PERITUS
ASSET MANAGEMENT, LLC

Active Credit

Independent Credit Research – Leverage Finance – July 2010

# INVESTING = YIELD

In our last quarterly missive "Just say No" we argued that the winds of debt deflation will lead to lower rates and the notion of inflation was suspect at best. This quarter that call looks good with the 5-year Treasury yield compressing from 2.5% to around 1.8%. At the very least we are beginning to have company on our side. Interesting how quickly opinions change. At the end of 2009 the experts were telling us that the U.S. dollar would collapse and interest rates would soar as issuance floods a market where demand was going to vaporize. We are not hearing many calls for runaway inflation anymore.

The economic picture seems pretty clear to us. The world went down the toilet in Q4-2008 and business effectively stopped. Orders were cancelled, production was severely curtailed, and companies used what they had in stock to satisfy whatever orders or sales eventually returned in Q1 and Q2 2009. As inventories of everything became critically low, they began to be rebuilt. Orders picked up off the bottom and the economic data didn't look so desperate. This was mistakenly believed by many people to be the "V shaped recovery" everyone so desperately longed for and evolved into the gigantic sucker's rally in the equity markets. But unemployment has not changed and the evidence is coming in strong that the last six months may have been as good as it gets for a while.

A few broad measures appear to provide strong support for this notion. First, referenced below, is the Baltic Freight Index, a good measure of whether raw materials needed for production are being moved to the producers:[1]

> LONDON, July 7 (Reuters) - The Baltic Exchange's main sea freight index .BADI, which tracks rates to ship dry commodities, fell to its lowest level in over 14 months on Wednesday as weak cargo activity continued to take its toll.
>
> The index, which gauges the cost of shipping commodities including iron ore, cement, grain, coal and fertiliser, fell 5.12 percent, or 109 points, to 2,018 points in its 30th consecutive decline to remain at its lowest since May 5 last year when it fell below the key 2,000 point level.

[1] Saul, Jonathan. "UPDATE 1-Baltic freight index slides to 14-month low." Reuters. July 7, 2010.

This was the lowest level in 14 months, which can be seen as an indication that production of finished goods is declining or at least stalling. So much for the global recovery. How about beating up on our favorite whipping boy, real estate?[2]

> seasonally adjusted Purchase Index decreased 4.1 percent from one week earlier. The Purchase Index decreased for the fourth consecutive week and is currently at the lowest level since April 1997. The unadjusted Purchase Index decreased 5.2 percent compared with the previous week and was 16.8 percent lower than the same week one year ago.
>
> "With another week of historically low mortgage rates, the trend from the prior three weeks continued, as refinance applications increased while purchase applications dropped. Purchase applications are now almost 40 percent below their level four weeks ago, while the refinance share, at 74 percent, is at its highest level since December," said Michael Fratantoni, MBA's Vice President

The Purchase Index is at its lowest level in 13 years? So even with interest rates at record lows it doesn't appear many people are buying homes. Again a giant head fake was created by the tax incentives as it just borrowed from future sales. We could drown everyone in a sea of bad economic data but you get the picture.

We have had a series of rousing internal debates over the past few weeks which have been very helpful as it allows us to critically think through the issues we face as high yield investors. On one hand we have an economy that we believe will sputter along for the better part of a decade with its head barely above water. On the other hand, as we have pointed out on more than one occasion, the credit fundamentals of many businesses remain tremendous. This is because businesses have aggressively cut back on expenses allowing them to generate lots of cash. And we are talking about record amounts of cash.[3]

> For a clue to Corporate America's state of mind, look no further than the piles of money stashed under its mattress. Facing an uncertain economic environment, U.S. firms have socked away cash at a rapid clip, amassing a rainy-day fund the likes of which hasn't been seen in over 40 years. At the end of March, non-financial firms had accumulated a record $1.84-trillion (U.S.) in cash and other liquid assets on their balance sheets, according to the latest figures from the U.S. Federal Reserve Board. As a percentage of total company assets, which include factories and other investments, cash is at its highest level since the early 1960s. When and where companies

