PERITUS
ASSET MANAGEMENT, LLC

Market Commentary

Independent Credit Research – Leveraged Finance – June 2013

TAPPING INTO TAPERING

Well, it's been quite a couple of weeks. Let's just take a breath and do a quick inventory of what has happened. Ben Bernanke said nothing new in his latest speech other than at some point the Fed will slow down their purchases of fixed income securities. Regardless of the substance of the message, the Treasury market has moved violently to the downside with the 10-year yield now above 2.5%. It was almost as if traders heard that the Fed would be dumping Treasuries and mortgage securities into the market rather than continuing to be accommodative. Equities have followed in unison, moving sharply lower. So where to from here and what are investors to do?

As high yield investors, we have historically not spent much time focusing on interest rates, as high yield as an asset class possesses a very short duration and has not been particularly interest rate sensitive. However, today's prolonged low interest rates may have somewhat altered that equation. With a much lower than average coupon and yield, high yield bonds have shown some interest rate sensitivity, though we believe that sensitivity is short lived.

Our summary and conclusions are as follows:

- The high yield bond market has historically been negatively correlated with rising rates, offering investors the best of both worlds: protection against rising rates and excellent yield. We believe that it is simply the best risk-return asset class in fixed income.
- The enemy to the high yield investor is defaults, not rising interest rates. The default environment over the coming few years is likely to be significantly below the long term average. With high yield spreads now dramatically higher due to the contagion of the Treasury market, we view the value proposition for investors as superb.
- Investors should view with caution the idea that equities alone will be the place to be going forward. Recent action has shown that Fed-induced liquidity has blown plenty of bubbles, including the broad equity market. Economic data out of Europe and China shows a continuing contraction of economic activity and the domestic economy remains subdued at best, as evidenced by the recent 1.8% GDP number.
- Whether rates rise or not, we believe that the high yield bond market offers investors excellent tangible income and is among the shortest duration asset class in fixed income.

INTEREST RATES AND HIGH YIELD BONDS

Much has been made over the last few weeks about interest rates and the Fed's repression of yields in the bond market. The $24 question is what interest rates would be if the Fed was no longer involved in the Quantitative Easing (QE) business? This has come to the forefront with our new word of the day, known as "tapering."

We have seen many people jumping on the bandwagon of "the bond bull is dead." Maybe yes, maybe no. The way we see it, interest rates are set by a number of factors. First are inflation expectations. Does anyone believe that there is tightness in the labor markets, the commodity markets or just industrial capacity in general? With elevated unemployment and a massive decline in most commodity markets, we see no hands. Okay kiss that driver of higher rates good bye. Next, you should think of money/debt as a commodity like anything else. There is a supply and demand for it. Demand for money is tricky because there is true demand, where you can generate a rate of return in excess of your cost of capital (positive carry or arbitrage), and then what we will call "fake" demand, which it is used to refinance existing debt at lower rates. There certainly has been plenty of refinancing activity, but how much real demand is there?

To us, the apparent lack of real demand is driven by two factors. First, the global economy is weak. Europe, the biggest economic zone in the world, is mired in something just short of a depression, China is slowing dramatically, and the U.S. is limping along as the tallest midget at the circus. So there is no need to expand production of anything. Second is the issue of demographics. Now whether demographics are causal here or just circumstantial is an interesting question. We have covered this topic in great detail in prior correspondence, but suffice it to say, the western world, along with Japan and China, is aging rapidly. Combining this demographic challenge with the continuing need of the public sector to de-lever, the lack of demand for money does not appear to be reversing anytime soon.

Even with the traditional inflation and demand drivers of higher rates not seeming to be present, many believe that a 3.5% yield for the 10-year Treasury is appropriate once the Federal Reserve "repression" is lifted. Okay, for the sake of argument, let's go with that. Rates rise by another 100 basis points. So how does that change your investment rationale? Now what? Perhaps the 5-year Treasury heads toward 2.5% and the low income world continues. But if rates do climb by 200 basis points off the low, could that also affect one of the major pillars of the so-called recovery called residential housing? Might that lead to another down draft in an already fragile economy, pulling rates back down again?

