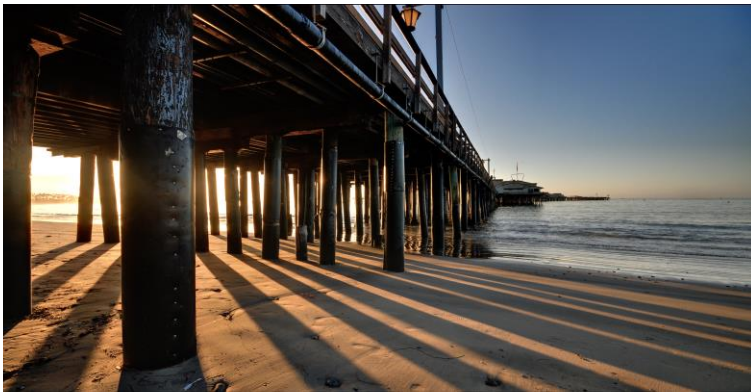

PERITUS

ASSET MANAGEMENT, LLC

Active Credit

Independent Credit Research – Leveraged Finance – September 2014

MARKET CONDITIONS AND INVESTMENT STRATEGY

Markets are funny beasts. Efficient? Perhaps. Manic? Always. What has been going on since everyone came back from the beach is quite simple: risk off. There has been a quiet but vicious downdraft in both credit and small cap equities which has really been hidden by those following the Dow and the S&P 500. Many stocks are down 20-30% from their recent highs and the Russell 2000 is on track to lose 7 or 8% since its July high.

In the world of credit, the high yield bond market has been a victim of the law of unintended consequences. Dodd-Frank, Basel III and Volcker all have driven dealer liquidity out of the market. Banks are simply not making deep markets in the high yield space which means when there is significant selling, bids can be harder to find. Much of the pain we have seen in September relates to these poor technical versus fundamentals. What is mind boggling is that the Fed themselves are behind much of this. Recall that in July Janet Yellen herself opined that high yield and biotech were areas of concern. This past week it was Richard Fisher (Dallas Fed President) taking center stage:

> "We're beginning to see extreme risk taking in the junk bond markets."

I find this disturbing on so many levels. Greenspan's "irrational exuberance" comment about the general investment climate at the time is now being taken to an asset class level by people who have no idea what is happening at a granular level. The notion that the Federal Reserve is all knowing and all powerful is among the most frightening things I have witnessed in my career. As a 30 year veteran of the high yield game, I have seen many cycles and many stupid things. Among the most insane was the "TMT" (telecom, media and technology) era from 1998-2002 where pure business plans with no revenues were financed in the high yield market. Those who can remember the acronym at the time was "CLEC" or competitive local exchange carrier. This was utter insanity and ended in tears in July of 2002 as Worldcom imploded and took down the sector, causing tens of billions of dollars of bonds to go to zero. Did the Federal Reserve recognize this? We will deal with this later on.

<u>Investment Strategy</u>

We have begun to significantly reposition our portfolios for what we view will be a challenging economic and investment environment ahead, as we work to continue to deliver what we see as attractive and, most importantly, sustainable yields for our investors. As many of our investors know, I stated at the beginning of the year that we are not believers in higher interest rates. So far we have been right on that call. Will the Federal Reserve hike short term rates next year? Perhaps, but I am unconvinced. Every time one of the Governors talks about an early 2015 rise, equity markets collapse. In my opinion, worst case the yield curve flattens as they raise short rates with the rest of the curve doing nothing. But I'm not sure that the US economy will withstand any substantial rate rise. Housing starts remain less than half of their pre-crisis peak and consumer spending and retail sales have been abysmal. Make no mistake, the Fed is going to be keeping a close eye on markets. Long gone is Mr. Volcker who was truly independent and did what he believed was right—politics and markets be damned.

At the risk of boring even me, the major elephant in the room remains demographics. People with disposable income (typically those over 50) aren't spending. Part of that is because you downsize and have fewer itches to scratch and part of it is fear of running out of money in retirement so you begin to save more ("paradox of thrift"). This is why low interest rates have not been the tonic the Federal Reserve had hoped for. While I believe much of QE and ultra-low rates has been the proverbial "pushing on a string," it did have impact early on. Companies have refinanced debt at incredible interest savings and banks have been able to rebuild their equity cushions. The problem is that much of this is not accruing to the real economy. Globally things are terrible, with Europe unable to climb out of recession and Japan dealing with huge tax, demographic and debt issues. China is still growing, but perhaps at less than half of the double digits the world had been accustomed to.

So under this umbrella, how are we working to generate what we see as attractive yields and solid returns for our investors? Within our portfolios, we have the ability to invest a portion in floating rate loans and equities, depending on the portfolio mandate, in addition to high yield bonds. We see this as a massive advantage as it provides the flexibility to position ourselves in what we see as the best yield-generating security from a return/risk perspective. Is this a change from our traditional "high yield" strategy? Absolutely not. Let me explain my thinking.

Loans

After a massive two-year surge of monies into loan funds, I felt that it was inevitable the tide would turn the other way. We have been very prescient on this, as outflows have certainly been the norm for loans in 2014 with investors growing weary of the rising rate pitch. So if we don't expect rates to rise why are we interested in floating rate loans? There are several reasons. First, this selling may create inefficiencies in the secondary market as there are not many natural buyers of secondary loans. We consider one of our core competencies as the ability to source and negotiate for purchase bonds and loans in an inefficient and choppy secondary market. Next, many companies we follow have chosen to issue loans rather than bonds because of investor demand over the last few years. So this naturally increases our opportunity set. Finally, loans may produce slightly lower yields, but can also lower the duration and lower volatility within our portfolios.

We believe that our strategy looks appropriate and has done what we expected it to. While the CLO market remains red hot and a source of buying power for loans, these investors continue to prefer the primary market (new issues) to source collateral. While they are certainly involved in secondary loans, most of these platforms are truly "structured" credit, meaning that the return they get comes from leveraging a very diverse portfolio not picking individual credits. We continue to see opportunities here and expect to further take advantage of our ability to invest in loans. We expect that this could provide stability and of course interest rate protection (it lowers our duration) should rates rise.

Equities

Let's turn our attention to the equity bucket. Why would credit investors want to include equities? We have more fully described this philosophy in our piece, "Peritus Investor's Manual," and we encourage our investors to read this thoroughly. But let me briefly explain. The massive refinancing wave we have seen over the last few years has taken out many bonds of dividend paying equities. The interest savings have been massive for these companies and have accrued to the benefit of the lowest part of the capital structure, the equity. So the dividend has a much higher margin of safety and/or it may allow the company to increase their dividends.

The second part of this relates to using the equity market to deliver potential alpha for our investors in a variety of themes. It is important to note that we are investing only in dividend paying stocks. The theme we are most engaged with today is energy. But energy is complicated. Once again we encourage our investors to read the "Energy Update" piece for detail on our take. But as a reminder, we are a believer in sustained high oil prices and a likely spike higher in the near future. We are also a believer in natural gas becoming a global commodity versus a regionalized one, which we expect will move the price grid higher there as well. For us oil is a supply side story. While US production has brought stabilized prices (at very high levels), Venezuela, Nigeria and Libya are in complete collapse. Iraq and the entire Middle East is becoming unhinged as well. Finally there is this little issue that the two largest oil producers in the world (Russia and Saudi Arabia) have publicly stated they want oil around $100.

But how we are getting exposure here is very different than our competitors. The US energy "revolution" is interesting but after a long period of studying the domestic market, we have come to the following conclusions. First, we believe the only attractive way to play the US game is through investments at the wellhead. What I mean by this is that private equity is investing in companies by giving them money to drill wells. They typically receive their money back in the first two years plus an ongoing royalty. This makes sense as production from tight/shale oil wells decline massively (80-90%) after the second year. In many cases, we see little value or sustainable business models that would support us buying bonds and loans at the corporate level.

Instead, what we have been doing is positioning in a number of Canadian producers via equity investments. The reasons are numerous for this. Very few investors are interested here, meaning we are receiving what we see as excellent valuations and very high dividend yields, which we believe are sustainable. Next, the Canadian dollar has fallen and continues to fall providing these companies with a nice potential windfall: remember, oil is sold in US dollars. Additionally, there remains a perception in the US that the lack of approval of the Keystone pipeline has created a "trap" or glut of Canadian crude. As we point out in our energy update, prices for "WCS" or Western Canadian Select, which is the relevant price for Canadian producers, are actually up this year. Recent EIA data shows that Canadian oil exports to the US are at all-time highs, averaging 3 million barrels per day with rail providing the transportation as new pipelines stall. So much for energy independence.

How has this worked so far? So far, poorly as we have seen a decline in recent months. Our stocks have been hit with the general small cap equity sell off and the perception of weak oil prices. As stated in past correspondence, WTI near term futures have fallen this year but remain around $94. The important news is that long dated futures prices for oil (2018-2020) are actually up 12% for the year. I find it funny that we are now calling this price "cheap" while in fact 2014 average prices will likely go down as the second highest in history. The recent WTI pricing pressure has minimal effect on our companies fundamentally, but for now perception is reality. Could oil prices fall further? Sure they can, but we expect that this will be very temporary given not only tightening global supply issues but the cost to produce a marginal barrel of oil. Importantly, our companies tend to hedge production 1-2 years out. We believe that patience will be very well rewarded here.

High Yield

Finally, let's turn our attention back to the majority of our investments, the high yield bond market. Our bear market really started back in the early summer when Janet Yellen decided to "talk down" the high yield market. We saw many asset allocators (algorithms) simply sell on this news. While fund flows turned massively negative, the underlying performance hung in there. In September, this has not been the case. Bonds have gapped down, some by as much as 20 points, during the month irrespective of fundamentals. While this has certainly caused pain, the reality for the asset class is that the biggest risk, defaults, continue to be mild and there is little evidence of any major default cycle about to begin in the next couple of years. So Fisher's comments are confusing in that light. As Fisher is the biggest hawk (i.e., he wants to raise rates sooner rather than later) he should be directing his comments at investment grade markets, which are far more interest rate sensitive. Overall, high yield companies remain liquid, profit margins have held in very well and with limited growth in the world, management teams remain hesitant to borrow to acquire or expand. We believe all of this is very positive for credit investors.

What we are doing in the high yield segment is taking some pain by selling some senior unsecured bonds and actually moving up the capital structure in some of our companies. This is the first time in about two years that we have seen spreads opening up in many of the most senior parts of the capital structure and we are attempting to take advantage of it and working to reduce portfolio risk. In years past we would have likely added to some of our existing subordinate positions, but we have learned through experience that when buyers return to the market, the senior parts of the capital structure are what is bought first.

Conclusion

There remains a very simple reality. We believe investors are going to be dealing with low interest rates for a very long time. I do not believe even the US economy is ready for higher rates. The world is once again slowing as the stimulus of low rates has played through. We expect that final demand for goods and services will be much lower than any economic textbook suggests as the developed world's population ages. North America, Europe and Japan are graying rapidly. Even China will have issues as the one child policy of the past 25 years comes home to roost. Under this auspice the desire for income and yield from both individuals and institutions is unabated. As high yield bond spreads have widened dramatically over the last month to levels not seen in over a year, we believe this provides an attractive entry point into high yield corporate debt.