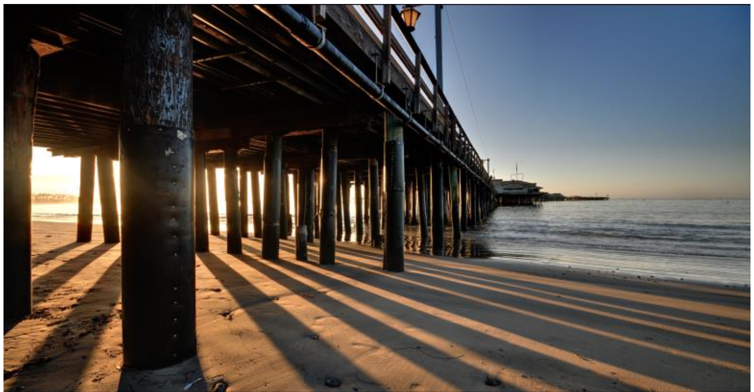


PERITUS

ASSET MANAGEMENT, LLC

Market Commentary

Independent Credit Research – Leveraged Finance – October 2014

ROME IS BURNING

Score Card

It is time for a major portfolio check-up and update. Our beginning of the year strategy piece, entitled "Of Elephants and Rates," was concerned with a few very important topics for investors: interest rates, equity valuations, and energy prices. We laid out our expectations that strong oil and gas prices would continue, rates would go nowhere or decline versus a consensus clearly calling for rates to rise in 2014, and equities would struggle against high valuations and a slow global economy. How have our expectations faired over the past three quarters? Well on interest rates, I'd say our call looks very prescient, or the chimp got the dart throw just right. Either way, we were pretty much on an island with that call back in January, but so far have seen rates decline from 1.75% as of year-end 2013 to currently around 1.50% on the 5-year Treasury and from 3.04% as of year-end to around 2.30% on the 10-year Treasury.[1] But of course this can change wildly in about four hours these days.

Next up was our call on equity markets. Two weeks ago this looked like a great call as the major indexes were getting crushed and most were negative for the year. But the last two weeks have seen the major indexes soar into record territory. I just don't get it. Two weeks ago rates on the 10-year Treasury plunged below 2% and stocks were falling, as the global growth concerns abound. Has anything changed besides more manipulation by Japan? I still believe the equity indexes will have a tough time for the remainder of the year. I think financial engineering in the form of lower rates on debt refinancing and a ton of stock buybacks juicing earnings have run their course. I do not believe revenue growth will surprise to the upside; therefore, I see valuations as more likely to fall than rise. It seems like very selective and pro-active investing would be the only way to deal with this versus indexing.

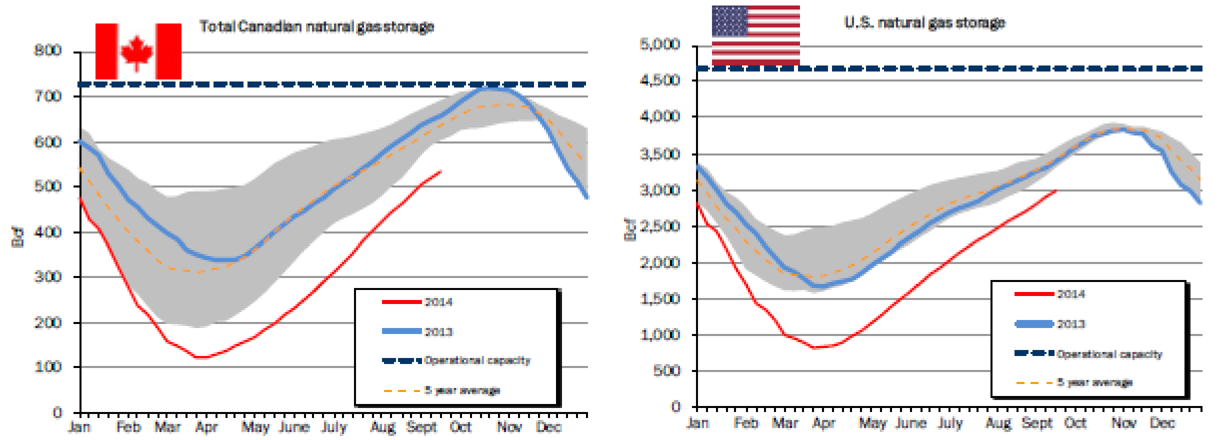
Let's turn our attention to energy prices. Natural gas has held in around the $4.00 area this year and I would have thought it would be higher predicated on a massive storage deficit heading into injection season. My belief was that with very few rigs drilling for gas and a normal summer, we would enter the winter season short on storage, causing gas prices to spike higher. Unfortunately, the weather man never got my memo and a very mild and cool summer ensued for most of the country. As we enter the end of the injection season we are still looking at pretty good storage deficits (pictured below), but apparently not enough to scare anyone:[2]

---

[1] Data sourced from the United States Treasury, general levels as of October 17, 2014.

