 82-83.

¹²Source: Credit Suisse, 2008 Leveraged Finance Outlook and 2007 Annual Review, January 18, 2008, page 94.

What has been discovered through this process is that there is no natural buyer for secondary loans. Thanks to the sub-prime debacle, investors are abandoning structured credit like rats from a sinking ship, and CLO creation has come to a complete standstill; indeed, many are unwinding, desperate for anyone to take the loan positions they hold. This has created our favorite imbalance, one where we can be price makers and not price takers. The values have developed as spreads¹³ have blown out to record highs, even for fully secured 1st lien loans.

Leveraged loan spreads



Certain segments of this loan market possess attractive attributes such as seniority, security, limited leverage, short maturities and good covenants. For each one of these, there is the stepchild with the opposite attributes, known as “covenant-lite.” *Caveat emptor*, there are no layups – you must do the work.

Structured Credit: The Baby and the Bathwater?

The structured credit (CDO or collateralized debt obligation) animal has until very recently been the proverbial 800lb gorilla of the credit markets. Over the past 20 years securitization has grown to be the largest client of Wall Street – a unique product because it was repeatable in basic form over and over again accessing buyers in need of capital efficient investment options. What characteristics made securitization so successful over the past two decades? In simple terms it was a whole lot easier to sell higher rated securities to investors rather than lower rated ones. Highly rated investments for banks and financial institutions are much more capital efficient ways to invest and theoretically carry less volatility. Securitization capitalized on this market characteristic by offering a lot of “financially engineered” AAA credit to banks and financial institutions during a time when AAA risk was becoming almost impossible to find. In essence, they took a bunch of non-AAA assets (mortgages, loans, credit card receivables, auto loans etc.) tossed them in a pool, added a little equity, stirred them up and came up with higher rated bonds. The top tranche was structured to achieve AAA ratings based on its historical default/recovery characteristics and the fact that there was a little bit of equity helping to “over-collateralize” things in case of problems.

So the investment banks were able to have their cake and eat it too because they were selling new AAA bonds to investors backed by lower quality assets sold into the securitizations also known as CDO trusts. Securitization has been around for the past two decades and has survived booms and busts in credit before. So, why now is this market in such disarray? Think of the growth in distribution and the ability for investors to get involved in credit where there once existed a variety of limitations. Securitization found and capitalized on a demand for AAA risk that was almost insatiable and that allowed for significant growth in the credit markets to occur. We believe this created the foundation for the banking business models to shift from that of risk taking (lending and capturing a spread) to flow trading. Rather than invest their own capital by building positions and end up more capital constrained, they could create more and more risk for the market to take on in large part through securitization, make money more effectively by taking a spread on the trades and fee income and not have the risk on their balance sheets. With every securitization that priced, bonds were moved from the trading desks into the CDO trusts and more room was left behind to make more.

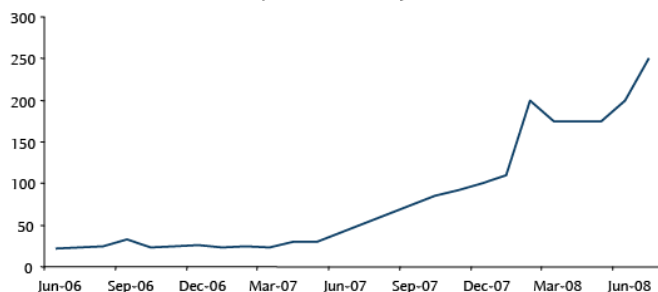
Our focus remains on corporate credit, so how does this whole meltdown present an opportunity that can be analyzed, valued and purchased? We see one specific area of focus and it is the secondary market for collateralized loan obligations known as “CLO’s.”

¹³Source: JP Morgan, *Credit Strategy Weekly Update, High Yield and Leverage Loan Research*, October 3, 2008, page 18.

