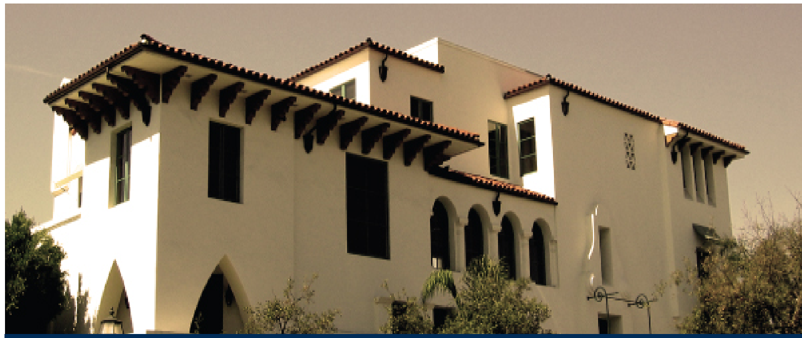


PERITUS
ASSET MANAGEMENT, LLC

Active Credit

Independent Credit Research – Leveraged Finance – October 2010

CERTAINTY

If I hear the word "uncertainty" one more time I'm going to choke. Every time I turn on a political or business show, I hear the current problems being blamed on "uncertainty." You want certainty? Death and taxes. There you go, all fixed. Since when is life or business ever certain? Was 9/11 a certainty? Was hurricane Katrina a certainty? Was JFK's assassination certain? Throughout history we have had to tolerate some level of uncertainty. Yet, why can't we seem to handle it this time around—or maybe it is just a convenient excuse because we don't want to face the reality of the certain economic weakness around us.

Here are a few certainties that we can take away from the past few years. We created fictional demand for all types of products from consumer electronics to housing. This was done by turning on the liquidity and leverage spigots. The seeds were sown in the early part of the new millennium, as the Federal Reserve dropped cash into everyone's lap by slashing interest rates post the technology meltdown. If you give people free money they spend it. Demand soared across the board and it was unsustainable. It all came crashing down around us in 2008. The response was to flood the market with liquidity to keep the system from collapsing. This was done by the Federal Reserve purchasing mortgages and Treasuries forcing money into the system and interest rates lower. What would seem to make sense to us is that with rates extremely low and demand for these bonds improving, the Fed should begin to sell some of them back into the market, giving them the ability to reload for the future. Instead they are going to purchase more?

The Fed's Approach

What we have all heard in the last couple of weeks is that the Federal Reserve is likely going to increase their balance sheet by purchasing more bonds, now known as QE 2 (quantitative easing, round 2). I get they are concerned that the economic weakness continues, but why would they take this approach? Rates are crashing through all time lows with the 5 year Treasury bond approaching 1%. Does anyone really believe that lowering mortgage rates and lowering Treasury yields further will fix either the real estate game or the employment situation? I'm certain that the Federal Reserve and the public have lost all sense of what the Fed is supposed to do. Here are their duties taken right from their own manual:[1]

[1] Board of Governors of the Federal Reserve System, Washington D.C. "The Federal Reserve System Purposes & Functions." Ninth Edition, June 2005, p. 1.

The Federal Reserve System

PURPOSES & FUNCTIONS

Today, the Federal Reserve's duties fall into four general areas:

- conducting the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates
- supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers
- maintaining the stability of the financial system and containing systemic risk that may arise in financial markets
- providing financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system

So two of their main goals include the pursuit of stable prices and moderate long-term interest rates. Well let's give them a D on both of these duties. It seems to me that the pursuit of maximum employment is causing some of this flailing around. Their strategy in trying to increase employment is to lower rates to ridiculous levels and destroy the U.S. dollar. They have successfully lowered the dollar, though employment has not responded, as recent reports confirm.[2]

Private sector sheds 39,000 jobs in Sept: ADP

WASHINGTON (MarketWatch) -- Employment in the U.S. private sector fell by 39,000 in September, the first drop since January, according to the ADP employment report released Wednesday.