[2] Skolinck, Phil, "Daily Letter—Global Energy Q4 Themes," Canaccord Genuity, Equity Research, October 7, 2014, p. 18.

U.S. and Canadian estimated natural gas in storage versus capacity



Source: EIA, Enerdata, Energy Intelligence, Wikipedia, Canaccord Genuity estimates

The charts above point out something that most people fail to recognize: energy prices are very regional. The AECO hub (Alberta, Canada) and the Henry Hub (Louisiana, US) are two of the major storage and distribution locations in North America and the most widely quoted prices in Canada and the US, respectively. But there are many others hubs where the price you are going to fetch for your gas is considerably lower. This is not only because of geographic supply/demand fundamentals, but also costs for transportation and processing as well. At this point in the cycle, we would be much more comfortable being exposed to AECO pricing versus Henry Hub, as Canada is running larger storage deficits. Higher gas prices will be weather dependent, so we will see how the winter plays out. There are still plenty of companies in the right geography that we see generating positive free cash flow at $4.00.

Now let's turn our attention to oil prices where, at first glance, our call has been dead wrong. But has it?

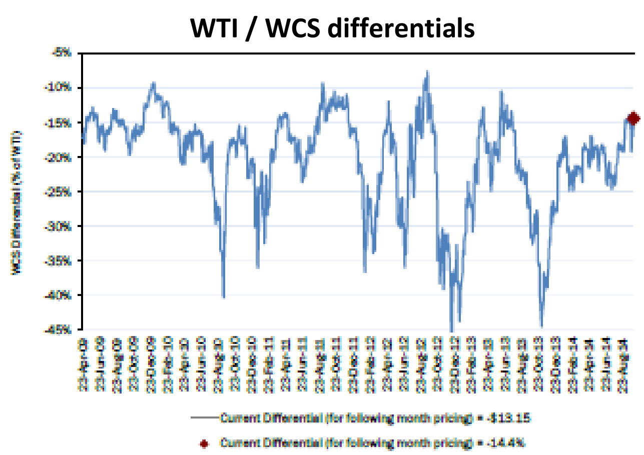
Digging into Oil

There is no question that virtually every stock and bond associated with the word "energy" has been taken to the woodshed, certainly causing us to underperform over the last couple months as we have been strategically allocated to certain players in the energy space. But a deeper dive into a very complex market shows a more divergent fundamental picture for oil producers. Below we have profiled various "oil" price points over the past year:[3]

[3] Data sourced from Bloomberg, as of October 29, 2014. While oil is generally priced in US dollars ($US/bbl), the Canadian dollar price ($CAD/Bbl) has been calculated by taking the FX Rate listed as of the designated date and multiplying by the US$ price/bbl. This is hypothetical and provided for informational use only, to capture the impact of the change in $USD/$CAD on potential prices for Canadian producers in local currency. Actual results may differ materially.

	Pricing			
Energy Prices ($US/bbl)	10/29/14	10/29/13	01/01/14	2014 Average
Crude Oil				
WTI ($US/Bbl)	$82.03	$98.20	$98.42	$98.26
WTI 48 Mo. Contract ($US/Bbl)	80.64	81.64	79.69	83.37
Brent ($US/Bbl)	86.98	109.01	110.80	105.17
WCS Spot ($US/Bbl)	68.20	64.38	75.55	79.17
WCS-WTI Differential ($US/Bbl)	13.83	33.82	22.87	19.09
FX Rate				
$USD/$CAD	$1.1186	$1.0469	$1.0623	$1.0963
Energy Prices ($CAD/bbl)				
Crude Oil				
WTI ($CAD/Bbl)	$91.76	$102.81	$104.55	$107.72
WTI 48 Mo. Contract ($CAD/Bbl)	90.20	85.47	84.65	91.40
Brent ($CAD/Bbl)	97.30	114.12	117.70	115.30
WCS Spot ($CAD/Bbl)	76.29	67.40	80.26	86.79
WCS-WTI Differential ($CAD/Bbl)	15.47	35.41	24.29	20.93

Looking at the US dollar prices, Brent prices have been hit the hardest down about 20% for the last year. While West Texas Intermediate (WTI) spot prices are down around 16% over the past year, long dated futures prices (WTI 48 Mo.) are almost flat for the year. **Western Canadian Select (WCS) prices, which is the relevant price for most of the oil producers we are exposed to in our portfolios, have actually increased over the past year, even with the collapse of the front month WTI futures price**. As pictured below, the price differential between WTI and WCS has dramatically compressed this year.[4] Combining the falling Canadian dollar with a relatively stable heavy oil price (WCS) means that margins have actually improved year over year for many of these producers, as oil is sold in US dollars but costs are in Canadian (local) currencies. In the short run, market psychology is winning, but we see that the fundamentals remain strong for many Canadian producers. In fact, Canadian producers tied to WCS are receiving $9.00 per barrel more this year than last (once converted to local currency, $CAD/Bbl). I don't hear that story from the press.

