PERITUS

ASSET MANAGEMENT, LLC

Active Credit

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The Necessity of Active Management in High Yield Investing

Summary and Conclusion

- Despite the yield compression in the high yield market over the past few years, we believe that high yield bonds and loans continue to offer significant opportunities for investors who are unconstrained by size and ratings. We see plenty of non-distressed credits offering what we consider appealing value in terms of both attractive yields, producing income for investors, and discounts, allowing for potential capital gains.

- Exchange Traded Funds ("ETFs") for high yield bonds have become a bigger factor in the market. While we believe the ETF format offers investors a benefit in terms of transparency of holdings, liquidity in trading, and tax efficiency relative to mutual funds, we have concerns about indexing or passive investing in the high yield market. These ETFs have structural constraints which can limit their flexibility, and we believe that this has made these funds exposed to additional risk factors.

- Due to their investment mandates, we see that the passive, index based funds have limited ability to deal with certain risk in the credit market. This is primarily default risk, but each cycle has its own issues. Today, this involves credit risk, as well as call and pricing risks. To us, the larger on the run names have become significantly over-valued as many current market prices are way above their call price. We believe that this may lead to future principal losses, not from default but from these bonds being called well below current trading prices. Investors need to understand the concept of yield to worst ("YTW") not just current yield when assessing their potential future returns.

- Additionally, the passive funds hold numerous credits that in our mind are likely defaults and/or restructurings waiting to happen. By their passive nature, these funds do not sell or steer clear of these questionable securities or the over-valued bonds in today's market. Active management is required not for just what is bought, but more importantly for what is avoided.

- The two biggest high yield ETFs largely exclude a huge portion of the actual high yield market. By their investment mandates per their respective underlying indexes, **the SPDR Barclays High Yield Bond ETF (ticker JNK) has limited ability to invest in bond tranches below $500 million and iShares iBoxx $ High Yield Corporate Bond ETF (ticker HYG) has limited ability to invest in bond tranches below $400 million and from issuers with less than $1 billion of outstanding face value.[1] These constraints can eliminate much of the market by issues. In fact, the Barclays High Yield Index has 2,124 bond holdings and only 928 of them are $500 million or more, or only 44% of the available issue universe, and only 43% of issues in this index meet the $400 million issue size and $1 billion issuer size threshold**.[2]

[1] Fund restrictions sourced from the ETF prospectus and summary prospectus at https://www.spdrs.com/product/fund.seam?ticker=JNK and http://us.ishares.com/product_info/fund/overview/HYG.htm. Size limitation based on the underlying indexes for each fund. The fund may use a representative sample of the underlying index, which means it is not required to purchase all securities in the underlying index. Both funds may invest up to 20% of the portfolio in assets not in the underlying index.

[2] Barclays High Yield Index holdings sourced from Barclays Capital, as of October 31, 2013. 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.

The State of the High Yield Market

The high yield market has seen strong demand over the past few years, with inflows into the space and record issuance. However, this is not 2007. During that period, we saw massive spread compression and it seemed every high yield bond, regardless of industry, was dramatically overvalued. While we believe there are many over-priced securities in high yield today, there are also plenty of credits that we believe remain undervalued as well.

The reality is that high yield bonds and leveraged loans still offer investors what we see as compelling yields. That's the good news. It is understood by many credit investors that immediate default risk (the next couple years) for the asset class is likely to be well below average.[3] This is also good news. The bad news is that this has led to a blind and dangerous stampede as investors pour money into passive high yield bond exchange traded funds (ETFs) over the past few years. The two largest passive high yield ETFs (the *iShares iBoxx $ High Yield Corporate Bond ETF*, ticker HYG, and *SPDR Barclays High Yield Bond ETF*, ticker JNK) together have approximately $26 billion in assets under management.[4] While we are very supportive of both the ETF model and the high yield market, we believe that passive investing in high yield will not work for the entire credit cycle. There is limited discipline in a passive strategy and this is anathema when credit cycles inevitably heat up.

