The New Case for High Yield:

A Guide to Understanding and Investing in the High Yield Market

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November 2010

PREFACE

It has been more than a quarter of a century since I began my career at a small boutique investment bank by the name of Drexel Burnham. Nearly 27 years later, the market we helped to create from almost nothing is now over $1.2 trillion. Yet with all the growth in the high yield bond market, very little has changed among investor attitudes toward the asset class. "Junk bonds" are still considered an alternative asset class and remain tremendously confusing to the investing public. They are considered by many to be very "risky" and illiquid. *The New Case for High Yield* is meant to be a road map to the truth. The truth is that the high yield market is a relatively straight forward, well developed and liquid market that has posted better risk adjusted returns than equities over virtually every relevant period during the 30 years that market data has existed for high yield.[1]

I've spent nearly my entire career investing in the high yield market and have been around for the majority of its modern history. I began in the business on the "sell-side" (constructing and selling bonds), but during the late 1980's I became intrigued with what we call the "buy side" of the business (buying bonds and managing money). I figured who better to be the buyer than somebody who was exposed to all of the shenanigans of the sell-side. In 1989, I read the writing on the wall and left Drexel before they carried away the furniture. Before embarking on the buy-side path, I felt that I needed more education. It was not an MBA that I was after but a more applicable and practical education. So off I marched into the Federal Courts in Los Angeles to work in and around the bankruptcy arena. I figured that the worst thing that can happen to a bond buyer is that the company stops paying interest and/or principal and the bond defaults, so it would be good to understand this process. I worked as a Chief Financial Officer in a number of debtor-in-possession or "DIP" cases, having to file financial statements along with explanations to the court, and became an expert witness in valuation issues.

What I learned during this time was that the bankruptcy judges understood both valuation and fraud issues. I also got a sense that they were inherently lazy: they did not want to see a bankrupt company back in their courtroom more than once. What this meant to me as a bond investor is that the amount of debt or leverage a company was allowed to maintain after a reorganization (Chapter 11) was limited and restricted. This knowledge would have a profound impact on the development of our investment philosophy and process down the road.

As I developed my own investing rationale, I also considered what I saw taking place in the equity markets around me. It is important to understand that as the investment business began to experience rapid growth in the early 1980's, stock investors basically fell into two camps: value and growth. In simplified terms, the growth camp believes that the focus should be on finding companies that are growing rapidly and the price or valuation is secondary. The value camp believes in a concept known as intrinsic value, and thorough fundamental analysis often plays a role in identifying this intrinsic value. The value camp also believes that prices of securities may or may not reflect the real worth or intrinsic value of the business at a given point in time. The objective of value investors is to find stocks where the intrinsic value is significantly higher than the stock market value, with the expectation that at some point the market will recognize this value and the stock price will appreciate.

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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. 13. Blau, Jonathan, Daniel Sweeney, Janet Yung, and Benjamin Zimmerman, "2010 Leveraged Finance Mid-Year Outlook and Review," Credit Suisse Global Leveraged Finance, July 30, 2010, p. 58. S&P 500 equity index versus the J.P. Morgan and Credit Suisse High Yield Index. See pp. 14-15.

I was quite intrigued with the notion of deep value investing and figured this could be applied to the bond market. Value investing in equities has its challenges. For instance, most value investors rely on market forces to arbitrage their perceived discount away. But what if Mr. Market does not cooperate for many years or decades and your value stocks go nowhere? Even worse, the advent of desktop computing power has allowed everyone to screen for "cheap" stocks so these discounts have become rarer. Yet I felt this value approach would aptly fit into the corporate bond market, and this is the approach we have taken here at Peritus since our foundation. Many of the challenges faced with value investing in equities seemed to be overcome in the corporate bond market. The biggest advantage for us in the bond market is that an exit strategy is assured. Bonds have a maturity date and price so you do not have to rely on Mr. Market being rational in order for the value to be realized. Though our high yield bond world has continued to expand at a rapid pace, the number of investors applying such a philosophy to bonds remains surprisingly limited.

There is one more massive disruption in the bond market that we believe can create or enhance the dislocation between market price and intrinsic value—the bond rating. Frankly, we do not know how the two major rating agencies (Moody's and Standard & Poor's) inserted themselves as the determiner of who gets credit and at what price, but their sterile, simplistic and backward looking views create much of the opportunity for value investors in credit. I have spent a career in the credit markets and still do not understand how the agencies determine what is a BB and what is a BBB credit. Yet this line in the sand is the difference between "investment grade" and "non-investment grade." I consider this nothing short of insanity.

At Peritus we view credit as AAA or D and do our own work. We determine on our own whether we believe it is a money good investment or not, no matter what the rating agencies tell us. If we believe that the business has a reason to exist, a sustainable capital structure and can generate free cash flow (along with numerous other qualities which you can read about later in this operator's manual) we may consider making the loan, so to speak. It continues to boggle the mind that after Worldcom and Enron (both initially highly rated by the agencies), and then the AAA sub-prime mortgage debacle that began to hit in 2008, that anyone would place any reliance on these ratings. Yet pricing and investment decisions are still determined everyday with ratings as a primary factor. Rather than fight this process, we would ask you to join us in taking advantage of the opportunities created by it. After all, we are all looking for inefficient markets.

The New Case for High Yield is meant to be an "owner's manual" for those investing in the high yield marketplace. In it we discuss the history of the asset class, compare historical risk adjusted returns with others asset classes, and provide details as to how we select securities for our portfolios. We hope you find it informative and useful and see the benefits of a high yield allocation in any investment portfolio.

Tim Gramatovich, CFA
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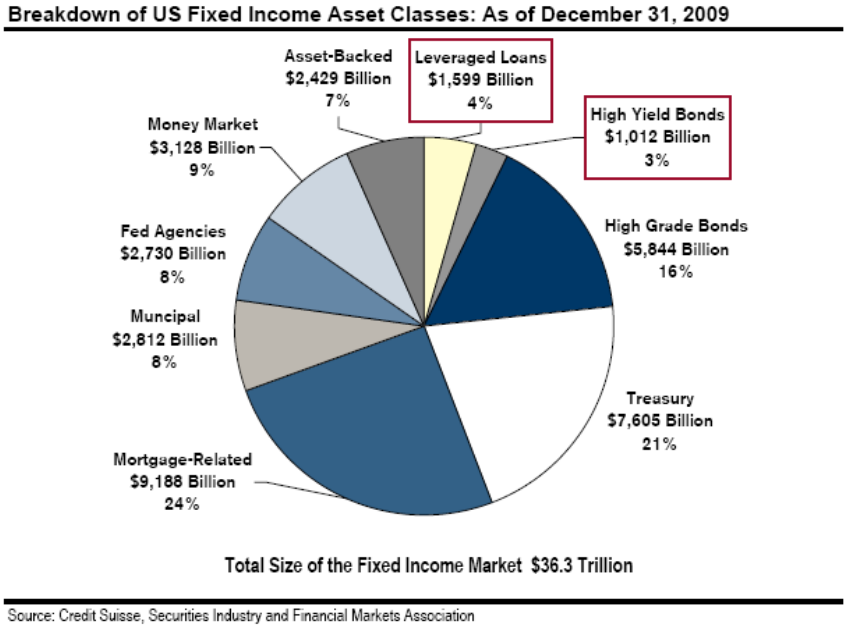
OVERVIEW OF THE FIXED INCOME MARKET

Before embarking on specifics of the high yield bond market it is important to gain an understanding of the fixed income marketplace and the investment options within it. The first thing to note is the sheer size, which is massive (over $36 trillion).[2] Somewhat surprisingly, mortgages represent the largest single subcategory of the bond market: this helps to explain why problems in the mortgage market nearly took down the entire financial system in 2008. The next largest subcategory is U.S. Treasury debt.



