PERITUS
ASSET MANAGEMENT, LLC

Active Credit

Independent Credit Research – Leveraged Finance – January 2015

THE YEAR AHEAD: HIGH YIELD, ENERGY, AND INTEREST RATES

To buy when others are despondently selling and to sell when others are avidly buying requires the greatest fortitude. Most investors find fear trumps fortitude in either bull or bear market cycles; fear of missing out on the former, and fear of loss on the latter.
Sir John Templeton

I buy when other people are selling.
J. Paul Getty

We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.
Warren Buffett

Pretty savvy advice from some fellas who made a buck or two in their lifetimes. Let's see if we can apply this to our asset classes and specific industries as we enter into another new year.

Year in Review

2014 will go down as a year that was a "statistical champion" as both stocks (as measured by the S&P 500 and the Dow Industrials) and bonds (the more interest rate sensitive asset classes) had very good years. Equity returns (like baseball statistics) have been very deceiving as much of their move came in the last two weeks of 2014. This is not based on a re-assessment of global growth or higher earnings, but was all about the dovish statement by the Fed following their Federal Open Market Committee meeting in mid-December:[1]

> **Federal Reserve issues FOMC statement**
> **December 17, 2014**
>
> Based on its current assessment, the Committee judges that it can be patient in beginning to normalize the stance of monetary policy. The Committee sees this guidance as consistent with its previous statement that it likely will be appropriate to maintain the 0 to 1/4 percent target range for the federal funds rate for a considerable time following the end of its asset purchase program in October, especially if projected inflation continues to run below the

[1] Federal Reserve press release, December 17, 2014. Emphasis added.

> Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored….
>
> When the Committee decides to begin to remove policy accommodation, it will take a balanced approach consistent with its longer-run goals of maximum employment and inflation of 2 percent. The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.

So the algorithms go wild and money flows and equity indexes go parabolic in the last two weeks of December on poor volumes as many professionals have closed out their years by the 15th of December. Regardless of how they got there, the S&P 500 gained 13% for 2014, while the Dow Industrials closed out the year 10% higher than it started. Candidly, I don't know of anyone who fully participated in this move. But the market does what it can to fool the majority. This performance was better than we anticipated, as fundamentals were simply overwhelmed by Fed Speak and money flows.

The bond market did its part to leave investors pulling their hair out. It was a year of duration over credit. What we mean is that interest rate sensitive sectors (Treasuries, mortgages and investment grade) dominated, while credit (high yield bonds and loans) were beaten down. Lest we forget, investors exposed to another income sub-set (master limited partnerships, or MLPs) were largely destroyed. At the beginning of 2014, we were one of the few firms calling for flat to lower rates, but even we did not see an 80 basis point move down in the 10-year Treasury.

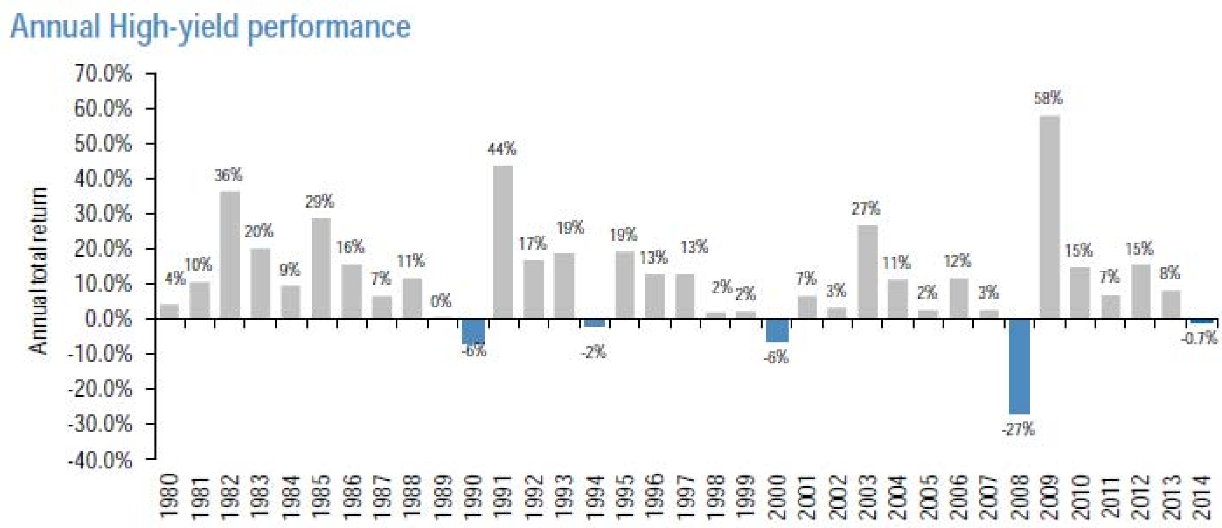
So where does that leave us as we head into 2015? Stocks look extended. They are not cheap by any measure but the party continues until it doesn't. Valuations being received by private technology companies in Silicon Valley are reminiscent of 2000. Uber received their last round of funding at a reported $40 billion valuation. This is a taxi cab paging company. Could the long awaited recovery actually be here and so these valuations are justified? Perhaps, but much of the future good news looks priced in already.

How about bonds? We entered 2014 with the consensus view that rates were going to rise. Interestingly, we enter 2015 with the opposite consensus that rates will be going nowhere to down. Shorting the US Treasury bond market has been the new "widow maker" (shorting Japanese bonds remains the original standard of ruin), but every dog ultimately has its day. Maybe 2015 will be the year that this short trade actually works. My only conviction is that 2015 will be very different than 2014. Risk premiums are rising and the world is going to see much more volatility. Energy markets are at the center of the storm. We will delve into this later on.

High Yield Bond and Loan Markets Summary

Turing to our world, the high yield bond and loan markets did not perform well in 2014. It was the polar opposite of equities. Despite what we view as excellent fundamentals, technicals (money flows) were distinctly negative. The high yield market saw outflows of $6.3 billion, while loans experienced outflows of $17.3 billion. Loans have actually seen outflows in 36 of the last 38 weeks.[2] We expected this in the loan market, as we did not buy the rising rate theory as 2014 began, and this has now left the loan market as an interesting place to hunt for credit opportunities. In January of 2014, 84% of the loan market traded above par; however, we ended the year with less than 19% of this market trading above par.[3]

High yield bonds were further punished, as oil prices collapsed over the latter half of the year. For reference, energy is the biggest industry component of the high yield market by a large margin. Depending upon the referenced index, it represents between 15-18% of the market.[4] Somewhat strangely, the high yield market ended up flat to negative (depending upon the index) in 2014:[5]



Source: J.P. Morgan.