The technical picture of the high yield bond market has changed significantly with the introduction and subsequent popularity of ETFs. Overall, ETFs are an excellent delivery mechanism. They provide investors transparency, liquidity and tax efficiency. Most of the ETF universe consists of passive or index strategies. While this is effective for many asset classes, such as Treasuries or very highly rated bond portfolios and certain sectors of the equity market, we believe it is not appropriate for high yield bonds. This gets back to what we discussed in our piece from last year, "Understanding Alpha versus Beta in High Yield Investing."

At the end of the day, the main risk that we deal with in high yield investing is default risk. The ability to say "NO" is crucial in credit investing. We have discussed that it is effectively a negative art: what you don't buy is likely more important than what you do. Buying bonds and loans is simply lending a company money. What bank would lend money to every company that walked in the door with a belief that the law of large numbers would play out? Then why do investors believe that owning 600+ names in a passive high yield fund will protect them?

The goal of these passive ETFs, and indexing in general, is to gain broad exposure to the market while benefiting from "diversification" and lowering risk. The reality is that we actually see greater risk potential with these strategies. Default is the primary risk that high yield investors face, but price and call risks are very real as well. To make our points clearer, a tangible example would be helpful, so we are going to focus our attention on the most popular (by market size, $15.9 billion) high yield ETF, the iShares iBoxx $ High Yield Corporate Bond ETF (ticker HYG).[5] However, it is worth noting that the same issues may pertain to other passive high yield ETFs. Here are the key points in our analysis of the passive, index-based funds:[6]

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[3] Acciavatti Peter, Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "Credit Strategy Weekly Update." J.P. Morgan High Yield and Leveraged Loan Research, North American Credit Research. October 4, 2013, p. 5.

[4] Total asset value of HYG and JNK sourced from Bloomberg, as of 11/11/13.

[5] Peritus has not owned, does not own, and is not making any recommendation to own or not to own the securities referenced.

[6] Index-based investing involves tracking the investment securities and returns of the underlying index, often via a representative sample of securities rather than a replication of the underlying index. These funds do not seek to outperform the index and generally do not undertake security selection or market timing; they generally do not attempt to take any defensive positions due to markets declining or appearing overvalued. Fund details and size constraints on the underlying index are available in the fund prospectus and summary prospectus, for HYG available at http://us.ishares.com/product_info/fund/overview/HYG.htm.

- Investors misunderstand the concept of yield.
- Fundamental analysis is not relied upon to make investment decisions.
- Limited pricing discipline exists as to where bonds are purchased.
- There is limited impetus or ability to sell bonds based on pricing/valuations, such as those trading well above their call price.
- These funds often have large commitments to legacy LBO paper.
- The investment mandates provide for limited motivation or ability to sell or avoid bonds likely to default or that have credit issues.
- Size constraints on the underlying indexes in certain cases can eliminate much of the high yield market.

Understanding Yield to Worst

First and foremost, all investors need to focus on the expected return of an investment. An incredible amount of information on yield is published by various funds and managers and can be confusing to all of us. However, we view the yield to worst (meaning the yield to the worst outcome, outside of a default, in holding a bond, which is generally the call date or maturity) as a good proxy to assess the potential return. Yet, it often seems that many investors and advisors continue to purchase the passive funds without adequate consideration of this metric. From our discussions and what we read, many seem to focus more on fees and trading volume rather than what is held in the underlying portfolio and what yield it is producing.

In analyzing this yield, corporate bond investors must deal with the "callability" of their bonds. This means that after a certain period of years following issuance (typically three or four years) the bonds can be called by the company. They are generally called because the company can refinance them cheaper and/or the company feels there is an opportunity to extend the maturities. While investors usually receive a call premium (we often see this premium start around $104 or $105, then declining to $100 as you get closer to maturity), they also lose the bonds and must redeploy the proceeds, often in a lower rate environment. What we have seen over the past couple years is that many bond prices have traded way above their call prices, meaning investors will suffer principal losses upon a call or maturity.