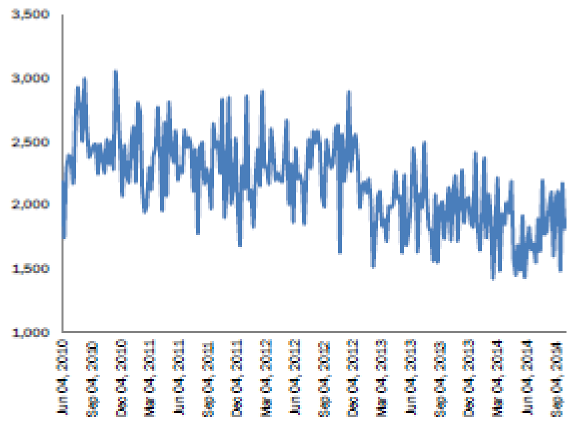


Source: Bloomberg/Net Energy

[4] Skolinck, Phil, "Daily Letter—Global Energy Q4 Themes," Canaccord Genuity, Equity Research, October 7, 2014, p. 9.

We have seen incredible volatility in these differentials historically but we believe that the dramatic spread blowouts of the past are gone. Here is why: heavy crude, such as that produced by many Canadian E&P companies, is in much shorter supply than light oil (produced in many US shale basins) and is needed by the US Gulf Coast Refineries. Mexican and Venezuelan production, other sources for this heavy oil, is weak and likely to decline further.[5]

Columbia, Mexico, and Venezuela combined imports into the U.S.
(MBbl/d-4 week moving average)



Source: EIA

So at the end of the day, given the supply/demand situation for the heavy oil produced in Canada and its ability to be transported through the world to meet demand, we see continued price stability, and even potential upside catalysts (which we'll discuss more below), for WCS and Canadian producers.

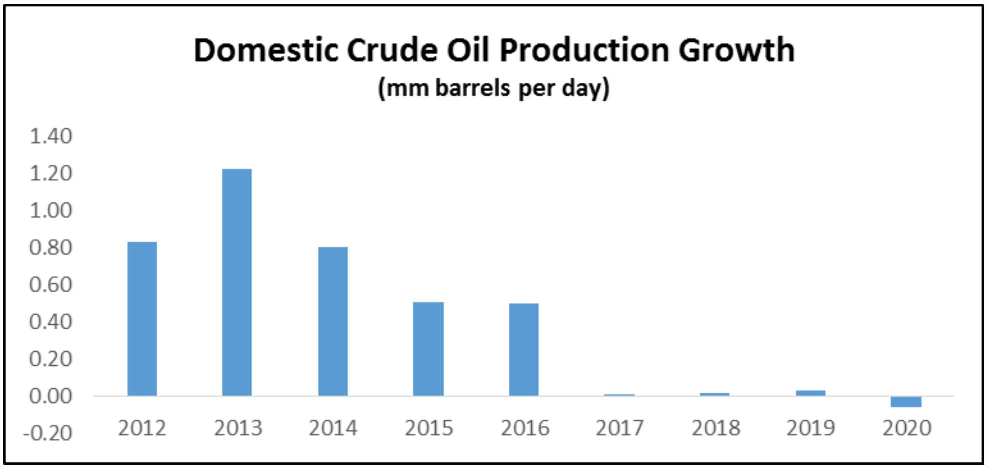
But what gives on this incredible Brent/WTI price meltdown? Saudi Arabia is the scapegoat and appears to be playing hardball and lowering prices, but why? Don't the Saudis require $100 oil? Yes and no. Their actual cost of production is very cheap, but it is the cost of running their country that requires a high price. Some speculate there is collusion between the US and Saudi Arabia in wanting to send a message to Mr. Putin, who cannot afford cheap oil. This seems plausible and has been making the rounds, but to what end? The Russian government I know isn't going to show up with an apology, they are going to show up with troops.

My take is basic economics, known as market share and pricing power. I have stated often and aggressively that I do not believe in the sustainability of the growth in crude production in the US. Shale basins are horrid reservoirs that largely consist of costly and quickly depleting wells. These "reservoirs" are also very small and will likely be exploited in years, not decades. Has anyone noticed that the oil majors aren't playing this game? Isn't that strange considering it's their business? Just this month we have seen two larger producers looking to sell their shale businesses, with Occidental said to be looking for a buyer of their Bakken assets as they reportedly focus on their most profitable operations and Reliance Industries looking to sell their Eagle Ford assets. These are not neophytes to the oil and gas business. Both are very large,

[5] Skolinck, Phil, "Daily Letter—Bottoms Up!?!," Canaccord Genuity, Equity Research, October 13, 2014, p. 7.