I say strangely because in 34 years, we have seen negative annual returns only four times before. Three of these coincided with a very significant spike in default rates (1990, 2000 and 2008), while in 1994 it related to the Federal Reserve moving rates up six times. So not only is this decline a rare occurrence, but it happened under a very low default environment and one in which interest rates actually fell.

So for 2015, is it that past is prologue for these two asset classes? I believe the answer is a resounding no and feel that in 2015 **active** credit strategies will handily beat the duration trade and those asset classes with interest rate sensitivity. Please note I am saying an active and very thoughtful approach, not a passive or index approach to credit. While I have been a very outspoken interest rate dove, I'm getting more uncomfortable with that thesis as more people have the same thought process. The year has begun with a risk-off trade, driving yields on the 10-year below 1.9%, but outside of a global depression (which I don't see), it's tough to envision rates much

[2] Fuller, Matt, "Outflows from loan funds continue in final 2014 report" and "Cash outflows from HY funds continue last week of 2014, at $960M," LCD, Leveraged Commentary and Data, January 5, 2015.
[3] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2014 High-Yield Annual Review." J.P. Morgan, North American High Yield and Leveraged Loan Research. December 29, 2014, p. 26.
[4] For instance, Energy is 17% of the JP Morgan USD US High Yield Index. Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2014 High-Yield Annual Review." J.P. Morgan, North American High Yield and Leveraged Loan Research. December 29, 2014, p. 7.
[5] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2014 High-Yield Annual Review." J.P. Morgan, North American High Yield and Leveraged Loan Research. December 29, 2014, p. 123.

lower. One of the arguments we made last year for flat to lower rates was that foreign Government bond markets had lower yields than our own. I believe much of the rate reduction we saw in 2014 was strong foreign buying of our market, particularly as the US dollar soared. While this arbitrage continues as we enter 2015, currency markets have a habit of changing on a dime. So we will see how this plays out this year.

Global Economics/Rates

The dominant economies of the world are the European Union, United States, China and Japan. Combined, these four countries/zones represent almost two-thirds of Global GDP. The dramatic fall in energy prices are a direct and massive tax cut for ALL of these economies. Listening to the media and even Wall Street can be dangerous to one's financial health, as evidenced by the myth that the US is now or soon going to be energy independent. This is absolute nonsense. The US consumes approximately 19.3 million barrels of oil per day.[6] We produce a little over 9 million barrels per day.[7] *That means that we are importing more than half of our oil needs daily*. This is why I believe that any damage to North Dakota and Texas is going to be dwarfed by the jolt being provided to the masses in the form of lower energy prices.

The EU, China and Japan import almost all of their energy needs. While all economies are not as energy intensive as they were ten years ago, oil is still the most important commodity input in the world. It is not just transportation fuels, but petrochemicals (think plastics and resins) that are oil derivatives. It touches every area of our life daily. Combine this massive tax cut with stimulus efforts underway by Draghi in the Eurozone and Abe in Japan and you have the makings of a potential surprise to the upside in consumption and overall growth. Markets are all about the look forward, so while the Eurozone and Japan have had feeble growth they will turn on the presses to do what they can to stimulate.

Obviously, oil-centric economies will be hit hard in 2015 but the question remains what impact will that have globally? At first blush it appears large. The world produces about 92 million barrels of crude oil per day.[8] If we take $45 off of each barrel that is the equivalent of $1.5 trillion annually not going into the hands of producers. This is a pretty big number and has led some to believe that this will be a net negative for the global economy. Before getting too worked up over this, let's put some things into perspective.[9]

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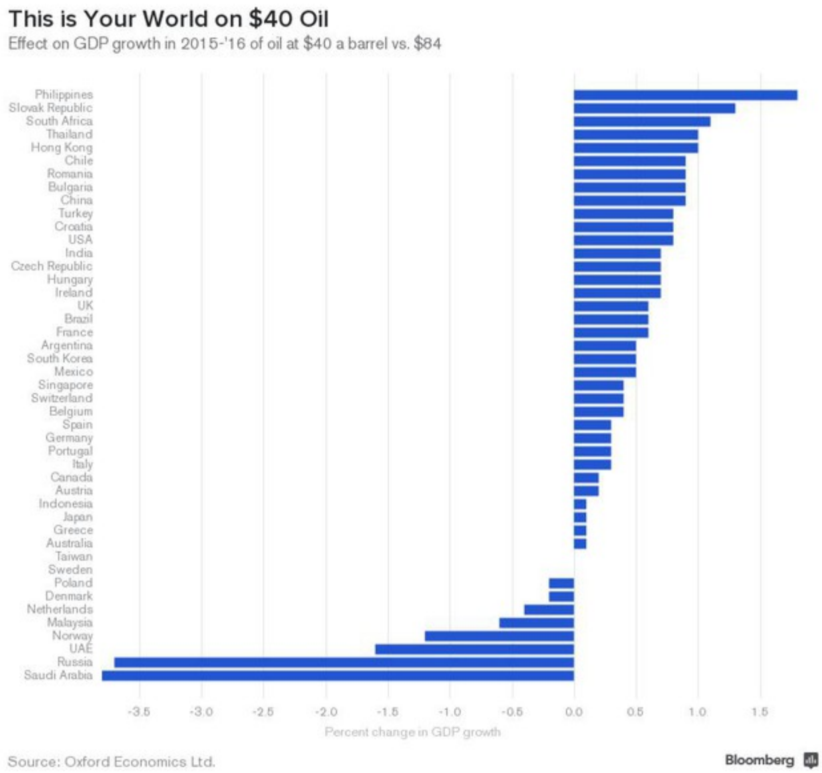
[6] Source: U.S. Energy Information Administration (August 2014), http://www.eia.gov/cfapps/ipdbproject/IEDIndex3.cfm?tid=50&pid=54&aid=2
[7] Source: U.S. Energy Information Administration (December 2014), http://www.eia.gov/dnav/pet/pet_sum_sndw_a_epc0_fpf_mbblpd_w.htm
[8] Based on IEA data from Oil Market Report © OECD/IEA, December 12, 2014, IEA Publishing; modified by Peritus. License: http://www.iea.org/t&c/termsandconditions/.
[9] Arnsdorf, Isaac and Simon Kennedy, "How $50 Oil Changes Almost Everything," Bloomberg, January 7, 2015.