The following chart¹⁴ profiles just a small portion of this universe but illustrates what is behind our thinking:

Source: Barclays Capital

Secondary AAA CLO spreads



What is truly mind-boggling is the speed of this unraveling. Spreads have blown out 10 fold going from 30 basis points over LIBOR to almost 300 basis points in a little more than a year! How can that be? Were these structures similar to the mortgage conduits where traditional mortgage paper was substituted with “subprime” paper and the AAA ratings were a joke? Or does this represent an opportunity? The nice thing about CLO’s is the relative transparency of the structure and assets. The assets are corporate loans which can be assessed for creditworthiness and recovery in the event of default. The structures can be analyzed to determine whether or not the

cash flows will be turned off based on the assessment of the portfolio. It would be very much like buying bonds in a bank but with much greater clarity. The exciting thing about this market is that you have an opportunity to buy as senior (AAA) or junior (equity) as you feel the risk/reward proposition justifies. Once again, you don’t have a bunch of competition on the buy side.

Bank for International Settlements: The Nail in the Coffin

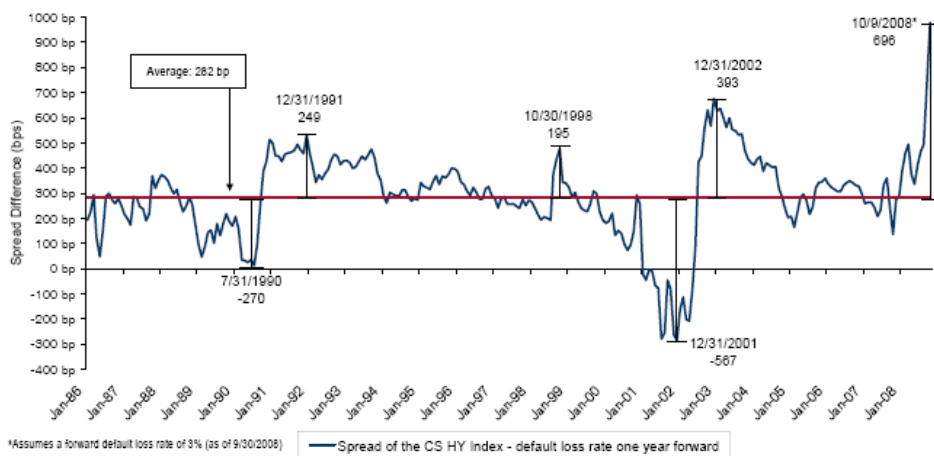
The Bank for International Settlements known as the “BIS” is effectively the bank for central banks. This Switzerland based organization sets capital requirements for the global banks. Basel II was an attempt to make sure that banks have enough capital to cover various assets based on their risk. As mentioned, it is likely that these regulations created much of the mess we see in structured credit by focusing banks on the AAA asset class. But more to the point, in the corporate space, note that the new regulations require banks to hold 150% of the current capital standards backing anything with less than a BB- rating¹⁵. That capital requirement is currently 8% and now heading to 12%.

Claims on corporates

Credit assessment	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-
Risk weight	20%	50%	100%	150%

So what we see is even more pressure to shed assets at a time when there is no bid. Nothing speaks to this more eloquently or portrays the opportunity better than the estimated liquidity premium. In simple terminology, this is the amount one is paid for simply showing up at the party. In 2002, this number came out to around 4%. This has been blown away by the current environment where it is now around 7%¹⁶. This is an almost unfathomable number and regardless of what one believes defaults will be, this can provide an incredible margin of safety.

Liquidity Premium Estimate for the High Yield Market



Source: Credit Suisse

¹⁴ Source: Barclays Capital, *Macro Outlook and Ramifications for HY*, September 3, 2008.

¹⁵ Source: Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards*, June 2006.

¹⁶ Source: Credit Suisse, *Leveraged Finance Market Update*, October 10, 2008, page 3

The Peritus Fund: Why Investing Now Matters

The information presented in this research piece leads us to the launch of our most recent fund, The Peritus Fund, L.P. We have been exceedingly patient in evaluating the timing of this fund launch with many interested parties asking over the past few months whether or not the time is right. We are confident that now is the most interesting opportunity to launch this fund and put capital to work based upon the following facts:

Spreads and Market Prices

The profile of credit spreads and the corresponding market prices for high yield bonds we estimate to be as cheap as the market has ever seen. Spreads are at all time wides (approx. 1300bps) versus the treasury market and this equates to a market value close to \$.70 on the dollar by our estimates. This represents a unique discount which corresponds to very attractive yield opportunities in the sectors we follow. It also underscores our view that further spread widening would be temporary as we turn the corner in the coming year.