Regardless of your view on interest rates, we believe the high yield market remains an excellent asset class whether rates rise or not. The following charts help to illustrate this lack of correlation to rising rates:[1]

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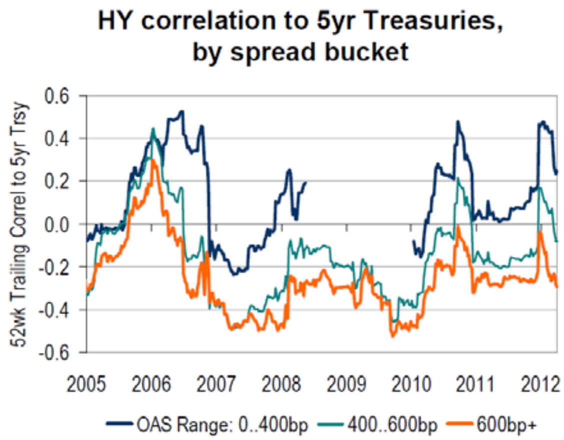
[1] Mikkelsen, Hans, Oleg Melentyev, CFA, Vineet Ahluwalia, Christopher Hays, and Neha Khoda, "High Yield, Loans in 2013: Against All Odds," Bank of America Merrill Lynch, December 26, 2012, p. 17.



Source: BofA Merrill Lynch Global Research

Past performance is not indicative of future results. OAS is the option adjusted spread range for products (spread buckets) with a 0 to 400bps spread over Treasuries, a 400 to 600bps spread over Treasuries, and an over 600bps spread over Treasuries. Data covers the period from 9/2/2005 to 11/16/2012.

Corporate bonds with spreads in the 400bps or above range are negatively correlated to Treasuries. Expanding this to look at the last 32 years, the data shows us that during the years when Treasury prices fall and yields rose, high yield bonds have had positive returns.[2] There has been 14 years of rising interest rates over this period and during those 14 years, high yield had an average return of 14.1%.

Year	J.P. Morgan High Yield Bond Index Return	J.P. Morgan Investment Grade Corp Bond Index Return	5-year Treasury	Change in 5-Yr Treasury Yield
1980	4.3%	0.5%	3.9%	2.21%
1981	10.4%	2.3%	9.5%	1.38%
1982	36.3%	35.5%	29.1%	-3.82%
1983	20.3%	9.3%	7.4%	1.38%
1984	9.4%	16.2%	14.0%	-0.46%
1985	28.7%	25.4%	20.3%	-2.58%
1986	15.6%	16.3%	15.1%	-1.68%
1987	6.5%	1.8%	2.9%	1.59%
1988	11.4%	9.8%	6.1%	0.73%
1989	0.4%	14.1%	13.3%	-1.30%
1990	-6.4%	7.4%	9.7%	-0.15%

[2] Data sourced from: Acciavatti, Peter, Tony Linares, and Nelson R. Jantzen. "2008 High Yield-Annual Review," J.P. Morgan North American High Yield Research, December 2008, p. 113. "High-Yield Market Monitor," J.P. Morgan, January 5, 2009, January 5, 2010, January 3, 2011, January 3, 2012, and January 2, 2013. 2008-2012 Treasury data sourced from Bloomberg (US Generic Govt 5 Yr). The J.P. Morgan High Yield bond index is designed to mirror the investible universe of US dollar high-yield corporate debt market, including domestic and international issues. The J.P. Morgan Investment Grade Corporate bond index represents the investment grade US dollar denominated corporate bond market, focusing on bullet maturities paying a non-zero coupon.

Year	J.P. Morgan High Yield Bond Index Return	J.P. Morgan Investment Grade Corp Bond Index Return	5-year Treasury	Change in 5-Yr Treasury Yield
1991	43.8%	18.2%	15.5%	-1.75%
1992	16.7%	9.1%	7.2%	0.06%
1993	18.9%	12.4%	11.2%	-0.79%
1994	-1.6%	-3.3%	-5.1%	2.62%
1995	19.6%	21.2%	16.8%	-2.45%
1996	13.0%	3.7%	2.1%	0.83%
1997	12.5%	10.4%	8.4%	-0.50%
1998	1.0%	8.7%	10.2%	-1.17%
1999	3.4%	-1.9%	-1.8%	1.80%
2000	-5.8%	9.9%	12.6%	-1.37%
2001	5.5%	10.7%	7.6%	-0.67%
2002	2.1%	11.0%	12.7%	-1.57%
2003	27.5%	7.9%	2.2%	0.51%
2004	11.5%	5.3%	2.3%	0.36%
2005	3.1%	1.7%	0.1%	0.71%
2006	11.5%	4.3%	2.6%	0.38%
2007	2.9%	5.3%	10.4%	-1.26%
2008	-26.8%	-1.8%	-1.8%	-1.89%
2009	58.9%	17.5%	17.5%	1.13%
2010	15.1%	8.9%	8.9%	-0.67%
2011	5.7%	8.5%	8.5%	-1.17%
2012	16.2%	9.9%	9.9%	-0.11%

So it appears the interest rate sensitivity that so many are concerned about in the high yield market has historically not been there.

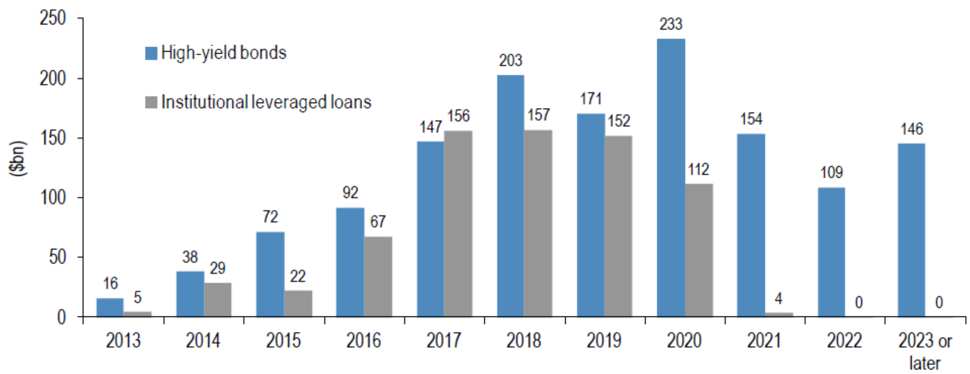
UNDERSTANDING RISK AND VALUE IN HIGH YIELD

While the common refrain is that rising interest rates are the enemy of bond investors, the high yield market is different. Default or credit risk is always the main adversary of the high yield investor. This is where the value proposition becomes much clearer, as it is our view that default rates for high yield will be substantially lower than their historical average over the coming years

A few charts might be helpful in explaining this. The first one shows the very low maturity profile of the high yield bond and loan market over the next four years.[3] Simply stated, a ton of debt has been refinanced at significantly lower interest rates and pushed out.

[3] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, and Rahul Sharma. "Credit Strategy Weekly Update," J.P. Morgan North American High Yield and Leveraged Loan Research, June 14, 2013, p. 12.

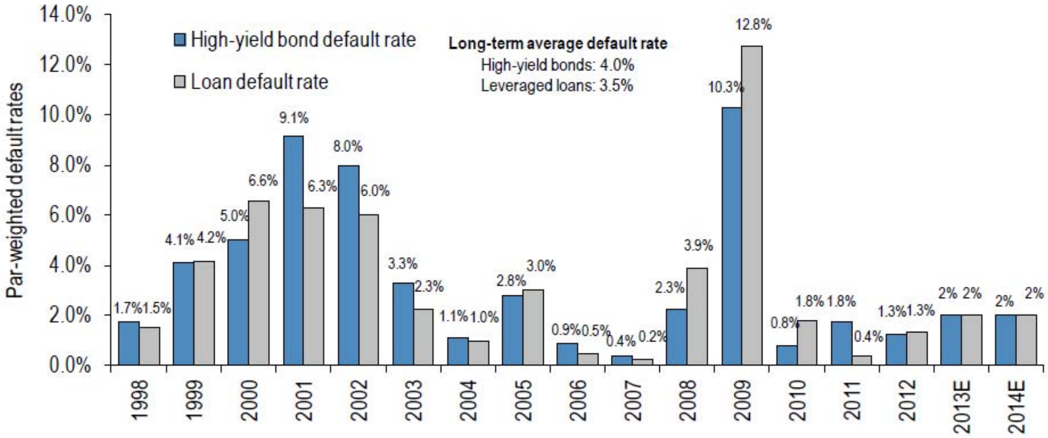
High-yield bond and institutional loan maturities



