PERITUS
ASSET MANAGEMENT, LLC

Market Commentary

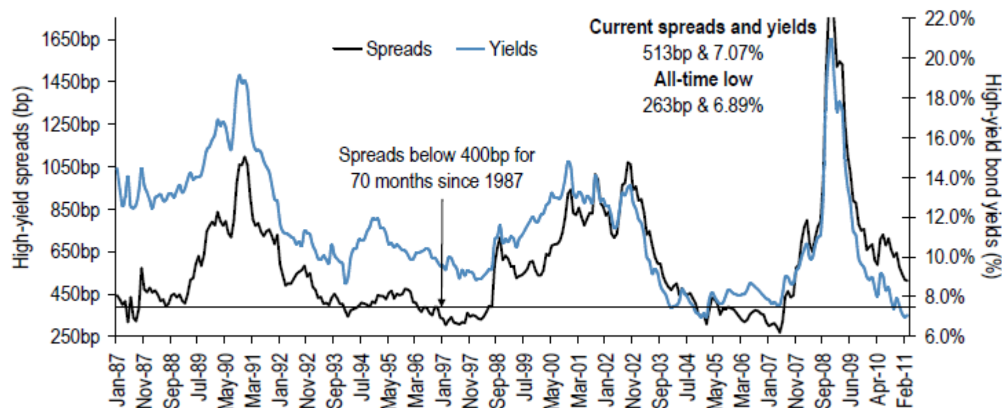
Independent Credit Research – Leveraged Finance – April 2011

Value Remains

The high-yield market has had a significant run over the past couple years, no one can deny that, so is there value still to be had in the space? We think so. First and foremost, we don't view the high-yield market as a "trade" based on market conditions. There are certain times where the current yields and capital gains opportunities are higher than other times. But at the end of the day, yield is always present in this asset class, via coupon income, while capital gains opportunities can be fleeting. It is just a matter of actively looking for those opportunities.

Additionally, even with the run-up in high yield, we still see the potential for some further spread tightening. Some recent data points from J.P. Morgan further help explain our thoughts.[1]

Historical high-yield bond spreads and yields

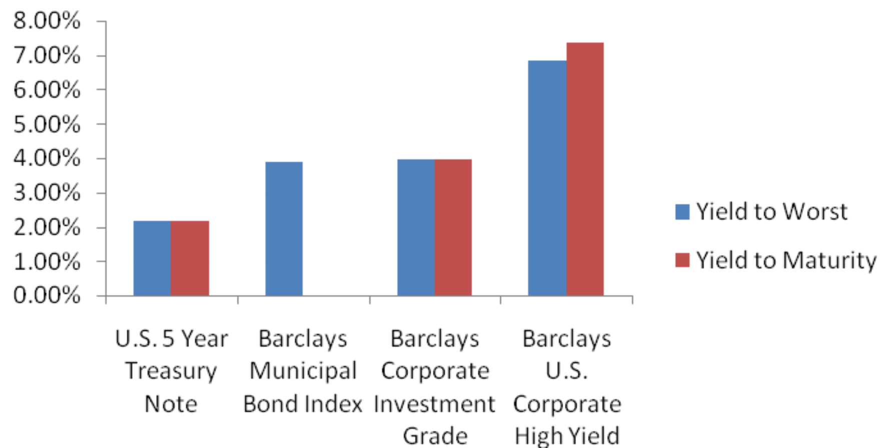


Source: J.P. Morgan

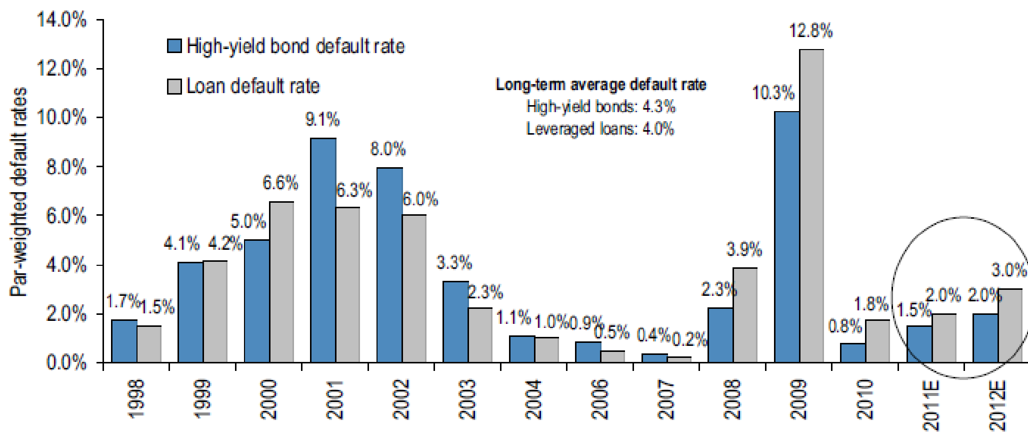
First, let's address the fact that yields are getting close to all-time lows. We must always evaluate yields in the context of the interest rate environment. With interest rates near all-time lows, it is only natural that yields would be lower than average. However, high yield still offers the best yield opportunity relative to other broad fixed income asset classes, as pictured below, and historically high yield has performed well in a rising interest rate environment (see our piece "High Yield in a Rising Rate Environment").[2]

[1] 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. April 1, 2011, p. 5.

[2] U.S. 5 Year Treasury Note data sourced from Bloomberg. Barclays Municipal Bond Index, Corporate Investment Grade Index, and Corporate High Yield data are sourced from Barclays Capital. The Municipal Bond Index covers the long-term, tax-exempt bond market. The Corporate Investment Grade index consists of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. The U.S. High Yield Index



However, looking back at the graph of spreads and yields, we see a current spread of 513bps. This is right around median levels of about 520bps and close to double the all time low of 263bps.[3] It is also important to evaluate spreads in the context of the major risk factor in the high yield space—default risk. Defaults are expect to remain well below average for the next several years, due to the wide open new issue market and improving liquidity at the corporate level.[4]



Note: 2010 default rates represent the ltm numbers as of November.
Source: J.P. Morgan.

covers the universe of fixed rate, non-investment grade debt. One cannot invest directly in an index. Prices, yields, and durations are subject to change. Yield statistics are no guarantee of actual performance and past performance is not indicative of future results. All data as of 4/11/11. The Modified Adjusted Duration is a measure of interest rate sensitivity based on the Yield to Maturity date.

3 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. April 1, 2011, p. 5, 18.

4 Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA and Alisa Meyers. "2010 High-Yield Annual Review" J.P. Morgan North American High Yield Research. December 2010, p. 13.

In their recent report, J.P. Morgan pointed out that "based on our default forecast of 1.5%, spreads for high-yield bonds should be T+390bps. In other words, the high-yield market could absorb an increase in 5-year Treasury yields of more than 100bps and prices could conceivably remain unchanged."[5] Or on the flip side, if we don't see a significant rise in rates, high yield spreads should move tighter. They go on to point out that high yield spreads have been sub 400bps about a quarter of the market's history.

We see no reason that investors should abandon the high yield market despite its recent move. While there are unarguably certain credits in the space that offer little in the way of yield or are not offering proper yields given their level of risk (i.e., the high levered, legacy LBO credits), there are still yield opportunities to be had for those that will take the time to scour the market for these values. As an active manager constantly looking for securities offering the best risk/return, we have compiled a portfolio with yields above those offered by the indexes.[6]

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

[5] 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. April 1, 2011, p. 5, 18.
[6] Data is based on a representative sample of a Peritus portfolio of securities as 4/11/11.