Looking into these passive funds, just how much of the HYG portfolio trades for a price above the first call price we often see of around $105? **Even with the massive refinancing effort over the past few years, over 50% of the HYG portfolio of issuers trades at or above $105, which represents $9.2 billion in assets! In fact, the average dollar price of this $9.2 billion is $110.**[7] So it appears investors buying this fund today are paying a massive premium for over half of the fund, which seems foolish to us. By their passive nature, whereby they mirror the index and largely buy and sell based on fund inflows and outflows, these funds do not have a mandate to sell and capture these premiums. So by continuing to hold these securities at large premiums, this could lead to future principal losses as these bonds are called at lower prices.

No Fundamental/Credit Analysis and No Price Discipline

Determining the appropriate yield involves buying a bond at the right price based on the company's fundamentals. Passive, index-based funds do not focus on analyzing the fundamentals of the bonds they own; when your mandate is to largely hold what is in an index, the company's credit statistics and the company and industry prospects are irrelevant. But how can you determine if you are being properly paid/generating an appropriate yield for the level of risk you are assuming without considering fundamentals and price? You can't.

[7] Data sourced from Bloomberg, based on holdings of iShares iBoxx $ High Yield Corporate Bond ETF as of November 29, 2013. Holdings, prices, and other statistics subject to change.

Between the very high premiums on outstanding bonds and the low yields on many newly issued credits, there is plenty to avoid in today's high yield market. By looking into the credit fundamentals, the investor can evaluate the sustainability of the capital structure and assess factors such as use of proceeds. The use of proceeds can include dividends being paid to private equity holders or leveraged buyouts (LBOs). While we are not opposed to LBOs, as they can often produce very supportive private equity partners, what does concern us is when the capital structure is levered up to a potentially unsustainable level due to these buyouts or large dividends to equity sponsors.

Selective Amnesia-LBO's

Losing discipline during boom times is a recipe for future losses. Back in 2006-2008, we saw this as private equity investors were leveraging up transactions at insane multiples, issuing a huge amount of bonds and loans in the process. The full effect of those actions has yet to be felt.

The bonds issued by these legacy leveraged buyouts (LBO's) are prevalent in both the high yield bond and loan indexes and the passive products that track them. Some of these companies have already gone through a restructuring (primarily bond exchanges) and we expect that more will do so in the future. Looking at a few examples of these LBO companies, the current debt multiples (net debt as a multiple of EBITDA, or earnings before interest taxes depreciation and amortization) are staggering.[8]

Company[9]	Net Debt Multiple
Energy Future Holdings/Texas Competitive Electric (TXU)	12.2x/10.2x
First Data Corporation (FDC)	9.3x
Harrah's/Caesars Entertainment (CZR)	13.8x
Clear Channel Communications (CCO/CCMO)	10.2x
Intelsat (INTEL)	7.3x

While a very tolerant and forgiving market has allowed many of these companies to extend their loans/bonds, the massive leverage (interest payments) plus capital expenditures don't allow many of these companies to generate the substantial free cash flow necessary to de-lever. So the sponsors are left with the greater fool game. Maybe equity market players will allow these companies to go public, creating funds for debt reduction (though we didn't see meaningful delevering in the case of Caesar's IPO last year), or perhaps their private equity sponsors can sell them to another private equity shop? This sounds like a hope certificate versus an investment strategy. Just how prevalent are these bonds in the market? Well, with high debt levels come numerous tranches issued, and therefore these become a component in the major high yield indexes. Here is what is held in the HYG portfolio:[10]

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[8] Total Net Debt/EBITDA statistics for the following companies sourced from company specific reports from J.P. Morgan published on the indicated date: First Data Corporation (10/29/13, p. 2), Caesars Entertainment Corp. (10/29/13, p. 8, OpCo used), Clear Channel Communications (11/7/13, p. 2), and Intelsat (11/1/13, p. 2). Energy Futures Holdings data sourced from report, "Short Circuit HY Utilities (IPP) October Monthly," J.P. Morgan North American Credit Research, 10/23/13, p. 11.