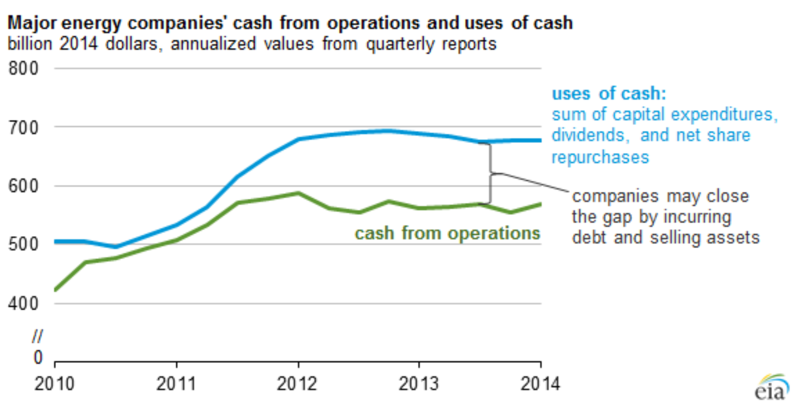
experienced global players. So anecdotal evidence suggests that the experienced oil and gas folks are sellers, or have sidestepped these areas altogether.

My best guess was that by the end of 2016, the growth in US oil production fades and then begins a slow but inevitable decline. I am apparently joined in this by the Energy Information Administration ("EIA").[6]



Source: U.S. Energy Information Administration, January 2014.

We have looked at investing in many US oil and gas companies through the high yield market. Unfortunately, most simply don't generate any free cash flow. And that was with oil near $100. With oil well below that, credit metrics begin to deteriorate quickly and the saving grace of what we view as unsophisticated capital coming in via debt and equity issuance that was plugging the holes can go away. The EIA has done their own analysis on this cash flow gap, as profiled below:[7]

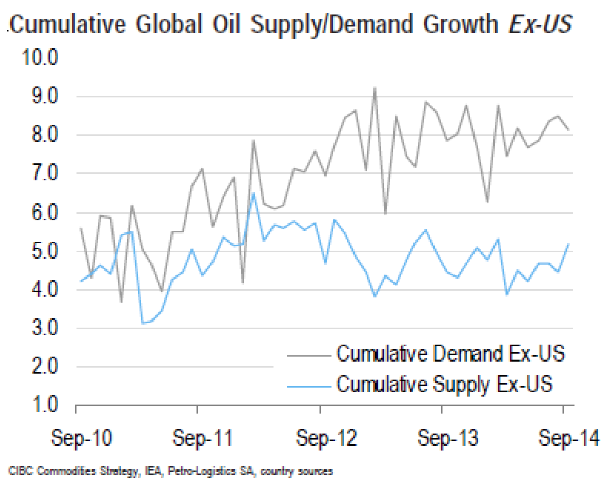


Source: U.S. Energy Information Administration (July 2014), based on Evaluate Energy database
Note: Annualized means each point on the graph is the sum of the previous four quarters. Thus, the first-quarter 2014 results on an annualized basis mean the data represent the sum of the four quarters ending March 31, 2014. The data above are the aggregate results of 127 global oil and natural gas companies.

[6] U.S. Energy Information Administration, data as of January 13, 2014.
[7] Source: U.S. Energy Information Administration, July 29. 2014, http://www.eia.gov/todayinenergy/detail.cfm?id=17311.

In the near term, we expect that this sharp price decline will have very little effect on company cash flows. First, oil companies generally aren't selling to customers off of a 1-month futures price. Secondly, a percentage of production is hedged going into 2015. But the genius here is that fear and low prices may force investors to focus on the cash flows, or lack of in many of these domestic businesses, and the true risk involved. Even when prices rise, the damage will have been inflicted as investors may now require more than a lease and the words "Permian, "Bakken" or "EagleFord."

A couple of quick points on supply and demand at a macro level are important. First, oil demand continues to grow. It is not growing as quickly as forecasted but annual demand is still projected to grow by 700,000 barrels per day this year (as recently estimated by the IEA[8]). On the supply side we are told that supply is soaring. While Libyan production has returned, it tends to go away as quickly as it shows up and is unsustainable. Venezuela appears to be in a death spiral and this oil price plunge simply will speed this up. While ISIS is now off the front page, we are not winning that war by dropping a few bombs, so Iraq remains on the verge of anarchy. Throw in Nigeria and you have an understanding of the tenuous nature of supply. Finally, does anyone think Russia is going to stand by as their daily revenues are cut by over $200 million? What isn't recognized is that outside of the US, supply has actually been falling[9], even with oil at $100. What is the likelihood that this changes with prices $20 lower?