Sources: J.P. Morgan; Markit

The next one depicts the expected default rate by J.P. Morgan.[4] Regardless of the strength or weakness of the economy, having very few maturities coming up over the next few years gives credence to the below average default rates forecasted.

Default rates are expected to remain low

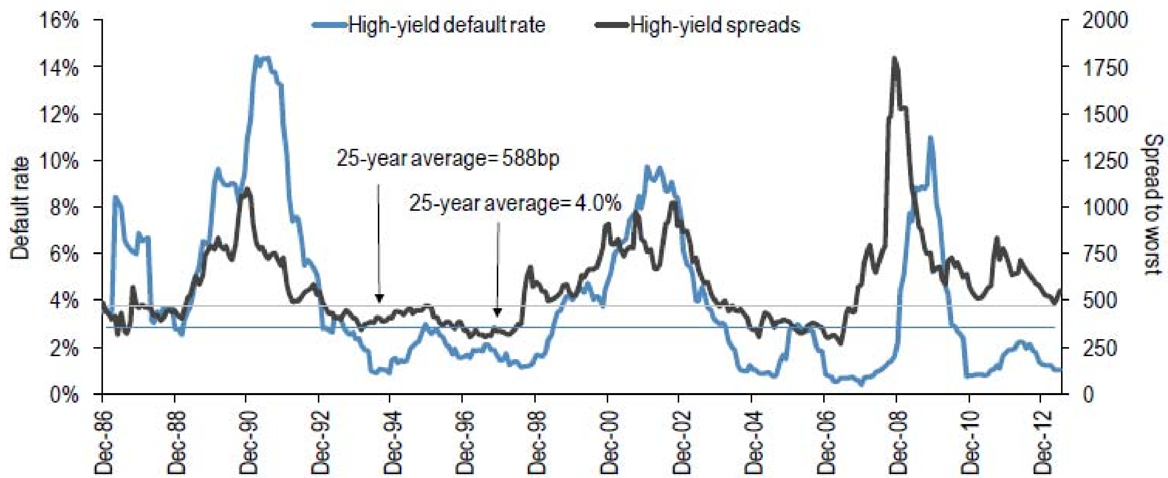


Source: J.P. Morgan.

Finally, we take a look at valuation, which for us refers to the spread or yield advantage over the 5-year Treasury bond. With the recent bout of rate concern, the overall index is now about at its 25-year average spread, yet the default rate should continue to track well below its long term average of 4%. Overlaying expected defaults and spreads provides an interesting picture.[5]

[4] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA and Rahul Sharma. "Credit Strategy Weekly Update," J.P. Morgan North American High Yield and Leveraged Loan Research, June 14, 2013, p. 14.
[5] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA and Rahul Sharma. "Credit Strategy Weekly Update," J.P. Morgan North American High Yield and Leveraged Loan Research, June 21, 2013, p. 7.

HY spreads versus default rates



Source: J.P. Morgan.

As can be seen, what we will call the value, or risk spread, has rarely if ever been this wide. Interestingly, throughout much of the 1990s defaults and spreads were well below average. Today we are but two years into the same default trend, yet spreads remain high. Those calling high yield a "bubble" should take note.

