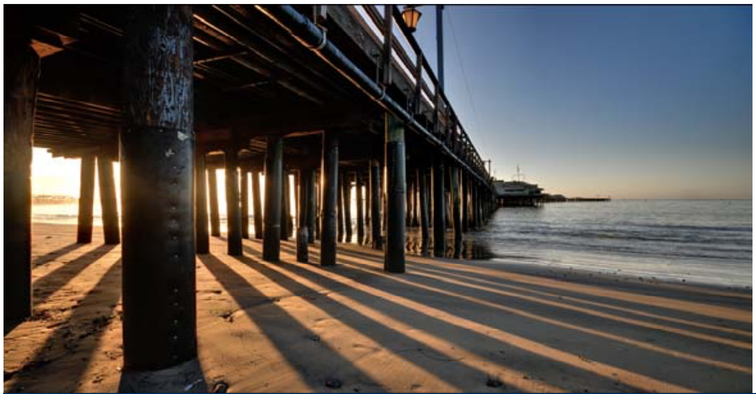

PERITUS

ASSET MANAGEMENT, LLC

Active Credit

Independent Credit Research – Leveraged Finance – December 2015

LIQUIDITY MANAGEMENT

Much attention has been drawn to the lack of liquidity in fixed income markets over the past six months. One of the areas of specific focus has been the high yield exchange traded fund (ETF) space, of which we are an active player. The recent feud between Carl Icahn and Larry Fink of Blackrock drew a great deal of media attention and unfortunately caused some investors to flee the asset class in a panic. This is both unfortunate and, in our opinion, the wrong thing to do, especially at this time.

There is no question that the full implementation of the Volcker provision inside Dodd-Frank and further bank regulation known as the Basel Accord (Basel 2.5 and 3 in this case) has reduced market making in non-investment grade bonds and loans. But it is important to understand a couple crucial facts. First, the high yield ETF market is tiny as a percent of the overall high yield market. In high yield bonds, ETFs represent approximately 3% of the overall market.[1] Secondly, ETFs are actually contributors of liquidity not detractors. During bond market holidays such as Columbus Day and Veterans Day, stocks traded but bonds did not. However, high yield bond ETFs trade without issue, whether the underlying assets were active/liquid or not.

Given the heightened scrutiny to liquidity, the SEC itself, not to be outdone, is looking into the liquidity of the underlying asset classes in open end structures such as ETFs and mutual funds. While no legislation has been proposed, they have "suggested" that a cap be placed on assets that don't trade over some pre-determined period of time such as two weeks. It appears that they are trying to solve a problem with a solution that doesn't exist. Almost all fixed income markets outside of Treasuries and parts of the mortgage market may be considered "illiquid" by some of these proposed standards. The municipal bond market is a great example where much of the market rarely trades. Investment grade corporate bonds are similar. Investors buy and hold these positions often until maturity or an event, such as a call. Does this in itself make the market "risky"? Not necessarily, and these markets have operated as such for decades.

Bonds are not stocks. You have a pre-set exit strategy in the form of a maturity. You get paid an interest rate to hold these positions and the fact they don't trade as actively is not something that requires more legislation. One would argue that the new regulations put in place post the

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[1] Acciavatti, Peter Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2014 High-Yield Annual Review," J.P. Morgan North American High Yield Research, July 31, 2015, p. 136. For further detail, see our piece "High Yield ETFs: Market Size, Money Flows, and Liquidity."

financial crisis created more volatility and less liquidity, so putting even more regulation on top of the existing regulation will only make things worse. Isn't this how we got our current tax code and the Affordable Care Act? We need open and free markets, not more government intervention/fixes that only cause more problems. The fact is, we have rarely seen a larger liquidity premium (bonds trading at big discounts to call or maturity prices) being paid to investors and we encourage them to take advantage of it. But we are not sticking our heads in the sand on this as it will not serve our investors or ourselves in the long run. Rather, in response we are adjusting our portfolio to maintain an active and strategic portion on the portfolio focused on liquidity in the form of newly issued high yield bonds.

Investing in high yield new issue paper gives investors access to credits generally at the most liquid point in their life cycle. Additionally, when a new issue is priced, the market has a chance to get an in-depth look at a company's updated financials and intentions for use of proceeds. This type of broad due diligence and negotiated pricing can bring tremendous stability. Our research (along with a hosts of others) shows that newly issued debt changes hands frequently within the first 3-4 months of issuance and tends to be well supported by the underwriting banks during that period before settling into longer term holders, providing what we believe to be a very liquid investment profile during the beginning months. Secondarily, the securities that qualify to be included in an index tracking, passive ETF or mutual fund would often add further price support as these vehicles would look to fill out their positions sometime after the new issue comes to market. With this strategic positioning of a portion of the portfolio focused on liquidity, our approach is to roll out of newly issued paper within about 90 – 120 days of issuance, constantly reinvesting in more recently issued paper to maintain our allocation.

The second issue investors worry about is volatility. When you combine this liquidity-focused segment of the portfolio with our existing floating rate bank loan bucket we are targeting to have a notable percentage of our holdings in what we believe to be a very low volatility, stable priced securities. Combining this new issue segment of the portfolio with our current deep-value credit investment process in both secondary bonds and loans is something we believe enhances the risk-return profile of our portfolio and is an essential step in delivering our process and portfolio to the market.

Market makers and investors need to be comfortable in holding and promoting any portfolio/fund/stock, and after months of discussions, we feel this approach meets their requirements. Index ETF's trade a fraction of their holdings for liquidity needs, so we expect our newly issued holdings will act as a similar mechanism. Our intention is that this will provide the market makers and investors the ability to have more fluidly and liquidity.

Through our modeling, back-testing and experience, with these loan and newly issued bond allocations in place we can turn our focus to the remaining high yield bonds that add significant alpha to the portfolio that we feel will help in achieving our goal of providing a consistent dividend and total return (yield to worst) that is targeted to be above the various high yield bond indexes.

Our goal is to provide shareholders and market makers with a higher rate of return in terms of both cash flow and total return (including potential capital gains) with less volatility from our actively managed approach versus many of the popular passive, index-based ETFs/mutual funds available. We believe this modification in portfolio operating dynamics should work to alleviate the concerns that exist in today's high yield market regarding liquidity, and give confidence to investors that we are focused on consistency in the returns, stability in the portfolio, and less volatility.

Definition:

Liquidity can describe the degree to which an asset or security can be quickly bought or sold in the market without affecting the asset's price.

Peritus I Asset Management Disclosure: