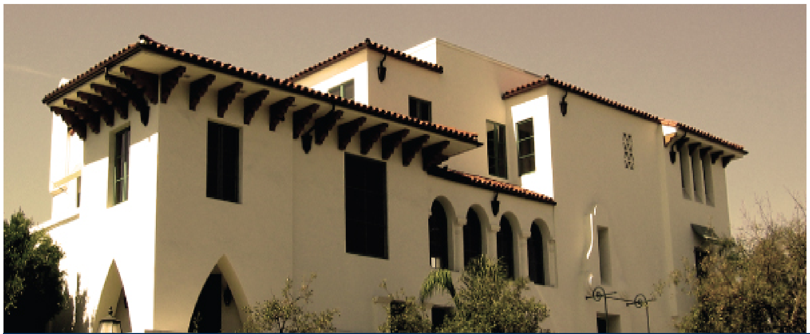


PERITUS

ASSET MANAGEMENT, LLC

Market Commentary

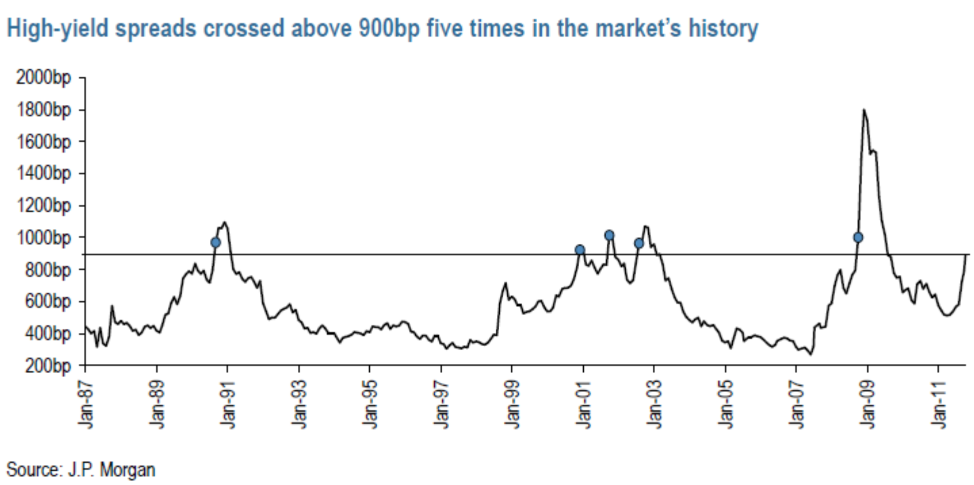
Independent Credit Research – Leveraged Finance – October 2011

High Yield – Time for a Real Allocation

Last week we were on a call, sponsored by AdvisorShares, talking to investors. These investors consisted of both individuals and financial advisors using or interested in the ETF we manage, the Peritus High Yield ETF (Ticker: HYLD). In addition to the usual questions on yields and portfolio holdings, three questions stood out. First, is the timing right to commit money today to the high yield asset class and, second, how much of a client's portfolio should be invested in high yield bonds? Finally, there was a question on liquidity in the ETF space—in essence, does volume indicate liquidity (or lack thereof)?

Timing

Let's take the first question. Is it the right time to commit monies to the high yield asset class? While we believe that the asset class provides either good or great opportunities depending on the market environment, the recent spread widening to over 900 basis points provides an entry point that historically has been what we see as SPECTACULAR. During the history of the high yield market spreads have crossed over 900 basis points five times. During each of these periods, the entry point was followed by superb performance as the chart below indicates: following all of these periods, we saw rapid and significant spread compression.[1]



[1] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, Alisa Meyers, and Rahul Sharma. "Credit Strategy Weekly Update: High Yield and Leveraged Loan Research." J.P. Morgan North American High Yield and Leveraged Loan Research. October 7, 2011, p. 13. **Spread**, or spread to worst, is the difference between the yield-to-worst on the index and the yield on a comparable maturity Treasury bond, quantified in basis points.