ACTIVE VS PASSIVE

Now those spreads are undoubtedly attractive, but the great news is that we don't believe they even represent the true opportunity set for investors. Those index spreads above include many BB names which possess yields of less than 4%, which skews the numbers. We have discussed the arbitrary restrictions of the passive high yield ETFs (JNK and HYG) many times over, including their issue size constraints and the forced inclusion of ridiculously low yielding names, such as AIG and Ally Financial. Remember (see our prior piece, "The Necessity of Active Management in High Yield Investing," September 2012), these size constraints eliminate 60-65% of the high yield market by issues.[6] Additionally, these funds have a negative convexity problem, where many bonds held trade at huge price premiums yet cannot be sold given the funds' mandates to hold what is in the underlying indexes. Simply selling or avoiding these high priced bonds and eliminating the ultra low-yielding BB names can increase yields significantly.

While selling premiums and buying discounts, along with eliminating the very low yielding names, is a great start, the real advantage of active management comes in the form of security selection. This encompasses both what is purchased for the portfolio, as well as what is avoided or not purchased. Peritus analyzes all of its investments in the same way an equity analyst would. Questions we ask include, but are not limited to:

- What does the future demand profile for the company's product or service look like?
- What are cost trends of the company's major expenses?

[6] Fund restrictions sourced from the ETF prospectus at https://www.spdrs.com/product/fund.seam?ticker=JNK and http://us.ishares.com/product_info/fund/overview/HYG.htm. Barclays High Yield Index holdings sourced from Barclays Capital, as of August 17, 2012. The Barclays U.S. High Yield Index is an unmanaged index considered representative of the universe of U.S. fixed rate, non-investment grade debt. One cannot invest directly in an index.

- Can the business generate free cash flow even if sales fall significantly?
- How much liquidity does the business possess?

The most important thing to remember is that there are very few bad bonds, but plenty of bad prices. Value investors such as Peritus believe that what you pay matters and with the recent back-up in the high yield market, securities that we view as undervalued are once again plentiful.

CONCLUDING THOUGHTS

So if you have a view that rates will continue to rise, what now? Looking at the various asset classes, given their low yields and high durations, we expect that Treasuries, municipals, mortgages and investment grade corporate bonds will all perform very poorly. In terms of equities, market participants have had an interesting ride over the past few years. While equity portfolios will and should remain a part of an investor's allocation, we would be cautious with the common refrain that equities are the place to be going forward. Earnings estimates are weakening for the coming quarters, China and Europe are frightening and the emerging markets are showing signs of imploding (i.e., Brazil). The U.S. dollar is rising, putting further pressure on the multinational companies focused on the export market. Ironically, investors who fled the bond market to chase for yield in equities (high dividend paying stocks, REITs, MLPs, etc.) may have experienced greater losses than if they would have stayed in bonds. But given their recent underperformance, some of these yield generating equities may be worth a look. Credit analysis is even more important in these selective situations as those dividend payments are the last thing to get paid in the capital structure.

Likewise, with leveraged loans there may be selective opportunities in that market but investors need to recognize that it is not the pure interest rate hedge many expect due to the existing LIBOR floors in many loans and the fact LIBOR hasn't moved. Furthermore, you have the same issues with a plethora of overvalued securities in the index products that you have in high yield, and if rates do rise, that impacts the interest cost and cash flow. So active management is essential in the leveraged loan market as well to parse out the overvalued securities and determine which credits can withstand higher interest costs.

We remain agnostic on the interest rate scenario as we have no historical precedent when it comes to both the massive QE purchases and subsequent withdrawal of the Federal Reserve from the Treasury and mortgage market. Regardless, the recent knee jerk selling of everything has given investors what we see as a tremendous entry point to the high yield market, especially for value-oriented, active managers such as Peritus. Whether perceived or actual, we expect that any interest rate sensitivity in the high yield market to be short lived and ultimately trumped by the underlying benign default environment and historically attractive spreads. Looking forward, we expect that high yield bonds will provide excellent income and limited sensitivity to rising interest rates, providing investors with a consistent coupon irrespective of what rates do.