So against this backdrop, how does one assess "value" in the high yield bond market? Looking at current spread levels (as outlined below), they are solidly above historical 20 year median of about 530bps, indicating to us that this weaker than average economy is largely priced in.[4] It is essential to consider the global macroeconomic environment and adjust for that, but historically this analysis has been done to assist us in **what** to buy not **whether** to buy. As we have pontificated on before, the market went down together then went up together. However it is now recalibrating itself to separate the wheat from the chaff. Is there evidence to support this theory? Well how about a little peek at some of this year's losers.[5]

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[2] Kemp, Carolyn. "Press Release – Weekly Application Survey." *Mortgage Bankers Association*. June 2, 2010.
[3] Slater, Joanna. "Corporate America sits on cash hoard." *The Globe and Mail*. July 4, 2010.
[4] Median 20 year spread provided by: 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.
[5] Blau, Jonathan, Daniel Sweeney, Janet Yung, and Benjamin Zimmerman. "Leverage Finance Market Update." Credit Suisse Global Leverage Finance Strategy and Portfolio Products. July 1, 2010, p. 9.

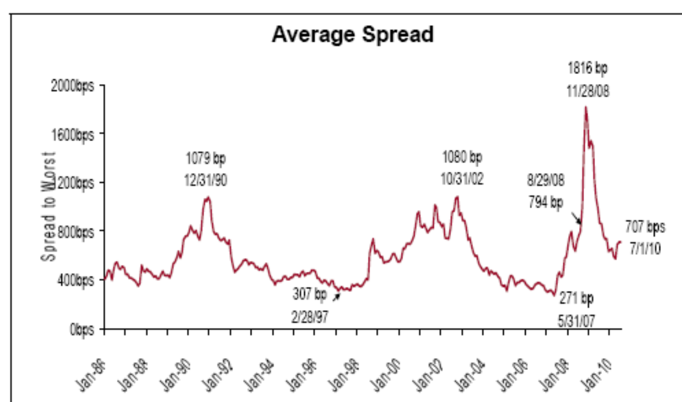
## Best & Worst Performers Sorted by Total Return: Year to Date

| ISSUER | COUPON | MATURITY | MDY | S&P | ISSUE | SIZE | PRICE | PRICE MOVE | PRICE CHANGE | TOTAL RETURN | PRINCIPAL RETURN | YTW | STW |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Worst Performers** | | | | | | | | | | | | | |
| Blockbuster | 9.000% | 9/1/2012 | Ca | C | Sr Sub Nts | 300 | 7.750 | -49.250 | -86.40% | -74.38% | -81.91% | 218.73% | 9999 bp |
| ATP Oil & Gas | 11.875% | 5/1/2015 | Caa2 | CCC+ | Sr Sec 2nd Lien Nts | 1,500 | 71.500 | -28.000 | -28.14% | -25.71% | -28.16% | 21.67% | 1993 bp |
| Spheris | 11.000% | 12/15/2012 | C | NR | Sr Sub Nts | 125 | 26.875 | -26.625 | -49.77% | -49.77% | -49.77% | Defaulted | |
| First Data | 11.250% | 3/31/2016 | Caa2 | CCC+ | Sr Sub Nts | 2,500 | 59.500 | -26.000 | -30.41% | -22.98% | -29.38% | 24.84% | 2280 bp |
| Colt Defense | 8.750% | 11/15/2017 | B3 | B+ | Sr Nts | 250 | 79.250 | -24.000 | -23.24% | -18.74% | -22.94% | 13.24% | 1074 bp |
| Ahern Rentals | 9.250% | 8/15/2013 | Caa3 | CCC | Sr Sec 2nd Pr Nts | 290 | 34.000 | -23.000 | -40.35% | -30.26% | -37.94% | 56.66% | 5561 bp |
| Satelites Mexicanos | 10.125% | 11/30/2013 | NR | NR | Sr Sec 2nd Pr Nts | 140 | 36.500 | -22.500 | -38.14% | -33.80% | -38.01% | 45.16% | 4400 bp |
| Great Atlantic & Pacific Tea | 11.375% | 8/1/2015 | Caa1 | CCC+ | Sr Sec 2nd Lien Nts | 260 | 83.250 | -22.000 | -20.90% | -14.79% | -19.99% | 16.36% | 1452 bp |
| Catalyst Paper | 11.000% | 12/15/2016 | B3 | CCC+ | Sr Sec Nts | 280 | 78.500 | -21.500 | -21.50% | -17.92% | -21.50% | 16.55% | 1428 bp |
| Nationstar Mortgage | 10.875% | 4/1/2015 | B2 | B | Sr Nts | 250 | 78.500 | -18.750 | -19.28% | -16.10% | -19.24% | 17.76% | 1605 bp |