In the meantime, how do we deal with this new reality? Energy is the most important commodity in the world and is the ultimate consumer essential. But a much deeper thought process must be employed in seeking to make money. First, we continue to avoid the players most at risk in this environment, which we see as the highly levered US shale producers. In our view these are value traps. Next we need to take advantage of first level thinking and continue to invest in Canadian oil producers who have been thrown out with the bath water. We are taking advantage of this by selectively owning high yield bonds and loans, along with some dividend-paying equities.

[8] Based on IEA data from the *Oil Market Report, World Oil Demand* © OECD/IEA October 2014, IEA Publishing; modified by Peritus Asset Management. License: http://www.iea.org/t&c/termsandconditions/.

[9] Spector, Katherine, "Panic! In the Oil Market," CIBC Commodities Strategy, October 16, 2014, p. 4.

Some may ask why equities when we have historically been focused on corporate credit? Let me explain our rationale here. The Canadian energy markets have only limited exposure to the bond and loan markets in the US. The majority use short term bank debt and equity as their capital structure. Analysts in the Great White North frequently punish companies that use leverage, so as a result companies generally have minimal debt, allowing them to pay and sustain significant dividends. We think of them as healthy MLPs with nice upside potential, generating a true return on capital, not of capital.

Importantly, we see a number of potential catalysts for this segment, including:

- Well hedged production through 2015
- Low decline rates in the underlying assets
- A falling Canadian dollar helping improve profits/margins
- Favorable heavy oil supply/demand dynamics that can support pricing
- Parity with Mayan/global crude prices due to new foreign transportation options

All of these factors lead to the most important metric for us: free cash flow generation. We are stress testing our exposure here under a new lower price grid irrespective of whether we believe these low prices are here to stay or not. In addition, we want to take advantage of this sell everything energy-related mentality and look to have some exposure to US downstream (refining) and natural gas midstream (infrastructure) assets as many have gotten to levels we would see as unreasonably cheap with fundamentals largely unchanged, even with the WTI-Brent oil price fiasco. We continue to see opportunities in the energy space and will remain strategically and selectively positioned within the industry. For a further look at the energy market dynamics, see our piece "Energy Market Update" (September 2014).

Current Events and Data Points

So we have made our investment case for energy, but what about the rest of the markets? Let's dig into some of the more recent news and economic data points that will also affect our thought process. The September employment report came in a bit better than expected. Does this report change our take on interest rates? It does not. October marks the end of the Federal Reserve's buying of mortgages and Treasuries yet the 10-year Treasury yield is hanging in around 2.3%, near 2014 lows. Since the end of quantitative easing (QE) and rising rate rhetoric is not hidden to market participants, what gives? I mean the unemployment rate is now below 6%, job growth is north of 200,000 per month and gasoline prices are down substantially, which should provide a boost to consumer spending. You have hawks on the Fed like Fisher pushing to raise rates sooner rather than later. Why isn't the bond market reacting to this by pushing rates higher?

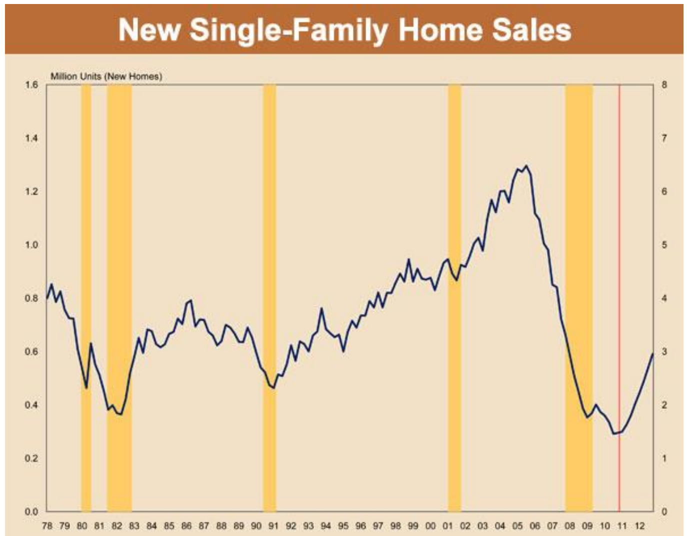
As a lifelong credit investor, if I had to make a bet on either equity players or bond market guys, I take the bond geeks any day, every day. What I believe rates are telling us is that all of this happy news is really about the rear view mirror. Could it be after almost six years that the cycle is exhausted and has peaked and we are heading the other way? I think that is likely. Let's do some rational thinking. Europe taken as a whole is the largest economic zone in the world. In case you haven't been seeing the data, many countries in Europe are drifting back into outright recessions, leading to negative growth. For instance, in the most recently reported numbers, German industrial production and factory orders plunged 4%, noted as the largest decline since early 2009 and, as they are the only real engine, this is not good.