[9] Peritus has not owned, does not own, and is not making any recommendation to own or not to own the securities referenced.

[10] Data sourced from Bloomberg, based on holdings of iShares iBoxx $ High Yield Corporate Bond ETF as of December 10, 2013. The yield statistics use the mid pricing provided by Bloomberg. Duration is based on the ask price provided by Bloomberg.

	Portfolio Weight (%)	Market Value (mm)	Par Position Value (mm)	Coupon (%)	Yield to Maturity (%)	Yield to Worst (%)	Modified Duration (yrs)
CZR 5 ⅝ 06/01/15	0.02	3,561,250	3,700,000	5.625	8.30	8.30	1.37
CZR 10 ¾ 02/01/16	0.05	7,209,550	8,550,000	10.75	22.75	22.75	1.66
CZR 12 ¾ 04/15/18	0.06	8,751,523	15,445,000	12.75	33.49	33.49	2.59
CZR 10 12/15/18	0.06	8,679,019	15,792,000	10	30.22	30.22	2.85
CZR 8 10/01/20	0.13	20,604,239	19,900,000	8	7.46	7.29	3.90
CZR 11 10/01/21	0.15	23,397,765	22,850,000	11	10.72	10.66	4.15
CZR 8 ½ 02/15/20	0.15	23,860,576	24,300,000	8.5	9.50	9.50	4.54
CZR 9 02/15/20	0.19	29,631,000	29,750,000	9	9.66	9.66	4.49
CZR 9 02/15/20	0.20	31,642,975	31,850,000	9	9.67	9.67	4.49
CZR 10 12/15/18	0.21	32,959,108	66,305,000	10	33.67	33.67	2.69
CZR 11 ¼ 06/01/17	0.26	41,575,050	40,860,000	11.25	10.76	10.21	1.32
CCMO 5 ½ 09/15/14	0.01	1,610,533	1,600,000	5.5	6.17	6.17	0.72
CCO 7 ⅝ 03/15/20	0.01	1,064,042	1,000,000	7.625	6.64	6.28	3.56
CCMO 10 ¾ 08/01/16	0.06	9,428,013	9,070,000	10.75	10.30	9.05	0.58
CCO 6 ½ 11/15/22	0.07	10,692,302	10,375,000	6.5	6.08	5.99	5.51
CCMO 11 ¼ 03/01/21	0.10	14,993,438	13,500,000	11.25	9.62	9.20	3.85
CCMO 9 12/15/19	0.21	33,351,562	31,250,000	9	8.46	8.34	3.56
CCMO 9 03/01/21	0.23	35,826,592	34,590,000	9	8.69	8.60	4.01
CCO 7 ⅝ 03/15/20	0.29	45,786,750	42,680,000	7.625	6.58	6.20	3.56
CCO 6 ½ 11/15/22	0.29	45,280,881	43,725,000	6.5	6.02	5.92	5.52
FDC 8 ⅞ 08/15/20	0.07	11,343,542	10,000,000	8.875	6.78	4.51	1.53
FDC 10 ⅝ 06/15/21	0.13	19,911,895	17,800,000	10.625	8.95	8.49	3.97
FDC 11 ¼ 01/15/21	0.11	17,091,562	15,450,000	11.25	9.19	8.64	3.88
FDC 11 ¼ 03/31/16	0.17	27,275,467	26,377,000	11.25	10.61	-5.23	0.08
FDC 11 ¾ 08/15/21	0.24	37,505,027	33,775,000	11.75	10.67	10.38	3.78
FDC 7 ⅜ 06/15/19	0.23	36,113,743	32,700,000	7.375	5.84	4.80	1.37
FDC 8 ¼ 01/15/21	0.28	43,817,356	39,952,000	8.25	7.03	6.63	1.85
FDC 6 ¾ 11/01/20	0.28	44,229,110	41,988,000	6.75	5.90	5.62	4.11
FDC 12 ⅝ 01/15/21	0.49	76,867,461	62,532,000	12.625	9.12	8.60	2.48
INTEL 6 ¾ 06/01/18	0.07	10,292,450	9,800,000	6.75	5.38	5.04	1.39
INTEL 8 ½ 11/01/19	0.08	13,277,667	12,000,000	8.5	6.45	1.96	0.86
INTEL 6 ⅝ 12/15/22	0.10	15,517,307	14,750,000	6.625	6.24	6.16	5.40
INTEL 6 ⅝ 12/15/22	0.09	14,621,387	13,800,000	6.625	6.22	6.14	5.39
INTEL 8 ⅛ 06/01/23	0.15	22,931,146	21,750,000	8.125	7.28	7.13	5.59
INTEL 7 ½ 04/01/21	0.17	26,425,917	23,665,000	7.5	5.72	4.23	2.09
INTEL 7 ¼ 04/01/19	0.25	38,918,671	35,463,000	7.25	5.43	3.45	1.23
INTEL 5 ½ 08/01/23	0.27	42,868,056	43,660,000	5.5	6.10	6.10	7.13
INTEL 7 ¾ 06/01/21	0.25	39,465,876	37,525,000	7.75	6.81	6.55	4.43
INTEL 7 ¼ 10/15/20	0.30	47,569,624	42,870,000	7.25	5.43	3.38	1.71
TXU 6 ⅞ 08/15/17	0.01	2,098,542	2,000,000	6.875	5.89	5.76	2.77
TXU 15 04/01/21	0.06	9,259,332	30,400,000	15	57.06	57.06	1.56
TXU 11 ½ 10/01/20	0.17	26,225,838	34,600,000	11.5	18.37	18.37	3.94
TXU 10 12/01/20	0.19	29,937,153	28,250,000	10	8.80	8.46	3.89
TXU 11 ¾ 03/01/22	0.26	41,362,295	34,770,000	12.25	9.43	8.16	2.62
TXU 10 12/01/20	0.28	43,802,930	41,092,000	10	8.78	8.43	3.89
TOTAL/AVERAGE	7.45	1,168,635,522	1,174,061,000	9.02	11.07	10.22	3.15

