PERITUS
ASSET MANAGEMENT LLC

Active Credit

Independent Credit Research – Leverage Finance – April 2010

JUST SAY NO

I'm concerned. Yes I do get paid to be worried and it's pretty normal in my line of work, but we have had a front row seat to what might be the biggest "melt up" in credit we have seen yet. The speed and violence of this rally is truly unprecedented. What makes me most concerned however is not the rally itself. As we have reflected upon, the corporate credit space HAS improved. Liquidity is excellent, profit margins (on lower sales bases) are good and the corporate bond market is wide open, giving larger companies access to capital. So saying the rally is completely unjustified is not true. But what has me up at night (besides those bathroom visits) is that none of the bigger issues have been even dealt with, forget solved.

Debt Deflation

Since we have spent a great deal of time describing the economic headwinds in our last letter, *A Tale of Two Markets*,[1] we won't pave the same road twice. Suffice it to say, while many are arguing for a strong and swift recovery, we believe that there are monsters in the room, including housing, Federal and State budgets deficits (including pensions), unemployment and of course Big Brother and the imminent increases in tax rates, which will restrain this notion. There has also been a great deal of recent chatter by the economic pundits about looming inflation and higher interest rates. We disagree. Instead, we concur with economist Irving Fisher's concept, developed in the 1930's, that excessive debt levels precipitate a deflationary economic environment.[2]

The concept of debt deflation is very real and quite simple to understand. Debt is taken on to purchase more and more assets as rising prices in everything from stocks to housing stoke the "get rich quick" fires. Then the asset values collapse but the debt level is still the same as it was at the peak of asset prices. Hyman Minsky, in his "Financial Instability Hypothesis" first published in 1992, gets to the heart of the issue.[3]

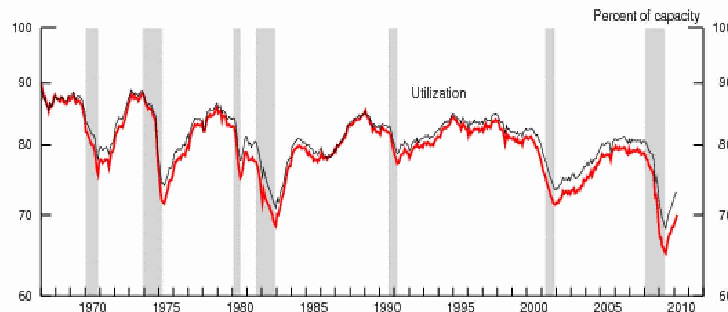
[1] See http://www.peritusasset.com/quarterly.php
[2] Hoisington, Van R. "The Debt Deflation/Inflation Debate." CFA Institute, www.cfapubs.org, March 2010, p. 35.
[3] Hoisington, Van R. "The Debt Deflation/Inflation Debate." CFA Institute, www.cfapubs.org, March 2010, p. 35.

The first stage is hedge financing, in which the lender fully expects the return of both principal and interest. The second stage is speculative financing, in which lenders believe they will receive their interest payments and are comfortable with the fact that the principal can always be refinanced. And the third stage is Ponzi financing, in which lenders have little expectation of receiving either their principal or interest payments but look to rapidly rising asset values for security. This scenario is, in fact, exactly what happened during the last several years—the last part of the debt cycle was Ponzi finance.

It takes two to tango: somebody needs to be lending the money to all the greedy asset gatherers. The excess and easy credit blow up asset values, but invariably they collapse.

The reason this debt deflation concept is important is because of all the rhetoric about inflation and rates. We believe government deficits and spending are unlikely to drive rates higher. Basic economics requires several factors to be present to argue for inflation and then ultimately higher interest rates: high capacity utilization (supply/demand curve), a functioning money multiplier and a stable or increasing velocity of money. Let's take each one of these in order.

First, we have no supply issues. With capacity utilization figures near all time lows, there is nothing but excess capacity across the board.[4] This often results in companies decreasing their prices to undercut their competition in order to drive up their demand and fill their capacity. Obviously, a recipe for deflation rather than inflation.



The money multiplier simply references the fractional banking system where a single equity dollar put into the banking system is generally multiplied by 9 or 10x over. Banks have historically needed only 8-10% equity and can lend out (leverage) the rest. However, since the banks vaporized their equity and balance sheets over the past couple years, there has been no lending, so no multiplier. All the money that went into the banks simply allowed for their survival.

[4] The Federal Reserve, www.federalreserve.gov/release/g17/current/ipg1.gif.