While we often discuss the notion of demographics constraining future growth rates, Debt/GDP ratios are just as important and are closely linked. The higher this ratio, the slower future economic growth will be. Here is the news: these ratios have continued to climb even though global interest rates have collapsed and we are six years into this so called “recovery.” Portugal, Italy, France, Spain, Japan and, yes, even the US have all gotten worse in the last six years. There has been no de-leveraging in Europe as all the talk of austerity was just that, talk. Deficit spending has continued and has not generated any economic growth, so both the numerator and denominator have gone in the wrong direction. Rome is truly burning. Interestingly, Draghi’s bluffs have actually worked so far, as he has been able to talk rates down in the Eurozone without doing anything tangible. Or is there more than Super Mario’s speeches behind these sub 2% yields?

Turning to Asia, Japan’s numbers have been frightening of late irrespective of the falling yen, which should have been fantastic for their exporters. The response is to launch a bazooka in the form of QE. So stocks soar for a couple days then what? China has matured and is entering a new era. No longer will they be growing at 10% per year, but perhaps half of that rate. Regardless of what information you believe or don’t believe out of China, the notion of a significant slowdown is supported by the poor data coming out of Japan and Germany (which are China export centric). This is the reality of the globe, but we are now led to believe that the US economy is going to be immune to all of this. I’ve not been a buyer of this story and am now getting plenty of company. For the 30 years I have spent in this business we have been all about expanding global trade not shrinking it, yet the surging US dollar will put a further crimp on exporters. Seems like we are more linked than ever and the future looks very slow, America included.

With these low rates perhaps housing will save us? Unfortunately this industry is unlikely to be much help either. For all the recovery talk, new single family home sales are running under 600,000 units which is near the same level as the bottom of recessions in 1982 and 1991.[10] Hefty down payments, poor wage growth and tough qualification standards restrict purchasers forcing many into renting apartments. Additionally, we are seeing demographic changes among the younger generation, with preferences shifting away from home ownership, so these low levels may persist for the long-term.

[10] “New Single-Family Home Sales,” *HousingEconomics.com, National Association of Home Builders.*



HousingEconomics.com, National Association of Home Builders

<u>Strategy and Opportunities</u>

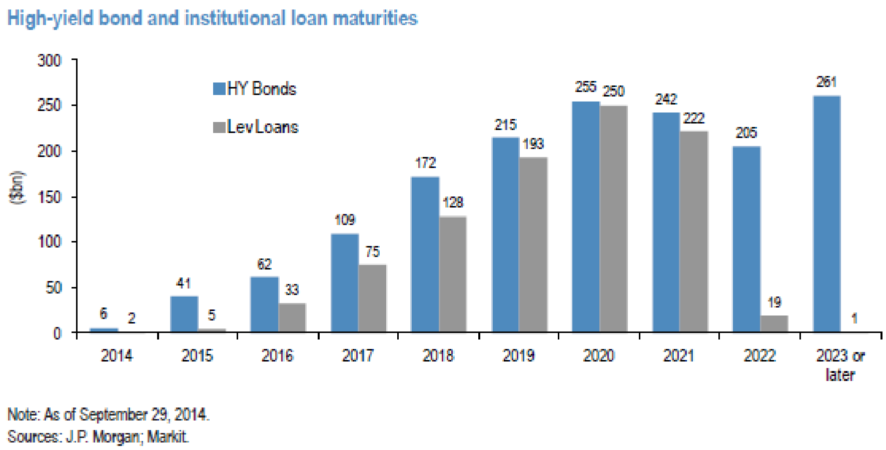
So what does this mean for investors and how are we planning on dealing with this backdrop? As previously stated, I think the equity market is going to continue to churn and head lower as the quarter goes on. The US economy is not strong enough by itself to support current valuations and the smaller more domestic-focused Russell 2000 appears to be the first to recognize this. While there have been pockets of really good fundamental business performance (autos being one), that appears to be slowing. Ford's recent announcement that sales and earnings are going to miss by a wide margin is the first evidence of this.

I have been concerned about broader equity valuations for some time and the recent behavior in the equity markets has justified my angst. (As an aside, if you are working with a portfolio manager who isn't worried at this stage, fire them.) The more things change the more they remain the same. "Go-Broke" (GoPro) is poster boy for silliness in the equity markets. Valuations for app companies and niche tech players are at levels last seen in 2000. Using a little bit of logic, equity markets are stretched after rising for almost six straight years. We don't need to be Nostradamus to suggest that we are far more likely to have peaked than we are going to re-accelerate.

But some may say with interest rates at next to nothing, money has to go into the equity market as there are no other choices, right? Wrong. There is certainly an initial benefit from low rates, which we have seen, as investors are forced to increase risk in the hunt for returns, but that fades over time. Persistently low interest rates suggest very low future growth rates, which tend to compress equity valuation multiples whether earnings are good or not.

Our fixed income world has certainly not been immune to all of this, as credit spreads for high yield bonds and floating rate bank loans have blown out over the past month, signaling an increasing fear premium. Price declines have been exacerbated by poor dealer liquidity, an unintended consequence of the post-financial crisis regulations (Basel III, Dodd-Frank and Volcker) impacting market making. This is the first stress test of our markets and it has been a dramatic failure.