As can be seen, the biggest impact is understandably on the two largest producers in the world: Saudi Arabia and Russia. But Saudi's total contribution to global GDP in 2013 was about $750 billion. This compares with Turkey who had a contribution of $822 billion. How about Mother Russia? Surely this is going to be a global disaster as that economy suffers and potentially defaults? Russia's GDP in 2013 was just over $2 trillion. While that sounds like a very big number, the UK by itself (not part of the Eurozone) contributed $2.7 trillion.[10] Russia's economy is about the size of Canada's, so while Putin's antics make for great press, Russia punches below their weight on the global scale. As a small consolation prize, Russian crude oil exports (over 5 million barrels per day[11]) are receiving about the same amount of Rubles per barrel (due to its collapse) as when oil is was $100 given that those barrels are sold in US dollars and converted back to Rubles.

All of this to say that the benefits of high oil prices accrue to the few and those few are not conspicuous consumers on a global scale. Additionally, printing presses will be on turbo charge for Japan and the Eurozone as we head into 2015, so some form of economic growth may actually appear and provide food to the bond bears. Given a likely increase in volatility and risk premiums, there will be moments where the flight to quality trade moves Treasuries higher and rates lower. But those will likely be short term events. Even when the Fed begins to raise short rates, we don't expect 5- and 10-year Treasury rates to rise that much, but I wouldn't bet on them falling in 2015. We believe that this means traditional core fixed income portfolios, which are largely focused on

[10] The World Bank: GDP Ranking (data for FY 2013).
[11]Source: U.S. Energy Information Administration (report as of March 2014, export data as of FY 2012), http://www.eia.gov/countries/analysisbriefs/Russia/russia.pdf.

investment grade bonds, will likely be staring at a very paltry coupon yield only in 2015. Or perhaps worse.

High Yield Credit vs. Investment Grade and Equities

So where does that leave investors? Let's turn our attention back to the high yield bond and loan markets. The good news is that both the high yield bond and loan markets have significantly less interest rate sensitivity. So should 2015 be the year that rates actually do rise from the bottom, we would expect that their shorter duration and higher starting yield will likely benefit and protect investors. The long-term numbers show that in the 15 years where we saw Treasury yields increase, high yield bonds posted an average return of 13.7%. This compares to a 4.5% average return for investment grade bonds over the same period.[12]

Year	J.P. Morgan High Yield Bond Index Return	J.P. Morgan Investment Grade Corp Bond Index Return	Change in 5 Yr Treasury Yield
1980	4.3%	0.5%	2.21%
1981	10.4%	2.3%	1.38%
1983	20.3%	9.3%	1.44%
1987	6.5%	1.8%	1.59%
1988	11.4%	9.8%	0.73%
1992	16.7%	9.1%	0.07%
1994	-1.6%	-3.3%	2.62%
1996	13.0%	3.7%	0.83%
1999	3.4%	-1.9%	1.80%
2003	27.5%	7.9%	0.51%
2004	11.5%	5.3%	0.36%
2005	3.1%	1.7%	0.74%
2006	11.5%	4.3%	0.34%
2009	58.9%	17.5%	1.13%
2013	8.2%	-0.8%	1.02%
Average	13.7%	4.5%	

If rates don't rise, the significant coupon income advantage will continue to provide a strong cushion relative to investment grade securities. Regardless, we believe that investors should embrace the high yield market as a core part of their fixed income allocation. Recent history has demonstrated that the optimum fixed income allocation (highest return per unit of risk) combines a balance of 50% high yield with 50% investment grade bonds, a more duration sensitive asset class.[13]

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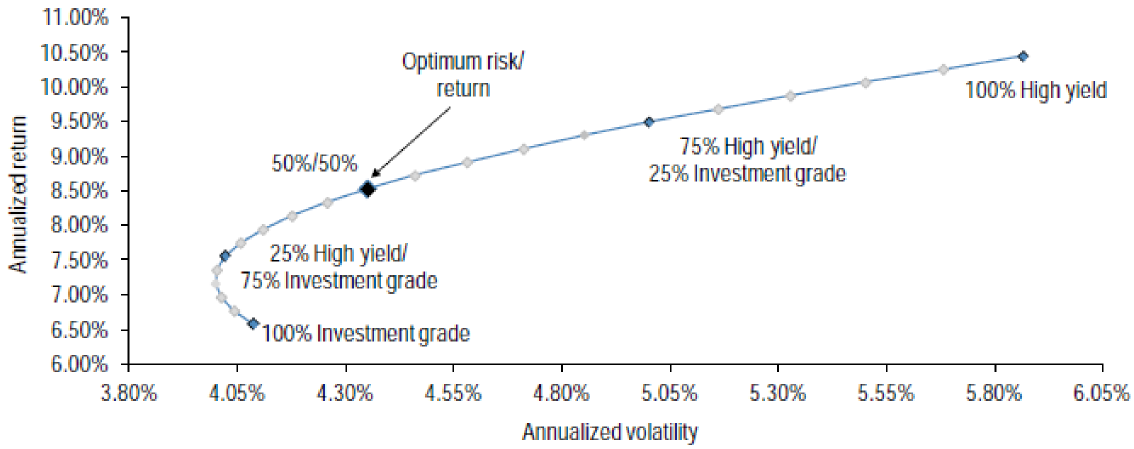
[12] Data sourced from: Acciavatti, Peter, Tony Linares, Nelson R. Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2008 High Yield-Annual Review," J.P. Morgan North American High Yield Research, December 2008, p. 113. "High-Yield Market Monitor," J.P. Morgan, January 5, 2009, January 5, 2010, January 3, 2011, January 3, 2012, January 2, 2013 and January 2, 2014. 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 nonzero coupon.

[13] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2014 High-Yield Annual Review." J.P. Morgan, North American High Yield and Leveraged Loan Research. December 29, 2014, p. 125.