Even the headline numbers that have shown unemployment improving have been deceiving:[3]

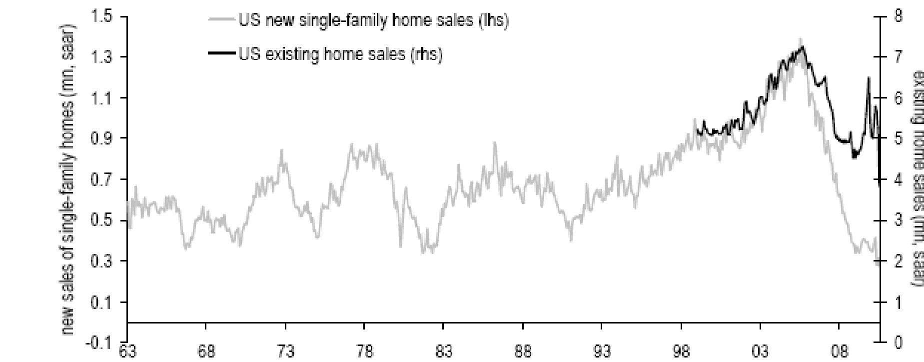
Unemployment rate a misleading measure of labor market weakness: The unemployment rate held at 9.5% in July and is down from a 9.9% jobless rate three months ago. But the lower jobless rate reflects a decline in labor force participation, not increased hiring. The household survey measure of employment (including fewer Census workers) declined even more than payroll employment in July and underperformed payrolls in each of the past three months. The ratio of employment to the working-age population, a better measure of labor market conditions, has dropped in each of the last three months even as the unemployment rate has improved.

[2] Robb, Greg. "Private sector sheds 39,000 jobs in Sept: ADP." *MarketWatch* (www.marketwatch.com). October 6, 2010.

[3] Kasman, Bruce, Rober Mellman, Michael Feroli, and Daniel Silver. "US Weekly Prospects." J.P. Morgan Economic Research. August 6, 2010, p. 3.

The other area of focus for the powers that be is real estate. Let's not spend a great deal of time here as we have covered this in the past. What we all know is that there are millions of houses that remain in limbo somewhere between default and foreclosure. This shadow inventory will be with us for years to come. Recent data provides certainty to just how awful things are.[4]

Both new and existing home sales slumped to record low levels

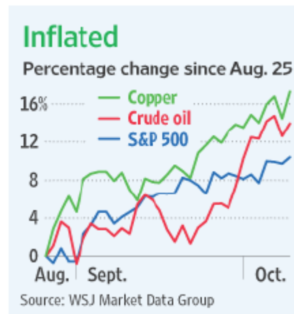


Source: Bloomberg.

Furthermore, the level of existing home inventories jumped from 8.9 months supply to 12.5, which is also the highest level since records began in 1999. Durable goods

Even with the 30 year fixed rate mortgage in the low 4% area, sales and inventories are not showing much improvement. The Fed has deviated from their traditional role in order to try to improve the employment and housing situation, but neither has responded to the fix.

Getting back to their failure in pursuing stable prices, what the Fed has managed to achieve is to create more asset bubbles in stocks and commodities. Input costs are soaring at a time when the economy is getting weaker. I keep hearing that they are shooting for a little inflation. Why? I didn't see that in their operating manual. Their idea is to create "good" inflation which means higher prices are a result of increased demand. But that isn't what is happening. Instead prices are rolling higher because money is cheap and is chasing risk.[5]



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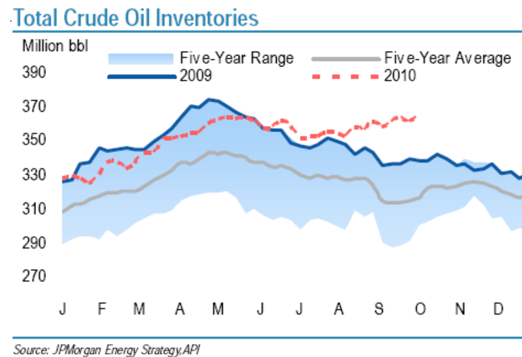
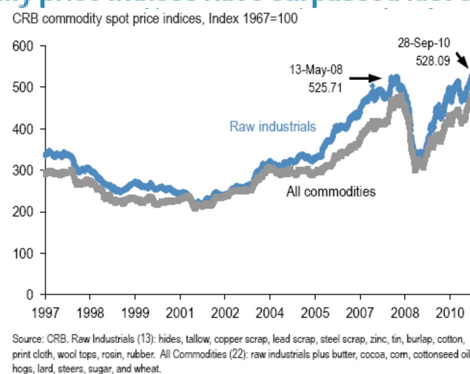
[4] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Alisa Meyers. "Credit Strategy Weekly Update: High Yield and Leveraged Loan Research." J.P. Morgan North American High Yield and Leveraged Loan Research. August 27, 2010, p. 3.

