PERITUS I
ASSET MANAGEMENT, LLC
Active Credit
Independent Credit Research – Leverage Finance – November 2009

The Case for High Yield in 2010

We were pretty convinced a year ago that the entry point into our asset class would turn out to be a once in a generation opportunity. What we did not expect is to see this play out in so short a time frame. With high yield spreads coming in dramatically, the question we are asking ourselves is what's next? Does the high yield corporate bond market makes sense going forward or have we squeezed all the juice out of this orange? Here are our conclusions:

- We believe that current high yield spreads of almost 7.5% vs. the 10-year Treasury[1] remain very attractive.
- High yield has outperformed equities over 1, 3, 5, 10 and 15 year periods, and has done so with less risk.[2]
- If you believe rates are likely to go higher, high yield historically has and we believe should continue to outperform investment grade bonds.[3]
- Fundamentals from our perspective have rarely been better as balance sheets are liquid and companies have been stress tested.
- We expect that market technicals are likely to remain in our favor for the foreseeable future as investors search for yield.

Spreads

With the tremendous rally we have seen in our world over the last year, the question becomes, is there value left in the market? Over the past 20 years, the average high yield spread has been 597 bps.[4]

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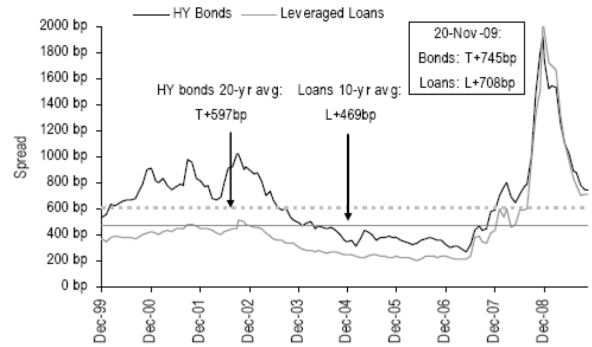
[1] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Alisa Meyers. "North American High Yield Research: US Fixed Income Markets 2010 Outlook." J.P. Morgan Securities, November 27, 2009, p. 1.
[2] See page 3.
[3] See page 3.
[4] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Alisa Meyers. "North American High Yield Research: US Fixed Income Markets 2010 Outlook." J.P. Morgan Securities, November 27, 2009, p. 3.



Note: Leveraged loan spreads are estimated based on the S&P/LSTA index (4-year average life), while high-yield spreads are based on J.P. Morgan Global HY Index.
Sources: J.P. Morgan; S&P/LCD

Let's round up to 6%. So with the 10-year Treasury at 3.25%, the "average" should give us a yield of about 9.25%. Since we don't view today as "normal" we pose three questions:

1. Is the longer term average spread of 6% unfairly biased by the blowout in 2008?
2. Should the tenuous economic landscape demand a premium over historical spreads?
3. Is the 10-year Treasury yield of 3.25% likely to rise substantially in 2010?

Trying to stay succinct in our responses, on the first point, there is likely some noise or distortion created by the 2008 spread blowout. Rather than eliminate the 2008 numbers, a more accurate picture is given by looking at longer term data going back to 1978, which puts the average spread at 5.24% over the 10-year Treasury.[5]

Annual Returns, Yields, and Spreads on 10-Yr Treasury and High-Yield Bonds,[a] 1978–3Q 09

	Return (%)			Yield To Maturity (%)		
Year	HY	Treasury	Excess	HY	Treasury	Spread
Arithmetic Annual Average 1978–2008	9.58	8.93	0.65	12.33	7.09	5.24

That would mean current high yield spreads of about 750 bps indeed do provide a nice premium over historical spreads, which gets to the second question. Interestingly, on a fundamental level, which we address later, we think spreads have room to narrow and the current environment may even justify spreads inside the long-term average. So while we will gladly take any premium over historical averages that the market offers, many company fundamentals don't warrant it, despite the economic landscape.

And how about those Treasury yields? Well, the obvious answer is that rates are likely to head substantially higher as the dollar continues to weaken and the U.S. Treasury has to issue massive amounts of debt. However, the obvious answer is often the wrong one. It has certainly proven wrong so far. This is not about quantitative easing, but the banks borrowing at effectively no cost and buying Treasuries. The strong bid is from the banks themselves, which is no accident.

[5] Fenn, John. "Altman High Yield Bond Default and Return Report." Citi Corporate Securities Strategy, November 11, 2009, p. 15.

We will have more on this in future correspondence, but simply put, it would not surprise us to see rates go nowhere for the foreseeable future.