Source: Credit Suisse, Securities Industry and Financial Markets Association

Yet, a sizable 23% of the fixed income universe is represented by "corporate credit" through leveraged loans, high yield bonds and investment grade corporate bonds. What comes as a surprise to many investors is that the non-investment grade sector of loans and bonds has grown to become a major asset class, now over $2.5 trillion. While the growth of the leveraged loan market has slowed in recent years, high yield issuance has exploded and will likely make up a larger percentage of the fixed income pie in the future.

By the chart above, it is obvious that corporate credit plays a major role in financial markets; yet, for some reason bonds have always been considered too complex for individual investors and remain misunderstood by many. While it is true that large players, such as insurance companies, pension funds and banks, dominate the landscape, bonds at their core are simple. A bond is a loan. A company can issue debt (bonds) or equity (stock). The debt/bonds rank ahead of the equity in a company's capital structure, so are considered less risky. This ranking means that the bondholders have a priority claim on the company's cash flows and get paid first. Corporate bonds have a maturity and an interest rate, creating a contracted stream of income for the bondholders. They typically pay this interest twice per year but trade with accrued interest,

[2] Blau, Jonathan, Daniel Sweeney, Janet Yung, and Benjamin Zimmerman. "2010 Leveraged Finance Mid-Year Outlook and Review." Credit Suisse Global Leveraged Finance. July 30, 2010, p. 40.

meaning that a buyer can buy the bond anytime before the paydate but would have to pay the seller the accrued interest up to that point. The maturity is the date at which the issuer is obligated to pay the bondholder back the "par value" of the bonds. Companies generally have the right to refinance at some point prior to that maturity, but must typically pay the bondholder a call or tender premium (pre-payment penalty) to do so. This finite exit strategy, either via maturity or refinancing, is one of the great features of bonds versus equities.

Another misunderstanding investors have relating to bonds is that a bond is issued and then goes away into the hands of investors, never to trade again. Most people do not understand that corporate bonds have an active and liquid secondary market, much like stocks. The difference is that the "bond exchange" is not a physical location like the New York Stock Exchange. Rather it is an electronic market created and maintained by large banks and investment banks. These features apply to both high yield and investment grade bonds.

ORGINS OF HIGH YIELD MARKET

Most investors place the origins of the high yield market in the late 1970's which would not necessarily be wrong if by the high yield market we mean "original issue" high yield. Truthfully, high yield lending has been going on for centuries. Back in the 1700's, the Rothschild family was a dominant high yield lender (lending at higher interest rates/yields to more risky borrowers) but their focus was on countries not companies. Over the last two centuries, as commerce and the modern corporation developed the bond market developed right along with it. However, for decades the focus of both sides (issuer and investor) was on highly rated companies, aided by John Moody's development in 1909 of the basic ratings system (Moody's Rating Service) used today.

The earliest modern era data we have on the high yield market came in 1957, when a researcher for the National Bureau of Economics Research named W. Braddock Hickman produced a seminal piece of work entitled *Corporate Bond Quality and Investor Experience*. As the title suggests, he reviewed the corporate bond market and investors' experience with it from 1900-1943. Hickman used the terms low grade and high grade to differentiate what we now refer to as "Junk" or High Yield and Investment Grade. His conclusions were as follows:[3]

> vestors. On the average and over long periods, the life-span yields realized on high-grade bonds were below those on low-grade bonds, with the result that investors, in the aggregate, obtained better returns on the low grades. The inverse relationship

[3] Hickman, W. Braddock. Corporate Bonds: Quality and Investment Performance. UMI, 1957, p. 14-15.

The foregoing may be summarized as follows: (1) Investors, in the aggregate, paid lower prices for, and thus exacted higher promised yields on, the low-grade issues; (2) default rates on the low grades were higher than on the high grades; (3) loss rates, which take into account not only default losses but also capital gains, were higher on low-grade issues; (4) the higher promised returns exacted on the low grades at offering proved to be more than sufficient to offset the higher default losses; (5) in consequence, life-span yields realized on low grades were higher than on high grades. The results were quite typical within major industry groups. Similar results were obtained for most of the longer assumed chronological investment periods.

The finding that realized returns were higher on low-quality corporate bond issues than on high-quality issues has implications for investment theory as well as for practical investment policy.

Hickman's findings turned everything about investing in fixed income on its head. **His conclusion was unmistakable in that low grade bonds outperformed high grade bonds** over this period. The increased default rates of low grade paper were more than offset by higher coupon income and recovery rates on the defaulted bonds. Apparently this superb piece of work was ignored until the late 1970's when a graduate student at the Wharton School by the name of Michael Milken dusted this script off and launched what became the original issue high yield market as we know it today. Michael Milken and Drexel Burnham Lambert ultimately became synonymous with high yield.

DEFINITION OF HIGH YIELD

Just what is the formal definition of high yield? High yield, or its more polite acronym "non-investment grade," is based off of the ratings grids provided by the two major credit rating agencies, Moody's and Standard & Poor's. In the case of Moody's, all bonds rated below Baa are considered high yield or non-investment grade. Similarly in the case of Standard & Poor's, all ratings below BBB are considered high yield. We remain perplexed as to how these two private companies came to monopolize the business and have become the definitive standard on who gets credit and on what terms. Ironically, even after their well publicized gaffes in the scandals of Worldcom and Enron, and more recently with the ratings of structured products, they ended up with more power, as we will explain in more detail later.

Investors should understand what the ratings agencies themselves say about their ratings.[4]

[4] "Moody's Rating Symbols & Definitions." Moody's Investor Service. August 2003, p. 3.

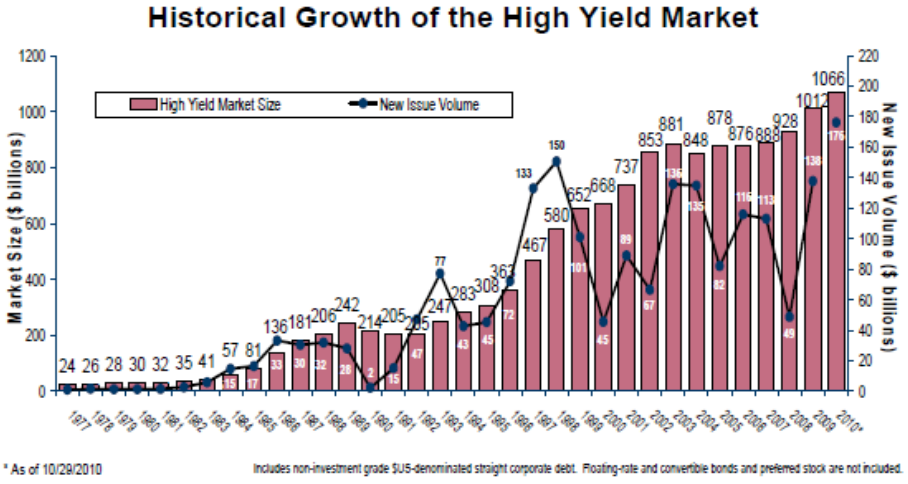
As ratings are designed exclusively for the purpose of grading obligations according to their credit quality, they should not be used alone as a basis for investment operations. For example, they have no value in forecasting the direction of future trends of market price. Market price movements in bonds are influenced not only by the credit quality of individual issues but also by changes in money rates and general economic trends, as well as by the length of maturity, etc. During its life even the highest rated bond may have wide price movements, while its high rating status remains unchanged.

The matter of market price has no bearing whatsoever on the determination of ratings, which are not to be construed as recommendations with respect to "attractiveness". The attractiveness of a given bond may depend on its yield, its maturity date or other factors for which the investor may search, as well as on its credit quality, the only characteristic to which the rating refers.

So if the ratings have "no value in forecasting the direction of future trends of market price" and "are not to be construed as recommendations with respect to attractiveness," what good are they? Candidly this is a question we have been asking for the past 25+ years. We see the ratings agencies as reactive not proactive, yet many investors in fixed income rely almost entirely on these ratings.

GROWTH OF HIGH YIELD MARKET

Regardless of what the rating agencies consider the investment value of high yield bonds to be, the growth of this market has been significant.[5]



There were several distinct periods of growth that assist in understanding the development of this market. Prior to 1985 the market consisted almost entirely of securities that were once investment grade but had since been downgraded. These securities became known as "fallen angels." It was in the 1980's that Drexel Burnham, and eventually all of Wall Street, began to embrace the concept of original issue high yield bonds to finance everything from leveraged buyouts to significant new industries including modernizing Las Vegas (Caesars World, Circus Circus, Bally's), creating cable networks (Turner Broadcasting-CNN) and ultimately even the

[5] Blau, Jonathan, Daniel Sweeney, Janet Yung, Karen Friedlander and Benjamin Zimmerman. "Leveraged Finance Strategy Update." Credit Suisse Global Leveraged Finance. November 4, 2010, p. 4.

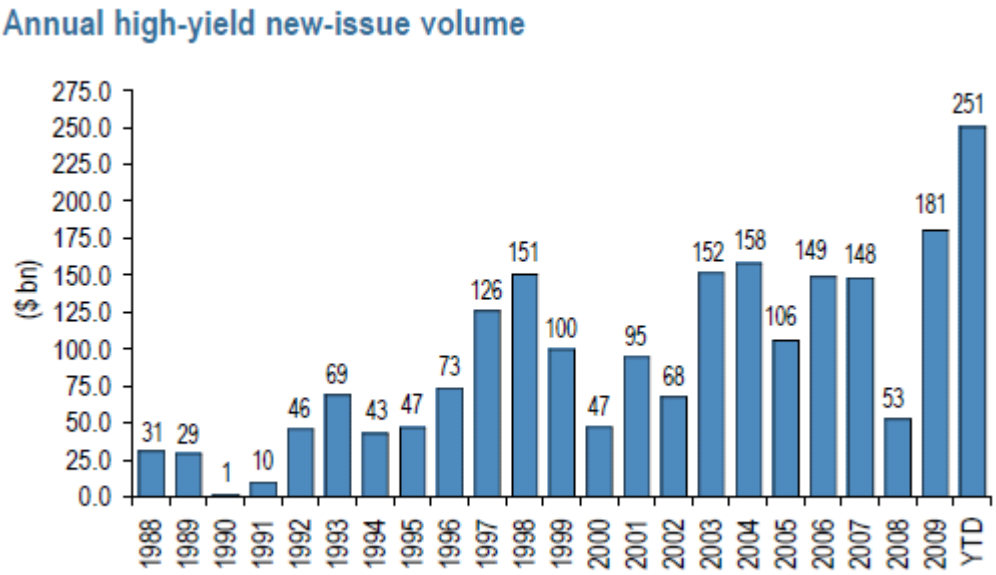
beginning of the wireless age (MCI and McCaw Cellular). It is important to note both then and now that the high yield issuers are not start up companies, but generally medium to large sized companies with well established product lines or services looking for an alternative form of financing to sustain or grow their businesses.

The high yield market offered several important advantages to issuers. Prior to the original issue high yield market, companies would have to finance themselves with equity and/or traditional bank debt. The problem is that equity financing is often very expensive and massively dilutive to existing shareholders, while bank debt is short term, has amortization payments and comes with restrictive covenants. Bank financing would not be effective in building out the massive infrastructure required in many of these cases. Thus, the long term nature and fixed coupon payments provided by high yield bonds allowed for the stability needed for these companies, and the market growth began.

However in 1990, the growth of the market stalled as the country entered a significant recession and default rates climbed. Given the limited size and breadth of the market at the time, many wondered whether this asset class would survive. But survive it did and as the country emerged from this period the high yield market growth resumed. Yet the truly exponential growth in the market would not begin until 1996 and did not take another breather until the end of 2003.

Several factors led to this exponential growth in issuance. First, the asset class gained the attention of many institutional money management consultants as the return profile from 1990-1995 had been very attractive. This demand enabled more companies to raise money in the high yield space versus bank debt or other forms of financing. This was both good and bad. It did bring in many new players on the issuance side of the market but as the demand grew so did the ability to raise money on fictional business plans, especially in the "TMT" (telecommunications, media and technology) space as the internet and technology bubble developed. Like in the equity market, billions of dollars were raised by companies with no revenues and only a plan for the future. This ultimately led to the second "nuclear winter" in high yield which occurred in 2002, culminating with the high profile defaults of Enron and Worldcom and the collapse of the technology and telecom markets. Once again, a period of healing and consolidation began as issuance subsided. But issuance once again picked up starting in 2006 and the market now stands at $1.1 trillion and growing rapidly with record issuance in 2010 as it draws to a close.[6]

[6] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Alisa Meyers. "Credit Strategy and Weekly Update." J.P. Morgan North American High Yield and Leveraged Loan Research. November 5, 2010, p. 35.