The final factor is velocity of money, or how much money turnovers in the system. Once again, this is falling not rising.[5]

Quarters	M2	Velocity	GDP
3Q2003–2Q2006	4.5%	2.0%	6.6%
3Q2006–2Q2009	7.0	–4.7	2.0
4Q2008–2Q2009	10.3	–12.6	–3.6

Sources: Bureau of Economic Analysis, Federal Reserve.

So all of this government spending and stimulus will likely amount to a pile of beans. This is one of the better summaries I have seen:[6]

> coefficient of government spending to GDP is negative and, of course, statistically insignificant. In the short run, when the government spends, an immediate positive impact occurs. But the problem is that the government has no money of its own to spend, so the money has to be borrowed or taxed from the private sector. To the extent that occurs, the private sector—the productive sector—becomes smaller, which means that the second-order effects on GDP of an increase in government spending are at best zero and more likely negative.

We don't see a robust economy to drive up inflation. The massive run up in equity, debt and commodity prices is nothing more than ponzi finance in which leverage has returned. Are the price increases justified and sustained by true fundamentals where demand is outstripping supply? We don't see evidence of this. But some may argue, what about the emerging markets and the idea that all of the slack in U.S. consumer demand will be picked up by these folks? Well certainly there has been some of that, but I remain skeptical. Final demand for goods and services has plunged everywhere and remains highly correlated.[7]

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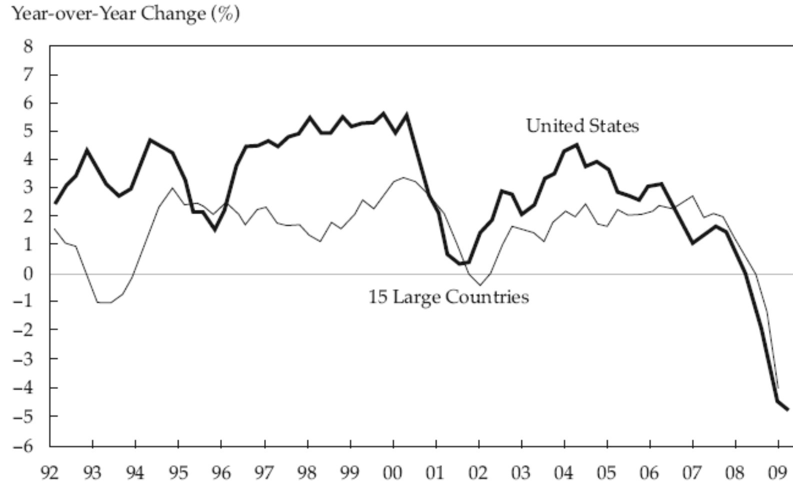
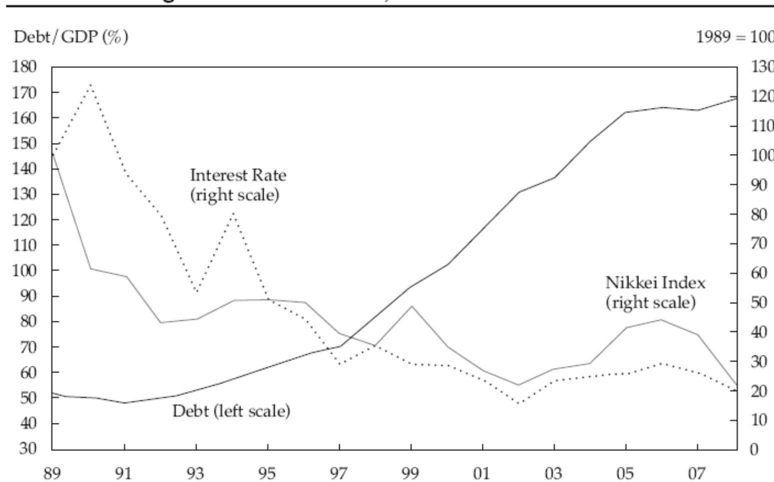
[5] Hoisington, Van R. "The Debt Deflation/Inflation Debate." CFA Institute, www.cfapubs.org, March 2010, p. 38.
[6] Hoisington, Van R. "The Debt Deflation/Inflation Debate." CFA Institute, www.cfapubs.org, March 2010, p. 39.
[7] Hoisington, Van R. "The Debt Deflation/Inflation Debate." CFA Institute, www.cfapubs.org, March 2010, p. 42.



Notes: U.S. figure is through 2Q2009. The 15 countries equal 40 percent of the world GDP. Excludes China because no data were available and the United States.

Sources: Statistical Office of the European Communities, Statistics Canada's CANSIM database, U.K. Office for National Statistics, Japan Cabinet Office, and Bureau of Economic Analysis.