The reason we highlighted a few of the names is that we have some specific knowledge in these cases. We owned Blockbuster and sold it moons ago based on a correct assumption of the business becoming a buggy whip. We have stared at First Data for years (in addition to writing about it) avoiding any temptation to play in a decent business with a ludicrous leverage profile. I personally reviewed Great A&P and also came to the conclusion that it was a trap even after building out a credit file on it. The market appears to be adjusting to exactly what we thought: a separation between the haves and have nots.

Obviously each industry and each company within an industry has its own fundamental story which will once again enter the forefront of importance. We have learned many important lessons over the cycles and I do not sense any guilt of Peritus stretching in this environment. Overall, we expect that there will be very little surprise to our companies should we head back down into another dip in demand. Stated another way, the directional "trade" in most asset classes including high yield is over. Thoughtful and diligent analysis will be required in the security selection process, favoring active management versus a passive product such as an index high yield ETF.

Now let us turn to some simple but powerful charts that provide for more clarity. First, historical spreads. As can be seen by the following, we have had three blowout periods where spreads exceeded 1,000 basis points or 10% above the 5-year Treasury bond.[6]



Source: Credit Suisse

[6] Blau, Jonathan, Daniel Sweeney, Janet Yung, and Benjamin Zimmerman. "Leverage Finance Market Update." Credit Suisse Global Leverage Finance Strategy and Portfolio Products. July 1, 2010, p. 4.

What is confusing the picture is that in 2008 we went off the charts to 1,800 basis points. I believe that this period was in fact an aberration, even for a systemic shock, and we corrected within months. Why do I think the 2008-09 period was an aberration? Because it was a global liquidity trap not a fundamental adjustment. Our world was sold down not because it was a disaster but because people needed to sell anything and everything to de-leverage. Look at the default statistics below.[7]

**Figure 1. Historical Default Rates — Straight Bonds Only, Not Including Defaulted Issues From Par Value Outstanding, 1971–3Q 09 (Dollars in Millions)**

| | Par Value | | |
|---|---|---|---|
| Year | Outstanding[a] ($) | Defaults ($) | Default Rates (%) |
| 3Q 09 | 1,152,952 | 93,095 | 8.074 |
| 2008 | 1,091,000 | 50,763 | 4.653 |
| 2007 | 1,075,400 | 5,473 | 0.509 |
| 2006 | 993,600 | 7,559 | 0.761 |
| 2005 | 1,073,000 | 36,209 | 3.375 |
| 2004 | 933,100 | 11,657 | 1.249 |
| 2003 | 825,000 | 38,451 | 4.661 |
| 2002 | 757,000 | 96,858 | 12.795 |
| 2001 | 649,000 | 63,609 | 9.801 |
| 2000 | 597,200 | 30,295 | 5.073 |
| 1999 | 567,400 | 23,532 | 4.147 |
| 1998 | 465,500 | 7,464 | 1.603 |
| 1997 | 335,400 | 4,200 | 1.252 |
| 1996 | 271,000 | 3,336 | 1.231 |
| 1995 | 240,000 | 4,551 | 1.896 |
| 1994 | 235,000 | 3,418 | 1.454 |
| 1993 | 206,907 | 2,287 | 1.105 |
| 1992 | 163,000 | 5,545 | 3.402 |
| 1991 | 183,600 | 18,862 | 10.273 |
| 1990 | 181,000 | 18,354 | 10.140 |