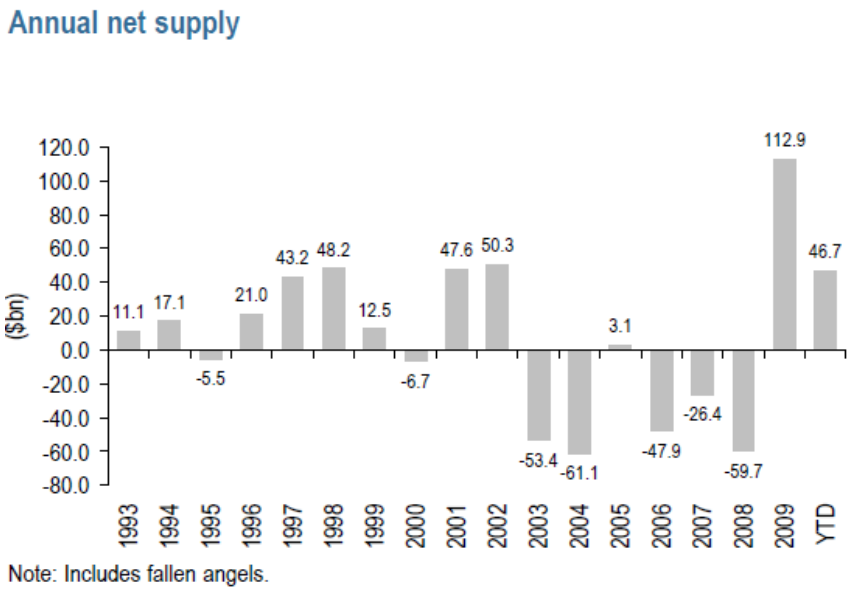


To have a functioning and growing market, you need both supply (issuers) and demand (investors). Though we have briefly touched upon the advantages for issuers (no principal payments, relaxed covenants and long term financing), an understanding of the buy side is also crucial. As listed below, there are five significant demand forces that exhibit themselves in the high yield market:

1. Coupon Cash Flows
2. Maturities/Refinancings
3. Calls
4. Mutual Fund Flows
5. Tenders

Bonds generate interest income for the owner and most investors in the space reinvest these coupons cash flows into more bonds. Each year, a certain percentage of the market matures which means that investors receive their principal back, again generating cash that needs to be reinvested. Similarly a percentage of the overall market will be called by the issuer each year, generating more cash for the holder and a need to redeploy proceeds. These three factors should be considered permanent technical features of the bond market. In addition, there are two other sources that come into play. High yield mutual funds generate both demand (money inflows creating a need to invest) but can also create supply (redemptions/outflows, meaning they need to sell bonds to fill the redemptions). A final area of potential demand is created when a company tenders for bonds. This is not a mandatory redemption for the holder, as is a call or maturity, but an optional one. If we combine all of these activities, we get a "net" supply figure.[7]

[7] Acciavatti, Peter, Tony Linares, Nelson Jantzen, and Alisa Meyers. "Credit Strategy Weekly Update." JP Morgan, North American High Yield and Leveraged Loan Research. September 24, 2010, p. 33.



On the demand side there is one more significant issue that is not captured in the above chart and that is flows into corporate bonds and loans from large institutional and other investors outside of the mutual fund world. Historically there have been waves of interest and flows into the high yield market. Looking at just the last decade, we have seen a crazy search for excess returns ("alpha") from every corner of the world. From hedge funds to private equity to emerging markets, everything has been tried. But at the end of the day there was no silver bullet. However, we feel that there is currently a secular shift underway towards the fixed income world, and more specifically high yield, as more people recognize the tangible yield provided by high yield bonds and the sector's risk adjusted outperformance (as we will explain later). As part of this shift, it now seems that a gradual recognition is setting in that pension plans are large and dangerous liabilities, not the benefit or perk everyone had assumed. We sense that a change in attitudes and awareness brought on by the 2008 financial crisis will be accompanied by a change in allocations and focus on yield.

With that, we expect the high yield market to have favorable supply/demand dynamics for the foreseeable future and growth to continue. As the market grows, so does the available opportunities for investment.

INEFFICIENT MARKET

In addition to the natural supply and demand of the market, it is very important to have a short history lesson in various legislative acts that have created and continue to create the market dislocation that allows investors an opportunity to produce attractive risk adjusted returns. "FIRREA," or the Financial Institutions Reform Recovery and Enforcement Act, passed in 1990 was the first piece of legislation that dramatically altered the landscape for high yield corporate bonds. In the time heading up to this legislation, bank failures were everywhere and Wall Street lost junk bond pioneer Drexel Burnham Lambert. Citibank was almost dead, over 700 Savings and Loans/Thrifts failed and the controversial California based insurance company, First Executive, disappeared. The Government sponsored an agency which became known as the Resolution Trust Corporation or "RTC" to deal with the S&L failures. Investments in "junk

bonds" and "junk loans" to emerging market countries such as Mexico and Brazil were at the center of the storm and were the root cause of all the problems according to the popular press.

Regardless of the lynching of Drexel and the junk bond pirates, the real root of the problem developing in the 1980's was actually real estate. A direct quote from William Seidman, former head of both the Federal Deposit Insurance Corporation ("FDIC") and the RTC, commenting on the 1980's issues:[8]

> The critical catalyst causing the institutional disruption around the world can be almost uniformly described by three words: real estate loans. In the U.S., the problem was made even worse by allowing S&Ls to make commercial real estate loans in areas they knew little about. They were already in trouble because they borrowed "short" and lent "long" in financing the housing market.

How familiar does that sound? In 2010, we are working off the biggest hangover in the history of residential real estate. Apparently we are slow learners or have selective amnesia. Bill Seidman, who was one of the most respected regulators of our time, had come to the conclusion that real estate lending was at the core of the meltdown in the '90's; though, he was ignored. Instead, the politicians decided that the answer was to make sure the Thrift's going forward were almost completely invested in real estate while forcing them to sell their high yield bonds at what was then the bottom of the market. Here were two of the requirements that came out of this ridiculous piece of legislation (FIRREA):[9]

> (7) required savings and loans to meet a new "qualified thrift lender" test of 70% of portfolio assets in residential mortgages or mortgage related securities.
>
> (14) required savings associations to divest their holdings in junk bonds by July 1, 1994, and generally follow the same investment guidelines as commercial banks. Junk bonds and direct investments of savings and loans must be held in separately capitalized subsidiaries.

Around the same time as all of this legislation was being passed, a group known as the Bank for International Settlements or "BIS" was passing the first Basel Accord. Known as Basel I, this accord set capital standards for global banks for a variety of very broad asset classes. Corporate bonds and loans were set at 8%, meaning a bank had to have Tier 1 capital (equity capital and reserves) of 8 cents to back each dollar held in a corporate security. Prior to this accord being passed in 1988, banks operated somewhat by the seat of their pants. They reserved what they deemed appropriate for various asset categories and worked with regional or national regulators on these issues.

The ink was barely dry on Basel I when pressure from the various banks sowed the seeds of a monumental and ill-understood piece of legislation that led to the meltdown that began during the last quarter of 2008. The argument sounded rational. Why would a loan to General Electric require the same amount of capital as one to Joe's Liquor Store? So back to the drawing board

[8] "Panel 3 Lessons of the Eighties: What Does the Evidence Show?" *History of the Eighties—Lessons for the Future.* p. 58.
[9] "Financial Institution Reform, Recovery and Enforcement Act (Firrea)." www.answers.com.

we went which led to the second Basel Accord or Basel II. At the heart of this proposal lies the notion of risk. The regulators wanted to make sure that capital reserves were appropriate for the risk of the assets held by banks. Sounds like good policy but how does one measure risk? Well enter our friends the credit rating agencies. What Basel II effectively said was that credit ratings will determine risk and the amount of capital required. Here is what was finalized:[10]

Claims on corporates

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

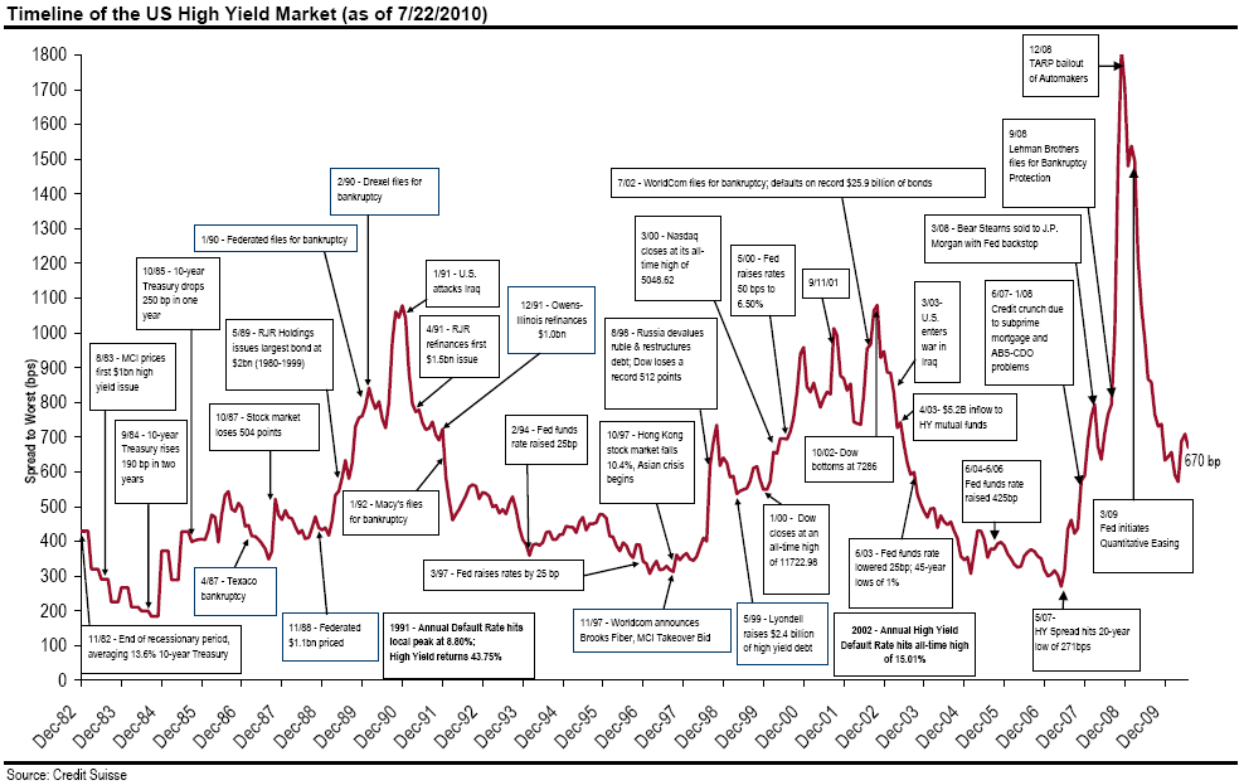
To translate into simple English, if 8% was the base capital charge, then AAA to AA- securities would require only 20% of this or 1.6% capital backing each dollar of securities held. Anything below BB- would require 150% of 8%, or 12% capital. What this led to was banks focusing their attention on the highest rated securities which required limited capital and allowed for massive leverage. Let's do the math. If a bank requires only 1.6% capital the inverse of this is the amount of leverage they get, which is over 60:1! So once again an arcane policy further restricts another group of major institutions from investing in lower rated securities (regardless of their true investment quality). Ironically the chase for AAA securities was at the root of the 2008 financial crash as Wall Street created and the rating agencies were relied upon to rate many synthetic AAA bonds that turned D (defaulted). As we had mentioned previously, the rating agencies ended up with more stature after proving they did not deserve it and the results were disastrous, as witnessed by the 2008 meltdown of the global markets.

Why is it important to understand such legislation? Mainly because it can shape who ends up owning certain asset classes. In both cases (FIRREA and Basel II) the banks became large sellers, creating opportunities for buyers. Great credit analysis, a pre-requisite for producing returns in this asset class, is aided by the opportunity-set itself, which is a function of the market and the lack of permanent investors created mainly by misinformation and poorly drafted legislation.

VALUATION

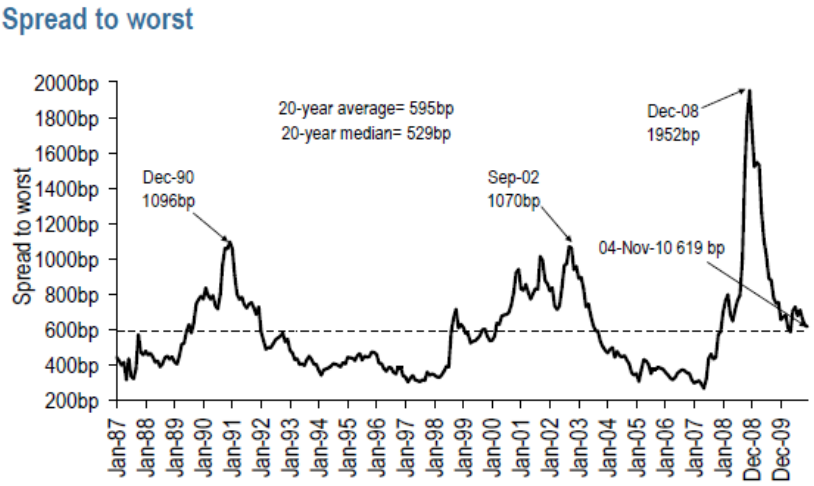
With the background set, we now turn our attention to specifics of the high yield market. Valuation in the corporate bond market is generally accomplished by analyzing the spread or yield advantage over a risk free rate, usually signified by a comparable maturity Treasury bond. Some historical perspective on spreads is helpful and the following graph (while busy) profiles both the historical spreads and the major events associated with the high yield market over its 30 year history:[11]

[10] "International Convergence of Capital Measurement and Capital Standards." Basel Committee on Banking Supervision. June 2006.
[11] Blau, Jonathan, Daniel Sweeney, Janet Yung, and Benjamin Zimmerman. "2010 Leveraged Finance Mid-Year Outlook and Review." Credit Suisse Global Leveraged Finance. July 30, 2010, p. 39.



Source: Credit Suisse

It has been quite a 30 year period which saw almost every conceivable economic environment. The following table has removed some of the noise so we can focus specifically on value via spreads.[12]

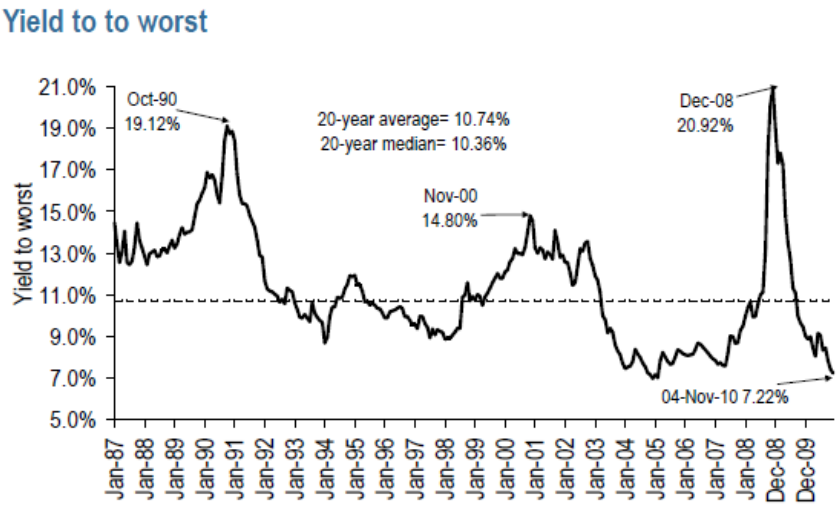


According to the historical spread graph, the average spread for the high yield bond market over the 5 year Treasury is approximately 600 basis points or 6%. Averages can be very deceiving as

[12] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA and Alisa Meyers. "Credit Strategy Weekly Update." J.P. Morgan North American High Yield and Leveraged Loan Research. November 5, 2010, p. 27.

the three spikes which occurred in 1990, 2002 and 2008 disproportionately skew the numbers upward, indicating to us that looking at the median spread is a more useful way to view spreads. Either way, a closer look shows that for approximately 70% of its history the market has been below that 6% spread level.

Another way to look at the market is on a "yield to worst" basis. The yield to worst is calculated as the yield to the time period or event that would yield the worst (lowest) return. Most often this event is the maturity, or yield to maturity. However, if the bond is priced above par then anything that shortens the maturity (such as a call) would cause the rate of return to decrease. As can be seen from this chart, the median yield to worst is approximately 10.4%.[13]



Investors in this asset class can use both spreads and yields as tools to assist them in determining whether the market as a whole is priced attractively or expensively versus other investment opportunities available. Obviously this needs to be put into the correct context along with the interest rate environment, economic growth and other variables. For instance, the spread near 620bps is over historical medians around 530bps, yet the yield to worst offered is below the median of 10.4% because of the unprecedented low interest rates we are now experiencing.

Regardless of how one values this marketplace, it is apparent that significant excess yield over the risk free rate exists and has for almost 30 years. The next natural question to ask is does this excess yield come with excessive risk?

DEFAULT RISK

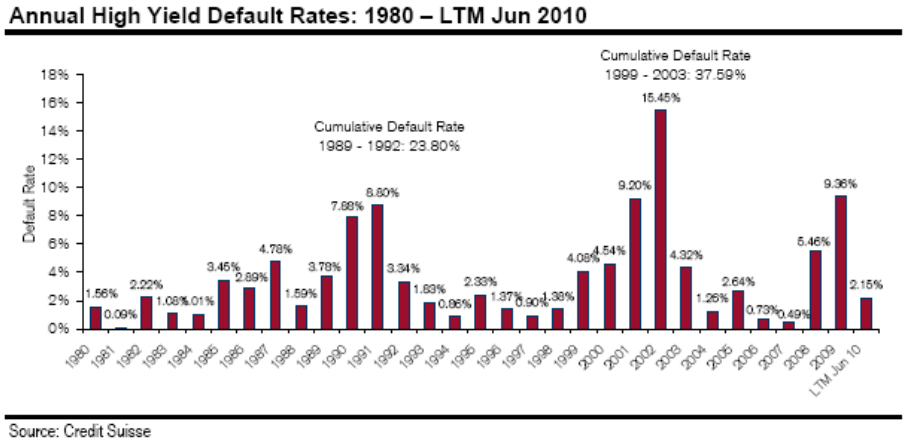
Valuation analysis must be done in the context of understanding and quantifying risk. Yet, defining risk can often be challenging. So before honing in on a definition, let's first look at the finite nature of a bond's existence. Unlike equities, bonds have a shelf life (maturity) but their effective maturity is generally much shorter as defined by certain events that can happen to

[13] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA and Alisa Meyers. "Credit Strategy Weekly Update." J.P. Morgan North American High Yield and Leveraged Loan Research. November 5, 2010, p. 27.

bondholders. We have identified below five specific events or outcomes with which bondholders must contend:

- Maturity: The most obvious of all is that a bond matures, but rarely do high yield bonds stay outstanding until their maturity.
- Call: The bond can be called by the issuer prior to maturity, typically with the bondholder receiving a premium to the par value. Most bonds come with three to five years of call protection, meaning the issuing company cannot call the bonds from holders during these protected years.
- Put: High yield bonds come with a change of control covenant called a "poison put" that allows the bondholder to "put" the bond back to the company in the event of a takeover. This is sometimes known as positive event risk.
- Tender: This is an offer by the company to acquire bonds at a certain price but it is at the option of the holder whether to take the offer.
- Default: When a company does not make the required interest payment within the required period (including grace periods) they have defaulted. This default may involve a bankruptcy proceeding (Chapter 11) or an out of court restructuring in which the company works with various participants to resolve this default. In some cases the company could be liquidated (Chapter 7).

Common sense would suggest that out of the five scenarios only one, a default, appears to be a negative for the investor. If in fact default is the risk most important to high yield bond investors, we need to understand just what the default experience has been. Default rates are graphically depicted below:[14]



The actual average annual default rate experienced by high yield bond investors for the last 32 years is 3.27%.[15] But this is not the end of the story for investors as default risk is only part of the equation. As investors we are interested in the simple notion of how much money is actually

[14] Blau, Jonathan, Daniel Sweeney, Janet Yung, and Benjamin Zimmerman. "2010 Leveraged Finance Mid-Year Outlook and Review." Credit Suisse Global Leveraged Finance. July 30, 2010, p. 102.
[15] Blau, Jonathan, Daniel Sweeney, Janet Yung, and Benjamin Zimmerman. "2010 Leveraged Finance Mid-Year Outlook and Review." Credit Suisse Global Leveraged Finance. July 30, 2010, p. 108.

lost in a default, or the loss rate. Said another way, we are interested in the inverse of this relationship, which is the recovery rate.

Annual Default Loss, Principal Loss, and Recovery Rates

Year	Defaulted Amount ($Billion)	Avg Default Loss Rate	Avg Principal Loss Rate	Avg Recovery Rate	Default Rate
1977	0.034	0.14%	62.75%	37.25%	0.21%
1978	0.013	0.05%	40.00%	60.00%	0.12%
1979	0.027	0.10%	69.00%	31.00%	0.14%
1980	0.232	1.33%	80.56%	19.44%	1.56%
1981	0.027	0.08%	88.00%	12.00%	0.09%
1982	0.736	1.50%	62.66%	37.34%	2.22%
1983	0.403	0.58%	48.43%	51.57%	1.08%
1984	0.478	0.50%	43.72%	56.28%	1.01%
1985	2.292	2.15%	56.19%	43.81%	3.45%
1986	3.006	1.90%	59.95%	40.05%	2.89%
1987	7.285	2.47%	46.29%	53.71%	4.78%
1988	3.005	1.11%	64.07%	35.93%	1.59%
1989	8.313	2.56%	61.45%	38.55%	3.78%
1990	17.914	5.91%	68.92%	31.08%	7.88%
1991	18.614	5.66%	58.51%	41.49%	8.80%
1992	6.858	1.91%	51.53%	48.47%	3.34%
1993	4.097	1.13%	55.49%	44.51%	1.83%
1994	2.236	0.52%	55.10%	44.90%	0.86%
1995	6.800	1.48%	57.56%	42.44%	2.33%
1996	4.526	0.80%	53.36%	46.64%	1.37%
1997	3.653	0.47%	46.29%	53.71%	0.90%
1998	7.061	0.92%	62.31%	37.69%	1.38%
1999	24.947	3.01%	68.73%	31.27%	4.08%
2000	29.969	3.55%	73.53%	26.47%	4.54%
2001	64.609	7.04%	72.01%	27.99%	9.20%
2002	122.861	11.51%	70.04%	29.96%	15.45%
2003	37.434	2.60%	55.70%	44.30%	4.32%
2004	10.871	0.65%	47.06%	52.94%	1.26%
2005	22.758	1.43%	49.46%	50.54%	2.64%
2006	6.426	0.28%	33.80%	66.20%	0.73%
2007	4.339	0.22%	40.36%	59.64%	0.49%
2008	49.588	3.78%	65.17%	34.83%	5.46%
2009	90.819	7.22%	72.64%	27.36%	9.36%
LTM Jun 10	21.573	1.16%	49.85%	50.15%	2.15%
Average	17.171	2.23%	58.54%	41.46%	3.27%