Furthermore, the notion that government spending can drive economies anywhere in the world doesn't seem to work: Japan remains our best example.[8]



Notes: Debt measured as a percentage of GDP. For Nikkei and interest rates, 1989 = 100.

Sources: Bank of Japan and *Nihon Keizai Shinbun*.

The Nikkei cracked in 1989 and has yet to come to life 20 years later. Most importantly is that government debt has soared out of control yet interest rates hover near 0% and their economy remains a basket case.

In summary, the notion of inflation and robust economic recovery looks ludicrous. All of this government stimulus is simply borrowed from the private sector which will dampen future economic activity. Debt deflations are rare, very painful and do not get fixed in a year. Yet, risk

[8] Hoisington, Van R. "The Debt Deflation/Inflation Debate." CFA Institute, www.cfapubs.org, March 2010, p. 41.

premiums across asset classes have collapsed as fear has given way to greed. This is a very dangerous recipe. Within all of this remains a small silver lining; interest rates are unlikely to rise and may indeed fall further from here. If interest rates reflect a "real yield" plus an inflation premium, the current ten year yield of 3.8% may end up looking unbelievably attractive in another year or two once the notion of deflation becomes more evident.

Discipline—The Lost Art

Both the direction and absolute level of interest rates are an important factor to consider when evaluating spreads in high yield. Just where are we today? The 5-year Treasury is now 2.5% and most of the high yield indexes are somewhere in the 8.5% yield range meaning that spread levels are approximately "average" at 550-600 bps over Treasuries.[9] So while all of us "wish" for a return of the good old days where corporate bond yields were in the teens, it is unlikely. What we are dealing with is an environment where cash flows/yields remain attractive but the huge discounts have been squeezed. In this environment, it is even more imperative to get things right, or more importantly to not be wrong.

It seems to me that managers add most of their value in two scenarios. First, in meltdowns, we should not get shaken out of positions by general market panic, selling at the worst possible time. And best of all we should have the ability and courage to buy bargains. Second, as important and often overlooked is the ability and courage to just say "NO" when things get silly. This not only requires an investment process that works, but more importantly adhering to one's discipline.

We have watched with great interest as the underwriting calendar heats up with all sorts of strange fare. We have chosen three of these recent new issues to make our point. First up is a deal involving CBS. Now to us, CBS is not a business that we are excited about. Network television in an age of the internet is close to becoming a buggy whip. There might be some value in the content but the advertising dollar has been steadily leaving for the last few years. Here are the deal particulars:[10]

CBS places BBB-/Baa3 bonds tight to talk; terms

Issuer	CBS
Ratings	BBB-/Baa3/BBB
Amount	$500 million
Issue	senior notes (off the shelf)
Coupon	5.750%
Price	99.877
Yield	5.776%

So the yield for owning this substantial business risk is 5.75%, or 2% more than a 10-year Treasury bond. Maybe people are comforted by the BBB- rating? Not exactly a ringing endorsement even by the rating agencies and we all know how accurate they have been. Just say no.

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[9] Acciavatti, Peter, Tony Linares, Nelson Jantzen, and Alisa Meyers. "Credit Strategy Weekly Update." J.P. Morgan North American High Yield and Leveraged Loan Research. April 16, 2010, p. 22.

[10] "CBS places BBB-/Baa3 bonds tight to talk; terms." LCDNews, March 30, 2010.

Next up is one that is personally repulsive, as we were badly burned in the failure of *Magnachip.* So within five months of them exiting bankruptcy and effectively wiping out most of the bondholders, they are coming to market with another deal, but the best part of all is that the proceeds are going to be used for a dividend to shareholders.[11]

MagnaChip sets $250M offering for dividend, debt repayment

MagnaChip Semiconductor is back in market less than five months after exiting bankruptcy with a $250 million bond offering to fund a dividend to shareholders. The deal is an eight-year (non-call four) senior note via Goldman Sachs, Barclays, Deutsche Bank and Morgan Stanley, and a full roadshow starts on Thursday and runs through next week, sources said.

Expected ratings are B+/B2, according to sources. Proceeds will be used to fund an approximate $130 million distribution to shareholders, pay down the roughly $62 million balance of the company's secured credit facility and fund working capital, the sources add.