Risk/return trade-off

(investment-grade vs high-yield bonds: 5 years ended November 28, 2014)

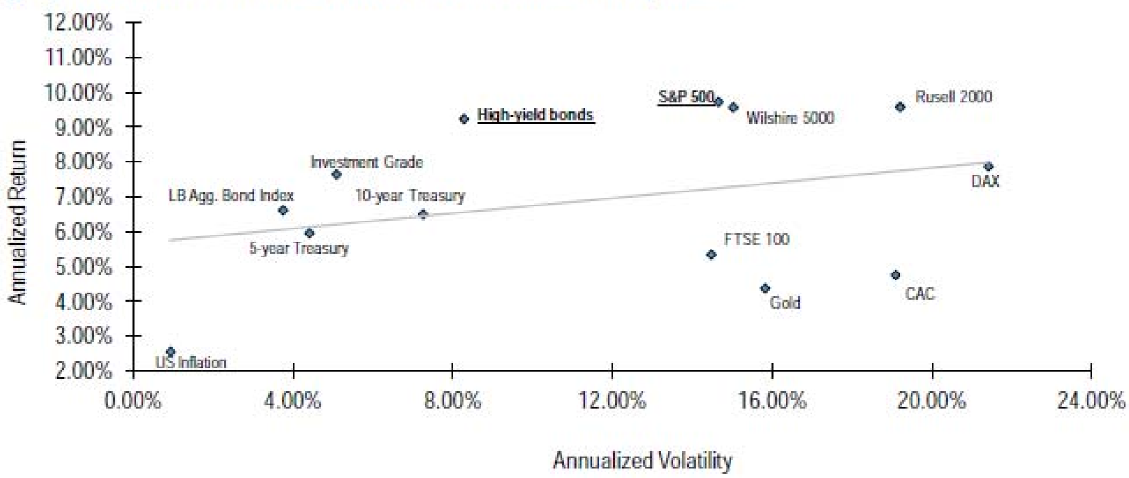


Source: J.P. Morgan.

What is interesting about this graph is that even using a 100% high yield allocation, volatility goes from about 4.3% per year to about 5.9%. We would view this is a rounding error and nothing but a bit of portfolio noise. Yet you would have picked up about 200 basis points in annualized return over this period. Lest you think this is data mining (picking a time frame that shows well), note that interest rates (as measured by the yield on the 10-year Treasury) fell from around 3.5% to 2.2% during this time, providing a massive boost for investment grade bonds.

Looking at other asset classes, using a time frame that dates back 25 years, high yield has done nearly as well as equities yet with approximately half the risk, as measured by volatility.[14]

High-yield bonds remain excellent substitutes for equities



Source: J.P. Morgan.

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[14] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2014 High-Yield Annual Review." J.P. Morgan, North American High Yield and Leveraged Loan Research. December 29, 2014, p. 123.

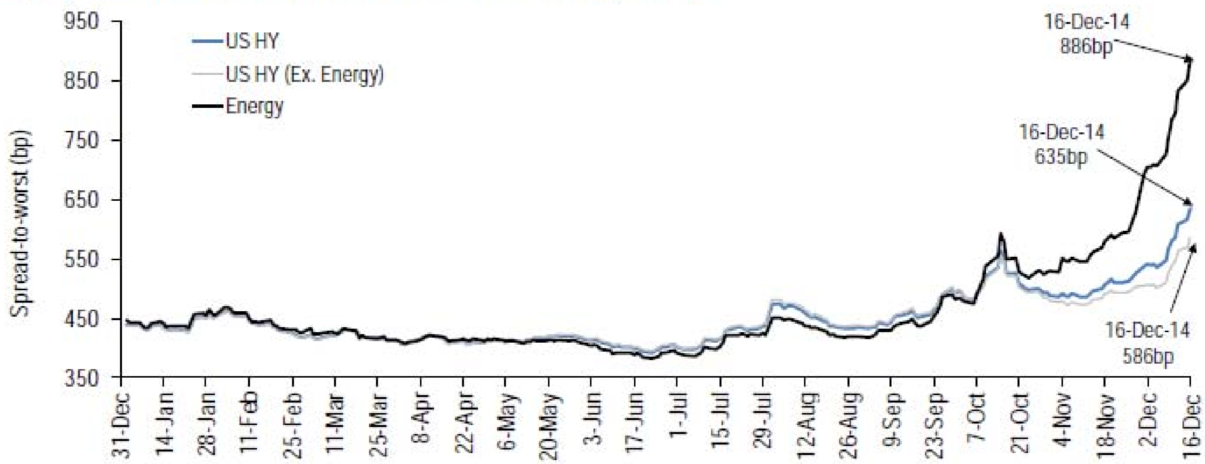
We believe that the compelling historical returns profile and lower risk (volatility) relative to equities warrants investors paying more attention to the high yield asset class and that it supports the argument that high yield should be a core part of an investment portfolio, especially in today's low-yielding environment.

Credit Fundamentals and the Current Opportunity

Let's take a look at where we are in the cycle and both the relative and absolute value of the high yield market. What we need is both a consolidated and more detailed look at the market. As previously mentioned energy is a massive part of the high yield game and candidly needs to be dealt with by all income investors, as it has a large representation in the investment grade, high yield, master limited partnership (MLP) and bank loan markets.

The overall high yield market without energy now trades at a spread-to-worst of right around 600 basis points over the 5-year Treasury. Including the energy markets, we are at 635 basis points over. [15]

High-yield bond spreads with and without energy bonds



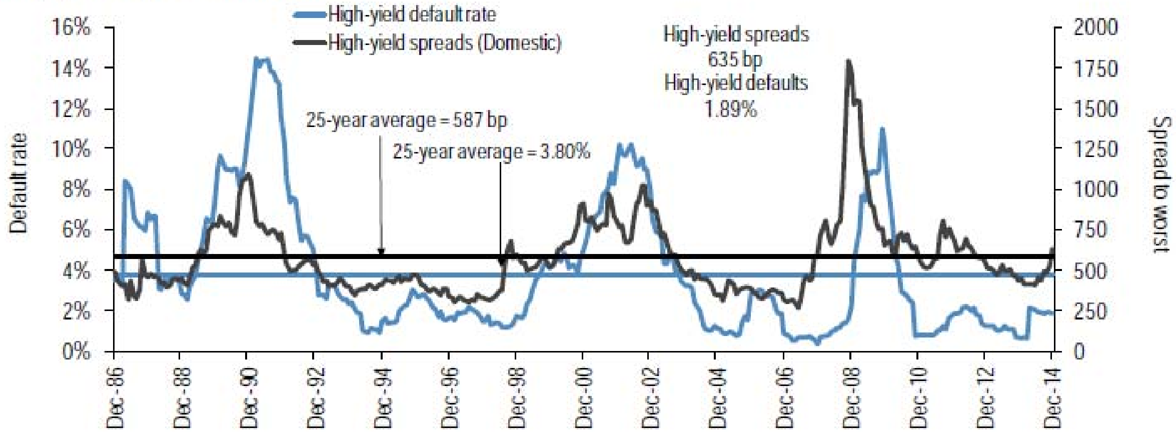
Source: J.P Morgan.

So from a historical perspective, we believe that the market looks very attractive. As can be seen from the graph below, lower default rates have historically coincided with low spreads. For instance, this graph indicates that we have often seen spreads around 450 basis points or under when default rates have been under the historic average of 3.8%. Today we sit at a default rate of under 2% and spreads of 635bps.[16]

[15] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2014 High-Yield Annual Review." J.P. Morgan, North American High Yield and Leveraged Loan Research. December 29, 2014, p. 112.