Importantly, even during 2008, when spreads broke through 900 basis points and continued soaring to over 1900 basis points, one year later, you would have generated a return of over 20% (as measured by the J.P. Morgan High Yield Index). J.P. Morgan summarizes the data below:[2]

> **Notably, if you had invested in high-yield bonds in September 2008 when spreads reached 900bp, you would have endured spreads widening to a record high 1900bp during the next 6 months and still managed to record a 1 year return of +20.35%.**

In addition to a terrific entry point in high yield, note the dramatic outperformance of high yield bonds compared to equities during the ensuing periods. In fact, over the following 1, 2, 3, 4 and 5 years, high yield out performed equities by a significant margin.[3] This does not even take into account that **high yield is significantly less risky than equities** (as measured by standard deviation or volatility of returns).[4]

High-yield bond and equity performance post spreads rising above 900bp

			High-yield annualized returns				
	3mo	6mo	1yr	2yr	3yr	4yr	5yr
Sep-90	-0.08%	18.42%	36.93%	28.43%	24.04%	18.38%	18.07%
Nov-00	9.17%	7.99%	7.48%	4.12%	10.90%	11.32%	9.96%
Sep-01	5.84%	8.24%	2.37%	14.10%	13.77%	11.97%	11.43%
Jul-02	-0.98%	8.10%	22.23%	17.96%	15.37%	12.59%	11.82%
Sep-08	-19.50%	-14.61%	20.35%	19.40%	14.20%	na	na
Average	**-1.11%**	**5.63%**	**17.87%**	**16.80%**	**15.66%**	**13.57%**	**12.82%**

			S&P 500 annualized returns				
	3mo	6mo	1yr	2yr	3yr	4yr	5yr
Sep-90	8.95%	24.81%	31.26%	20.71%	18.08%	14.30%	17.14%
Nov-00	-5.43%	-3.90%	-12.22%	-14.40%	-5.52%	-1.23%	0.64%
Sep-01	10.69%	10.99%	-20.49%	-0.54%	4.04%	6.04%	7.66%
Jul-02	-2.39%	-5.26%	10.65%	11.89%	12.61%	10.76%	12.15%
Sep-08	-21.94%	-30.54%	-6.91%	1.27%	2.42%	na	na
Average	**-2.03%**	**-0.78%**	**0.46%**	**3.79%**	**6.33%**	**7.47%**	**9.40%**

			Difference				
	3mo	6mo	1yr	2yr	3yr	4yr	5yr
Sep-90	-9.04%	-6.40%	5.67%	7.72%	5.96%	4.08%	0.93%
Nov-00	14.60%	11.89%	19.70%	18.52%	16.42%	12.55%	9.32%
Sep-01	-4.85%	-2.75%	22.85%	14.64%	9.73%	5.94%	3.76%
Jul-02	1.41%	13.36%	11.58%	6.06%	2.76%	1.83%	-0.33%
Sep-08	2.45%	15.93%	27.26%	18.13%	11.78%	na	na
Average	**0.92%**	**6.41%**	**17.41%**	**13.01%**	**9.33%**	**6.10%**	**3.42%**

Source: J.P. Morgan.

[2] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, Alisa Meyers, and Rahul Sharma. "Credit Strategy Weekly Update: High Yield and Leveraged Loan Research." J.P. Morgan North American High Yield and Leveraged Loan Research. October 7, 2011, p. 1. The **J.P. Morgan Global High Yield Index** is an unmanaged index designed to mirror the investable universe of the U.S. dollar high yield corporate debt, including domestic and international issues. One cannot invest directly in an index.

[3] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, Alisa Meyers, and Rahul Sharma. "Credit Strategy Weekly Update: High Yield and Leveraged Loan Research." J.P. Morgan North American High Yield and Leveraged Loan Research. October 7, 2011, p. 14.

[4] See chart below, Footnote 5, for detail on risk adjusted returns.

History would indicate that in today's environment, the high yield bond market seems to be not only an exceptionally attractive place to be invested, but an even better place to be positioned than equities.

Allocation

Which then gets to the second question, what percentage of a portfolio should be invested in the high yield asset class? I am bewildered that this question often emerges when the historical data we have on the high yield asset class is clear: high yield outperforms equities on a risk adjusted basis. As we noted above, over certain time frames, high yield outperforms equities without even adjusting for risk. Note the table below taken from our whitepaper, *The Case for High Yield Securities*.[5]