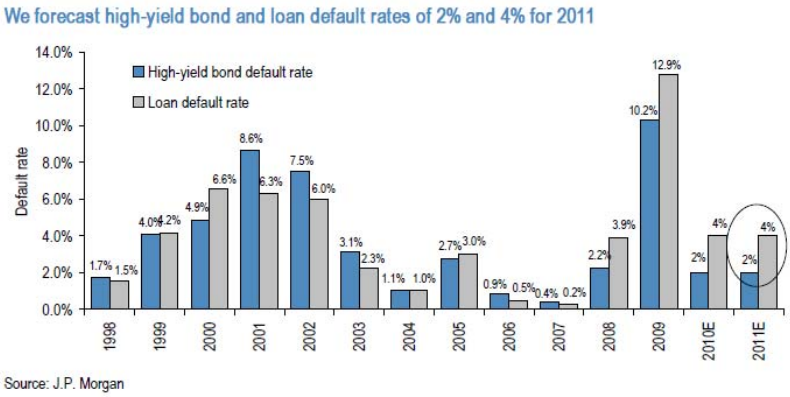
Source: Credit Suisse

The last 32 years have shown a recovery rate of 41.46%. In English this means that upon default an investor could have recovered over 41% (or over $41) of the par amount of the bond. Notice that this recovery rate assumes that the investor paid $100 (par) for the bonds. If an investor paid less than par, the recovery rate would be higher and the loss lower. Additionally, an investor typically holds the bonds for some period before a default occurs, meaning that they would have received a number of interest payments, further reducing the net loss.

The "net-net" of the story is that the average loss rate for high yield indexes is approximately 2.2% per year without any active management. Getting back to Hickman's finding over a half century ago that the "higher promised returns expected on the lower grades at offering proved to be more than sufficient to offset the higher default loss," let's put some math behind it. If we use the median yield to worst of 10.4% and an average loss rate of 2.2%, we get a "risk adjusted"

average yield of 8.2%, which seems attractive by most measures. And this risk adjusted yield does not even include the positive event risk from early calls, put, or tenders at a premium.

But the question we must always deal with as investors is does the future differ dramatically from the past? Will these attractive risk/default adjusted returns continue? In this case, it appears that near-term might even be better than history, to our benefit as investors. High Yield bond default rate forecasts for the next couple of years appear well below historical averages.[16]



RISK AND RETURNS

Default and loss rates are important to understand, but at the end of the day investors expect to earn a return commensurate with the risk they are taking. As we look at the actual returns, the data points in this case are spectacular. It is a fact that the high yield bond asset class has OUTPERFORMED equities over almost every historical time frame one can use on a risk adjusted basis. Here, risk is defined as standard deviation or volatility of returns over the period, an easily comparable measure across all asset classes. What is even more impressive is that over the 1, 3, 5, 10 and 15 year periods high yield has outperformed equities in dramatic fashion, even without adjusting for the fact there is less risk. The following table provides the detail:[17]

[16] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Alisa Meyers. "Midyear 2010 High-Yield and Leveraged Loan Outlook and Strategy." J.P. Morgan North American Credit Research. July 7, 2010, p. 10.

[17] 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. Chart data as of November 2009. 1 Year return for the period 9/30/09-9/30/10 is 18.17% for the JP Morgan Global HY Index versus 7.96% for the S&P 500 Index.

	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%**

JP Morgan Global HY Index, data as of November 2009

As one can see, the outperformance is dramatic and was done with significantly less risk (volatility). Amazingly, even throughout the history of the high yield market (30 years) the story remains the same.[18]

Risk/Reward Profile of Various Assets: 1980 – June 2010

January 1980 - June 2010	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	5.15%	0.94%	5.49	13.97%	0.09%	4.92%	30	0	0.00
U.S. IT Gvt	8.79%	6.51%	1.35	29.10%	-3.59%	9.33%	27	3	0.59
U.S. LT Gvt	9.97%	12.13%	0.82	40.36%	-13.26%	8.79%	24	6	0.45
ML Mortgage	9.03%	7.41%	1.22	40.15%	-1.60%	7.74%	29	1	0.56
ML Corp	9.21%	7.86%	1.17	35.53%	-6.82%	9.11%	27	3	0.55
LB US Agg Bd USD	8.82%	6.28%	1.40	32.62%	-2.92%	8.12%	28	2	0.61
LB AAA Corp	8.74%	8.24%	1.06	39.32%	-3.64%	8.01%	26	4	0.47
S&P 500	10.79%	17.39%	0.62	37.43%	-37.00%	16.30%	24	6	0.40
Russell 2000	10.12%	22.32%	0.45	47.25%	-33.79%	17.41%	21	9	0.32
DJ Wilshire 5000	10.64%	17.78%	0.60	36.40%	-37.33%	15.99%	23	7	0.39
MSCI EAFE	9.53%	19.62%	0.49	69.94%	-43.06%	12.06%	22	8	0.31
Gold	2.95%	18.78%	0.16	31.92%	-32.15%	0.91%	17	13	-0.03
U.S. Inflation	3.48%	1.26%	2.76	12.40%	0.09%	3.16%	30	0	-1.32
FTSE NAREIT All REITs	10.27%	18.99%	0.54	38.47%	-37.34%	15.16%	23	7	0.36
High Yield Bonds	10.63%	9.72%	1.09	54.22%	-26.17%	10.93%	26	4	0.61

* Monthly Data

Source: Credit Suisse, Bloomberg, Ibbotson Associates

Even taking into account the massive equity bull market of the mid to late 1980's and the enormous technology and internet rallies of the late 1990's (two equity runs not likely to be repeated in our lifetimes), high yield performed equally with equities with approximately half of the risk. In all of these measures and time periods of returns and risk, high yield outperforms. Surprisingly, high yield's best year of 54.22% dramatically outperformed the S&P 500's best year of 37.43%. It would make sense that equities would have greater upside because they have more risk, but this is not the case. Note also that the worst year in high yield history was down 26.17% but the S&P 500 was down 37% in its worst year. It is also worth noting that high yield

[18] Blau, Jonathan, Daniel Sweeney, Janet Yung, and Benjamin Zimmerman. "2010 Leveraged Finance Mid-Year Outlook and Review." Credit Suisse Global Leveraged Finance. July 30, 2010, p. 58.

has also outperformed the other fixed income asset classes (the various government, mortgage, and investment grade corporate bond indexes listed) on a pure returns basis over this period.