Default Expectations

Given the jitters associated with the overall global economy, many academics and pundits are calling for defaults in the general market to escalate in the coming year. Indeed we have already seen this with such names as Lehman Brothers, an investment grade rated entity prior to default. While we agree that defaults will rise, we view the high yield market as *very* different from the high yield market which last experienced double digit defaults. This down cycle was not prompted by an over supply of financing through high yield bonds. Rather, this time around the high yield market was not the driver for general market spread widening and as such we see tremendous opportunity to invest in bonds which do not represent hope for survival but rather bonds issued by companies with real businesses and an expectation of cash flow performance.

Investment Hypothetical—What If?

Consider that high yield bonds provide the one thing all other asset classes currently lack—attractive cash flows. Our portfolios¹⁷ will likely exceed 9% in coupon cash flow. The 10 year US Treasury has had a yield profile below 4% for quite some time. By utilizing coupon income combined with a unique opportunity to buy at such a price discount, we expect cash flows from the portfolio will act to mitigate any default experience which might occur. See the corresponding chart below outlining the math behind the estimates. With an outsized and unusual default assumption assessed on a portfolio, buying assets that cash flow like those of high yield bonds and entering the market at an approximate 30% discount to par, results in a positive return by our estimates of 6% assuming no change in price. This is not a feature you can utilize in any other asset class given the obvious disparity between coupon cash flows generally in high yield bonds versus other asset classes. We think the concept that a discounted price equates to an elevated level of risk is misguided. Picking the right credit exposures matters and we have always believed in this basic investment tenet. The manager matters in a time where investors realize that active management is necessary and investing is much different than trading.

Model Portfolio Characteristics as of October 8, 2008:

Par Value	\$140.9mm
Market Value	\$100mm
Average Price	\$70.95

Default Scenario:

Default rate	12.00%
Defaulted par value	\$16.9mm
Market value loss to default	\$6.9mm
% change due to default loss	-6.9%
<u>Current coupon yield</u>	<u>12.9%</u>
Net Effect	6.0%

Note 12% is more than 3 times the historic average in HY defaults.¹⁸

Investment Objective:

While there is substantial cushion involved in our asset class presently - our objective is to provide absolute returns. This means performance which is positive and in simple terms makes our clients money. We believe there is no value to being “relatively” better than an index if that index is losing money. The purpose of our fund is to invest in companies where we expect the security price to appreciate in value while being paid appropriately to carry the risk. We have a long standing strategy seeking to provide true alpha to our investors and the launch of this fund is the vehicle which we believe will deliver our strategy and the opportunities we see available in current market environment.

¹⁷ Model portfolio does not represent an actual portfolio but includes credits Peritus has evaluated for inclusion and therefore depending upon timing and market conditions as well as any use of leverage and other factors, actual results may vary. The information presented is subject to change. The model portfolio and statistics utilized within are for illustration purposes only, assume \$100 million is invested over a 1 year horizon with no change in price and a default and recovery rate of 12% and 30% respectively. Actual results could be materially different depending upon market conditions.

¹⁸ Source: CITIGROUP, Altman High Yield Bond Default and Return Report, July 24th, 2008, page 8.

Concluding Thoughts

We believe that we have entered our favorite part of the credit cycle, no liquidity. It is during these periods where true bargains can be found. In summary:

- *With event risk, duration concerns, credit risk and lack of spread, investment grade corporate bonds as the main asset class in fixed income portfolios make little sense.*
- *Treasury bonds have provided an excellent hedge in fixed income portfolios due to their flight to quality effect. During times of crisis, gains in these securities have historically helped offset spread widening in other areas.*
- *The leveraged finance opportunity set totals close to \$3 trillion today and continues to grow. Active credit management is now and will always be required to be successful in all corporate credit markets. Every exposure needs to be researched, assessed and valued thoroughly. There are no layoffs in credit even if the assigned ratings are high.*
- *The secondary high yield bond market has experienced dramatic re-pricing. Though both credit quality and liquidity risk are partially responsible, contagion originating in other segments of the fixed income market has exacerbated the downward movement to spread levels that to us appear unjustified. Liquidity premiums have never been this high.*
- *The emergence of secondary trading in leveraged loans due in large measure to unwinding financial leverage has created unprecedented opportunities to buy deeply discounted loans. Deep price discounts combined with secured and senior positions in corporate capital structures and shorter maturities, can make up for the lower coupon paid on loans.*
- *Contagion in structured credit has created an opportunity to purchase select secondary tranches of CLO's at risk/return levels never before seen.*

Peritus I Asset Management Return 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 and all opinions expressed are 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.