Historical Returns vs. Peer Group

While current spreads seem to indicate there is still value in the high yield asset class, the other aspect we found interesting was a look at how high yield has performed versus the other major asset classes. High yield bonds have less risk than equities on two levels: first on an absolute level because bonds are senior to equity in the capital structure of a company and secondly on a relative level measured by standard deviation or volatility. As can be seen below, high yield out-performed equities by a wide margin over 1, 3, 5, and 10 years and also outperformed over 15 years.[6] And all with less risk than equities, as measured by the annual volatility. Interestingly, high yield also outperformed the Treasury bond market for all periods except the three year.

	Average annual returns				
	1 year	3 year	5 year	10 year	15 year
5-year Treasury	6.76%	7.87%	5.00%	6.12%	6.40%
10-year Treasury	9.24%	7.42%	4.96%	6.18%	6.73%
EMBIG	39.64%	6.73%	8.41%	11.12%	11.74%
JULI	29.73%	6.54%	5.06%	6.92%	7.40%
S&P 500	9.80%	-7.02%	0.34%	-0.95%	7.33%
Leveraged loans	**30.50%**	**2.47%**	**3.76%**	**4.54%**	**5.22%**
Global HY	**47.58%**	**5.64%**	**6.22%**	**6.90%**	**7.59%**

	Average annual volatility				
	1 year	3 year	5 year	10 year	15 year
5-year Treasury	6.01%	5.24%	4.60%	4.85%	4.61%
10-year Treasury	13.69%	9.11%	7.83%	7.88%	7.47%
EMBIG	8.59%	12.45%	10.22%	10.22%	13.77%
JULI	8.38%	8.52%	6.98%	6.08%	5.65%
S&P 500	23.64%	19.58%	15.97%	16.13%	15.78%
Leveraged loans	**16.27%**	**14.00%**	**10.79%**	**7.76%**	**6.38%**
Global HY	**16.60%**	**16.31%**	**12.76%**	**10.44%**	**9.08%**

Furthermore, we believe high yeild should be added to a fixed income portfolio. If you subscribe to the notion of a rising interest rate environment going forward, high yeild has historically outperformed investment grade by a wide margin as rates rise.[7]

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[6] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Alisa Meyers. "North American High Yield Research: US Fixed Income Markets 2010 Outlook." J.P. Morgan Securities, November 27, 2009, p. 13.

[7] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Alisa Meyers. "North American High Yield Research: US Fixed Income Markets 2010 Outlook." J.P. Morgan Securities, November 27, 2009, p. 14.

12-months ending:	10-year Treasury yield move	High-yield bonds total return	Investment-grade bonds total return
Sep-87	+220bp	5.97%	0.20%
Feb-89	+117bp	7.32%	4.72%
Dec-94	+204bp	-1.57%	-3.34%
Dec-99	+179bp	3.38%	-1.89%
May-04	+130bp	13.23%	-0.47%
Jun-06	+120bp	4.64%	0.27%

Source: J.P. Morgan

Additionally, unlike investment grade, high yield actually has a negative correlation with the 10-year Treasury over the last 15 years, providing excellent diversification benefits for those feeling rates are headed higher.[8]

	10-year TSY	LB Agg. Bond Index	JPM JULI IG Index	JPM Global HY Index	S&P 500	JPM EMBIG
10-year TSY						
LB Agg. Bond Index	0.91					
JPM JULI High-Grade Index	0.69	0.89				
JPM Global HY Index	**-0.13**	**0.21**	**0.47**			
S&P 500	-0.13	0.07	0.26	**0.60**		
JPM EMBIG	0.13	0.30	0.44	**0.55**	0.56	
Leveraged loans	**-0.33**	**-0.01**	**0.24**	**0.79**	**0.40**	**0.28**