[16] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2014 High-Yield Annual Review." J.P. Morgan, North American High Yield and Leveraged Loan Research. December 29, 2014, p. 115.

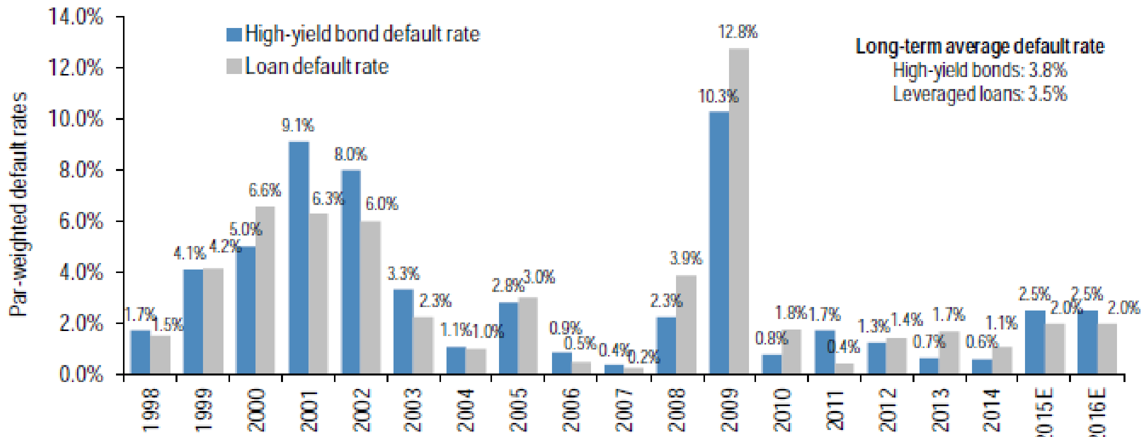
High-yield spreads and default rates



Note: 2014 data through December 16.
Source: J.P Morgan.

Here's the rub. I believe we are in a very low default environment over the next 2-3 years EXCEPT for the domestic oil and gas producers who levered up to play in the shale. This is why we need to compare apples with apples. The mid-2% numbers JP Morgan suggests for high yield default rates in 2015 and 2016 pass muster ex oil and gas.[17] So we view a spread of around 600 basis points (excluding energy) and a 2.5% default rate as representative of both relative and absolute value in this environment.

Default rates to rise but remain below long-term averages



Note: 2014 default rate is LTM as of November 30 and excludes the $36bn default of TXU.
Source: J.P. Morgan.

There are two reasons for our confidence that a very low default environment will continue. First, fundamentals have simply not gotten out of whack as they generally do six years into a credit cycle. Leverage metrics remain near the lows of the past five years.[18]

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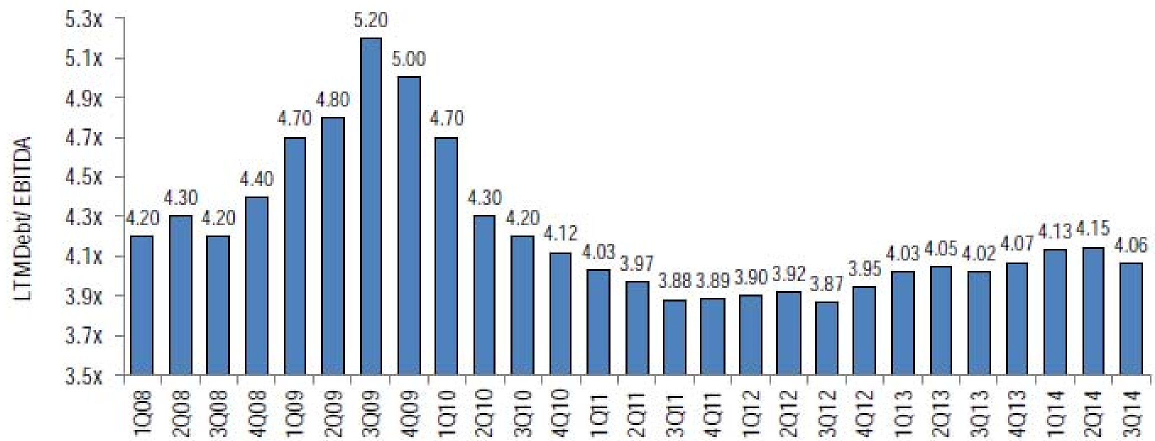
[17] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2014 High-Yield Annual Review." J.P. Morgan, North American High Yield and Leveraged Loan Research. December 29, 2014, p. 14.
[18] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2014 High-Yield Annual Review." J.P. Morgan, North American High Yield and Leveraged Loan Research. December 29, 2014, p. 142.

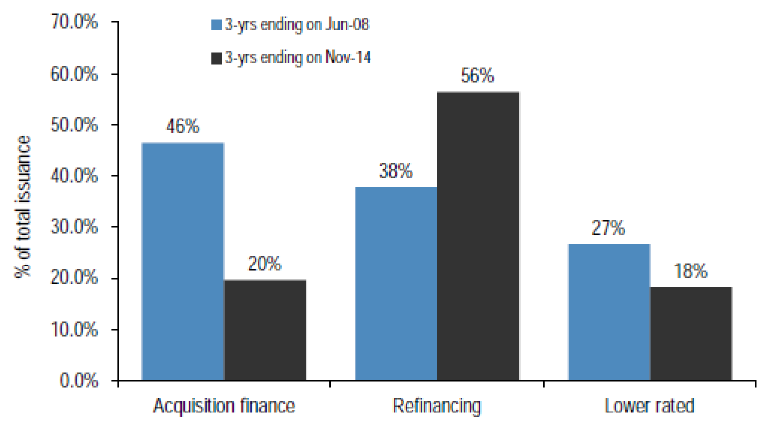
Leverage decreased to a four-quarter low



Sources: J.P. Morgan; CapitalIQ.

Also importantly, use of proceeds for newly issued bonds continues to be dominated by refinancing not M&A or leveraged recapitalizations, so bad behavior has been limited:[19]

A focus on refinancing and de-levering has corporate balance sheets in a better position than in 2008



Source: J.P. Morgan.