And last but not least, the final deal involves two of our most dreaded slogans: dividend recap and PIK toggle. Rarely have we seen both of these combined and at the holding company no less.[12]

Freeedom Group PIK toggle notes price at 98; terms

Gun maker **Freedom Group** this afternoon completed an offering of partial PIK toggle senior notes via Bank of America and Deutsche Bank, sources said. The drive-by came spot-on guidance, and oversubscription allowed for a $25 million upsizing, to $225 million. Under terms of the offering, the company can elect to pay 11.25% in cash or half PIK and half cash at 11.75%, according to sources. The holdco transaction, which comes under the name FGI Holding, is rated B-/B3. Proceeds will fund a dividend to parent Freedom Group, which will in turn redeem series A preferred shares, sources said. The company is controlled by Cerberus. Terms:

These types of transactions should give investors an understanding of why the corporate credit markets must be **actively managed.** An indexed approach (as some ETF's have done) is not appropriate as you end up with exposures to bad businesses, as well as the massively levered LBOs we have discussed in depth in prior writings. In our opinion this passive approach subjects investors to significantly greater default risk. Regardless of what environment one finds themselves in, bad deals are bad deals. Fortunately for us, we can say no thanks. Focusing on fundamentals and being disciplined in our investment decisions is not an option but a requirement.

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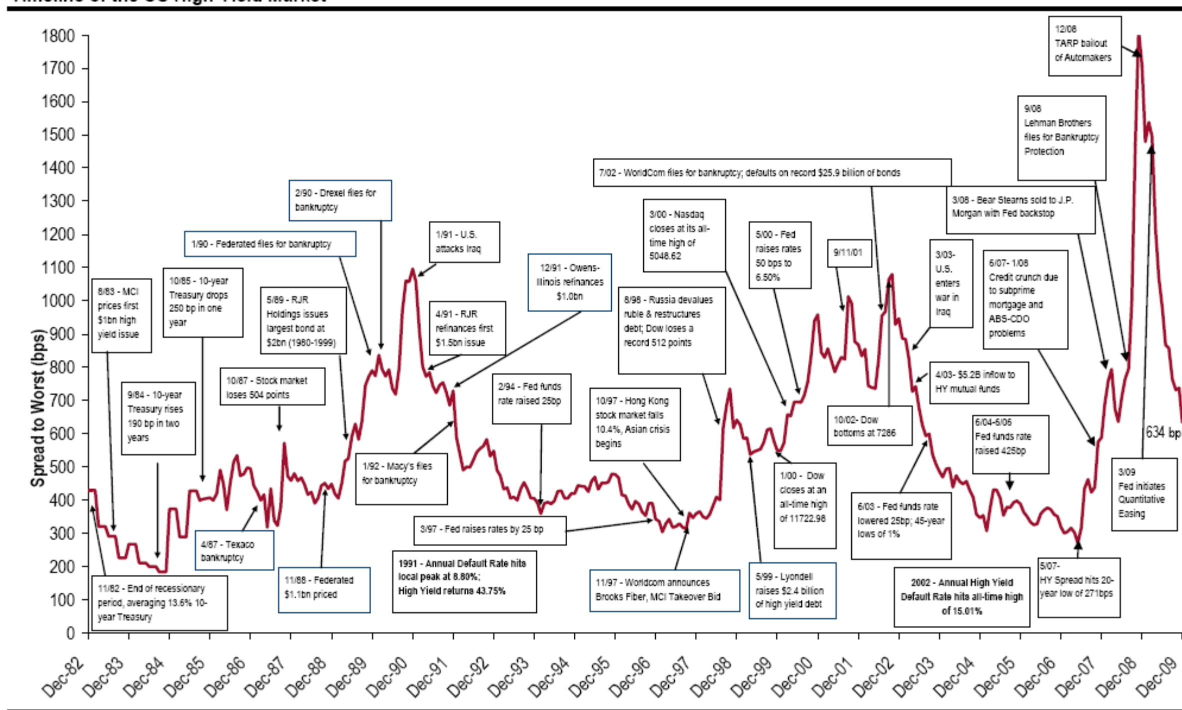
[11] Fuller, Matt. "MagnaChip sets $250M offering for dividend, debt repayment." LCDNews, March 24, 2010.

[12] "Freedom Group PIK toggle notes price at 98; terms." LCDNews, March 30, 2010.

History Lesson

So as we look to where we might be going, it is important to review where we have been. The credit space is perhaps a little easier to navigate than the equity markets. Spread levels have a reasonably long history and tell you how much you are getting paid for taking on risks. In our world, risk is mainly in the form of credit risk (the ability and willingness of a borrower to pay interest and principal on a timely basis). Some historical perspective is in order.[13]



Source: Credit Suisse

Though this chart is a tad busy, it does paint an excellent story. There appears to be a "mean" or average spread of the high yield market around 550-600 basis points over the 5-year Treasury. It appears by this chart that for approximately 70% of the market's history, high yield has traded inside this number. We have had three systemic shocks to credit spreads, 1989-1991, 2000-2003 and, of course, 2007-2009. Interestingly, each one of these nuclear winters healed rapidly, lasting about two years. However, note that each of the "normal" periods lasted different amounts of time. From 1982-1989 and 1991-1998, each period had 7-8 years of "normalized" spread levels under 600 bps. But this time frame was compressed in 2003-2007, as we saw only 4-5 years of normalized spreads. All that to say, there is no real historical framework that allows for the prediction of the length of cycles.