So nearly 7.5% of this portfolio, or almost $1.2 billion, is invested in just these large LBOs that we have listed. There are certainly some tranches within each of these structures that will be money good, even in the event of a bankruptcy filing. However, our opinion is that many of them will be impaired or worth less than par in a restructuring. In our experience net leverage above 5x some rational level of EBITDA is generally a recipe for problems.

Defaults

The challenge with portfolios holding these LBOs, or any credit with a capital structure that does not work, is that the passive funds, such as HYG, are not mandated to sell bonds anticipated to default. Again, to no fault of their own, but by their mere structure, they own what fits their policy statement, viable credits or not. It isn't until after an official default that the credit is removed from the index and generally from the funds that track the index.[11]

A recent example in this arena is the former TXU (now known as Energy Future Holdings and Texas Competitive Electric). This company was taken private in 2007 in one of the largest ever LBOs, and issued a massive amount of debt in the process, but it has never been able to grow into its capital structure. After countless out of court distressed debt exchanges, there has been much recent discussion about an official bankruptcy filing in the works. The writing has been on the wall in this name for years, but it is part of the indexes, thus part of the passive products. While some of the existing tranches will likely be money good, even in a bankruptcy, we are already seeing huge discounts in other tranches, and the passive products can seemingly do nothing but ride the wave down.

If you see a train coming towards you, you'd get out of the way, but here, they can't. These passive portfolios have limited ability to deal with credit and default risks until after a default has already occurred.