Last but not least, there are simply not that many maturities to be dealt with over the next three years.[20] Looking out even through to the beginning of 2017, $109 billion of high yield bond maturities is the equivalent of about four months of supply.[21]

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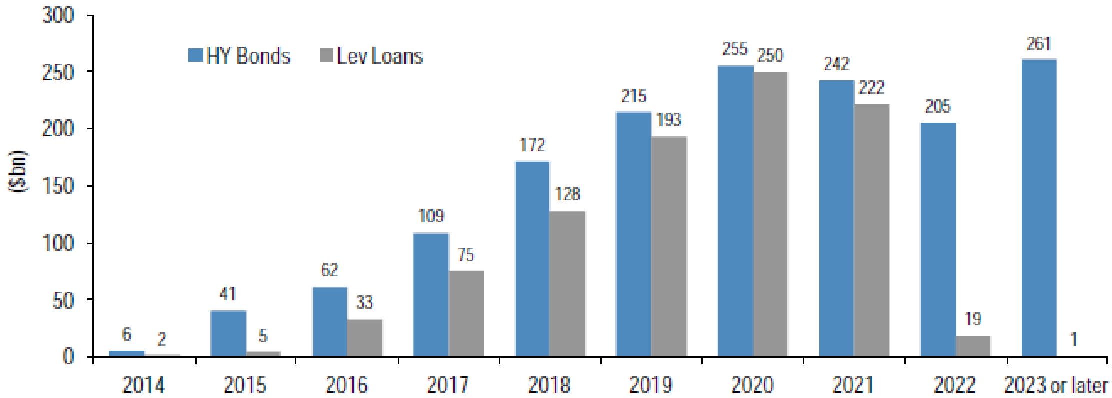
[19] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2014 High-Yield Annual Review." J.P. Morgan, North American High Yield and Leveraged Loan Research. December 29, 2014, p. 18.

[20] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2014 High-Yield Annual Review." J.P. Morgan, North American High Yield and Leveraged Loan Research. December 29, 2014, p. 28.

[21] Four months of supply based on the 2014 monthly issuance run rate. Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2014 High-Yield Annual Review." J.P. Morgan, North American High Yield and Leveraged Loan Research. December 29, 2014, p. 28.

High-yield bond and institutional loan maturities



Note: As of September 2015.
Sources: J.P Morgan; Markit.

Interest rates are unlikely to provide a tailwind to mortgages, Treasuries or investment grade corporates as we saw in 2014. We believe that means expected returns on a best case scenario are the 2-3% coupon for most of these areas. With spreads around 600 basis points and a very low risk (default) environment expected over the coming years, we believe that investors should continue to move toward non-investment grade bonds and loans as a larger part of the new core fixed income portfolio in 2015.

The Oily Slope

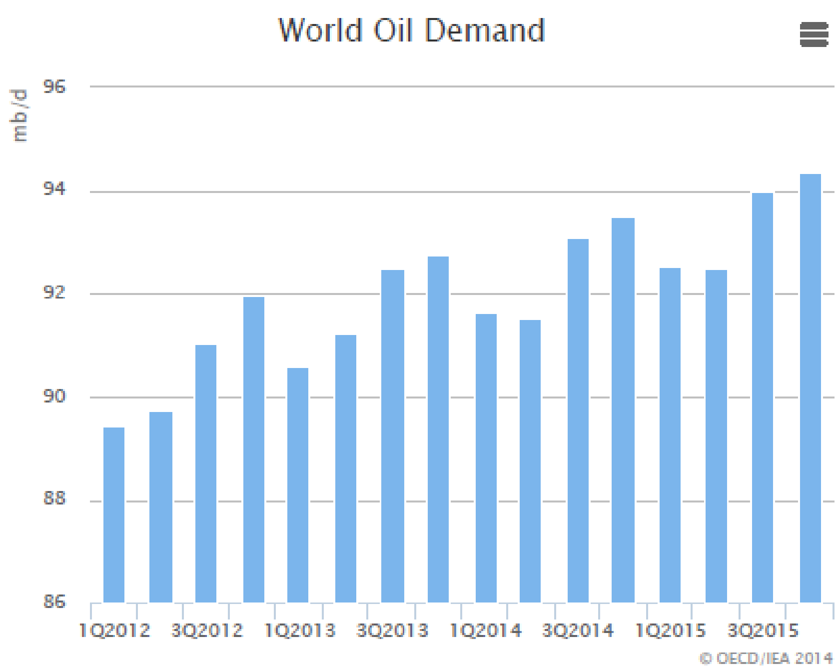
Another topic that is important to investors, particularly those involved in income generating strategies, as we look toward the year ahead is that of energy and what to do with the oil and gas market in 2015. Absolutely no one (including ourselves) saw a 50%+ decline in oil prices coming. While we get into industry specifics in the paragraphs that follow, we need to make a few things very clear. First, we do not recommend direct exposure to E&P companies in the US shale game. We don't believe that the majority are sustainable businesses, but projects. We were not tempted on the way up and not in the least interested on the way down. As energy is the largest part of the high yield market, avoiding it is impossible. On the exploration and production side, we believe investors should consider exposure to Canadian producers who receive the benefit of a falling C$ and strong heavy oil differentials.

Drilling down fundamentally, investors should look for a high reserve life index and a company that is capital efficient. This means the company does not have to spend money acquiring land and that they are able to replace a barrel of production with a reasonable spend. Think of both of these as maintenance capital expenditures. Finally, look for companies that have high netbacks (cash flow per barrel) or cash flow margins. Pricing of oil will always vary, but without these factors (as we see in many of the US shale producers) we see little interest in investing.

Our thesis remains on target, but it hasn't mattered much over the past year as everything has been decimated. But as oil prices inevitably bottom and move higher, we expect the underperformers to become outperformers. Importantly, the lack of free cash flow or sustainable business models for most US shale producers (even at much higher prices) is now being exposed. We believe supply and demand fundamentals are not well understood as the media serves up platitudes and hyperbole. Let's take a closer look at why we believe the currently low oil prices are unsustainable.

Oil Demand

The argument has been that the world is over-producing by around 1.5 million barrels per day. Let's say that this is under-estimated and it's 2.5 million per day. Global consumption is approximately 92 million barrels per day.[22] So 2.5/92 is 2.7%. This 2.7% "glut" causes oil prices to fall over 50%? That certainly looks like an over-reaction because this type of price move is usually caused by a collapse in demand (as we saw in 2008). We certainly have not seen this in 2014. In fact, demand continues to increase. Not at the 1 million per day originally forecasted, but has moved from a quarterly average of 91.77 million barrels per day in 2013 to 92.44 million barrels per day in 2014, for a demand increase of around 700,000 barrels per day.[23]



And this demand growth occurred with oil prices at $100 and the same weak global economic backdrop we continue to have. We are seeing a similar story domestically, as recent demand continues to rise. It would certainly make sense that lower prices would not hurt demand, but if anything increase it. Transportation fuels (gasoline, diesel and jet fuel) remain the biggest demand component for oil and SUV sales in both the US and China are soaring. Investors also need to be aware that seasonality plays into the oil markets, with demand globally picking up as we enter spring.