But what we do know is that each of the meltdown periods was precipitated by spreads collapsing into or below the 300 bps range. These levels become dangerous and a warning sign that it is time to reassess. We also know that the subsequent blowouts in spreads involved the flight to quality trade, which we have discussed before. This simply means that money left high

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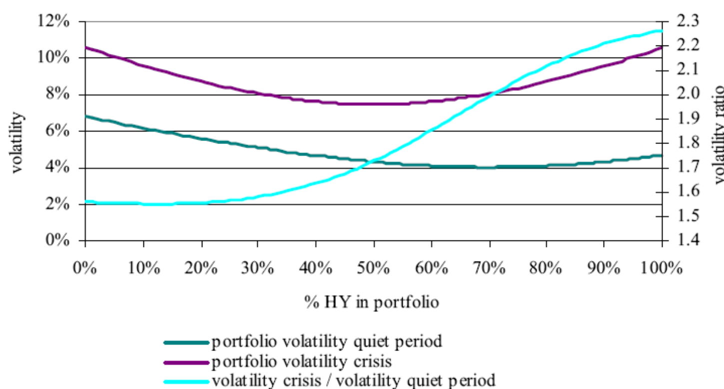
[13] Blau, Jonathan, Daniel Sweeney, and Janet Yung. "2010 Leveraged Finance Outlook and 2009 Annual Review." Credit Suisse, Global Leveraged Finance. January 22, 2010, p. 19.

yield, as well as other asset classes, and went into Treasury bonds. Take yourself back to October 2008 and recall that short-term Treasury bills actually had negative yields, meaning investors were paying the Government for holding their money.

So as we look for ways to reduce risk, would it make sense to add Government bonds to a high yield portfolio as a natural hedge when certain spread levels get violated? Perhaps a 10% position at 550 basis points, 20% inside 500 and 30% inside 400? Though this chart is slightly dated, it does distinctly show that portfolio volatility using Government debt and high yield in varying combinations maximizes risk adjusted returns.[14]

Figure 5: Volatility during the quiet period and during a crisis, and volatility ratio: U.S. portfolios (GVT and HY bonds)



Layering in Treasury bonds as a hedge makes sense on many levels including the issue of positive carry. While there is an opportunity cost (the yield is less), it is still generating cash versus shorting fixed income securities outright, where you pay the coupon. We will have much more on our version of "core plus" and the options and opportunities we are evaluating in the months ahead.

<u>Summary and Conclusion</u>

We've had a dramatic move in all asset classes over the past year and a collapse of various risk premiums across the board. It is a very dangerous thing to let one's guard down given the economic backdrop. We do not see any robust economic growth on the horizon to drive a sustainable move in equities; rather, we expect problems to persist. Furthermore, if we are correct on our belief that deflation is more likely to be seen than inflation and that interest rates will remain low, attractive yield in Governments or investment grade will be hard to find.

While I am concerned about the environment around us, I continue believe that in looking at the investment options before us, High Yield still provides the best risk-reward equation of any asset class. We are at a point in the cycle where most of the return in credit should come from the coupon cash flow/yield, as chasing capital gains in this environment looks dangerous to us.

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[14] Briere, M and A. Szafraz. "Crisis-Robust Bond Portfolios." Solvary Business School, Centre Emile Bernheim Research Institute in Management Sciences. December 2007, p. 19.

Given that the current yield for our model portfolio is just under10%,[15] *we don't see this as a bad thing. The "trade" in high yield is no longer buy everything and ride the wave of spread narrowing. It is time once again to think. We continue to focus our attention on reducing risk and considering various options to assist in this effort, such as an overlay with Treasuries, all while continuing with our stated goal of producing an excellent income stream over the coming years.*

As always, feel free to call with any questions.

Sincerely,

PERITUS ASSET MANAGEMENT, LLC

Timothy J. Gramatovich, CFA
Chief Investment Officer

Peritus I Asset Management Disclosure:

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[15] The Model Portfolio does not represent actual trading; rather it represents Peritus' approved list of investments as April 19, 2010. Depending on the timing, market conditions, use of leverage, portfolio size, and other factors, the actual portfolio could be materially different. Prices and other statistics are subject to change.