Size Constraints

Another issue that we see with the passive funds is their size constraints, and the potential risk of missed opportunity. Again, looking specifically at HYG, this fund, per the underlying index, is limited in its ability to purchase issues that have less than $400 million of outstanding bonds and issuers with less than $1 billion face value of bonds outstanding. JNK, the other large high yield ETF, per its underlying index, is limited in its ability to purchase issues with less than $500 million of outstanding bonds.[12] The reality is that the underlying indexes for these funds eliminate a huge portion of the high yield market. For instance, in the entire Barclays High Yield Index, which we would view as representative of the broader high yield market, only 44% of the bond tranches in the index are over that $500mm of par threshold and only 43% meet the $400 million issue size and $1 billion issuer size threshold. This means that due to the size constraints within the funds' mandates, these passive funds are limited in their access of over 50% of the available tranches in the high yield market.[13]

It is curious to us as to why a high yield fund would set such an arbitrary limit on size that would eliminate over half of the market it is supposed to access. But it appears to get back to the misnomer of size equating to liquidity. This is surface knowledge and our three decades of experience tell us that the number one determinant of liquidity is fundamental performance. There is generally a bid for names with strong fundamentals. Stranger yet, since fund redemptions are largely what drive bond selling, the notion of having greater "liquidity" doesn't relate to having to sell a bond if fundamentals deteriorate because that isn't what decisions are based upon here.

That certainly doesn't sound like a wise way to make a loan. What we at Peritus are concerned about is a margin of safety (which we assess as free cash flow generation after debt service and capital expenditures) and the future of this margin of safety. Candidly, we tend to prefer niche businesses that generate a product or service we consider recession resistant. We pay a great deal of attention to market share as well. Smaller markets and businesses tend to attract much less competition, which is a good thing for investors. So by imposing this random size constraint, we would not be able to build a portfolio that made any sense to us or our investors. And given that these passive ETFs are such large players in the market, the reality that

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[11] In terms of defaults, issuers are not removed from the underlying index until they have been subject to a D rating, which generally occurs after a bond has already defaulted. These issues are removed at the next rebalancing date following the D rating.

[12] Fund restrictions sourced from the ETF prospectus and summary prospectus at https://www.spdrs.com/product/fund.seam?ticker=JNK and http://us.ishares.com/product_info/fund/overview/HYG.htm. Size limitation based on the underlying indexes for each fund. The fund may use a representative sample of the underlying index, which means it is not required to purchase all securities in the underlying index. Both funds may invest up to 20% of the portfolio in assets not in the underlying index.

[13] Barclays High Yield Index holdings provided by Barclays Capital, as of October 31, 2013. 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.

we now see is that these smaller tranches often end up being less volatile as they are not subject to the pressure from the fund flows seen from the large high yield funds that impose size restrictions. At the end of the day, our experience has been that the biggest determinant of liquidity is fundamental performance and as long as your credit is performing well, the liquidity will likely be there to sell if and when needed.

Final Thoughts

We don't see these passive, index-based ETFs as reflective of the real high yield market. To us, true high yield investing involves buying money good credits that are undervalued—in other words, paying the right price/generating the right yield given the company's fundamentals. However, as we previously noted, in some of the passive ETFs, we are seeing a sizable portion of the portfolio trading at large premiums to par and generating a paltry yield, and then notable allocations to some highly levered LBO credits and other credits that we would classify as questionable that generate large yields given the risk; we would view this as the worst of both worlds. On one side, you are generating little yield and seemed to be positioned for potential principal losses on a large portion of the portfolio because many of the bond prices are currently well above the call or maturity price. On the other side, you are also potentially confronted with losses given the investments in some companies facing what we see as likely restructurings in the future.

There is a middle ground and this is where we at Peritus find the opportunity in high yield investing. We see plenty of non-distressed credits offering what we consider appealing value in terms of both attractive yields, producing income for the investor, and discounts, allowing for potential capital gains. These opportunities are especially prevalent in the off-the-run names that are often overlooked by others due to structural limitations.

We have spent our careers in the high yield space, testing our thoughtful, value-based and fundamentally driven approach to investing through numerous market cycles. It is worth repeating: active management is absolutely essential in high yield investing. Having constraints on your portfolio only inhibits your ability to take advantage of the opportunity the market has to offer. An intelligent approach to the high yield market is crucial for investors looking forward.