Oil Supply

Our view of oil supply differs significantly from most. It is our view that oil supply globally is much more tenuous than believed. Much of it rests in the hands of unstable regimes now made

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[22] Based on IEA data from Oil Market Report © OECD/IEA, December 12, 2014, IEA Publishing; modified by Peritus. License: http://www.iea.org/t&c/termsandconditions/.

[23] Based on IEA data from Oil Market Report © OECD/IEA, December 12, 2014, IEA Publishing; modified by Peritus. License: http://www.iea.org/t&c/termsandconditions/.

that much more unpredictable with a lower price deck. Libya, Nigeria and Venezuela are the shakiest of all. Libyan production surprised to the upside for a few months but has once again collapsed. Venezuela is imploding and Nigeria remains a frightening place where kidnapping is among the most lucrative professions. These three combined produce around 5 million barrels of crude oil per day.[24]

OPEC Crude Oil Supply: Q3 2014 *(million barrels per day)*	
Algeria	**1.15**
Angola	**1.64**
Ecuador	**0.56**
Iran	**2.8**
Iraq	**3.28**
Kuwait	**2.6**
Libya	**0.58**
Nigeria	**2.07**
Qatar	**0.76**
Saudi Arabia	**9.7**
United Arab Emirates	**2.7**
Venezuela	**2.2**
OPEC Total	**30**
Other Liquids	**6.12**
Total OPEC Supply	**36.2**

You can begin to see why Saudi is tired of being the hero. Each time that a production cut is needed, they do so to the benefit of these "team-mates" who pay no attention to the new quotas. So they grow weary of playing parent to the dysfunctional children. My belief is that they continue to target those that caused much of this pain in the first place: the US and Nigeria.

More specifically, the growth in US light oil production has displaced not only Saudi crude heading to the US, but much of the Nigerian crude that used to make its way to our ports. This Nigerian crude then finds its way to Asia to compete with the Saudis. This is simply not going to be something they will tolerate. Given that these countries had little re-investment in infrastructure at prices twice what they are today, it is just a matter of time before production/supply challenges emerge.

One final comment on supply. Russia remains the largest oil producer in the world at over 10 million barrels per day.[25] Recent data points show very strong production, but this is another country whose production is severely at risk. Not only are they dealing with a collapsing Ruble and imploding economy, US sanctions have severely restricted both access to capital and technology. Much of Russian production comes from Siberia which is not exactly the cheapest or

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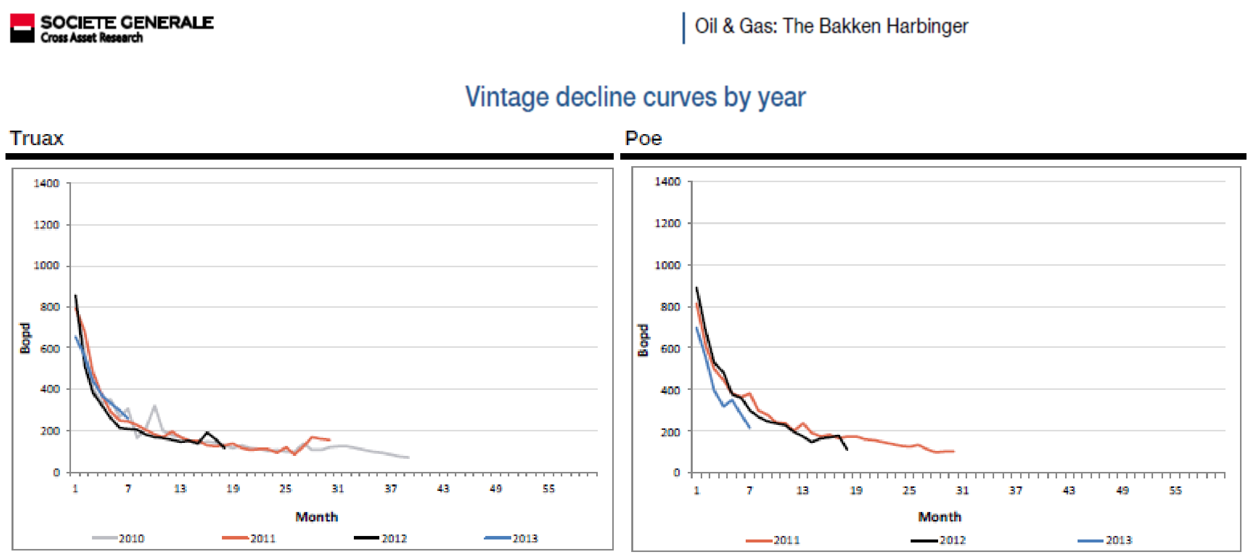
[24] Source: U.S. Energy Information Administration (September 2014).

[25] Source: U.S. Energy Information Administration (November 2013), http://www.eia.gov/countries/country-data.cfm?fips=RS.

easiest territory to operate in. Those who continue to think the world is swimming in oil should be very careful projecting $30 oil. Low oil prices are very de-stabilizing to many of the largest producers in the world. Remember these producers are not democracies and will do what it takes to ensure their own survival.

US Shale/Tight Oil—Projects Not Businesses

Last but not least let's spend a little time on the "miracle" of US oil production. We do not view this as an opportunity, but a falling knife and value trap. Most of these producers did not generate free cash flow at prices twice what they are today. The reason is because the business model is non-existent in many cases. The oil and gas business is capital intensive, but in tight oil production, wells decline at such severe rates, you never get off the treadmill of heavily reinvesting capital to sustain production. Here are two of the better Bakken zones through 2013 but they all have similar decline profiles:[26]



We've seen reported decline rates upwards of 70% in their first year. There is simply no way to build a sustainable business with these types of declines. Unconventional production such as this required two things to get going: high oil prices and very cheap long term capital. Both of these things existed in spades over the last few years and are now gone. These businesses face a vicious circle. They cannot cut back drilling because if they do, their production dies quickly given the rapid well decline rates. But since there is no free cash flow, where does the money come from to drill the wells? It had come from the high yield market. But do not fret, the cavalry is coming in the form of private equity. Here is a very recent announcement from LINN Energy:[27]

> **Alliance with GSO Capital Partners**
>
> In addition, LINN announced that it has signed a non-binding letter of intent with private capital investor GSO Capital Partners LP ("GSO"), the credit platform of The Blackstone Group L.P. (NYSE:BX) ("Blackstone"), to fund oil and natural gas development (the

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[26]Herrlin, John, Bob Parija, CFA, Russell Koch, CFA, and Vincent Lovaglio, "Oil & Gas: The Bakken Harbinger," Societe Generale, Cross Asset Research, December 20, 2013, p. 22..