PERITUS' APPROACH TO HIGH YIELD

So with all of this superb data on the high yield asset class, why would an investor need an active manager? Why couldn't the investor just buy the index? The answer to this begins with an understanding of what a manager is supposed to do. At Peritus we view our job as managing risk, not managing money. While we expect to outperform the various indexes we are compared to, we believe that outperformance stems as much from what we don't buy as it does from what we do buy.

In essence, avoiding credit problems is the key to active management in the credit space. This is why we choose to view credit as AAA or D. If we expect the company to be able to pay its bills over the life of the bond and then pay us our capital investment back at call or maturity, to us it is an AAA credit. If we don't, it goes into the D bucket and we avoid the name. Investment vehicles tracking the indexes don't have the ability to select only the credits that fit that "AAA" profile, which we feel puts active managers like Peritus at an advantage. Furthermore, many investors have restrictions based on ratings that limit their investment opportunities. And as we have pointed out in painstaking detail through the years, we believe the ratings process to be massively flawed and we do not restrict our portfolios by ratings. We believe this has been incredibly helpful in allowing us to add value for our clients.

In terms of what we do buy, we focus on the credits we feel offer the best risk/return profile, paying particular attention to the companies that have a product or service that is essential or recurring, hard asset values that provide some support for the company's value, a manageable capital structure, and/or a stable revenue stream or an adjustable cost structure should revenues fall. Additionally, excess liquidity and the ability for the company to generate free cash flow are other important areas of focus. After all bills are paid (including working capital and capital expenditures), we want the business to have money left over, which provides a margin of safety for us as debt investors.

Several over-arching themes dominate the investment philosophy at our firm. Unlike many of our competitors, Peritus does not hold any preconceived notions or restrictions on what industries or even subordination we will buy. We let Mr. Market determine where value exists for us at any given moment. All industries, subordinations, and ratings will be considered when we manage our portfolios. Additionally, while many consultants and investors like to pigeon-hole managers, Peritus is eclectic in its approach and process. We are not top down or macro in our approach nor are we purely bottom-up fundamental investors. We have found putting blinders on inhibits our performance, so feel the best approach to investing is melding the best of both. Furthermore, we generate our own investment ideas and do all of our own research internally.

One of the questions most often asked of us is how do we find securities to include in our portfolios? There is really no magic to the process except that our analysts and portfolio managers are voracious readers and are always on the hunt for opportunities. Here are some of the methods we use:

- Axe Sheets/Yield Screens: Everyday investors like Peritus have access to dealers' inventory of bonds, which are listed on what's known as an "axe sheet." As we scan through these and other yield screens put out by the investment banks, often we find securities in the mix that we believe might be attractive.
- Insider Equity Purchases: Company insider buying of stock is something we have used effectively for years. Since equity is below us in the capital structure, this indicates management's confidence in their company and potentially a nice margin of safety for bond buyers.
- Industry Themes: Most value investors, including Peritus, are contrarians at heart. We believe in the philosophy of buying something when it is out of favor (i.e. straw hats in the winter). We are always on the lookout for industries or individual credits that are out of favor for what we believe to be wrong or temporary reasons.

Once we have built our prospect list, we begin the detailed and grinding process of credit analysis. We begin by looking at the three major financial statements produced by companies: the Income Statement, the Balance Sheet and the Statement of Cash Flows. We conduct our credit and valuation analysis in reverse order of most conventional methods practiced by investors.

Financial Analysis

Income Statement ⟵	Balance Sheet ⟵	Cash Flow Statement
Revenues—Volume/Pricing	Cash Balance	Cash from Ops/Working Capital
Expense Trends	Debt Levels/Capital Structure	Capital Expenditures
EBITDA Levels and Margins	Leverage Metrics	True Free Cash Flow

Traditionally, much time and attention is spent on the income statement yet we find it least valuable. The income statement can be and often is easily manipulated and not reflective of the true financial condition of a company. A simple example will explain how. Company XYZ sells $100 million of widgets to the government. Their income statement shows a very nice profit of $25 million before taxes. Only one problem, the government doesn't pay for their purchase. So while the income statement shows a lovely profit, the cash flow statement shows a massive cash drain and the balance sheet shows a huge account receivable line item. Our concept of "true free cash flow" incorporates both working capital and capital expenditures, which don't show up on the income statement. To get a more accurate picture, we "reverse engineer" the financial statement analysis.

Our goal at Peritus is to hold a diversified basket of securities that generates what we see as significant tangible yield to the investor and allows for some capital appreciation. What we don't want is to be "di-worsified" by holding one of everything, which is not truly an active credit approach. Selectivity and discretion are key. Our preference and history is to hold approximately 40-70 securities in our portfolios, which we believe accomplishes our goals.

To summarize our process:

Idea Generation

- Identify macroeconomic and industry themes.
- Identify any contrarian market plays.
- Look for companies that meet our investment criteria.
- Screen for yields within our target range.

Credit Analysis

- Conduct fundamental credit and valuation analysis.
- Determine leverage metrics and free cash flow projections.
- Conclude where in the capital structure we see the best opportunity.

Credit Monitoring

- Monitor all daily company, industry, and market news.
- Provide a comprehensive update upon the release of quarterly earnings.
- Identify any fundamental credit or industry deterioration or downside exposure.

Portfolio Management

- Identify expected price upside or downside and execute trades accordingly.
- Monitor credit concentration.
- Overlay portfolio positioning with our market outlook.

We believe that to be successful in the credit markets, we must look at debt as senior equity. We do not stop at traditional credit analysis, but look at a complete appraisal of the business' intrinsic value. In essence, successful investing marries the process of financial analysis, valuation, and market psychology.

CONCLUSION

We hope that this historical look has helped to clear up some of the misunderstandings and misperceptions about the high yield asset class. We feel the high yield market, and Peritus' approach to investing in it, offers significant benefits to investors. In summary:

- The high yield market is a large, developed and liquid asset class. Additionally, it continues to grow with a record amount of new issuance this year providing ample supply to create a diversified and, by our measure, an attractive portfolio.
- Over the 30 year history of the high yield market, high yield has outperformed equities on a risk adjusted basis in virtually every relevant time series. Said another way, the high yield market has posted similar or higher returns with less risk, as measured by volatility, than equities.
- We see active management versus passive management or indexing as the best approach to the high yield space. Many asset classes are appropriate for indexing but we don't believe high yield is one of them. Peritus offers an active, value based approach to credit. We don't limit ourselves by arbitrary restrictions such as ratings, industries, subordination or diversification/tracking error. Instead, we focus on where we see the best value.

As a final thought, we don't view this asset class as a "trade." During certain periods of time many asset classes can be highly correlated, yet over the long haul, industry and company fundamentals will dominate. The decision is therefore not yes or no to the asset class, but rather

which names or industries within it are most attractive given the environment ahead. Whether it is viewed as an equity alternative (higher risk adjusted returns) or a significant portion of a fixed income allocation (higher yields, shorter maturity), that is best left up to the investors themselves. We do know that history has shown the asset class to be an outperformer and we view high yield, and the tangible yield it offers, as a core component to any portfolio.

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.