We believe that the move in the high yield market has been way overdone. The most relevant risk for high yield investors is that of default, and we do not expect that a no growth environment will lead to a massive default cycle. Most maturities have been pushed out beyond 2016, as pictured below,[11] and balance sheets and leverage metrics did not have a chance to get anywhere near as out of control during this cycle.



The 20-year median spread (spread-to-worst) level is 526 bps.[12] With average spreads currently at 553bps[13], the high yield market is above these median levels, despite a well below average default environment[14]. In reality, we see the reported index spread and yield (yield-to-worst) levels as deceiving. Much of the index consists of large, on the run names that continue to trade at premiums, seemingly skewing the spreads lower. With this now lack of dealer liquidity, we are seeing volatility create increased liquidity premiums. We always want to capture excess yield without taking on more fundamental credit risk, thus see this spread widening as an opportunity to work to selectively and aggressively capture this excess yield via this liquidity premium in our portfolios. Welcome to the bond and loan markets of the present and future.

<u>Commodity Markets</u>

I want to swing back to the commodity markets for a minute. We do not need to spend any more time on our oil thesis, as we have thoroughly beaten that horse, but another commodity, gold, is beginning to get a bit interesting. Before anyone thinks I have lost it, I am simply talking about bonds in some of the lower cost miners. Always remember the advantage of being a debt investor: you aren't looking for or in need of a quick trade or turnaround. What you are looking for are survivors. We only need our companies to keep the lights on at the bottom of the cycle. Those companies that do this often capture huge rewards. Darwin was a questionable biologist, but should have won the Nobel Prize in economics. Darwinian economics ("survival of the

---

[11] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "Credit Strategy Weekly Update." J.P. Morgan, North American High Yield and Leveraged Loan Research. October 3, 2014, p. 9.

[12] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "Credit Strategy Weekly Update." J.P. Morgan, North American High Yield and Leveraged Loan Research. October 17, 2014, p. 40.

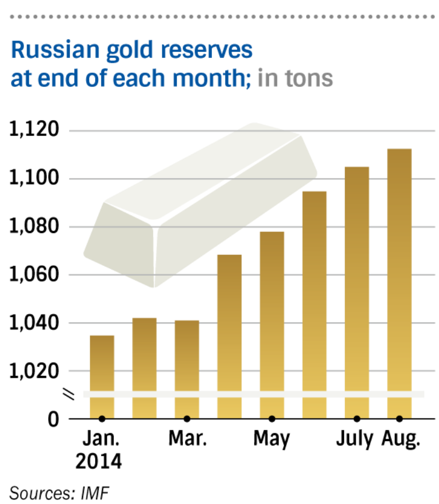
[13] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "Credit Strategy Weekly Update." J.P. Morgan, North American High Yield and Leveraged Loan Research. October 17, 2014, p. 40

[14] J.P. Morgan projects default rates to remain 2% or below through 1H 2016, well below the historical average of 3.9%, Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "Credit Strategy Weekly Update." J.P. Morgan, North American High Yield and Leveraged Loan Research. October 3, 2014, p.11.

fittest") is law in down cycles. Those that make it through can end up with pricing power and increased market share, and thrive in the long-term. Think of auto suppliers who survived the terrible period from 2005-2009. They have been making a great deal of hay in the last five years.

I am not a gold bug in any way and am not looking for some type of inflation protection. What I am interested in is gold's potential reaction to the ultimate reality that global Central Bankers are in fact nothing more than government bureaucrats. The insanity of thinking that they can control economic outcomes or steer the globe is utter insanity. At what point will people begin to lose faith in the whole process? I have often mumbled to myself that gold makes no sense and has no fundamental or industrial value. And fiat (paper) currency does? Throughout the history of man, gold was a store of value and medium of exchange. It wasn't until Nixon ended Bretton Woods for good in 1971 that the world did not link some portion of their money supply to gold. China, Russia, India, Korea and Japan combined hold around two-thirds of all foreign exchange reserves (total US dollar foreign exchange reserves are estimated to be around $12 trillion by the IMF[15]). As the following article indicates, it seems like Russia and China are not exactly enamored with the option of holding their reserves in the US dollar, and Germany and France are already way ahead of them:[16]

> *Attending the St. Petersburg International Economic Forum in May, Putin stressed to reporters that it is important to deposit gold and currency reserves in a rational and secure way. Many market observers expect Russia to increase its gold holdings over the next few years, as the ratio of gold in its foreign reserves is still smaller than those of France and Germany, whose gold holdings are around 60% of total foreign reserves….China, which has been critical of the sanctions against Russia and has strengthened economic ties with the country, has also been increasing its gold holdings in recent years. Some market watchers predict that if China and Russia, which have adopted a confrontational approach to Western countries, further increase their gold holdings, the dollar's status as a key currency could be shaken.*



Nikkei Asian Review, http://asia.nikkei.com

[15] Currency Composition of the Official Foreign Exchange Reserves, www.imf.org. Data as of Q2 2014.
[16] Tanaka, Takayuki, "Russia boosts gold reserves to soften sanctions," Nikkei Asian Review, http://asia.nikkei.com, October 7, 2014.