Risk/Reward Profile of Various Assets: 1980 - June 2011

January 1980 - June 2010	Annualized Total Return*	Annualized Standard Deviation*	Return/Risk	Highest Annual Return	Lowest Annual Return	Annual Median Return	Number of Positive Return Years	Number of Negative Return Years	Sharpe Ratio*
30-Day U.S. Treasury Bills	4.98%	0.96%	5.21	13.97%	0.09%	4.88%	31	0	0.00
U.S. Intermediate Term Government Bonds	8.63%	6.46%	1.34	29.10%	-3.59%	9.21%	28	3	0.59
U.S. Long Term Government Bonds	9.61%	12.07%	0.8	40.36%	-13.26%	9.63%	25	6	0.44
Merrill Lynch Mortgage Backed Security Index	8.86%	7.30%	1.21	40.15%	-1.60%	7.33%	30	1	0.56
Merrill Lynch US Corporate Bond Index	9.13%	7.76%	1.18	35.53%	-6.82%	9.12%	28	3	0.57
Lehman Brothers U.S. Aggregate Bond Index	8.66%	6.20%	1.4	32.62%	-2.92%	7.89%	29	2	0.62
Lehman Brothers AAA Corporate Index	8.56%	8.14%	1.05	39.32%	-3.64%	7.98%	27	4	0.48
S&P 500 Index	11.37%	17.42%	0.65	37.43%	-37.00%	15.80%	25	6	0.44
Russell 2000 Index	10.89%	22.42%	0.49	47.25%	-33.79%	18.33%	22	9	0.36
DJ Wilshire 5000 Index	11.27%	17.82%	0.63	36.40%	-37.33%	16.09%	24	7	0.43
MSCI EAFE Index	10.16%	19.74%	0.51	69.94%	-43.06%	11.63%	23	8	0.35
Gold	3.49%	18.79%	0.19	31.92%	-32.15%	0.98%	18	13	0.01
U.S. Inflation	3.49%	1.26%	2.78	12.40%	0.09%	3.06%	31	0	-1.19
FTSE NAREIT ALL REITs Index	10.92%	18.96%	0.58	38.47%	-37.34%	15.50%	24	7	0.4
High Yield Bonds	10.75%	9.62%	1.12	54.22%	-26.17%	11.43%	27	4	0.64

During the 30+ years of history of the high yield asset class, returns have been similar to equities yet risk (standard deviation) has been dramatically lower—actually almost half that of equities. Note also that high yield has both higher highs and less downside. This makes sense as bonds produce considerable income which dampens volatility while remaining senior in the capital structure.

So if high yield bonds generate considerable tangible returns through income, are less risky and perform nearly as good or better than equities, depending on the timeframe, why wouldn't investors consider this asset class part of their "core" portfolio? If an investor is comfortable with 50-60% of their allocation toward equities, why wouldn't they rethink this and instead allocate a more significant portion to high yield? By the data, it would seem to make sense.

[5] Blau, Jonathan, Daniel Sweeney, Janet Young, and Karen Friedlander. "2011 Leveraged Finance Mid-Year Outlook and Review." Credit Suisse Global Leveraged Finance, July 28, 2011, p. 62. Risk as measured by standard deviation. **Volatility** is a relative rate at which the price of a security moves up and down, often found by calculating the annual standard deviation of returns.

Liquidity

Now turning to the final question on liquidity, the simple answer is that, unlike in the stock market where there are a limited number of shares to buy and sell, volume does not provide a good indication of liquidity in the exchange traded fund space. Although no security is ever perfectly liquid, ETFs are in fact considered very liquid securities, despite at times having low daily trading volume. Each ETF has market makers who are assigned to trade and contractually obligated to provide liquidity to investors by making markets in their designated ETF.

These market makers can create and redeem shares based on market demand. For the end investor, this means there is always a buyer or seller for their shares, and even large orders can be facilitated via the creation or redemption of shares. Just like any other stock, large buy or sell volume can move the ETF price; however unlike a regular stock broker, the ETF market makers' ability to create and redeem shares if there are more buyers or sellers overwhelming the market and outpacing supply or demand allows the market makers to keep the security price relatively close to the reported NAV (net asset value), which is updated every 30 seconds by a third party pricing agent. This characteristic of exchange traded funds generally enables investors to buy and sell shares relatively close to the real underlying market value of the securities within the ETF, in whatever their transaction size may be. (For additional information on trading exchange traded funds, click here.)

Conclusion

With the recent spread widening in the high yield market, we feel this space is now offering investors compelling value and history would indicate that spread levels such as we are seeing today provide an exceptionally attractive entry point. While many investors who follow some of the traditional allocation models have generally allocated a much smaller portion of their portfolio to the high yield space, we believe it is time for astute investors to rethink those models. If you can invest in an asset class that not only provides similar returns as equities but does so with less risk, how can you deny a sizable allocation to the high yield space? We feel now is the time for a real allocation to the high yield asset class.