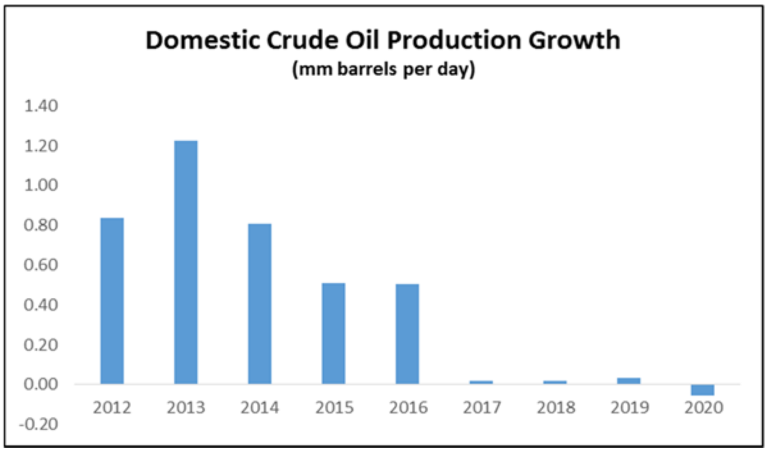
[27] LINN Energy press release, "LINN Energy Announced 2015 Oil and Gas Capital Budget, Reduces Annual Distribution to $1.25 Per Unit," January 2, 2015. Emphasis added.

> "DrillCo Agreement"). Subject to final documentation, funds managed by GSO and its affiliates have agreed to commit up to $500 million with 5-year availability to fund drilling programs on locations provided by LINN. Subject to adjustments depending on asset characteristics and return expectations, GSO will fund 100% of the costs associated with new wells drilled under the DrillCo Agreement and is expected to receive an 85% working interest in these wells until it achieves a 15% internal rate of return on annual groupings of wells, while LINN is expected to receive a 15% carried working interest during this period. Upon reaching the internal rate of return target, GSO's interest will be reduced to 5%, while LINN's will increase to 95%.

Private equity gets the joke. They aren't investing in the debt or equity of LINN or anyone else. They are investing at the "project" or wellhead level. They get paid back in very short order (typically two years) and should generate a very nice rate of return. This makes perfect sense to us and we would expect there would be plenty more of these announcements as the debt and equity markets say "no mas" to this group. But what is left over for the company? Bupkus. To put it mildly the cost of capital is egregious. We would call it death spiral financing, but many of these businesses are already the walking dead.

Management teams will put the positive spin on this type of financing but we aren't buying it. But my two personal favorites remain that they will cut capital expenditures and grow production and focus only on the best spots. Really? What were they drilling before? Their worst zones? The hope will be that oil prices will move higher and the capital markets will once again be open. While we do expect oil prices to go back up, buying distressed debt or equity in these shale companies remains primarily a fool's errand. High yield debt is rarely ever paid back, but instead is refinanced. The problem is that investors are now looking at the numbers (which wasn't necessary at $100 oil apparently) and they are recognizing that for many there is no sustainable business to finance. In many cases there never was. The distressed community is certainly a bad bid, but I would question the "loan to own" strategy. In a default you may end up with the assets, but what are those assets? Rocks that require a great deal of capital to generate revenue, but still see no sustainable free cash flow, so what is the value of that asset? To us $0.00.

The hard reality is that the boom in production in tight oil is a temporary phenomenon. Both the International Energy Administration ("IEA") and the Energy Information Administration ("EIA") recognize this and the only argument is when production peaks and begins to decline. Nobody knows if this is 2017 or 2020 but they do know that day approaches. Projects not businesses.



Source: U.S. Energy Information Administration, data as of January 13, 2014.

We do not believe an acquisition cycle will occur in the US regardless of pricing or distress. Two companies that are both bleeding and merge won't solve their problems. Perhaps there will be some fire sales on land, but keep in mind the best acreage is largely already owned by well capitalized players early to the game. But we do believe that such a consolidation cycle will begin in earnest in the Canadian markets, where we do see long-term, sustainable production in many cases. The first to fall was Talisman, which announced in December that it was being acquired by Repsol. [28]

> **Repsol to Acquire Talisman Energy for US$8.00 Per Common Share In All-Cash Transaction**
>
> **CALGARY, ALBERTA**
> **Highlights:**
> - All-cash price of US$8.00 (C$9.33) per Talisman common share delivers significant and immediate value to Talisman common shareholders.
> - The purchase price for common shares represents a 75% premium to the 7-day volume weighted average share price and a 60% premium to the 30-day volume weighted average price.

If you shopped early, unfortunately you didn't get the red tag special. But for those who were buyers of the stock near its bottom, you did pretty well. While it's too early to predict a trend, we expect a considerable amount of consolidation north of the border going forward.

This is not 2008/2009. Oil demand domestically and globally is stable to growing and we would expect that demand growth may well accelerate at the currently low prices. This is in the face of tenuous global supply from the likes of Libya, Nigeria, and Venezuela, and potentially even Russia. Furthermore, we expect that the currently depressed prices will force many US shale producers to shut in production or get out of the game altogether, as the capital market access dries up, the treadmill stalls. Our belief is that the price of oil cannot stay below the cost of a new marginal barrel of production for too long. The marginal barrel is all about unconventional (tight

[28] Talisman Energy press release, "Repsol to Acquire Talisman Energy for US$8.00 Per Common Share in All-Cash Transaction," December 16, 2014.

oil, deepwater and oilsands) and this requires prices north of $80 at a minimum to generate any economic incentive. While virtually all positions in the energy business have been killed in 2014, a rising tide will not carry all boats going forward. We expect our thought process to be rewarded as the oil prices recover.

Concluding Thoughts

Wholesale selling of the high yield asset class due to its large exposure to the energy industry has created what we see as attractive entry points into numerous names that have nothing to do with the energy markets. We did not see these types of discounts going into 2014. The significant majority of floating rate bank loans now trade at a discount to par as well. While we don't expect interest rates to rise much in 2015, they are unlikely to fall and become a tailwind for longer duration asset classes, such as investment grade bonds. With a benign default environment, we believe that capturing the significant yield advantage provided by high yield bonds and loans should be a priority for fixed income investors.