Point Counterpoint



Chirag Gandhi

AGREE

Credit-rating agencies provide relatively independent and well-reasoned guidance. Disagreement on their usefulness emerges from investors who are critical and shift the blame. The significant influence of rating changes on market expectations and credit spreads proves their importance.

What are the alternatives to rating agencies? We are in the midst of a crisis in confidence on the objectivity and independence of sell-side firm analysts. It is not clear if Street firms can make an economic justification for running truly independent research floors. This is clear from the layoffs of well-known analysts that we have seen. The current environment has demonstrated the urgent need for both availability and reliability of research with broad coverage. Rating agencies have become valuable with their vast coverage and timely comments on current information. Their efforts to maintain consistency in the interpretation of information across sectors and countries while incorporating critical qualitative factors are commendable.

What is expected of the rating agencies? Is it to upgrade your portfolio holdings? Is it to interpret information not yet available? Is it to be right every time in their judgment? Rarely have I heard anyone complain about an upgrade. It is important to set fair expectations. This dynamic industry does not allow for perfection and to expect it would be unrealistic. I admit, changes in rating methodology are frustrating, but incorporating secular changes in credit analysis is critical. For example, the use of market sentiment in rating decisions is more important than ever before due to rising leverage and its impact on the bottom line via the rising cost of capital. It's not a mere marketing tool or a search for a safe haven. My expectation from any research analyst is to tell me what he or she truly thinks, and I will decide whether to believe it or not. An investor should not have to worry about the honesty of dialogue. Rating agencies and a few pure credit research firms satisfy this need.

Market prices pay close attention to ratings. Therefore, companies pay close attention to rating agencies. CFOs are more humble and careful listeners during their meetings with rating agencies. This makes the guidance about companies' credit-worthiness from rating agencies valuable. Bond investors often stave off the equity research analysis. Rating agencies with their focus on the debt side of capital structure are the closest ambassadors of bond investors. //

Chirag Gandhi is an assistant portfolio manager for Global Fixed Income Portfolio with State of Wisconsin Investment Board in Madison, Wis., USA.



Tim Gramatovich, CFA

DISAGREE

Credit ratings and the historical methodology used to establish them are far too simplistic today. Historical financial ratios, revenue size, and access to capital and liquidity analysis should be nothing more than a starting point.

As an active participant in the credit markets, my focus is on the purchase of undervalued corporate bonds. I look for businesses that have large market shares, have a product or service that is essential, generate free cash flow, and have a management team in place with both experience and discipline.

Management and intellectual capital today are at a premium. There is great performance dispersion among companies within the same industry. Intellectual capital needs to be valued, and some form of "operational risk" needs to be incorporated into the ratings game.

Political risk was thought to be something that emerging market players focused on. But recent U.S. history suggests that ignoring politics and the legislative process is dangerous. For instance, asbestos issues have bankrupted numerous companies, and electricity deregulation has forced many utilities to their knees.

Historically, ratings agencies have favored large companies for their ability to access the capital markets. This unlimited access to capital has been turned off

for many companies. Many of these businesses possess complicated financial statements. Should companies with simple capital structures now receive higher ratings? Conversely, should complicated financial structures be penalized in the ratings process?

Recent history suggests that models or investment strategies that rely on historical default and recovery rates may be of limited effect. It is not unusual in recessions to see default rates increase by two to three times the historical averages. However, during 2001, BBB rated debt was *10.5 times more likely to default than it was during the 1980-2000 time frame*. Conversely, the highest risk segment (CCC) experienced a far lower incidence of default than historical data would justify.

Recent events have exposed the ratings process as being mediocre at best. Too many companies that held high credit ratings have failed recently. One could excuse an Enron as a massive fraud or outlier, but dozens of other "investment grade" companies have followed a similar path to bankruptcy.

The imaginary investment grade line between BBB- and BB+ is vanishing, and the ratings techniques used to determine such a line are outdated in today's global economy. //

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AGREE OR DISAGREE
Credit-rating agencies provide useful and timely information about the credit-worthiness of companies in today's market.