Source: J.P. Morgan; S&P/LCD

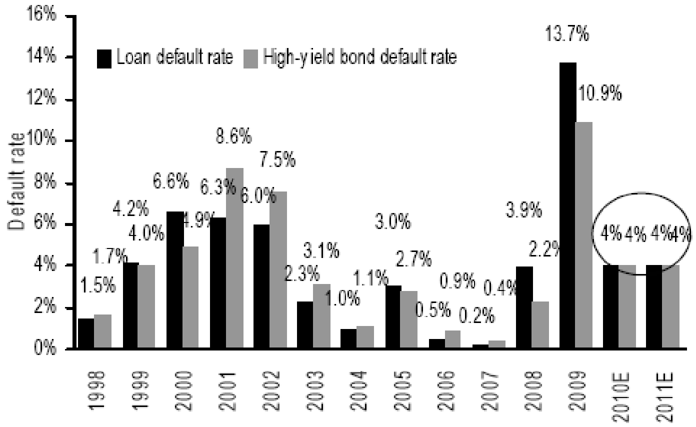
Fundamentals

Now turning to company specifics, what is so strange to us about where we sit today is the fact that fundamentals from our perspective have rarely been better. Understand that as debt investors, we have a very different focus than equity investors. Sales and earnings per share growth are meaningless to us. Instead, one thing we want to see is free cash flow generation and more importantly, has the company applied this free cash flow to pay down debt. As the world ended late last year and sales plunged for almost everyone, many businesses generated a ton of cash because they didn't reinvest in the inventory cycle. In simple terms, they sold what they had and pocketed the cash. So their balance sheets became very liquid and cash rich. Many have now chosen debt paydown over investing in expansion. This is what deleveraging is all about. So while the world frets about recovery and growth, we prefer the no-growth environment in which we seem to currently find ourselves.

One additional point that needs to be made involves the notion of stress testing. No matter how much modeling you do to stress test a business and its ability to pay bills during a downturn, there is nothing like a real world fire drill where revenues plunge 40% quarter over quarter to truly stress test a business. How many times in a lifetime are we likely to see this occur? This is the first time most of us have ever seen this regardless of how long we've been in business. So for those companies that have survived, we do not think it is very likely that things will ever get much worse than the Q4-08 through Q1-09 period.

[8] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Alisa Meyers. "North American High Yield Research: US Fixed Income Markets 2010 Outlook." J.P. Morgan Securities, November 27, 2009, p. 14.

Finally, no discussion about fundamentals would be complete without touching on expected defaults. This is where things get even more bizarre. Six months ago it was well "understood" that defaults were going to soar to record heights and remain elevated for years. Well soar they did, but after a brief visit in double digit territory, expected defaults have plunged to around 4% for 2010 and 2011.[9] How can that be?

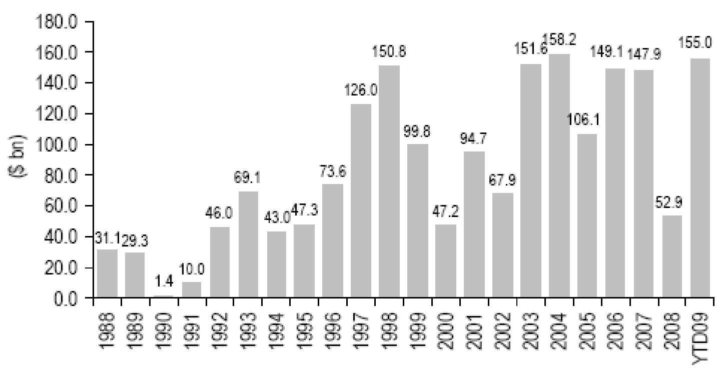


Note: High-yield bond and loan default rate forecasts are par-weighted.
Sources: J.P. Morgan; S&P/LCD

Technicals

One of the main reasons that default rates are plunging is due to the opening of the market to new issuance. Nobody at the beginning of 2009 saw this happening. As can be seen below, through November 20th there has been $155 billion of new issues.[10] No doubt that 2009 will see an all time annual record as it relates to new issue volumes.

Annual high-yield new-issue volume



Source: J.P. Morgan

With both short term rates represented by LIBOR and intermediate rates represented by the 10-year Treasury at incredibly low levels, investor demand for yield is likely to help keep the

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[9] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Alisa Meyers. "North American High Yield Research: US Fixed Income Markets 2010 Outlook." J.P. Morgan Securities, November 27, 2009, p. 6.

[10] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Alisa Meyers. "North American High Yield Research: Credit Strategy Weekly Update." J.P. Morgan Securities, November 20, 2009, p. 26.

primary market open for the foreseeable future. Money flows into high yield mutual funds have been the big catalyst in 2009, but our own experience and the wave of institutional searches underway suggests that allocations are just getting going in the pension world.

Conclusion

As we remain surrounded by massive and growing unemployment, a collapsed real estate market and a host of other economic issues, corporate credit investors seem to find themselves in something of a nirvana. I would prefer to be massively negative as we have had an incredible run in 2009 but credit cycles rarely operate this way. We would prefer that a fear premium gets reinstated into our market and bonds sell off to give us even more value. But wishing for it is not an investment strategy; it is bias. The reality is many balance sheets are incredibly liquid and being de-levered as management teams focus on survival not growth. Companies have been stress tested like never before and money flows into high yield bonds are likely to increase as institutional investors seem to be under-allocated to the asset class. Current yields appear very attractive and, when compared with other major asset classes, we feel high yield should be an outperformer once again in 2010.