[5] Evans, Kelly. "Fed's Reflation Bet Could Hit Consumers Before It Helps." *The Wall Street Journal.* October 11, 2010.

But this rally is not based on fundamentals at all. Many of the major commodities are traded in U.S. dollars so as the dollar falls (due to the printing press at the Fed running overtime and low rates) these prices rise. Oil is the most obvious example.[6]



We see inventories at all time highs for this time of the year, and this was during a time when we had a drilling moratorium in the Gulf due to the BP disaster. So there is no fundamental reason for oil to increase. The concept of lowering rates to 0% is to get investors to move out onto the risk spectrum to keep the capital markets going. Well congratulations, this goal has been more than accomplished. And oil isn't the only commodity soaring.[7]



So the CRB (commodities research bureau index, a measure of various commodity futures prices) has now blown through the highs established in 2008. Since we know demand isn't roaring back in North American or Europe, is it China and India that is causing this? Heck no, it is financial market speculation; just what the doctor ordered. Look at the growth of the commodity ETF game and how beautifully it correlates with the CRB index as investors pour money into these funds to ride the commodity trade.[8]

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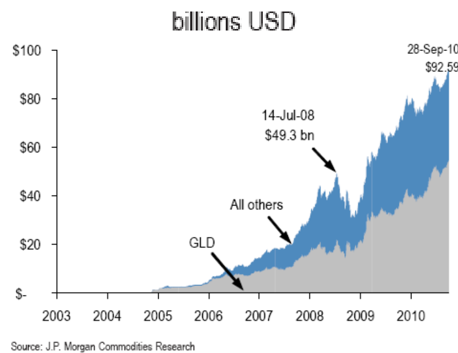
[6] Yoo, Sung. "Snapshot of API Weekly Oil Inventory Data." JP Morgan Global Commodities Research. October 5, 2010, p. 2.

[7] Fenton, Colin, Lawrence Eagles, Michael Jansen, Scott Speaker, David Martin, Peter Nance, Jeff Brown, Lewis Hagedorn, Jonah Waxman, Tobin Gorey, Sung Yoo, and Ryan Sullivan. "Commodity Markets Outlook and Strategy: Consumers, start your hedges." JP Morgan Global Commodities Research. September 30, 2010, p. 5.

[8] Fenton, Colin, Lawrence Eagles, Michael Jansen, Scott Speaker, David Martin, Peter Nance, Jeff Brown, Lewis Hagedorn, Jonah Waxman, Tobin Gorey, Sung Yoo, and Ryan Sullivan. "Commodity Markets Outlook and Strategy: Consumers, start your hedges." JP Morgan Global Commodities Research. September 30, 2010, p. 14.



Haven't we seen this movie before? So the fix to the economy is to create more bubbles in financial assets. Perfect.

Credit Markets

So just how does all of this effect our world? Demand (technicals) has been very strong for most of 2010, but unlike in the commodity space, there does seem to be a fundamental reason behind the strength. It appears to us that a secular shift into fixed income and yield by large pension plans and retail investors is underway after the significant underperformance of equities over the last decade. Yet, with treasury yields currently so low, and potentially going lower with this next round of quantitative easing, and investment grade corporates not much better, allocations to high yield are increasing. As part of this, high yield mutual fund inflows have been substantial so far this year. This volatile flow of funds leads to an aggressive new issue market and of course the more money that flows into the arena, the more aggressive pricing becomes. During these periods it is very important to possess both patience and discipline. Candidly, it is during these times when credit managers are most important. Being able to say no is crucial. What you don't buy is often more important than what you do buy.

DineEquity, a deal done during the first week of October, is a classic example of what we wouldn't buy.[9]

DineEquity bonds price at par to yield 9.5%; terms

bond deal drew CCC+/B3 ratings. Leverage will be roughly 3.5x through the secured debt and 5.7x total, sources said.

DineEquity operates restaurants (Applebees and IHOP) so not exactly a recession resistant business in the currently tough climate. The company has debt leverage of 5.7x EBITDA which we find to be very aggressive, especially given the nature of the business and lack of hard assets. Yet this deal was priced at a 9.5% yield and was a blowout success with seemingly little thought by investors about the future or fundamentals of the business. What we often find is that when money flows become too robust into any area or at the top of cycles, discipline goes out the

[9] Standard & Poors Leveraged Commentary & Data. "DineEquity bonds price at par to yield 9.5%; terms." October 6, 2010. "DineEquity cuts pricing on $900M TL amid strong demand." October 5, 2010.

window and this is evidenced by things such as use of proceeds (dividends to equity sponsors), limited covenants and aggressive leverage metrics. These types of credits would qualify as an unequivocal "NO" for us, which is a benefit of active management. Holding one's discipline at the current time is key.