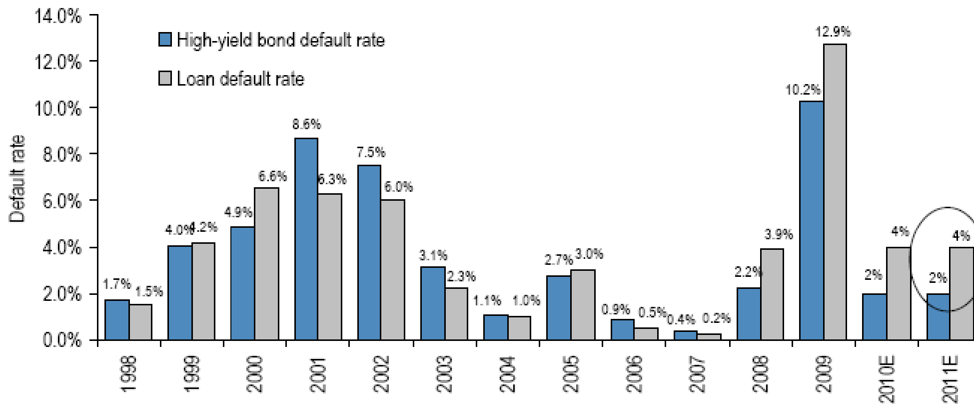
As can be seen, huge cumulative default rates occurred in 1990-91 and 2001-02 (greater than 20%). This provided a fundamental rationale for the beating (spike in spreads, drop in prices) during those periods. In 2009, we saw elevated default rates but nothing like the prior nuclear winters.

Getting back to the spread graph, if you drew a line at 800 bps of spread, there was a pretty minimal amout of time the indexes spent north of that number. In fact you can measure that period in months not years. I would say in the history of the market it might be a total of two or three years. Now draw a line just above 400 bps and you can see that the market spent about half or more of its history at that level. My guess is around 15 years. Averages can be deceiving but regression to the mean is at work.

Here is why. The world looks at high yield as a formula: default rate x (1-recovery rate) = loss rate. If the expected default rate is 5% and the average recovery rate is 40%, then the loss rate is expected to be 3%. If the spread is 800 bps over treasuries then the "net" risk adjusted return is 500 bps over the risk free rate. What level of "risk adjusted return" gets the appetites flowing?

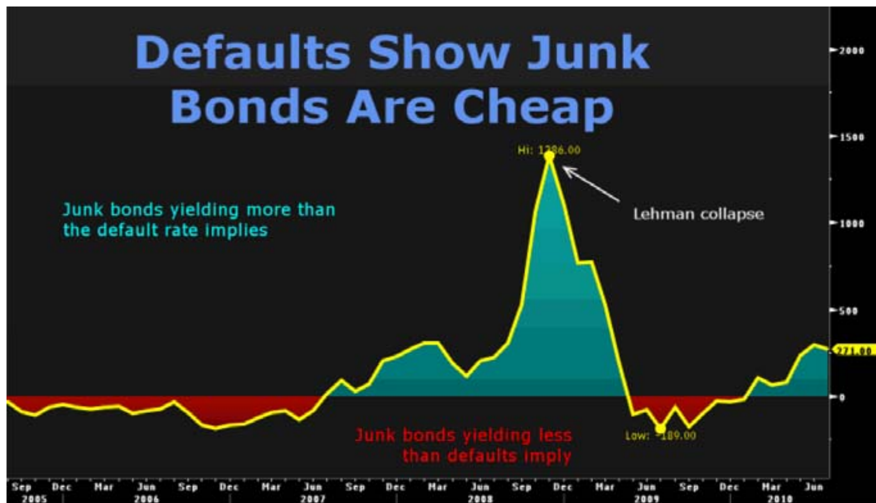
[7] Fenn, John. "Altman High Yield Bond Default and Return Report." Citi Corporate Securities Strategy. November 11, 2009, p. 5.