Since a large percentage of the remaining reserves are held by countries considered the developing world it seems to me that these cultures may be much more comfortable with gold over paper. Given the soaring dollar, the collapsing euro and China's failure to make the yuan a reserve currency, perhaps we all will.

What is important is how we might express this in our portfolios. This is not a speculative "trade," nor is it a hedge. In studying a number of miners it reminds me a great deal of the pharmaceutical or biotechnology industry. In the case of pharma, product development often takes a decade or more of research and development and then trials. Once a product is approved, the margins are enormous because all of that R&D has been expensed (or capitalized) in prior years. So it is a distorted picture. Think the same of mining. A decade to get approvals, assays, coring and then mining infrastructure in place. Then you mine and sell it and operating costs are not that large.

It is interesting how the media continues to talk about how gold has lost its luster and has fallen precipitously. But it really hasn't. It began the year at $1,200 and is around the same level today[17]. Another point I find very interesting is that bond yields for the major and intermediate gold producers remain very low. This gets to my point about the profitability of this industry and the cash generating ability once developed. We have in our gun sights a couple of bonds in this space that offer what we see as a good yield that may make it into our portfolios. We are seeing these companies generate free cash flow and expect it will continue at levels nicely below current prices, so a very good credit investment from our perspective but with the potential upside we see coming from a changing world. Many gold miners will continue shrinking capacity as prices fall below "sustaining costs." These sustaining costs include capital investments (maintenance capital expenditures) to maintain a flat reserve level. But as is the case for many commodity producers, there is a decade worth of production available with minimal additional spending necessary, allowing for plenty of cash generation potential. Ironically this lack of growth is a huge positive for credit investors.

Concluding Thoughts

What many investors don't grasp is that you can actively position businesses and industries in a fixed income portfolio the same way you can equities. The difference is that we get paid every day as our securities accrue interest and we have finite outcomes via stated maturities, which helps us remain patient.[18] We don't require earnings growth or beating Street estimates to make money. We just need the companies to pay their bills and generate some free cash flow, perfect for the subdued economic environment we see going forward. Together the high yield bond and floating rate bank loan market total over $3 trillion[19], providing for plenty of areas of potential alpha generation.

---

[17] Data sourced from Bloomberg, as of October 28, 2014.

[18] Bonds and loans have a stated maturity date as the ultimately outcome, barring a security default. However, there may be reasons that a bond or loan is taken out or redeemed earlier, such as due to early calls or tenders at premium prices. Actual results may differ materially from the stated maturity.

[19] Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "Credit Strategy Weekly Update." J.P. Morgan, North American High Yield and Leveraged Loan Research. April, 4, 2014, p. 43. Blau, Jonathan, James Esposito, and Daniyal Khan, "Leveraged Finance Strategy Weekly," Credit Suisse Global Leveraged Finance, June 27, 2014, p. 25.

The concurrent storms in energy and the secondary bond/loan markets have tested our mettle. We expect that both of these will pass as quickly as they came, but provide fantastic entry points for thoughtful investors as there is a hard cold reality every investor is facing: interest rates (yields) remain paltry and we expect will continue to for the foreseeable future. While we question the sustainability of certain sub-segments of the energy sector, namely the domestic shale players, we believe that there are many other sub-segments within the energy space that have been punished for wrong and what we see as temporary reasons and we are continuing to work to actively take advantage of those mispricings. Additionally, the recent market volatility has opened up discounts in many names within the high yield space; active managers can now look to capitalize upon these securities offering capital gains potential and avoid the credits that continue to trade at premiums above call prices, the latter which are pervasive in the high yield indexes and passive products that track them. And while we do expect that rates will remain low for the foreseeable future, if you don’t agree with this take, it is important to note that the high yield asset class has historically had a lower duration and less interest rate sensitivity than many other fixed income alternatives, and with the inclusion of loans and generally seasoned credits in investment portfolios, this can lower duration below that of the general high yield indexes.

Generating attractive, tangible income is what many investors are looking for. Every out front maneuver is a little lonely. But if you feel entirely comfortable, then you’re not far enough ahead to do any good; that warm sense of everything going well is usually the body temperature at the center of the herd. We see an exceedingly attractive opportunity set in today’s high yield debt markets for investors looking for yield generation and, with the recent repricing of the market, we are seeing good opportunities for capital gain potential as well. We believe this is a great entry point for selective investing within the high yield bond and loan markets.