So is this deal representative of the world we live in? Fortunately the answer is no. There are plenty of opportunities in the high yield space with reasonable business profiles and lower leverage metrics yielding around 8-9% (on a YTW basis) or better. And on the other side of the ledger is that the 5 year Treasury bond yields just over 1%, something none of us have ever seen before. A YTW of around 9% represents a yield advantage of almost 8% or an 800 basis point spread over the 5 year Treasury. The median spread has been approximately 550 basis points historically.[10] While an argument can be made that this premium is warranted given the global macroeconomic challenges, at a microeconomic level we are not so sure. Expected defaults in the corporate credit space continue to plunge for several reasons.[11] First, the refinancing wave over the past 18 months has pushed out maturities and provided plenty of liquidity for many companies. Secondly, management continues to focus on the balance sheet, meaning lots of cash flow generation and debt paydowns. So we see the high yield market as continuing to offer attractive opportunities for investment.

One of the major misunderstandings of our world is that the high yield market is homogeneous or a single trade. We hear people all the time telling us that high yield, or credit in general, is expensive or cheap depending on a multiple of factors. While this view may be appropriate for macro traders, it is not meaningful for investors (and let's be clear that there is a difference between traders and investors). We view high yield as a core component to any portfolio, given the steady coupon cash flow it provides, which can also serve as an offset to any potential price volatility. Furthermore, the corporate credit markets are massive, with high yield and leveraged loans at almost $2.5 trillion combined. This market breadth and depth allows us, as active managers, to customize the risk and exposures we want for the environment in which we find ourselves. Examples of this portfolio positioning include:

- Specific credit exposures—yield to call versus capital gains plays
- Industry exposures
- Floating rate or fixed rate coupons
- Subordination choices—secured, senior or subordinated exposure
- Maturity or duration

So we view our job as managing through the various cycles that we are faced with. As we see it, a slow or no growth economy is nirvana for credit investors. This seems counter-intuitive but it is pretty straight forward. When management teams believe they are in for an extended period of difficult times, the focus is on surviving which means balance sheet improvement and debt

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[10] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Alisa Meyers. "Credit Strategy Weekly Update: High Yield and Leveraged Loan Research." J.P. Morgan North American High Yield and Leveraged Loan Research. October 1, 2010, p. 23.
[11] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Alisa Meyers. "Midyear 2010 High-Yield and Leveraged Loan Outlook and Strategy." J.P. Morgan North American Credit Research. July 7, 2010, p. 10.

reduction. If however the future is perceived as rosy, growth and all the silly decisions that go along with it come to the forefront. Empire building can destroy a balance sheet in short order.

Conclusion

Our expectation is for the economy to muddle along for a while. While the market is excited about the Fed's renewed attempts at quantitative easing, we don't expect it to have much tangible impact on spurring the economy. The last ten years have shown equity investors nothing. Some have extrapolated this into believing that it is now the perfect time for equities and the past will not become prologue. This is dangerous reasoning. Plenty of research has shown that the bulk of returns from equities have come from dividends and their compounding, yet currently yields overall remain paltry. [12] *If yield remains critical to returns, why not enjoy this yield with significantly less risk (as measured by volatility) in the bond market?*[13]

One final point. We believe passive strategies in corporate credit will likely lead to sub-par returns. Correlations across asset classes have tightened dramatically over the past few months. There is very little separation by the market among industries yet many industries have dramatically different fundamentals. Oil and natural gas is but one example yet both trade with similar yields. If we have one prediction for 2011 it is that fundamentals will assert themselves. Caveat emptor.

Sincerely,

PERITUS ASSET MANAGEMENT, LLC

Timothy J. Gramatovich, CFA
Chief Investment Officer

Peritus I Asset Management Disclosure:

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[12] One such example, see Robert Arnott, "Bonds Why Bother?" April 20, 2009, www.IndexUniverse.com.
[13] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA and Alisa Meyers. "North American High Yield Research: US Fixed Income Markets 2010 Outlook." J.P. Morgan Securities, November 27, 2009, p. 13. Data as of Q3 2009.