This is really a question for consultants, but 300 bps is my guess. With default rates plunging (expected to be under 2% this year and likely similar in 2011) the formula would be 2% x (1-0.4) or 1.2%.[8]




Source: J.P. Morgan

So, using the math, the risk adjusted excess spread is 5.8% assuming the 7% spread currently. As the graph below pictorally depicts, default rates indicate that high yield bonds are cheap at current spread levels.[9] This is likely why we are seeing the current wave of core-plus and high yield institutional searches. It is also a very strong rationale for our belief that high yield remains **very attractive** at these spread levels.

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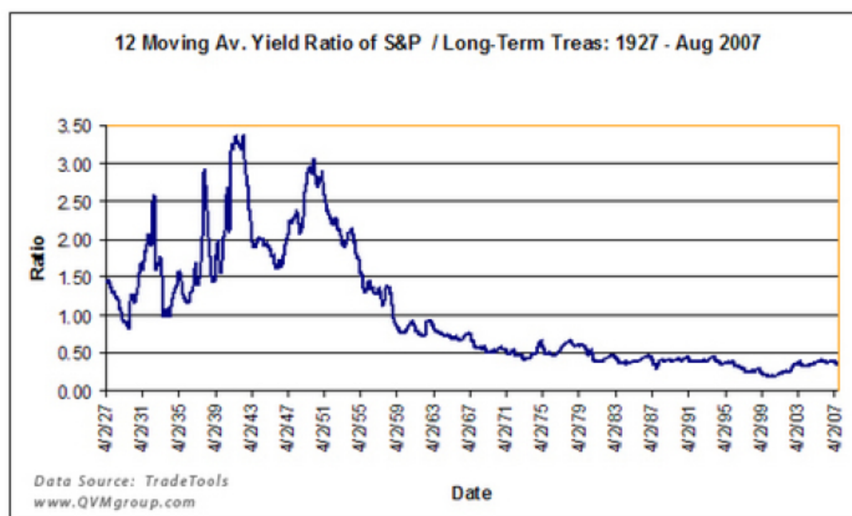
[8] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Alisa Meyers. "Midyear 2010 High-Yield and Leveraged Loan Outlook and Strategy." J.P. Morgan North American Credit Research. July 7, 2010, p. 10.
[9] Bloomberg.

That's great Tim for this year and even next but what does 2012 hold? We have no idea folks. As 2009 began the consensus wisdom was rates in the U.S. would soar because we had to issue trillions of dollars of Government paper and nobody would buy it. The U.S. dollar was also going to collapse, further exacerbating the problem. But here we are at 3.0% on the 10-year Treasury and the debt deflation we have spoken of is now being understood. I believe we are entering a long period of low rates and low returns across all asset classes. P/E ratios are compressing in the equity business even though earnings are quite decent.

The problem for equities is that there is no growth to drive price appreciation. Profit margins probably peaked already for this mini cycle but free cash flow generation is now and should continue to be strong. That's because as sales fell by 40% for many companies, people were slashed, inventories were liquidated and very little capital spending happened. As previously discussed, inventories were re-built a little over the last couple of quarters but that's mainly done and, as we analysts have been discovering from our earnings calls, nobody is really drinking the grape Kool-Aid of "growth."

So given the low returns environment in which we find ourselves, the search for yield is on. Large and much more permanent investors such as public pension plans appear to be favoring debt and yield over chasing growth via equities. I see this as a secular (decade or multi decade) process, not something that will adjust in a couple of months. It was in the late 1950's that something changed and the notion that yield was no longer important in investing. Note the yield chart profiling the dividend yield of the S&P 500 and long term treasuries.[10]




To us the notion of stocks yielding more than bonds makes perfect sense. The equity is the first loss or riskiest security. If you want investors to own it you have to entice them. But somehow along the way we've been fed a bunch of bologna about share buybacks and growth being more tax efficient versus paying out the cash flows in dividend form, so investors have accepted lower yields on stocks despite the higher risk. Now people are beginning to realize that these retained earnings and share buybacks haven't helped make them money and are instead turning to the

[10] Shaw, Richard. "Stock Dividend Yield vs. Interest Rates: And 80 Year History." *Seeking Alpha.* September 4, 2007.

fixed income markets for tangible yield in the form of interest income. We expect high yield to continue to play a larger part.

Concluding Thoughts

Our take of very slow economic activity is probably right, but as lenders isn't that always our take? I have stated for years that our economic forecast is recession heading into depression. That is the way to make loans. In this environment care needs to be taken in assessing the true nature of the demand for a product or service. We prefer lending to those companies that produce what we see as consumer essentials. Irrespective of this, high yield has slaughtered equities over almost every historical time frame. A view below shows high yield's dramatic outperformance over the past 15 years with significantly less risk as measured by volatility (data through late 2009).[11]

| | Average annual returns | | | | |
|---|---|---|---|---|---|
| | 1 year | 3 year | 5 year | 10 year | 15 year |
| 5-year Treasury | 6.76% | 7.87% | 5.00% | 6.12% | 6.40% |
| 10-year Treasury | 9.24% | 7.42% | 4.96% | 6.18% | 6.73% |
| EMBIG | 39.64% | 6.73% | 8.41% | 11.12% | 11.74% |
| JULI | 29.73% | 6.54% | 5.06% | 6.92% | 7.40% |
| S&P 500 | 9.80% | -7.02% | 0.34% | -0.95% | 7.33% |
| **Leveraged loans** | **30.50%** | **2.47%** | **3.76%** | **4.54%** | **5.22%** |
| **Global HY** | **47.58%** | **5.64%** | **6.22%** | **6.90%** | **7.59%** |

| | Average annual volatility | | | | |
|---|---|---|---|---|---|
| | 1 year | 3 year | 5 year | 10 year | 15 year |
| 5-year Treasury | 6.01% | 5.24% | 4.60% | 4.85% | 4.61% |
| 10-year Treasury | 13.69% | 9.11% | 7.83% | 7.88% | 7.47% |
| EMBIG | 8.59% | 12.45% | 10.22% | 10.22% | 13.77% |
| JULI | 8.38% | 8.52% | 6.98% | 6.08% | 5.65% |
| S&P 500 | 23.64% | 19.58% | 15.97% | 16.13% | 15.78% |
| **Leveraged loans** | **16.27%** | **14.00%** | **10.79%** | **7.76%** | **6.38%** |
| **Global HY** | **16.60%** | **16.31%** | **12.76%** | **10.44%** | **9.08%** |

So as the world continues to adjust their investment thinking back to yield, we urge investors to establish allocations in the high yield bond market at what we believe to be very attractive levels, especially when compared to low treasury rates and even lower dividend yields on equities. One thing we do know is that investors in the high yield space should not be using index products to get this exposure. The largest high yield index ETF's are loaded with some of the highest levered credits of the past era. Many of these bonds are likely to experience losses through default or exchanges. Instead, we see the active management style, as provided by Peritus, as the most effective way to be positioned in the high yield space.

As always, feel free to call with any questions.

Sincerely,

[11] 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.

**PERITUS ASSET MANAGEMENT, LLC**

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